

ADVANCED CORPORATE ACCOUNTING

COURSE CODE: M21CM01DE

Discipline Specific Elective Course
Master of Commerce
Self Learning Material



SREENARAYANAGURU
OPEN UNIVERSITY

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The State University for Education, Training and Research in Blended Format, Kerala

SREENARAYANAGURU OPEN UNIVERSITY

Vision

To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

Mission

To be benchmarked as a model for conservation and dissemination of knowledge and skill on blended and virtual mode in education, training and research for normal, continuing, and adult learners.

Pathway

Access and Quality define Equity.

Advanced Corporate Accounting

Course Code: M21CM01DE

Semester - III

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Self Learning Material
(With Model Question Paper Sets)



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Course Code: M21CM01DE

Semester- III

Discipline Specific Elective Course

Master of Commerce

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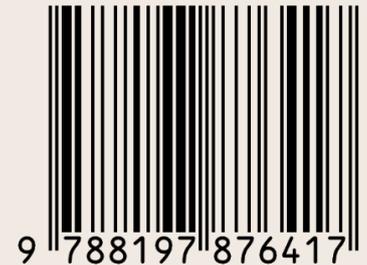


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Dear learner,

I extend my heartfelt greetings and profound enthusiasm as I warmly welcome you to Sreenarayanaguru Open University. Established in September 2020 as a state-led endeavour to promote higher education through open and distance learning modes, our institution was shaped by the guiding principle that access and quality are the cornerstones of equity. We have firmly resolved to uphold the highest standards of education, setting the benchmark and charting the course.

The courses offered by the Sreenarayanaguru Open University aim to strike a quality balance, ensuring students are equipped for both personal growth and professional excellence. The University embraces the widely acclaimed “blended format,” a practical framework that harmoniously integrates Self-Learning Materials, Classroom Counseling, and Virtual modes, fostering a dynamic and enriching experience for both learners and instructors.

The University aims to offer you an engaging and thought-provoking educational journey. This learning material titled Business Policies and Strategic Management offered for MCom programme builds on the knowledge gained in undergraduate studies. It takes the basic understanding of business concepts and expands on them. The course combines theory and real-world practices to give learners a complete picture. We use case studies and examples to help explain complex ideas. Throughout the Blocks, learners will develop their analytical and decision-making skills, which are crucial for managing businesses effectively. The Self-Learning Material has been meticulously crafted, incorporating relevant examples to facilitate better comprehension.

Rest assured, the university’s student support services will be at your disposal throughout your academic journey, readily available to address any concerns or grievances you may encounter. We encourage you to reach out to us freely regarding any matter about your academic programme. It is our sincere wish that you achieve the utmost success.



Warm regards.
Dr. Jagathy Raj V. P.

01-01-2025

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01 BLOCK

Accounting Standards- Amalgamation Absorption and External Reconstruction

Block Content

- Unit - 1 Accounting Standards
- Unit - 2 International Financial Reporting System (IFRS)
- Unit - 3 Amalgamation, Absorption and Reconstruction

Unit 1

Accounting Standards

Learning Outcomes

After completing this unit, the learners will be able to:

- ◆ explain the concepts and benefits of the accounting standards
- ◆ make a comparison between Indian Accounting Standards (Ind-AS) and International AS
- ◆ get awareness about the objectives and functions of the Accounting Standard Board (ASB)
- ◆ explain Accounting Standards 1 to 21

Background

Accounting standards are considered the standardised language of business to communicate high-quality information in financial statements based on principles of transparency, accuracy, consistency, reliability and comparability with stakeholders. Initially, companies across the world having global business operations prepared financial statements for each country in which they conducted business, following that country's Generally Accepted Accounting Principles (GAAP). These principles evolved from the International Accounting Standard (IAS) issued by the International Accounting Standards Committee (IASC) from 1973 to 2001. The Institute of Chartered Accountants of India (ICAI), being the apex accounting standard-setting body in India, constituted the Accounting Standard Board (ASB) on 21st April 1977, with the prime objective to formulate accounting standards to establish a sound financial reporting standards framework in India. ASB formulated a series of Accounting Standards (AS) starting from IAS 1 and concluding with IAS 41 in December 2000. IASC had a lifespan of 27 years till the year 2001. Then, it was restructured to form the International Accounting Standards Board (IASB). At the time of establishment, IASB agreed to adopt the revised set of standards issued by IASC, i.e., IAS 1 – 41, but with a condition that any standards to be published after that would follow a series known as the International Financial Reporting Standard (IFRS).

IFRS is increasingly becoming a globally accepted accounting standard that meets the needs of the world's increasingly integrated global capital markets. The adaptation of standards that require high-quality, transparent and comparable information is welcomed by investors, creditors, financial analysts and other users of financial statements. This enables comparability of financial information prepared by entities located in different parts of the world. The use of a single set of accounting standards facilitates investments and other economic decisions across borders, increases market efficiency and reduces the cost of raising capital.

Keywords

Accounting Standard, Accounting Standard Board, Indian Accounting Standards

Discussion

1.1.1 Introduction

Accounting standards are a set of principles and procedures that businesses must follow while preparing and presenting financial statements. These standards ensure that the financial reporting process is consistent, transparent, and comparable, allowing investors, regulators, and other stakeholders to make informed decisions. The primary goal of accounting standards is to create a framework for firms to present their financial information in a clear, accurate, and consistent manner. This allows stakeholders to examine an entity's financial health, performance, and cash flow. Accounting standards often address a variety of areas of financial reporting, such as the recognition, measurement, presentation, and disclosure of transactions. They apply to a variety of accounting difficulties, including revenue recognition, asset valuation, and the management of liabilities.

◆ ICAI issues accounting standards

In India, Accounting Standards are issued by the Institute of Chartered Accountant of India. While Indian Accounting Standards (IndAS) are composed by ICAI corresponding to IFRS with necessary changes considering Indian requirements, and published by the Ministry of Corporate Affairs keeping in view the recommendations of National Financial Reporting Authority (NFRA) as per the section 133 of the Companies act 2013.



- ◆ Policy documents

1.1.2 Meaning of Accounting Standards

Accounting standards are policy documents that deal with the identification, measurement, treatment, presentation, and disclosure of accounting events and transactions in financial statements. They are issued by the government, respectable professional accounting associations, and other regulatory bodies. Accounting standards provide the structural framework for the preparation of financial statements with credibility. The main objective of accounting standards is to reduce the usage of other accounting alternatives in the preparation of financial statements within the bounds of rationality. It offers comparability of financial statements of different organizations with an aim to provide meaningful information to different users of financial statements. Accounting standards also aid the regulatory bodies in setting a benchmark for accounting accuracy.

1.1.3 Definition of Accounting Standards

According to Kohler accounting standard may be defined as “a code of conduct imposed on accountants by custom, law or professional body”. Hence, accounting standards may be defined as the accounting principles and rules which are to be followed for various accounting treatments while preparing financial statements on uniform basis and which will reveal the same meaning to various stake holders of business.

1.1.4 Accounting Standards - Benefits

Some of the benefits of accounting standards are enumerated below;

- ◆ Attains uniformity in accounting
- ◆ Enhance the reliability of Financial statements
- ◆ Prevents fraud and accounting data manipulations
- ◆ Assists auditors
- ◆ Comparability
- ◆ Helps in managerial accountability

1.1.5 International Accounting Standards

International Accounting Standards (IASs) are a set of rules for the preparation of financial statements. They were issued by the International Accounting Standards Council (IASC) formed in 1973, and endorsed and amended by the International Accounting Standards Board (IASB). IASs were the first in such a

row of standards, and they mainly focus on ensuring the comparability of financial statements of businesses worldwide, increasing trust and transparency in financial reporting and promoting global trade and investment.

Current IASs

Table 1.1.1 International Accounting Standards

International Accounting Standards		Date of Issue
IAS 1 (revised)	Presentation of financial statements	Sep 2007
IAS 2	Inventories	Dec 2003
IAS 7	Statements of cash flows	Dec 1992
IAS 8	Accounting policies, changes in accounting estimates and errors	Dec 2003
IAS 10	Events after the reporting period	Dec 2003
IAS 11	Construction contracts	Dec 1993
IAS 12	Income Taxes	Nov 2000
IAS 16	Property, plant and equipment	Dec 2003
IAS 17	Leases	Dec 2003
IAS 18	Revenue	Dec 1993
IAS 19	Employee benefits	Dec 2004
IAS 20	Accounting for government grants and disclosure of government assistance	Jan 1995
IAS 21	The effects of changes in foreign exchange rates	Dec 2003
IAS 23 (revised)	Borrowing costs	Jan 2008
IAS 24	Related Party Disclosure	Dec 2003
IAS 26	Accounting and reporting by retirement benefit plans	Jan 1995
IAS 27 (revised)	Consolidated and separate financial statements	Jan 2008
IAS 28	Investments in associates & joint ventures	Dec 2003
IAS 29	Financial reporting in hyperinflationary economies	Jan 1995
IAS 30	Disclosure in the financial statements of banks and similar financial institutions (not examinable).	Jan 1995
IAS 31	Interests in joint ventures	Dec 2003
IAS 32	Financial instruments: presentation	Dec 2003

IAS 33	Earnings per share	Dec 2003
IAS 34	Interim financial reporting	Feb 1998
IAS 36	Impairment of assets	March 2004
IAS 37	Provisions, contingent liabilities and contingent assets	Sep 1998
IAS 38	Intangible assets	March 2004
IAS 39	Financial instruments: recognition and measurement	Dec 2004
IAS 40	Investment property	Dec 2003
IAS 41	Agriculture	Feb 2001

◆ Introduction of IFRS 18 and IFRS 19

In 2024, the International Accounting Standards Board (IASB) introduced two significant standards namely IFRS 18: Presentation and Disclosure in Financial Statements, and IFRS 19: Subsidiaries without Public Accountability: Disclosures which are effective from 1st January 2027. IFRS 18 represents the most significant change to companies' presentation of financial performance since IFRS accounting standards were introduced more than 20 years ago. It will give investors better information about the company's financial performance and consistent anchor points for their analysis. IFRS 18 replaces IAS 1 - Presentation of Financial Statements. It carries forward many requirements from IAS 1 unchanged.

1.1.6 Accounting Standard Board (ASB)

The Institute of Chartered Accountants of India constituted Accounting Standards Board (ASB) on 21st April 1977 for the purpose of harmonizing diverse accounting policies and practices in use in India and also to meet the requirements of the various users of accounting information.

◆ Composition

The composition of ASB consists of elected members of the Council of the ICAI nominated on the ASB, nominees of the Central Government representing Department of Company Affairs, the Office of the Comptroller (Controller) and Auditor General of India, the Central Board of Direct Taxes on the Council of ICAI, representatives of Institute of Cost and Works Accountants of India, Institute of Company Secretaries of India, Industry Association, Reserve Bank of India, Securities and Exchange Board of India, Central Board of Excise and Customs, academic institutions from universities and from Indian Institute of Management, financial institutions, eminent professionals co-opted by ICAI, Chairman of the Research Committee and Chairman of the Expert Advisory Committee of ICAI and representative of any other body as considered appropriate by the ICAI.

1.1.6.1 Objectives of ASB

The objectives of Accounting Standard Board consist of:

- i. To propose and recommend the areas in the accounting standards required to be developed.
- ii. To develop accounting standards for the purpose of giving assistance to the council of ICAI for establishing accounting standards in India.
- iii. To assess how far the relevant International Accounting Standards/International Financial Reporting Standards can be adopted in the light of conditions and practices existing in India.
- iv. Periodic review of Accounting Standards regards to changed conditions and revise the same if required.
- v. To give timely interpretations and guidance on Accounting Standards.
- vi. To perform such other functions relating to Accounting Standards.

1.1.6.2 Functions of ASB

The following are the important functions of ASB

- ◆ Formulate Accounting Standards in line with the applicable laws, customs, usages and business environment prevailing in India. These formulated standards will be established by ICAI.
- ◆ While formulating Accounting Standards, ASB will try to integrate the International Accounting Standards issued by IASC (predecessor to IASB) or International Financial Reporting Standards issued by IASB, as the case may be, considering the conditions and practices prevailing in India
- ◆ ASB is entrusted with the responsibility of generating the Accounting Standards and inducing the relevant parties to adopt them in the preparation and presentation of financial statements.
- ◆ Provide guidance and interpretations on problems arising from Accounting Standards
- ◆ Responsible for periodic review of Accounting Standards and revise the same if required.

1.1.7 Accounting Standards 1 to 21

The following Accounting Standards are issued by the Institute of Chartered Accountants of India.



AS 1 – Disclosure of Accounting Policies

This Standard deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements. The accounting procedures used in the creation and presentation of the financial statements can have a substantial impact on the perspective that is expressed in the financial statements of an organisation regarding its state of affairs and profit or loss. Different enterprises followed different accounting policies while preparing the financial statements. Proper disclosure of accounting policies followed is necessary to acknowledge the view presented in the financial statements. In certain cases, the law demands the disclosure of accounting policies followed.

◆ Better understanding of statements

In recent years, certain enterprises in India started using the practice of attaching a separate sheet for presenting the accounting policies used in the preparation and presentation of financial statements along with their annual reports. This practice is not common to all enterprises, generally. Many enterprises include in the Notes on the Accounts descriptions of some of the significant accounting policies. However, the nature and degree of disclosure vary considerably between the corporate and the non-corporate sectors and between units in the same sector. This accounting standard aims to promote a better understanding of financial statements by necessitating disclosure of relevant accounting policies and the manner in which accounting policies are applied in the financial statements. This kind of disclosure allows for a meaningful comparison of the financial statements of different enterprises.

AS 2 (Revised in 2016) – Valuation of Inventories

A major issue in accounting for inventories is determining the value of inventories until the associated revenues are recognised. This standard solves this issue by the determination of such value, including the calculation of the cost of inventories and any write-downs to net realisable value. This standard has applicability in accounting for inventories except –

- i. Work in progress arising under construction contracts, including directly related service contracts (refer to Accounting Standard (AS) 7, Construction Contracts).
- ii. work in progress arising in the ordinary course of business of service providers;
- iii. shares, debentures and other financial instruments held as stock-in-trade; and
- iv. producers' inventories of livestock, agricultural and forest

products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well-established practices in those industries.

◆ Some inventories are excluded

The inventories specified in paragraph (IV) are measured at net realisable value at some stages of production. This happens, for example, when agricultural crops have been harvested, or mineral oils, ores and gases have been extracted, and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists, and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Standard.

AS 3 (Revised in 1997) – Cash Flow Statements

◆ Changes in cash and equivalents

The Standard covers the information regarding the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities. An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented. Users of an enterprise's financial statements are interested in knowing how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise. Enterprises need cash for essentially the same reasons, regardless of their principal revenue-producing activities. They need cash to carry out their day-to-day operations, to provide returns to their investors and to pay their obligations.

AS 4 (Revised in 2016) – Contingencies and Events occurring after the Balance Sheet date

This standard deals with the treatment of contingencies and events occurring after the balance sheet while preparing the financial statements. Certain subjects which may end up into contingencies are not included in the scope of this standard due to the special considerations applicable to them. They are:

- i. liabilities of life assurance and general insurance enterprises arising from policies issued.
- ii. obligations under retirement benefit plans; and
- iii. commitments arising from long-term lease contracts.

Under the scope of this standard, contingency is defined as a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or

non-occurrence, of one or more uncertain future events. Events after balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity. Two types of conditions can be identified under the standard:

1. Those which provide further evidence of conditions that existed at the balance sheet date; and
2. Those which are indicative of conditions that arose subsequent to the balance sheet date.

AS 5 (revised in 1997) -Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

The objective of this Standard is to lay down the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This facilitates the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Standard requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also deals with the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies. Under the scope of the standard:

- ◆ Ordinary activities are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from these activities.
- ◆ Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to arise frequently or regularly.
- ◆ Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.
- ◆ Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

AS 6 - Depreciation Accounting

Accounting standard 6 was withdrawn when AS 10, Property, Plant and Equipment, came into existence. The Ministry of Corporate Affairs (MCA) amended the Companies (Accounting Standards) Rules in 2016 to remove AS 6.

AS 6 was originally issued in 1982 and applied to all depreciable assets, with some exceptions. These exceptions include:

◆ Applied to all depreciable assets

- ◆ Forests, plantations, and other natural resources
- ◆ Wasting assets, such as the extraction of minerals, oils, and natural gas
- ◆ Research and development
- ◆ Goodwill and other intangible assets
- ◆ Livestock
- ◆ Land unless it had a limited useful life

AS 7 - Construction Contracts

This standard prescribes the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activities in construction contracts, the date at which the contracting activity is started, and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary problem in the accounting treatment of construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. To resolve this issue, the standard uses the recognition criteria established in the framework for the preparation and presentation of financial statements to determine when contract revenue and contract costs should be recognized as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.

◆ Construction of an asset

Under this standard, construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

AS 8 – Accounting for Research and Development

This Standard deals with the treatment of costs of research and development in financial statements. Accounting Standard 8 is withdrawn from the date of AS 26 came into applicability.

AS 9 – Revenue Recognition

This Standard prescribes the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard deals with the recognition of revenue arising in the course of the ordinary activities of the enterprise. The ordinary activities include:

- ◆ The sale of goods
- ◆ The rendering of services, and
- ◆ The use by others of enterprise resources yielding interest, royalties and dividends.

This standard not covers following aspects of revenue recognition to which special considerations apply:

- i. Revenue arising from construction contracts
- ii. Revenue arising from hire-purchase, lease agreements
- iii. Revenue arising from government grants and other similar subsidies;
- iv. Revenue of insurance companies arising from insurance contracts.

AS 10 (revised in 2016) – Property, Plant and Equipment

The objective of this Standard is to prescribe the guidelines for accounting treatment for property, plant and equipment in financial statements. It will help the users of the financial statements to spot information about investment made by an enterprise in its property, plant and equipment and the changes in such investment. The major issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

This Standard is applicable in accounting for property, plant and equipment except when another accounting standard necessitates a different accounting treatment for the same. This standard is not applicable to:

- a. Biological assets related to agricultural activity other than bearer plants (A bearer plant is a living plant that is used to produce or supply agricultural produce, and is expected to bear produce for more than one period. It also has a low chance of being sold as agricultural produce, except for incidental scrap sales. For example, Sugarcane roots that produce standing sugarcane, Tea bushes that produce tea leaves, and Coffee plants that produce cherries). This

Standard applies to bearer plants but it does not apply to the produce on bearer plants; and

- b. Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (a) and (b) above.

AS 11 - The Effects of Changes in Foreign Exchange Rates

An enterprise is said to have operations in foreign exchange in two ways. Either it may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be converted into the enterprise's reporting currency. The major issues in accounting for foreign currency transactions and foreign operations are to make decisions about which exchange rate to use and how to recognize in the financial statements the financial effect of changes in exchange rates. This standard deals with these two areas such as accounting for transactions in foreign currencies and translating the financial statements of foreign operations. It also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

◆ Differences in foreign exchange rates

AS 12 - Accounting for Government Grants

This Standard deals with accounting for government grants. Government grants are otherwise known as subsidies, cash incentives, duty drawbacks, etc. This Standard does not cover:

- i. The special issues arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature;
- ii. Government assistance other than in the form of government grants;
- iii. Government participation in the ownership of the enterprise.

◆ Deals with accounting for government grants

Under the scope of this standard, government grants are defined as assistance by the government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot rea-



sonably have a value placed upon them and transactions with the government which cannot be distinguished from the normal trading transactions of the enterprise.

AS 13 – Accounting for Investments

This Standard prescribes the accounting for investments in the financial statements of enterprises and related disclosure requirements. This Standard does not include:

- i. The bases for recognition of interest, dividends and rentals earned on investments which are covered by Accounting Standard 9 on Revenue Recognition;
- ii. operating or finance leases;
- iii. Investments in retirement benefit plans and life insurance enterprises;

Mutual funds and venture capital funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 2013. As per this standard, the meaning assigned to investments is that the assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not considered as 'investments'.

◆ Assets

AS 14 - Accounting for Amalgamations

This standard handles the accounting treatment for amalgamations and the treatment of any resultant goodwill or reserves. This Standard is mainly applicable to companies although some of its requirements also apply to financial statements of other enterprises as well.

◆ Standard not deal with acquisition

This standard does not deal with cases of acquisitions which occurs when there is a purchase by one company (referred to as the acquiring company) of the whole or part of the shares, or the whole or part of the assets, of another company (referred to as the acquired company) in consideration for payment in cash or by issue of shares or other securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired company is not lost its separate identity even after acquisition.

AS 15 - Employee Benefits

This Standard prescribe the accounting treatment and related disclosure for employee benefits. This necessitates an enterprise

to recognize:

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

Under the scope of this standard employee benefits include short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees.

This Standard is applicable to accounting for all employee benefits, except employee share-based payments. It also exempts accounting and reporting by employee benefit plans.

AS 16 – Borrowing Costs

This standard deals with the accounting treatment of borrowing costs. This Standard does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability. Under the purview of this standard borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds. Borrowing costs may include:

- a. Interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
- b. Amortization of discounts or premiums relating to borrowings;
- c. Amortization of ancillary costs incurred in connection with the arrangement of borrowings;
- d. Finance charges in respect of assets acquired under finance leases or under other similar arrangements; and
- e. Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

AS 17 – Segment Reporting

This Standard establishes principles for reporting financial information about the different types of products and services an enterprise produces and the different geographical areas in

which it operates. Such information helps users of financial statements –

- a. Better understand the performance of the enterprise;
- b. Better assess the risks and returns of the enterprise and
- c. Make more informed judgements about the enterprise as a whole.

This Standard should be applied in presenting general purpose financial statements. The requirements of this Standard are also applicable in the case of consolidated financial statements. An enterprise should comply with the requirements of this Standard fully and not selectively. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need to be presented only on the basis of the consolidated financial statements. In the context of reporting segment information in consolidated financial statements, references in this Standard to any financial statement items should be considered to be the relevant item as appearing in the consolidated financial statements.

AS 18 – Related Party Disclosure

This Standard applied to reporting related party relationships and transactions between a reporting enterprise and its related parties. The requirements of this Standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.

This Standard deals only with related party relationships described in (i) to (v) below:

- i. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);
- ii. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;
- iii. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;
- iv. Key management personnel and relatives of such personnel; and
- v. Enterprises over which any person described in (iii) or (iv)

is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise

◆ Transfer of resources between related parties

within the scope of this standard related parties are the parties considered to be related if, at any time during the reporting period, one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. As per this standard related party transactions are the transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

AS 19 – Leases

This standard prescribes the appropriate accounting policies and disclosures in relation to finance leases and operating leases to lessors and lessees. This standard should be applied in accounting for all leases except the following cases:

- a. Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and
- b. Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and
- c. Lease agreements to use lands

This standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, this Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

AS 20 -Earning Per Share

◆ Comparison of performance

This standard lays down the principles for the determination and presentation of earnings per share which will facilitate comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise. The focus of this standard is on the denominator of the earnings per share calculation. Even though earnings per share data have limitations because of different accounting policies used for determining 'earnings', a consistently determined denominator enhances the quality of financial reporting.

AS 21 -Consolidated Financial Statements

This standard put forth principles and procedures for the

preparation and presentation of consolidated financial statements. Consolidated financial statements are prepared by a holding company to provide financial information about the economic activities of its subsidiaries. These statements are intended to present financial information about a parent and its subsidiary as a single economic entity to show the economic resources controlled by the group, the obligations of the group and the results the group achieves with its resources. This Standard should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent. It also be applied in accounting for investments in subsidiaries in the separate financial statements of a parent.

1.1.8 Indian Accounting Standards

Indian Accounting Standards (Ind AS) refers to a set of accounting standards which are converged with the International Financial Reporting Standards and notified by the Ministry of Corporate Affairs, Government of India. They are formulated by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India (ICAI) and in consultation with the National Financial Reporting Authority (NFRA). These standards are mandatory for certain Indian companies, ensuring their financial statements align with global practices. The Indian Accounting Standards (Ind AS), as prescribed under Section 133 of the Companies Act 2013 and as notified under the Companies Rules, 2015, have been formulated keeping in view the Indian economic & legal environment. It is issued with a view to converge with IFRS Standards, as issued by and copyright of which is held by the IFRS Foundation.

◆ IFRS-converged standards

1.1.8.1 Applicability of Ind AS

MCA has notified a phase-wise convergence to IND AS from current accounting standards. IND AS shall be adopted by specific classes of companies based on their Net worth and listing status.

Table 1.1.2

Financial Year	Mandatorily Applicable To
2016-17	Both listed and unlisted companies whose net worth is greater than or equal to 500 crore INR
2017-18	All listed companies, irrespective of net worth, and Unlisted companies whose net worth is greater than or equal to 250 crores.

2018-19 onwards	When a company's net worth becomes greater than 250 crore INR
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Ind AS is mandatory applicable to all Banks, NBFCs, and Insurance companies from 1st April 2018, whose Net worth is more than or equal to INR 500 crore with effect from 1st April 2018.

All NBFCs whose Net worth is more than or equal to INR 250 crore but less than INR 500 crore shall have IND AS mandatorily applicable to them with effect from 1st April 2019.

Whenever a company gets enclosed under the roadmap, Ind AS becomes mandatory, its joint venture, holding, subsidiary and associate companies will also have to adopt Ind AS without consideration to their net worth.

Summarised Overview

Accounting standards are policy documents issued by the government, respectable professional accounting associations, and other regulatory bodies that deal with the identification, measurement, treatment, presentation, and disclosure of accounting events and transactions in financial statements. They provide a structural framework for the preparation of financial statements with credibility. International Accounting Standards (IASs) are a set of rules for the preparation of financial statements issued by the International Accounting Standards Council (IASC) and endorsed and amended by the International Accounting Standards Board (IASB). The Indian Accounting Standards (Ind AS) have been formulated keeping in view the Indian economic & legal environment and is issued with a view to converge with IFRS Standards. Accounting Standards Board (ASB) was constituted by The Institute of Chartered Accountants of India for the purpose of harmonizing diverse accounting policies and practices in use in India and also to meet the requirements of the various users of accounting information.

Self-Assessment Question

1. Define Accounting Standards
2. What do you mean by Indian Accounting Standards?
3. What do you mean by ASB ?
4. What are International Accounting Standards?
5. What are the advantages/ benefits of Accounting Standards?
6. Explain the various Accounting Standards 1-21.
7. Explain the objectives and functions



Assignments

1. Explain the provisions of accounting standards AS-15, accounting for amalgamation.
2. Discuss the importance of good will and capital reserve in accounting for amalgamation and absorption.
3. Write the steps involved in the accounting procedure of amalgamation in the books of transferor and transferee company.

Suggested Reading

1. Jain, S. P., & Narang, K. L. (2008). *Advanced accountancy*. Kalyani Publishers.
2. Lele, R. K., & Jawaharlal. (2015). *Accounting theory*. Himalaya Publishers.
3. Gupta, R. L., & Swamy, R. (2015). *Advanced accountancy*. Sultan Chand & Co.
4. Anthony, R., Hawkins, D. F., & Merchant, K. A. (2018). *Accounting text & cases*. Tata McGraw-Hill.

Reference

1. Jain, S. P., & Narang, K. L. (2008). *Advanced accountancy*. Kalyani.
2. Maheshwari, S. N., & Maheshwari, S. K. (1995). *Corporate accounting*. Vikas Publishing House.

Space for Learner Engagement for Objective Questions

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SGOU



Unit 2

International Financial Reporting System (IFRS)

Learning Outcomes

After the completion of the unit, the learner shall be able to:

- ◆ gain knowledge of phased implementation of IFRS in India
- ◆ comprehend the scope and advantages of IFRS in the Indian Scenario
- ◆ recognise the basic distinction between Ind.AS and IFRS

Background

Globalisation and the removal of international trade barriers have emphasized the necessity of a single set of reliable and comprehensible accounting information reporting standards. There are many accounting standards all over the world, with each country using a version of their own generally accepted accounting principles, also known as GAAP. These allow firms to report their financial statements in accordance with the GAAP that applies to them. The complication lies in whether the firm does business in multiple countries. How can investors then deal with multiple standards, which ones are accurate, and how can corporations be compared based on their financials? The answer to these questions lies within the adoption of the International Financial Reporting Standards, or IFRS, which is being developed and supported by the International Accounting Standards Board (IASB). International Financial Reporting Standards (IFRS) refers to a group of accounting standards which provides guidelines to report transactions in the book of accounts. IFRS was issued by the International Accounting Standards Board (IASB) in 2001 to replace the International Accounting Standards, with the aim of ensuring transparency, comparability, and consistency in the preparation of financial statements. The adoption of IFRS helps financial statement users make international comparisons among public companies.

Keywords

IFRS, Convergence, Scope, IASB, IASC

Discussion

1.2.1 Meaning

◆ Global standards for uniformity

International Financial Reporting Standards (IFRS) are a set of globally recognized accounting standards developed by the International Accounting Standards Board (IASB). These standards aim to bring uniformity, transparency, and comparability to financial statements across different countries and industries. The adoption of IFRS has been seen as a significant step towards harmonizing global accounting practices and facilitating cross-border investments. India, being one of the fastest-growing economies in the world, is also closely integrated with global financial markets. To facilitate foreign investments and align its accounting practices with international norms, began the process of converging its domestic accounting standards with IFRS. This effort is crucial for improving the comparability of financial statements prepared by Indian companies with those from other countries, especially in an increasingly globalized business environment.

Table 1.2.1 List of IFRS

IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinue Operations
IFRS 6	Exploration and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of Interests in Other Entities

IFRS 13	Fair Value Measurement
IFRS 14	Regulatory Deferral Accounts
IFRS 15	Revenue from Contracts with Customers
IFRS 16	Leases

1.2.2 Characteristics of IFRS

IFRS are used as an endeavour to harmonize accounting globally for the presentation and preparation of accounting statements to be easier, more understandable and comparable. The fundamental features are enumerated below

- ◆ IFRS have a specific structure as they establish rules and guidelines for the accounting transactions.
- ◆ It maintains stability and transparency globally.
- ◆ IFRS influence the ways of reporting the financial statements.
- ◆ IFRS provides a common set of accounting principles internationally.
- ◆ It is issued by IASB and maintained by IFRS
- ◆ IFRS are principle-based standards and not mandatory.
- ◆ It brings consistency and comparability

1.2.3 Objectives of IFRS

IFRS is a set of rules for reporting accounting transactions globally. Basic objectives are listed below.

- ◆ Synchronization in accounting transactions throughout the world
- ◆ High-quality standards, internationally accepted accounting & reporting standards
- ◆ Help investors formulate investment choices and make economic decisions
- ◆ Precise interpretation
- ◆ Makes financial statements more relevant
- ◆ Complete and unbiased financial statements
- ◆ Comparability
- ◆ verifiability

1.2.4 IFRS in India

International Financial Reporting Standards (IFRS) refers to a group of accounting standards that provide guidelines for reporting transactions in the book of accounts. IFRS was issued by the International Accounting Standards Board (IASB) in 2001 to replace the International Accounting Standards, with the aim of ensuring transparency, comparability, and consistency in the preparation of financial statements.

- ◆ Aimed at aligning with Indian accounting standards

In India, the adoption of IFRS was a major regulatory reform aimed at aligning Indian accounting standards with international norms. The need for adopting IFRS in India was recognized in the 2000s, as global trade, investments, and mergers & acquisitions were becoming increasingly interconnected. India's adoption of IFRS was seen as a way to improve the country's financial reporting and make its businesses more attractive to global investors. The Indian version of IFRS is known as Ind AS (Indian Accounting Standards). While IFRS serves as the foundation for Ind AS, there are certain adaptations to make these standards more relevant to the Indian business environment and legal framework.

1.2.4.1 Road map of IFRS implementation in India

In India, accounting standards are developed by the Institute of Chartered Accountants of India (ICAI). India chose to adopt the International Financial Reporting Standards in 2007. ICAI began the process of producing a comprehensive set of accounting standards that are "converged with" IFRS and will be known as Indian AS. There is a distinction between adoption and convergence with IFRS. Adoption entails utilizing IFRS as issued by the IASB. Convergence means that the Indian Accounting Standard Board and the IASB will continue to collaborate to establish high-quality, consistent accounting standards over time.

Indian Accounting Standards Converged to IFRS in a phased manner:

- The first phase included (a) companies that are part of the NSE - Nifty 50 index, (b) companies that are part of the BSE Sensex 30 index, (c) companies that have shares or other securities listed in overseas stock exchanges and listed and unlisted companies with a net worth over Rs. 1000 crores. The companies mentioned in the first phase had to prepare their Opening balance sheet in accordance with IFRS converged standards or Ind-As from 1st April 2011.

- ii. The second phase included listed and unlisted companies with a net worth of over Rs. 500 crores but not exceeding Rs. 1000 crores. The companies would prepare their financial statements in accordance with converged standards as of 1st April 2013.
- iii. The phase included companies with a net worth of Rs. 500 crores or less. The companies would prepare their opening balance sheet in accordance with converged IFRS standards from 1st April 2014

In March 2014, the Institute of Chartered Accountants of India (ICAI) presented a new IFRS roadmap and convergence strategy for India, following the failure of the previous plan. According to the suggested roadmap, the ICAI suggested that chosen enterprises follow Indian accounting standards only in the production of the consolidated financial statements. New IFRS roadmap is as follows:

- ◆ **Phase 1:** On April 1, 2016, Mandatory Application was issued for companies listed or unlisted in India with a net worth of more than or equal to Rs. 500 crores. Ind-As are mandatory for these companies from 1 April 2017.
- ◆ **Phase 2:** On April 1, 2017, Mandatory Application includes companies that are listed or under the listing process as of March 31, 2016, and also have a net worth of more than or equal to Rs.250 crore but less than Rs. 500 crores. Ind-As are mandatory in these companies from April 1, 2017.
- ◆ **In phase 3:** On April 1, 2018 Mandatory Application: Ind-As are applicable on a mandatory basis for all the Banks, Insurance, NBFCs companies from 1st April 2018. The following conditions for these entities are necessary to meet:
 - i. Net worth is more than or equal to Rs. 500 crores with effect from 1st April 2018. Accounting standards for Banks and Insurance companies are separately set by the IRDA (Insurance Regulatory and Development Authority) of India.
 - ii. NBFCs include core investment companies, stockbrokers, venture capitalists, etc.
- ◆ **In Phase 4:** On April 1, 2019, Mandatory Application: All Non-banking financial organizations having net worth larger than or equal to RS250 crore but not greater than five hundred crores.

Exemptions: Companies listed on small and medium-scale en-

terprises and companies which are not included in the above phases are exempted from adopting Ind.AS

1.2.4.2 Convergence – Indian Scenario

In India, the Ministry of Corporate Affairs has taken the step of aligning Indian Accounting Standards with IFRS beginning April 1, 2011. The convergence process is gaining steam, with credit going to the Ministry of Corporate Affairs. The Ministry has offered unwavering support and direction to the several regulatory and legal organizations tasked with ensuring a smooth transition. Fortunately, the highest levels of the Indian government have concluded that convergence of Indian Accounting Standards with IFRS is critical for the country to play a leading position in the global foray.

- ◆ Role of Ministry of corporate affairs

1.2.4.3 Advantages of Convergence with IFRS

The adoption of IFRS is beneficial to various stakeholders such as regulators, professionals, preparers of financial statements, analysts, users of financial information and so on.

- ◆ **Economy:** The convergence with IFRS benefits the economy as a whole by accelerating growth of international business. It strengthens the economy with a strong and efficient capital market, where cost of capital becomes cheaper, leading to inflow of international investment into the country.
- ◆ **Investors:** Convergence with IFRS facilitates those investors who want to expand their cross-border business operations. For this purpose, investors want information that is relevant, reliable, timely and comparable across locations. Convergence with international standards will mean a clear understanding of financial statements by investors.
- ◆ **Industry:** Entities can raise capital from foreign markets at lower cost only if they can create trust and confidence in the minds of the foreign investors through “True and Fair” presentation of their financial statements by adopting globally acceptable standards.
- ◆ **Accounting professionals:** Convergence benefits accounting professionals who can offer their services to different parts of the world. It offers diverse opportunities to accounting professionals in any part of the globe, as the same accounting practices

1.2.5 Scope of IFRS in India

IFRS in India covers different areas of financial reporting such as:



- ▶ **Matching with Global Standards:** India's accounting regulations are gradually moving closer to IFRS. The Ministry of Corporate Affairs (MCA) and the ICAI have spearheaded this initiative, which has resulted in the adoption of Indian Accounting Standards. These are primarily based on IFRS.
- ▶ **Use by different entities:** SEBI says listed companies in India must use Ind AS. This aligns them with international standards. The goal is to improve the financial data given to investors and stakeholders. This boosts trust from investors and makes it easier for foreign investment. Entities subject to IFRS are:
 1. **Publicly Listed Companies:** In India, IFRS is mandatory for companies listed on stock exchanges or those with significant public accountability (e.g., large private companies with significant public interest).
 2. **Large Companies (International and Local):** Companies meeting certain criteria such as revenue thresholds, total assets, or number of employees may also be required to adopt IFRS, even if they are not publicly listed.
 3. **Multinational Corporations:** Global companies that operate across borders often use IFRS to ensure their financial statements are comparable across jurisdictions.
 4. **Financial Institutions:** Banks, insurance companies, pension funds, and other financial institutions are typically required to report in accordance with IFRS, as these entities have significant public interest.
- ▶ **Auditing Shifts:** Shifting to IFRS in India changes things for auditors. Auditing standards and methods might need to change to check IFRS-compliant accounts. We need auditors skilled in IFRS.
- ▶ **Governs the presentation and measurement of various financial statements:** IFRS governs the presentation and measurement of various financial statements and transactions. Financial statements include income statement, balance sheet, cash flow statement, statement of changes in equity, consolidated financial statements and notes to the financial statements.

1.2.6 Benefits of IFRS in India

IFRS adoption brings numerous advantages to India:

- ◆ **Global Comparability:** Ind AS helps align India's financial reporting with global standards, enhancing comparability for multinational corporations and investors. This is useful for investors and companies that want to compare performance globally.
- ◆ **Attracting Foreign Investment:** Through IFRS, Indian companies become more attractive to foreign investors. Investors choose companies whose financial information is clear and compatible with other countries. Standardization of accounting practices can attract foreign investments, as investors are more familiar with IFRS-based financial statements.
- ◆ **Enhanced Transparency:** IFRS-based standards often lead to improved transparency in financial reporting, reducing the scope for manipulation of financial statements.
- ◆ **Improved Corporate Governance:** The adoption of IFRS brings in better corporate governance practices, especially with respect to the accuracy of financial reporting.
- ◆ **Standardization of Accounting Practices:** IFRS helps standardize accounting practices across different nations. This will minimize the complexity and costs associated with different accounting systems, especially for companies having their operations in multiple countries.

1.2.7 Difference between Indian Accounting Standards and IFRS

IndAS stands for Indian Accounting Standards. IndAS is known as the Indian version of IFRS. Ind AS is designed exclusively for Indian businesses and is implemented in the Indian corporate environment.

IFRS, which stands for International Financial Reporting Standards, is formulated by the International Accounting Standards Board (IASB) and is utilised in approximately 144 countries, making it one of the most widely accepted accounting standards globally. Ind AS is largely based on IFRS but not a full replica. Some differences remain due to India's unique legal, taxation, and regulatory framework.



Table 1.2.2

Basis of Difference	IndAS	IFRS
Formulated by	The Institute of Chartered Accountants of India (ICAI)	International Accounting Standards Board
Disclosure about compliance	Mandatory disclosure is not explicitly required for companies complying with Ind AS.	Companies complying with IFRS are required to disclose in the notes to their financial statements that the financial statements comply with IFRS.
Format of Balance sheet	Companies Ind AS are not mandated to adhere to such specific requirements regarding the classification of assets and liabilities as current and non-current. However, guidelines are provided for the presentation of the balance sheet in accordance with Ind AS.	Companies adhering to IFRS are required to follow specific guidelines for the presentation of their balance sheet. These guidelines include the classification of assets and liabilities into current and non-current categories.
Language to be used	IndAS require companies to adhere to a specified language when preparing financial statements, disallowing the option for companies to choose their preferred language.	IFRS allow companies the freedom to select any language they prefer for preparing their Statement of Financial Position, Statement of Changes in Equity, Statement of Cash Flows, and accompanying Notes
Scope	It is also known as India specific version of IFRS	It is an internationally recognised accounting standard
Date of filing	The filing date for companies following IndAS is determined based on when a company's first financial statement is filed with the Registrar of Companies. This filing date is typically five years after the initial filing or as per the provisions of any other applicable law. This means that companies must submit their financial statements within five years from the initial filing or according to any other specified time frame mandated by law.	The filing date is three years after the company's first financial statement is filed with the Registrar of Companies or as per the provisions of any other applicable law. This implies that companies adhering to IFRS must submit their financial statements within three years from the initial filing or according to any other specified time frame stipulated by law.
Period of reporting	Period of reporting is usually a financial year	Companies are required to report financial statements quarterly

Implemented by	Exclusively implemented in India	Utilised by 144 countries worldwide
Components of balance sheet	The Companies Act 1956 requires the preparation of the Balance Sheet, profit and loss account and notes to the accounts. As per AS 3 Level 1 enterprises are necessary to prepare the cash flow statement. Under Ind AS, the statement of changes in equity is not required	<p>A complete set of financial statements would include:</p> <ol style="list-style-type: none"> 1) Statement of financial position 2) Statement of comprehensive income 3) Statement of changes in equity 4) Statement of cash flow 5) Notes to accounts, including significant accounting policies 6) Statement of financial position at the beginning of the earliest comparative period presented when the entity: <ol style="list-style-type: none"> a) makes any change in accounting policies with a retrospective effect, b) retrospectively restates any item on its financial statements or c) when it changes the classification or grouping of any item on its financial statements

Summarised Overview

International Financial Reporting Standards (IFRS) are a set of globally recognised accounting standards developed by the International Accounting Standards Board (IASB) to bring uniformity, transparency, and comparability to financial statements. The adoption of IFRS has been seen as a significant step towards harmonising global accounting practices and facilitating cross-border investments. In India, the adoption of IFRS was a major regulatory reform aimed at aligning Indian accounting standards with international norms. The need for adopting IFRS in India was recognised in the 2000s, as global trade, investments, and mergers & acquisitions were becoming increasingly interconnected. India's adoption of IFRS was seen as a way to improve the country's financial reporting and make its businesses more attractive to global investors. The Indian version of IFRS is known as Ind AS (Indian Accounting Standards).

Self-Assessment Question

1. What do you mean by IFRS?
2. What are the characteristics and objectives of IFRS?
3. State the advantages of convergence with IFRS.
4. Explain the scope of IFRS in India
5. Elucidate the benefits of IFRS in India

Assignments

1. Explain the key differences between Ind AS and IFRS.
2. Explain the road map of IFRS implementation in India

Suggested Reading

1. Jain, S. P., & Narang, K. L. (2008). *Advanced accountancy*. Kalyani Publishers.
2. Lele, R. K., & Jawaharlal. (2015). *Accounting theory*. Himalaya Publishers.
3. Gupta, R. L., & Swamy, R. (2015). *Advanced accountancy*. Sultan Chand & Co.
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Reference

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SGOU

Unit 3

Amalgamation, Absorption and Reconstruction

Learning Outcomes

After studying this chapter, the learner will be able to:

- ◆ explain the differences between reconstruction, amalgamation and absorption of companies
- ◆ understand the different methods of computation of purchase consideration
- ◆ explain the different accounting entries and adjustments required in connection with amalgamation
- ◆ explain the meaning of certain key terms under AS 14

Background

A company can reorganise its financial structure to address financial difficulties, optimise operations, reduce costs, or enhance the company's market position. Reorganisations can take various forms, such as a merger (where two companies combine), a demerger (where a part of the company is separated into a new entity), or a restructuring of ownership or management. Reorganisations can be driven by the need to adapt to changing market conditions, achieve economies of scale, or resolve internal challenges like debt restructuring. They often require careful legal, financial, and operational planning and may involve significant changes to a company's financial statements, governance, and business strategy. The term reconstruction mainly refers to the reorganisation of a company which has suffered heavy losses or is overcapitalised. Reconstruction may be internal or external. In internal reconstruction, the rights of investors, including creditors, debenture holders, etc., are altered. The company does not go for liquidation. In case of external reconstruction, a new company is formed to take over the business of the existing company and the latter is then wound up. The concept behind this reconstruction is that the same parties shall carry on the same business to a large extent.

Keywords

Amalgamation, Absorption, External Reconstruction, AS 14

Discussion

1.3.1 Amalgamation and Absorption

- ◆ In amalgamation new company is formed to take over the other

The term amalgamation means taking over the business of two or more companies by a company newly established for this purpose. Those companies whose businesses are taken over are wound up. Absorption means taking over the business of one or more companies by a company already in operation. The basic difference between amalgamation and absorption is that in the case of amalgamation, a new company is formed to take over the business of one or more existing companies. Still, in the case of absorption, no new company is formed. For example, if X Ltd. and Y Ltd. are taken over by Z Ltd., a company newly formed for this purpose, it is a case of amalgamation. In this situation, both X Ltd. and Y Ltd. will be harmed. If it is a case of absorption, X Ltd. takes over the business of Y Ltd. No new company has been formed for this purpose. X Ltd. is already in existence, and it has taken over the business of Y Ltd.

As per the Companies Act 2013, the term amalgamation includes absorption. However, under the provisions of Accounting Standard 14 issued by the Institute of Chartered Accountants of India on “Accounting for Amalgamations”, do not use the word absorption. It categorises amalgamation into two categories: Amalgamation in the nature of mergers and;

- Amalgamation in the nature of purchase

- ◆ All merger other than in nature of merger

In an amalgamation in the nature of a merger, the assets and liabilities of the transferor company are transferred at book values to the transferee company, and the purpose of amalgamation is to continue the business of the transferor company. The purchase consideration is satisfied by the issue of shares in the transferee company. In all other cases, it is considered an amalgamation in the nature of a purchase.

As per the Companies Act 2013, the term amalgamation includes absorption. However, under the provisions of Accounting

Standard 14 issued by the Institute of Chartered Accountants of India on “Accounting for Amalgamations”, do not use the word absorption. It categorises amalgamation into two categories: Amalgamation in the nature of mergers and; Amalgamation in the nature of purchase

1.3.2 Amalgamation and External Reconstruction

Amalgamation is different from external reconstruction in the following perspectives –

- i. **Purpose/ Objective :** The purpose of external reconstruction is to reconstitute the financial structure of the company. While the purpose of amalgamation is to restrict competition and to gain the benefits of economies of large-scale production
- ii. **Number of companies:** In case of amalgamation, two or more companies are amalgamated to form one new company or one or more companies are merged into another company or taken over by an existing company. While in external reconstruction, only one company is involved in reorganising the company’s financial structure.
- iii. **Vesting of rights and liabilities:** Amalgamation consists of amalgamation of the rights and liabilities to the transferee company, ie, after amalgamation, the rights and liabilities will be vested with the transferee company. In the case of external reconstruction, the undertaking carried on by the company is not a substance transferred to an outsider but to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company.

1.3.3 Vendor Company and Purchasing Company

For accounting purposes, the companies in amalgamation, absorption or external reconstruction can be classified as follows:

1. **Vendor Company:** In the case of amalgamation, the companies to be amalgamated are called the vendor companies or transferor companies. Similarly, in absorption, the company to be absorbed is the vendor company. In the case of external reconstruction, the company to be reconstructed is the vendor company. In all situations, the vendor companies are wound up after selling their business.
2. **Purchasing Company:** The company purchasing or tak-

ing over the business of other companies or companies is called the purchasing company/transferee company. It may be an existing company in the case of amalgamation/absorption or a newly formed company in the case of external reconstruction.

1.3.4 Purchase consideration

- ◆ Amount payable by the purchasing company to the vendor company

Purchase consideration refers to the amount payable by the purchasing company to the vendor company in return for taking over the business of such company. However, it is not necessary for the purchasing company to take over all the assets and liabilities of the vendor company. It may take over all or some of the assets of such values as mutually agreed. In the case of liabilities, it may also take over all or none or some of the liabilities of the vendor company.

1.3.4.1 Methods of calculation of purchase consideration

The purchase consideration can be calculated using different methods. The selection of the method depends on the information given. The following techniques can be used for ascertainment of purchase consideration-

1. Direct Ascertainment Method

- ◆ The purchase consideration amount is directly stated

Under this method, the purchase consideration may be directly stated in the question. For example, it may be noted that the purchasing company agrees to take over the business of the vendor company for a sum of ₹5 lakh. In this case, the amount of purchase consideration will be taken as ₹5 lakh. No calculations are needed in this case.

2. Net Payment Method

In this method, the purchase consideration is calculated by taking the sum of all the amounts that the purchasing company agreed to pay the vendor company. Payments made by the purchasing company are made by various parties interested in the vendor company. For example, if the purchasing company agrees to pay ₹3 lakh in shares for shareholders, ₹2 lakh in debentures for debenture holders and ₹1 lakh in cash for the creditors of the vendor company. The amount of purchase consideration would be a total of 3,00,000, 2,00,000 and 1,00,000, i.e., ₹6,00,000.

3. Net Assets Method

In this case, the purchase consideration is calculated by ascertaining the company's net assets. Net assets are the difference

between the vendor company's assets and liabilities and those taken over by the purchasing company. For this purpose, assets and liabilities are to be taken at the values mutually agreed upon.

Illustration 1.3.1

A Ltd. takes over the business of B Ltd. at the following values

Fixed assets	₹2,00,000
Current assets	₹1,50,000
Debentures	₹1,00,000
Current liabilities	₹50,000

Calculate the amount of purchase consideration.

Solution

The amount of purchase consideration is as follows:

Assets taken over:

Fixed assets	₹2,00,000
Current assets	<u>1,50,000</u>
	3,50,000

Less: Liabilities taken over: Debentures 1,00,000

Current liability	<u>50,000</u>	<u>1,50,000</u>
		<u>2,00,000</u>

Illustration 1.3.2

The following is the Balance Sheet of 'P' Ltd. as of 31.3.2022

Liabilities	₹	Assets	₹
15,000 Equity Shares of 100 each fully paid	15,00,000	Sundry assets	20,00,000
General Reserve	20,000	Discount on issue of Debentures	20,000
10 % Debentures	3,00,000	Preliminary Expenses	30,000
Sundry Creditors	2,00,000	P & L A/c	30,000
Bank Overdraft	20,000		
Bills Payable	40,000		
	<u>20,80,000</u>		<u>20,80,000</u>

'Q' Ltd. agreed to take over the business of 'P' Ltd. Calculate purchase consideration under the Net assets method after con-

sidering the following:

The market value of 60% of the sundry assets is estimated to be 10% more than the book value of the remaining 40%, which is 5% less than the book value. The liabilities are taken over at book values. There is an unrecorded liability of 30000.

Solution

Calculation of purchase consideration as per Net assets method

Sundry assets = 20,00,000 x 60/100 x 110/100 = 13,20,000		20,80,000
20,00,000 x 40/100 x 95/100 = 7,60,000		
		20,80,000
Less: Liabilities		
10% debentures	3,00,000	
Sundry creditors	2,00,000	
Bank Overdraft	20,000	
Bills Payable	40,000	
Unrecorded liability	<u>30,000</u>	<u>5,90,000</u>
		14,90,000

4. Share Exchange Method

Under this method, the purchase consideration is ascertained on the basis of the ratio in which the shares of the purchasing company are to be exchanged for the shares in the vendor company. This exchange ratio is generally determined on the basis of the value of each company's shares.

Illustration 1.3.3

The following is Alfa Ltd's balance sheet.

	Particulars	₹
A	Equity and Liabilities	
1.	Shareholder's Funds	
	a) Share capital	
	Authorised:	
	Share capital equity shares of ₹10	
	each Issued, subscribed & paid up:	
	20,000 Equity shares of ₹ 10 each	
	fully paid	2,00,000
	b) Reserves and Surplus	50,000
		2,50,000

2.	Non-current liabilities Long-term Borrowings: Debentures	50,000
3.	Current Liabilities: Trade Payables	50,000
	Total = 1+2+3	3,50,000
B Assets		
1.	Non-current Assets	
	a) Fixed assets Tangible assets	3,00,000
2.	Current Assets	50,000
	Total= 1+2	3,50,000

Alfa Ltd. is to be taken over by Beta Ltd. Each share of Alfa Ltd. has a market value of ₹15, while that of Beta Ltd. has a market value of ₹30. The purchase consideration is to be satisfied in the form of shares to be issued by Beta Ltd. You are required to calculate the purchase consideration amount.

Solution

Each share of Beta Ltd has a market value of ₹30, while that of Alfa Ltd has a market value of ₹15. This means for every two shares of Alfa Ltd., Beta Ltd will issue one share. The amount of purchase consideration can be calculated as follows:

$$20,000/2 = 10,000 \text{ issued at } ₹30 = ₹3,00,000$$

If Beta Ltd decides to issue shares at face value (at par), the purchase consideration would be ₹ 1,00,000 (i.e., 10,000 shares x ₹10).

1.3.3.2 Share fractions

In many situations, the purchasing company issues shares as a purchase consideration for the vendor company. However, in certain cases, on account of the share exchange ratio, the purchasing company will not be able to issue a whole number of shares to the shareholders of the vendor company. There arises the problem of share fraction. Since shares can be issued only in whole numbers, the purchasing company pays cash for the share fractions at a price mutually agreed for the whole share.

- ◆ Purchasing company pays cash for the share fractions at a price mutually agreed

Illustration 1.3.4

The purchasing company agrees to issue 5 shares of ₹10 each for every three shares of ₹10 each of the vendor company. The total number of shares of the vendor company is 20,000. The market price of each share of the purchasing company is ₹15.

Solution

Total number of shares to be issued by the purchasing company to the vendor company = $20,000 \times 5/3 = 33,333.33$. There is a fraction of $1/3$ of shares, not possible to issue as shares. Here, the purchase consideration would be

In shares	= 33,333 @ 15 each	4,99,995
In cash	= $15 \times 1/3$	5
		<hr/> 5,00,000

Note: in the absence of any particular instruction in the question. It is assumed that the cash in return for the fraction of shares will be paid on the basis of the market price of the share.

1.3.5 Accounting Entries

The recording of transactions in the books is the same as in amalgamation, absorption, or external reconstruction. In each of these cases, two parties are involved, i.e., the vendor company or companies and the purchasing company as shown below:

Table 1.3.1

Case	Vendor Company or companies	Purchasing Company
Amalgamation in the Nature of Merger	Two or more existing companies to be taken over	A new company formed for the purpose of taking over the business
Absorption/ Amalgamation in the nature of purchase	One or more companies to be liquidated	Existing companies take over the business
External Reconstruction	Only one existing company is to be liquidated	A new company is formed to take over the business

The accounting entries to be passed in the books of the vendor company and the purchasing company were as follows:

1.3.4.1 Journal Entries in Books of Vendor Company

Since the vendor company has to end its operations, it will dispose of all its assets, pay off the liabilities and distribute the surplus, if any, to its shareholders. The accounting entries passed in the

Note: Alternatively, for cases (i) & (2) no entry may be passed in the vendor company's books. But that practice is not advisable.

9. For transfer of profit on realisation

Realisation A/c Dr.
 To Equity Shareholders A/c

(in case of loss the entry will be reversed)

10. For transfer of equity share capital etc.

Equity Share capital A/c Dr.
General reserve A/c Dr.
Accumulated profits A/c Dr.
 To Equity Shareholders A/c

11. For transfer of fictitious assets

Equity Shareholders A/c Dr.
 To Profit and Loss A/c (Debit balance)
 To Preliminary expenses A/c
 To expenses on the issue of shares A/c

12. For payment to equity shareholders

Equity Shareholders A/c Dr.
 To Shares in the purchasing company A/c
 To Bank A/c

1.3.4.2 Entries in the books of purchasing company

1. For purchase consideration due

Business Purchase A/c Dr.
 To Liquidator of vendor company A/c
(With the amount of purchase consideration)

2. For taking over assets and liabilities

Assets taken over A/c Dr.
 To Liabilities taken over A/c
 To Business Purchase A/c

Note: Each asset and liability is to be debited and credited in-

dividually at the values at which they are taken over and not at their book values in the books of the vendor company. Goodwill appearing in the books of the vendor company should not be recorded here. In a situation where the value of net assets is more than the amount of purchase consideration, the balance should be credited to the capital reserve. Otherwise, if the value of purchase consideration is more than the net assets the balance should be debited to goodwill).

3. For payment of purchase consideration

Liquidator of Vendor Company A/c	Dr.
To Share capital A/c	
To Securities Premium A/c	
To Debentures A/c	
To Bank A/c	

(In case the shares or debentures have been issued at a discount or premium, the concerned discount or premium account should be debited or credited, as the case may be).

4. For Liquidation Expenses

- a. If the purchasing company agrees to pay a fixed amount by way of liquidation expenses to the vendor company. In such a case, the amount of liquidation expenses will be added to the amount of purchase consideration. No particular entry is needed for this.
- b. If the purchasing company agrees to reimburse the vendor company to the extent of liquidation expenses. In this case, the liquidation expenses will not be included in the purchase consideration. A separate entry will be passed on payment of such costs:

Goodwill/ Capital reserve A/c	Dr.
To Bank A/c	

(The amount of liquidation expenses will be debited to goodwill or capital reserve account, as calculated under entry (b) mentioned above).

1.3.6 AS 14 Accounting for Amalgamations

The term amalgamation is used when two or more existing companies are liquidated, and a new company is formed to take over the business. However, the term ‘absorption’ is used when one or more existing companies go for liquidation and an

- ◆ prescribes the accounting procedure for amalgamation

existing company takes over or purchases their business.

AS 14 is issued by the Institute of Chartered Accountants of India (ICAI). This standard is applicable to accounting periods commencing on or after 1.4.1995. This standard prescribes the accounting procedure for amalgamation and treatment of any resultant goodwill or reserves.

1.3.6.1 Definitions as per AS 14

The following terms are used in this standard with the meanings specified:

- Amalgamation:** Amalgamation means the amalgamation as per the provisions of the Companies Act, 2013, or any other statute that may be applicable to companies.
- Transferor company:** The company which is amalgamated into another company
- Transferee company:** The company into which the transferor company is amalgamated
- Reserve:** Means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability).

1.3.6.2 Types of Amalgamation as per AS 14

For accounting purposes, amalgamation is classified into two:

- ◆ Amalgamation in the nature of merger
- ◆ Amalgamation in the nature of purchase

i. Amalgamation in the nature of merger

The type of amalgamation which satisfies all the conditions mentioned below is categorized as ‘amalgamation in the nature of merger’.

- ◆ After amalgamation, all the assets and liabilities of the transferor company become the assets and liabilities of the transferee company.
- ◆ Shareholders having not less than 90% of the shareholding in the equity shares of the transferor company (other than equity shares already held therein, immediately before the amalgamation by the transferee company or its subsidiaries or their nominees) become equity share-

holders of the transferee company by virtue of the amalgamation.

- ◆ The purchase consideration paid by the transferee company to the equity shareholders transferor company should be discharged wholly by the issue of equity shares in the transferee company, except for share fractions.
- ◆ The transferor company's business is intended to continue after the transferee company's amalgamation.
- ◆ No adjustment is made in the book values of assets and liabilities of the transferor company when they are incorporated to the books of the transferee company except to ensure uniformity of the accounting policies.

In the case of amalgamation in the nature of a merger, there is a complete pooling of assets and liabilities of the combining entities. Also, the equity shareholders of the combining entities continue to have share in the combined entity. After this amalgamation, the resultant figures of assets, liabilities, capital and reserves of the combined entity more or less represent the sum of the relevant figures of the amalgamating companies.

ii. Amalgamation in the nature of purchase

Described as an amalgamation which does not satisfy any one or more of the conditions specified in the 'amalgamation in the nature of merger'.

1.3.6.3 Methods of accounting for amalgamations

There are two important methods of accounting for amalgamation:

- ◆ Pooling of interest method
- ◆ Purchase method

i. Pooling of interest method

This method is followed by in amalgamation in the nature of merger. Main objective of this method of amalgamation is that the separate businesses run by the amalgamated companies were intended to be continued by the amalgamating company or transferee company. Accordingly, small changes are made in correcting the individual financial statements of the amalgamating companies. While making accounting entries, the following points are considered:

- a. In the transferee company's financial statements, the assets, liabilities and reserves of the transferor company should be

◆ Followed by in amalgamation in the nature of merger

recorded at their existing carrying amounts and in the same form as at the date of amalgamation. The profit and loss account balance of the transferor company should be added with the corresponding balance of the transferee company or can be aggregated to the general reserve if any.

- b. After amalgamation, both the transferee and transferor companies should follow uniform accounting policies even though the companies adopt conflicting accounting policies prior to amalgamation. The effect of changes in accounting policies on any financial statements should be reported as per the Accounting Standard 5, "Profit or Loss for the period, prior period items and changes in accounting policies".
- c. The difference between the share capital plus other forms of purchase consideration and the share capital of the transferor company should be adjusted in reserves.

The following journal entries will be passed in the books of the transferee company:

1. On amalgamation of the business (Purchase consideration due)

Business Purchase A/c	Dr.	
		To Liquidator of transferor company A/c

2. When assets, liabilities and reserves are taken over from the transferor company and incorporated in the books

Sundry assets A/c (Individually)	Dr.	(book value)
To Sundry liabilities A/c (Individually)		(book value)
To Profit and Loss A/c		(book value)
To Reserves A/c		(book balance)
To Business purchase A/c		

The difference between the debits and credits is adjusted in the reserves of the transferee company.

3. When purchase consideration paid

Liquidator of transferor company A/c	Dr.	
		To Share capital A/c
		To Securities premium A/c
		To Cash A/c
		To Non-cash considerations

1. For taking over of assets and liabilities

Sundry assets A/c (individually) Dr. fair value/book value
 To Sundry liabilities A/c (Individually) Fair value/book value

 To Share capital A/c
 To Securities Premium A/c (or debit discount on
 issue of shares)

 To Cash A/c
 To Non-cash considerations A/c

The difference between the above-mentioned debits and credits is debited to goodwill account or credited to capital reserve as the case may be.

2. When statutory reserve is maintained

Amalgamation adjustment A/c Dr.
 To Statutory reserve (by name)

3. When statutory reserve is to be cancelled

Statutory reserve A/c Dr.
 To Amalgamation adjustment A/c

Table 1.3.2 Difference between pooling of interest method and purchase method

Basis	Pooling of Interest method	Purchase method
1. Applicability	Applicable for amalgamations in the nature merger	Applicable for amalgamation in the nature of purchase
2. Incorporation of assets and liabilities	Total incorporation of Assets, liabilities, reserves and surplus of the transferor company to the books of the transferee company.	Partial incorporation only those assets and liabilities taken over by transferee company to its financial statements, ignoring reserves and surplus.
3. Goodwill or capital reserves	No goodwill or capital reserve account is created to adjust the difference between purchase consideration and the net assets taken. Difference is adjusted in general reserve or other reserves.	The difference between consideration and net assets taken over by the transferee company will be adjusted in goodwill or capital reserve as the case maybe.

4. Amalgamation adjustment account	No such account is maintained in the books of transferee company as all reserves are incorporated to its financial statements	Amalgamation adjustment account is maintained in the assets side of balance sheet of the transferee company under the head miscellaneous expenditure if the transferor company has to carry forward any statutory reserve for legal compliance
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Illustration 1.3.5

P Ltd acquires Q Ltd. For a consideration of ₹40,00,000 to be satisfied in the form of fully paid equity shares of ₹10 each. The balance sheets of the two companies on 31st March, 2022, the date of acquisition, were as follows.

	Particulars	P Ltd ₹	Q Ltd. ₹
A	Equity and Liabilities		
1.	Shareholder's Funds		
	a) Share capital		
	Authorised: Share capital equity shares of ₹10 each		
	Issued, subscribed & paid up: 4,00,000 Equity shares of ₹ 10 each fully paid	40,00,000	-
	3,00,000 Equity shares of ₹ 10 each fully paid	-	30,00,000
	b) Reserves and Surplus		
	General Reserve	15,00,000	4,00,000
	Development Rebate Reserve	4,00,000	1,00,000
	Export Profit Reserve	5,00,000	3,00,000
	Profit and Loss Account	10,00,000	8,00,000
		74,00,000	46,00,000
2.	Current Liabilities:		
	Trade Payables	20,00,000	16,00,000
	Total (1) + (2)	94,00,000	62,00,000

B	Assets		
1.	Non-current Assets	-	-
2.	Current Assets	94,00,000	62,00,000
	Total (1) +(2)	94,00,000	62,00,000

You are required to pass the necessary journal entries in the books of P Ltd. (transferee company). When amalgamation by way of (i) merger and (i) by way of purchase. Also prepare the resultant balance sheets assuming that the Development Rebate Reserve and Export profit Reserve are required to be continued.

Solution

i. When amalgamation is by way of merger

In such case the amalgamation method followed is 'pooling of interest method'. The accounting entries would be:

Books of P Ltd.

Journal entries

Date	Particulars	Dr. ₹	Cr. ₹
	Business purchase A/c Dr. To Liquidator of Q Ltd. (Being purchase consideration due)	40,00,000	40,00,000
	Sundry Assets A/c Dr. General Reserve (bal. figure) To Sundry Liabilities To Profit and Loss A/c To Export Profit Reserve To General reserve To Development Rebate Reserve To Business Purchase A/c (Being merger of assets and liabilities of company Q Ltd. With P Ltd.)	62,00,000 10,00,000	16,00,000 8,00,000 3,00,000 4,00,000 1,00,000 40,00,000
	Liquidator of Q Ltd. Dr. To Equity Share capital (Being purchase consideration paid)	40,00,000	40,00,000

P Ltd. (After amalgamation by way of merger)

Balance Sheet

As on 31st March 2022

	Particulars	Amount (₹)
A	Equity and Liabilities	
1.	Shareholder's Funds	
	a) Share capital Authorised: Share capital equity shares of ₹10 each Issued, subscribed & paid up: 8,00,000 Equity shares of ₹ 10 each fully paid-up	80,00,000
	b) Reserves and Surplus General Reserve Development Rebate Reserve Export Profit Reserve Profit and Loss Account	9,00,000 5,00,000 8,00,000 18,00,000
		1,20,00,000
2.	Current Liabilities: Trade Payables	36,00,000
	Total (1) + (2)	1,56,00,000
B	Assets	
1.	Non-current Assets	-
2.	Current Assets	1,56,00,000
	Total (1)+(2)	1,56,00,000

ii. When amalgamation is by way of purchase

In such case the accounting entries passed as per 'the purchase method'.

Books of P Ltd.

Journal entries

Date	Particulars	Dr. ₹	Cr. ₹
	Business purchase A/c Dr. To Liquidator of Q Ltd. (Being purchase consideration due)	40,00,000	40,00,000

Sundry assets A/c	Dr.	62,00,000	
To Sundry liabilities			16,00,000
To Business Purchase A/c			40,00,000
To capital reserve			6,00,000
(Being merger of assets and liabilities of company Q Ltd. With P Ltd.)			
Liquidator of Q Ltd.	Dr.	40,00,000	
To Equity Share capital			40,00,000
(Being purchase consideration paid)			
Amalgamation adjustment			
	A/c Dr	4,00,000	
To Development Rebate Reserve			1,00,000
To Export Profit Reserve A/c			3,00,000
(Being carrying forward of statutory reserves in the books of transferee company)			

P Ltd. (After amalgamation by way of purchase)

Balance Sheet

As on 31st March 2022

	Particulars	Amount (₹)
A	Equity and Liabilities	
1.	Shareholder's Funds	

	a) Share capital Authorised: Share capital equity shares of ₹10 each Issued, subscribed & paid up: 8,00,000 Equity shares of ₹ 10 each fully paid-up	80,00,000
	b) Reserves and Surplus General Reserve Capital Reserve Development Rebate Reserve Export Profit Reserve Profit and Loss Account Amalgamation Adjustment A/c	15,00,000 6,00,000 5,00,000 8,00,000 10,00,000 (4000)
		1,20,00,000
2.	Current Liabilities: Trade Payables	36,00,000
	Total (1) + (2)	1,56,00,000
B	Assets	
1.	Non-current Assets	
2.	Current Assets	1,56,00,000
	Total (1) +(2)	1,56,00,000

1.3.7 Unrealised Profits

Unrealized profit arises out of transactions between the transferor company and the transferee company. The proper adjustment has to be made in respect of such unrealized profit. Unrealized profit arising out of charging of profit on the sale of goods by one company to another and the goods still lying unsold with the company who purchased the goods.

◆ Transaction between transferor company and transferee company

Entries corresponding to unrealized profit is to be passed in the books of the purchasing company. All other entries in the books of the purchasing company relating to the over of assets and liabilities are to be passed in the usual way without any change. The following entry may be passed in the books of the purchasing company when there is unrealized profit:

Goodwill/ Capital Reserve	Dr.
To Stock A/c	



Solution

Books of A Ltd.

Realisation Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Fixed Assets	24,000	By Sundry Creditors	8000
To Current Assets	10,000	By B Ltd	45,000
To Shareholders A/c(Profit)	19,000		
	53,000		53,000

Shareholders' Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Shares in B Ltd	45,000	By Share Capital	20,000
		By General Reserve	6000
		By Realisation A/c	19,000
	45,000		45,000

Books of B Ltd.

Journal Entries

Date	Particulars	Dr. ₹	Cr. ₹
	Business purchase A/c Dr. To Liquidator of A Ltd. (Being purchase consideration due)	45,000	45,000
	Fixed assets A/c Dr. Current Assets A/c Dr. Goodwill A/c (Bal. figure) Dr. To Sundry Creditors To Business Purchase A/c (Being taking over of assets and liabilities)	24,000 10,000 19,000	8000 45,000
	Liquidator of A Ltd. Dr. To Share capital A/c (Being purchase consideration paid)	45,000	45,000

Sundry Creditors A/c	Dr.	3000	
To Sundry Debtors			3000
(For cancellation of intercompany owings)			
Goodwill A/c	Dr.	1000	
To Stock A/c			1000
(unrealised profit included in stock)			

Working note

Calculation of unrealized profit on stock	
Cost of stock	6000
Rate of profit on cost	20%
Amount of unrealized profit = $6000 / 120 \times 20 =$	1000

1.3.9 Inter-company investments

Inter-company investments can take place in three ways:

- When the purchasing company holds shares in the vendor company
- When the vendor company holds shares in the purchasing company
- When both companies hold shares in each other

The accounting treatment in each of the cases has been discussed in the following parts:

a. When the purchasing company holds shares in the vendor company

When the purchasing company holds shares in the vendor company, the purchase consideration has to be properly adjusted by considering the shareholding of the purchasing company in the vendor company. For example, if the net assets of the vendor company are valued at ₹2 lakh and the purchasing company holds 20% of the equity share capital of the vendor company, the purchase consideration should be taken as only ₹ 1,60,000 (i.e. ₹ 2,00,000 – 40,000). This reduction happens because 20% of the net assets of the vendor company are already held by the purchasing company. Therefore, it is meaningless to ask the purchasing company to first pay the amount to the vendor company and then the vendor company to pay the same amount back to the purchasing company. The following points should be noted

◆ Types of intercompany investments

◆ Consider shareholding of purchasing company in the vendor company

alent to the shareholding of the purchasing company will be reduced from the purchase consideration, and the same will be debited to the shareholder's account and credited to the Realisation account.

The journal will be:

Date	Particulars	Dr. ₹	Cr. ₹
	Purchasing Company A/c Dr. To Realisation A/c (Amount of purchase consideration)	32,000	32,000
	Share capital A/c Dr. To Shareholders A/c (Transfer of sharecapital)	30,000	30,000
	Shareholders A/c Dr. To Realisation A/c (Adjustment of shares by the purchasing company)	8000	8000

◆ Paid-up value of shares of purchasing company transferred to realisation account

- c. This method is like method (b) explained above, except that only the paid-up value of the shares already held by the purchasing company transferred to the realisation account from the shareholders' account. For example, in the above situation a sum of ₹6000 (20% of paid-up share capital) will be transferred from shareholders account to the realisation account rather than ₹8000 transferred in method (a) and (b).

Note: the students are advised to follow method (a) or (b), because method (c) is not popular.

- ii. In the purchasing company's books, the account "Investment in shares in the vendor company" will be credited at cost at the time of recording the entry for taking over assets and liabilities.

Illustration 1.3.7 (Absorption with purchasing company's shareholding in the vendor company)

Following are the balance sheets of X Ltd and Y Ltd. as on 31st December, 2023.

X Ltd.
Balance Sheet

Liabilities	₹	Assets	₹
Share capital: 10,000 shares of ₹10 each.	1,00,000	Fixed assets	1,50,000
Reserves	90,000	Current assets	1,00,000
Debentures	50,000	Shares in Y Ltd	50,000
Creditors	60,000	4,000 shares	
	3,00,000		3,00,000

Y Ltd.
Balance Sheet

Liabilities	₹	Assets	₹
Share capital 10,000 shares of 10 each.	1,00,000	Fixed Assets	1,00,000
Reserves	50,000	Current Assets	1,00,000
Creditors	50,000		
	2,00,000		2,00,000

X Ltd. takes over the business of Y Ltd. The purchase consideration is to be computed on the basis of intrinsic value of each company's shares as recorded in the balance sheets. It is to be satisfied by issue of shares.

Solution

Intrinsic value of shares of Y Ltd.:	₹
Assets (as per Balance Sheet)	2,00,000
Less: Liabilities	<u>50,000</u>
Net assets	1,50,000
No of shares	10,000
Value of a share $1,50,000/10,000 = ₹15$	
Intrinsic value of shares of X Ltd.:	
Assets (as per the Balance sheet)	
Fixed Assets	1,50,000
Current Assets	1,00,000
Shares in Y Ltd.	<u>60,000</u>
	3,10,000
Less: Liabilities	<u>1,10,000</u>

Net Assets	2,00,000
No of shares	10,000
Intrinsic value of share = 2,00,000/10,000 = ₹20	
Purchase Consideration to be payable by X Ltd to Y Ltd.	
Net Assets	1,50,000
Less: 4/10(4000/10,000) of Net Assets held by X Ltd.	<u>60,000</u>
Purchase Consideration	90,000
Each share of X Ltd has an intrinsic value of ₹20	
No of shares to be issued by X Ltd to Y Ltd = ₹90,000/20 = ₹4,500	

Y Ltd.

Journal entries

Date	Particulars	Dr. ₹	Cr. ₹
	Realisation A/c Dr. 2,00,000 To Fixed assets A/c 1,00,000 To Current Assets A/c 1,00,000 (Transfer of assets)		
	Creditors A/c Dr. 50,000 To Realisation A/c 50,000 (Transfer of liabilities)		
	X Ltd. Dr. 90,000 To Realisation A/c 90,000 (Purchase Consideration due)		
	Share capital A/c Dr. 1,00,000 Reserves A/c Dr. 50,000 To Shareholders A/c 1,50,000 (Transfer of share capital and reserves)		
	Shares in X Ltd Dr. 90,000 To X Ltd. 90,000 (For receipt of purchase consideration)		

Shareholders A/c	Dr.	60,000	
To Realisation A/c (The amount adjusted by X Ltd. for shares held by it in the vendor company)			60,000
Shareholders A/c	Dr.	90,000	
To Shares in X Ltd. (Satisfaction of shareholders claims)			90,000

Ledger Accounts
Realisation Account

Particulars	₹	Particulars	₹
To Fixed assets	1,00,000	By Creditors	50,000
To Current assets	1,00,000	By X Ltd.	90,000
		By Shareholders A/c	60,000
	2,00,000		2,00,000

Shareholders Account

Particulars	₹	Particulars	₹
To Realisation A/c	60,000	By Share Capital	1,00,000
To Shares in X Ltd	90,000	By Reserves	50,000
	1,50,000		1,50,000

b) When the vendor company holds shares in the purchasing company

After acquiring the vendor company's business, the purchasing company is authorized to all assets of the vendor company including the shares which the vendor company may be holding in the purchasing company. However, a company can't purchase its own shares. Therefore, while computing the number of shares to be issued by the purchasing company to vendor company, the number of shares already held by the vendor company in the purchasing company should be deducted from the total number of shares that will be otherwise issued by the purchasing company. Let us consider an example, if vendor company hold 500 shares in the purchasing company, and the number of shares to be issued by the purchasing company to the vendor company as purchase consideration is 2500, with the shareholding by the vendor company and the purchasing company can't purchase its own shares. It would issue only 2000 shares to the vendor company. The purchase consideration is computed by multiplying

◆ No:of shares held by vendor company in the purchasing company deducted from total no:of shares

number of shares so issued with the price at which they have been issued by the purchasing company.

The shares already held by the vendor company in the purchasing company should be valued at the same price at which it is getting the new shares from the vendor company. Profit or loss on such revaluation should be transferred to realisation account.

Illustration 1.3.8 (Absorption with vendor company's shareholding in the purchasing company)

The balance sheets of A Ltd. and B Ltd. as on 31st December 2023 are shown below:

A Ltd.			
Balance Sheet			
Liabilities	₹	Assets	₹
Share capital 10,000 shares of ₹10 each.	1,00,000	Fixed Assets	2,00,000
		Current Assets	1,00,000
General Reserve	1,00,000		
Creditors	50,000		
Debentures	50,000		
	3,00,000		3,00,000

B Ltd.			
Balance Sheet			
Liabilities	₹	Assets	₹
Share capital: 5,000 shares of ₹10 each.	50,000	Fixed Assets	50,000
		Current Assets	20,000
		Shares in A Ltd. 2000 shares	30,000
General Reserve	30,000		
Creditors	20,000		
	1,00,000		1,00,000

A Ltd. takes over B Ltd. The purchase consideration is to satisfied by the issue of equity shares of A Ltd. issued on the basis of intrinsic value of shares of companies.

Solution

Intrinsic value of A Ltd' s Shares	₹
Assets (Fixed assets + Current Assets)	3,00,000
Less: Liabilities (Creditors + Debentures)	<u>1,00,000</u>

Net Assets		2,00,000
No of shares		10,000
Intrinsic value of a share $2,00,000/10,000 = ₹20$		
Intrinsic value of B Ltd' s shares		
Fixed assets	50,000	
Current assets	20,000	
Shares in A Ltd (2000 × ₹20)	<u>40,000</u>	1,10,000
Less: Liabilities (Creditors)		<u>20,000</u>
Net assets		90,000
Value of a share = $90,000/5000 = ₹18$		
Purchase consideration		
Net assets of B Ltd.		90,000
Value of share of A Ltd.		₹ 20
No: of shares to be issued by A Ltd to B Ltd ($90,000/20$)		4500 Shares
But, B Ltd. holds 2000 shares in A Ltd and A Ltd. is not allowed to purchase its own shares. Hence, the number of shares to be issued by A Ltd. to B Ltd. for taking over of business will be $(4500-2000) = 2,500$		
Purchase consideration = $2500 \times ₹20 = ₹50,000$		

Books of B Ltd.

Journal Entries.

Date	Particulars	Dr. ₹	Cr. ₹
	Realisation A/c Dr.	70,000	
	To Fixed Assets A/c		50,000
	To Current Assets A/c		20,000
	(Being Transfer of assets)		
	Creditors A/c Dr.	20,000	
	To Realisation A/c		20,000
	A Ltd. Dr.	50,000	
	To Realisation A/c		50,000
	(Purchase Consideration due)		
	Shares in A Ltd Dr.	50,000	
	To A Ltd.		50,000
	(For receipt of purchase consideration)		

Shares in A Ltd. A/c	Dr.	10,000	
To Realisation A/c (Revaluation of shares already held by B Ltd in A Ltd.)			10,000
Share Capital A/c	Dr.	50,000	
General Reserves A/c	Dr.	30,000	
To Shareholders A/c (Transfer of Share capital and reserves to Shareholders A/c)			80,000
Realisation A/c	Dr.	10,000	
To Shareholders A/c (Profit on realisation)			10,000
Shareholders A/c	Dr.	90,000	
To Shares in P Ltd. A/c (Payment to shareholders)			90,000

Realisation Account

Particulars	₹	Particulars	₹
To Fixed assets	50,000	By Creditors	20,000
To Current assets	20,000	By A Ltd.	50,000
To Shareholders (Profit)	10,000	By Shares held by A Ltd	10,000
	80,000		80,000

Shareholders Account

Particulars	₹	Particulars	₹
Shares in A Ltd	90,000	By Share capital	50,000
		By General Reserve	30,000
		By Realisation A/c (Profit)	10,000
	90,000		90,000

Shares in A Ltd. Account

Particulars	₹	Particulars	₹
To Balance b/d	30,000	By Shareholders A/c	90,000
To A Ltd.	50,000		
To Realisation A/c	10,000		
	90,000		90,000

Books of A Ltd.

Journal Entries

Date	Particulars	Dr. ₹	Cr. ₹
,	Business Purchase A/c Dr. To Liquidator of B Ltd A/c (Being Purchase Consideration due))	50,000	50,000
	Fixed Assets A/c Dr. Current Assets A.c Dr. To Creditors A/c To Business Purchase A/c (Taking over of assets and liabilities)	50,000 20,000	20,000 50,000
	Liquidator of B Ltd.A/c Dr. To Share Capital A/c To Securities Premium A/c (Payment of Purchase Consideration)	50,000	25,000 25,000

C. When both companies hold shares each other

In such situations, it is required to find out the value of shares of each company using algebraic equations.

Illustration 1.3.9 (Absorption with mutual shareholdings).

Following are the balance sheets of A Ltd. and B Ltd as on 31st December 2022:

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share capital (₹ 100 each)	10,00,000	5,00,000	Assets	10,00,000	8,00,000
			Shares in B Ltd. (3000 shares)	5,00,000	
Sundry creditors	2,00,000	1,00,000	Shares in A Ltd. (2000 Shares)		2,00,000
Reserves	3,00,000	4,00,000			
	15,00,000	10,00,000		15,00,000	10,00,000

You are required to prepare the necessary accounts in the books of the vendor company and pass the journal entries in the books of the purchasing company if a new company AB Ltd takes over both A Ltd and B Ltd.



Solution

If AB Ltd. takes over both A Ltd. and B Ltd. on the basis of intrinsic value of shares:

Let the net asset of A Ltd. be A

Let the net asset of B Ltd. be B

$$A = 8,00,000 + 3/5 B \quad \dots\dots\dots (1)$$

$$B = 7,00,000 + 1/5 A \quad \dots\dots\dots (2)$$

OR

$$A - 3/5 B = 8,00,000 \quad \dots\dots\dots (3)$$

$$-1/5 A + B = 7,00,000 \quad \dots\dots\dots (4)$$

Multiply equation (4) by 5 then add equations (3) and (4)

$$A - 3/5 B = 8,00,000$$

$$-A + 5 B = 35,00,000$$

$$4 + 2/5 B = 43,00,000$$

$$= \quad \underline{22/5 B = 43,00,000}$$

$$B = 43,00,000 \times 5/22 = ₹ 9,77,273$$

By substituting the value of B in equation (1), we get

$$A = 8,00,000 + 3/5 \times 9,77,273$$

$$= 8,00,000 + 5,86,364$$

$$= 13,86,364$$

Purchase consideration for A Ltd:

₹

Value of net assets of A Ltd. = 13,86,364

Less: 1/5 of shares held by B now held by AB Ltd = 2,77,273

Purchase Consideration = 11,09,091

Purchase consideration for B Ltd.

Value of net assets of B Ltd. = 9,77,273

Less: 3/5 shares already held by X Ltd. which are

Now held by AB Ltd. = 5,86,364

Purchase consideration = 3,90,909

**Books of A Ltd.
Realisation Account**

Particulars	₹	Particulars	₹
To Sundry assets	10,00,000	By Sundry creditors	2,00,000
To Shares in B Ltd.	5,00,000	By AB Ltd.	11,09,091
To Shareholders A/c (Profit)	86,364	By Shareholders' A/c (For shares now held by AB Ltd.)	2,77,273
	15,86,364		15,86,364

Shareholders' Account

Particulars	₹	Particulars	₹
To Realisation account	2,77,273	By share capital	10,00,000
To purchase consideration from AB Ltd.	11,09,091	By Reserves	3,00,000
		By Realisation A/c	86,364
	13,86,364		13,86,364

**Books of B Ltd.
Realisation Account**

Particulars	₹	Particulars	₹
To Sundry assets	8,00,000	By sundry creditors	1,00,000
To Shares in B Ltd.	2,00,000	By AB Ltd. Purchase (consideration)	3,90,909
To Shareholders account (profit)	77,273	By Shareholders' A/c	5,86,364
	10,77,273		10,77,273

Shareholders' Account

Particulars	₹	Particulars	₹
To Realisation A/c (for shares now held by AB Ltd.)	5,86,364	By Share capital	5,00,000
		By Reserve	4,00,000
		By Realisation A/c	77,273
To purchase consideration from AB Ltd.	3,90,909		
	9,77,273		9,77,273

Books of AB Ltd.
Journal entries(Without Narratives)

Date	Particulars	Dr. ₹	Cr. ₹
	Business Purchase (A Ltd.) Dr Business Purchase (B Ltd.) Dr. To Liquidator of A Ltd. A/c To Liquidator of B Ltd. A/c	11,09,091 3,90,909	11,09,091 3,90,909
	Sundry assets (A Ltd.) A/c Shares in B Ltd. A/c Goodwill (balancing Figure) To Sundry Creditors (A Ltd.) A/c To Shares in A Ltd. A/c To Business Purchase (A Ltd.) A/c	10,00,000 5,00,000 9,091	2,00,000 2,00,000 11,09,091
	Sundry assets (B Ltd.) A/c Shares in A Ltd. A/c To Sundry Creditors (B Ltd.) A/c To Shares in B Ltd. A/c To Business Purchase (B Ltd.) A/c To capital Reserve (Balancing Figure)	8,00,000 2,00,000	1,00,000 5,09,000 3,90,909 9,091

1.3.10 Amalgamation Schemes

The scheme of amalgamating two or more companies necessitates revaluation of the assets and liabilities of each company. Each company's value of goodwill is also determined. The net assets available for equity shareholders are determined after making suitable provision for possible liquidation expenses. Preference shareholders and debenture holders are usually paid at par in the form of preference shares and debentures of the new company. However, the value of equity shares of the vendor company is generally ascertained on the basis of the net assets available for equity shareholders.

- ◆ Necessitates revaluation of the assets and liabilities of each company

Sometimes cash transferred from the vendor company is not sufficient to pay for formation expenses etc. of the new company. In such a case, the new company may have to arrange for funds required for this purpose either through bank loan or issue of shares to promoters, public etc. In case of absorption of one company by another, the same principles mentioned above are followed. Also, the equity share exchange ratio between the ab-

sorbing company and the absorbed company is also ascertained on the basis of intrinsic value of each company's shares.

Summarised Overview

Amalgamation involves the merger or acquisition of two companies, where one is the vendor company (being acquired) and the other is the purchasing company (acquiring the vendor the vendor company). The financial aspects of this process include the calculation of purchase consideration, which can be in the form of cash, shares, or a combination. The purchase consideration is computed using methods like the lump sum method, net payment method, net asset method (based on assets minus liabilities) or the share exchange ratio (based on the value of shares). Key accounting entries include recording the fair value of assets and liabilities acquired, recognizing any goodwill (if the purchase price exceeds the net assets), and handling inter-company owings (e.g., loans or receivables) to eliminate double-counting in consolidated financial statements.

Unrealized profits from transactions between the vendor and purchasing companies need to be adjusted, as these are only recognized when the goods or assets are sold to external parties. Additionally, intercompany investments are eliminated in consolidation to prevent duplication of assets. According to Accounting Standard 14 (AS 14), two methods are used to account for amalgamations: the pooling of interest method (where assets and liabilities are combined at book value) and the purchase method (where assets and liabilities are recorded at fair value, and goodwill is recognized if applicable). An amalgamation scheme outlines the details of the merger or acquisition, such as asset transfers and share adjustments.

Self-Assessment Question

1. What is amalgamation?
2. Explain pooling of interest method of amalgamation?
3. Explain amalgamation schemes?
4. Briefly explain the types of amalgamation?
5. What are the conditions to be satisfied in case of amalgamation in the nature of merger as per AS 14?
6. What are the two methods of accounting for amalgamation of companies?
7. Briefly explain the Net asset method of calculating purchase consideration?
8. State the difference between pooling of interest method and purchase method?
9. Write a short note on Intercompany investments?
10. Write a short note on Intercompany owings

11. Arun Ltd. takes over the business of Mohan Ltd. at the following values

Fixed assets	₹4,00,000
Current assets	₹1,50,000
Debentures	₹3,00,000
Current liabilities	₹1,00,000

Calculate the amount of purchase consideration

12. The following is the Balance Sheet of Varun Ltd. as on 31.3.2022

Liabilities	₹	Assets	₹
14,000 Equity Shares of 100 each fully paid	14,00,000	Sundry assets	15,20,000
General Reserve	10,000	Discount on issue of Debentures	60,000
10 % Debentures	1,00,000	Preliminary Expenses	40,000
Sundry Creditors	1,00,000	P & L A/c	20,000
Bank Overdraft	10,000		
Bills Payable	20,000		
	16,40,000		16,40,000

‘Madhav’ Ltd. agreed to take over the business of ‘Varun’ Ltd. Calculate purchase consideration under Net assets method after consider the following:

The market value of 60% of the sundry assets is estimated to be 10% more than the book value that of the remaining 40% at 5% less than the book value. The liabilities are taken over at book values. There is unrecorded liability of 30000.

Calculation of purchase consideration as per Net assets method

Assignments

1. The following details are given for the absorption of X Ltd. by Y Ltd.

	X Ltd.	Y Ltd.
Net assets	33,30,000	41,25,000
Number of equity shares of 100 each	9000	15,000
Reserves	15,30,000	11,25,000

The absorption proposed as follows:

The holders of every three share in X Ltd. were to receive four shares in Y Ltd. plus as much as cash as its necessary to adjustment the rights of shareholders of both the companies in accordance with intrinsic value of their respective shares. You are required to calculate the purchase consideration?

2. Explain the accounting entries involved in an amalgamation under the purchase method as per Accounting Standard 14 (AS 14). Illustrate the entries with a simple example where Company A acquires Company B?
3. Explain the different types of Amalgamation as per AS 14

Suggested Reading

1. Gupta, R. L., & Radhaswamy, M. (2024). *Corporate accounting*. Sultan Chand and Sons.
2. Pillai, R. S. N., Bhagavathi, V., & Uma, S. (2010). *Fundamentals of advanced accounting* (Vol. 2). S Chand and Company Limited.

Reference

1. Maheshwari, S. N., Maheshwari, S. K., & Maheshwari, S. K. (2022). *Corporate accounting*. Vikas Publishing House Private Limited.
2. Jain, S. P., Narang, K. L., Agarwal, S., & Sehgal, M. (2019). *Advanced accountancy: Corporate accounting* (Vol. 2). Kalyani Publishers.
3. Maheshwari, S. N., Maheshwari, S. K., & Maheshwari, S. K. (2017). *Advanced accountancy* (Vol. 1). Vikas Publishing House Private Limited.

Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

SGOU

02 BLOCK

Accounts Of Holding Companies

Block Content

- Unit - 1 Holding company and subsidiary company
- Unit - 2 Accounts of holding company and subsidiary company



Unit 1

Holding company and subsidiary company

Learning Outcomes

After completing this unit, the learner will be able to:

- ◆ get an idea of the concepts of holding and subsidiary companies
- ◆ comprehend the consolidation procedure
- ◆ analyse minority interests and evaluate the cost of control
- ◆ distinguish between pre-acquisition and post-acquisition profit

Background

In the era of business growth, many organisations are growing into large corporations through acquisitions and mergers, gaining control by one company over the other; acquisitions and mergers ultimately lead to cost reduction, market control, sharing of material supplies, product diversification, or tax benefits. Whatever the object behind these ventures is, the ultimate result is a large-scale corporation. The formation of a holding company is the most popular device for achieving these objectives.

Keywords

Holding company, subsidiary company, minority interest

Discussion

When a company acquires a majority share in the ownership capital or is in a position to influence or control the management of the other company, the company is called a holding company, and the other company is called a subsidiary company. These subsidiaries have their own existence and are managed by inde-

pendent governing boards (in the case of public enterprises) and holding companies (in the case of commercial enterprises). A holding company is one that holds either the whole of the share capital or a majority of the shares in one or more companies so as to have a controlling interest in such companies; such other companies are known as subsidiary companies.

2.1.1 Meaning & Definition of Holding Company & Subsidiary Company

As per sec 2 (87) of the Companies Act,2013, a company becomes the subsidiary of another if;

- ◆ Control over board of directors
- ◆ Ownership of share-capital

- a. That another company controls the composition of its Board of Directors; or
- b. That another company holds more than half of total share capital; or (More than 50%)

(Note: Total share capital = Paid up share Capital + Convertible preference share capital)

- c. That the first-mentioned company is a subsidiary of any Company which is a subsidiary of another company.

As conclusion, holding company is parent company that owns and controls another company, known as subsidiary.

For example suppose company XY owns 60% of company AB's shares. In this case XY is holding company and AB is subsidiary company

2.1.1.1 Groups of Companies

Sometimes, a company expands by keeping its separate corporate identity intact. In such a situation, a company (holding company) gains control over the other company (Subsidiary). This Control is exercised by one company over the other by –

1. Purchasing a specified number of shares i.e. ownership through voting rights of that company (Subsidiary company) or
2. Exercising control over the Board of Directors

The companies connected in these ways are collectively called a Group of Companies

2.1.1.2 Holding Company

As per section 2(46) of the Companies Act 2013,

“Holding company”, in relation to one or more other companies, means a company of which such companies are subsidiary companies. The parent company (Holding Company) does not produce any kind of goods or services or conduct any other business operation. The holding company offers several benefits, such as gaining more control, retaining the management of the subsidiary company and incurring lower tax liabilities.

2.1.1.3 Subsidiary Company

Section 2(87) of the Companies Act 2013 defines “Subsidiary Company” as an enterprise that is controlled by another enterprise (known as a Holding Company); subsidiary companies are of two types;

- a. Wholly owned
- b. Partly owned

2.1.1.4 Wholly owned and partly owned subsidiaries

A wholly owned subsidiary is a company entirely owned by a holding company, which provides the holding company with complete control over its operations, management, and strategic choices. In wholly owned subsidiary, there is no controlling interest because all the shares with voting right are held by the holding company. Wholly owned subsidiaries are especially beneficial for market entry, guaranteeing uniformity in branding, policies, and operating standards across different locations. They allow the holding company to protect secret technologies and confidential information. This arrangement imposes considerable financial and operational risks on the holding company, which is solely accountable for financing, managing, and addressing any liabilities of the subsidiary. Wholly owned subsidiaries are a strategic option for companies that prioritise control and integration.

◆ Enable holding company to maintain total control

A partially owned subsidiary is a company in which a holding company possesses less than 100% ownership, frequently sharing ownership with other investors or entities. This framework permits the holding company to maintain substantial influence, especially if it possesses a majority ownership (exceeding 50%), while facilitating collaboration with other stakeholders. Partially owned subsidiaries represent a strategic option for companies seeking to create relationships, minimise expenses, and explore new prospects without incurring full ownership and liability.

◆ Shared ownership

2.1.1.5 Objectives of Holding Companies

There are many objectives of holding Companies, which are

listed below

- ▶ To eliminate competition
- ▶ To enjoy the economies of large-scale production
- ▶ To achieve an assured market for the product of the company
- ▶ To ensure a smooth supply of raw materials

2.1.1.6 Types of Holding Company

- ◆ **Pure Holding company:** Those companies which do not participate in another business other than controlling on or more enterprises. It is to own stocks in other companies
- ◆ **Mixed Holding Company:** Those companies which do not only control other companies but are also involved in their own operations
- ◆ **Immediate Holding Company:** A company that retains voting power or control of another company, in spite of the fact that the company itself is already controlled by another entity. It is a company that is already a subsidiary of another.
- ◆ **Intermediate:** This is a company that is both a holding company of another entity and a subsidiary of a large corporation. As a holding company of a smaller group, it might be exempt from publishing financial records.

2.1.1.7 Advantages of Holding Companies

The advantages of Holding companies are enumerated below

1. **Better quality Decisions:** The Holding company concentrates on implementing corporate policies and strategies and operating levels.
2. **Better utilization of resources:** The Holding company pools the resources of a group of enterprises.
3. **Easy method of acquiring control:** Organizations will have to spend only less in acquiring control of the other company
4. **Reduces Competition:** competition among two or more companies is totally eliminated.
5. **Easy exit from subsidiary:** The company can easily sell the shares of the subsidiary in the open market.
6. **Income Tax benefits:** As both companies maintain sepa-



rate identities, they can avail of tax benefits by carrying forward their losses from previous years.

7. **Efficient Management:** As both companies are maintaining separate identities, efficiency in management can be achieved
8. **Enhances Corporate Planning:** The holding company can concentrate on corporate planning, acquisition, and update technology
9. **Managerial and commercial culture:** The holding company's management promotes commercial and managerial culture instead of bureaucratic culture.

2.1.2 Consolidation Procedures

Consolidation procedures for holding and subsidiary companies entail combining the financial statements of the holding company and its subsidiaries to provide a unified picture of the group's total financial performance. This technique provides a more holistic perspective of the economic unit rather than merely concentrating on the individual performance of each company.

- ◆ Combining the financial statements to measure financial performance

Consolidation procedures for parent and subsidiary enterprises entail merging the financial statements of the parent entity and its subsidiaries to provide a cohesive representation of the group's total financial performance. This technique provides a more holistic perspective of the economic unit rather than merely concentrating on the individual performance of each company.

2.1.2.1 The Stages in the consolidation process generally encompass

► Determine Control

The first step is to establish control over the subsidiary. This is usually accomplished when the holding company possesses over 50% of the subsidiary's voting shares.

- ◆ More than 50% of share ownership

► Prepare Separate Financial Statements

The holding company and each subsidiary shall prepare their respective individual financial statements.

► Eliminate Intercompany Transactions

Transactions between the holding company and its subsidiaries, including sales, purchases, and loans, are deleted to prevent

double-counting and to provide a consolidated representation of the group's activities.

► **Adjust for Variations in Accounting Policies**

If the holding company and its subsidiaries employ disparate accounting policies, adjustments are made to maintain consistency in the consolidated financial statements.

► **Consolidate Financial Statements**

The financial statements of the holding company and its subsidiaries are combined on a line-by-line basis, adding similar items such as assets, liabilities, revenues, and expenses.

► **Allocate Minority Interest**

When the holding company owns less than 100% of the subsidiary, a minority interest allocation is implemented to represent the portion of the subsidiary's equity not controlled by the holding company.

► **Prepare Consolidated Financial Statements**

The final step is the preparation of consolidated financial statements, encompassing the consolidated balance sheet, income statement, statement of cash flows, and statement of changes in equity.

Consolidation techniques give a more precise and holistic perspective of a corporate organisation's financial performance and status. Integrating the financial statements of the main business and its subsidiaries enables investors and other stakeholders to have a clearer comprehension of the group's overall financial condition and future potential.

Consolidation techniques give a more precise and holistic perspective of a corporate organisation's financial performance and status. Integrating the financial statements of the main business and its subsidiaries enables investors and other stakeholders to have a clearer comprehension of the group's overall financial condition and future potential.

◆ Subsidiary's equity not hold by holding company

2.1.2.3 Additional Considerations

► **Goodwill**

If the acquisition cost of the subsidiary exceeds the fair value of the subsidiary's net assets, goodwill is recognized as an intangible asset.



► Foreign Currency Translation

If the subsidiary operates in a foreign currency, the subsidiary's financial statements are translated into the parent company's functional currency.

► Accounting Standards

The consolidation process must comply with relevant accounting standards, such as International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP).

2.1.3 Minority interest

Minority interest, also known as non-controlling interest, refers to the portion of a subsidiary company's equity that is owned by shareholders other than the parent company. This occurs when a parent company holds more than 50% but less than 100% of a subsidiary, meaning it has control over business operations, but some ownership remains with outside investors. These minority shareholders have a financial stake in the company and are entitled to a share of its profits, but they do not have significant influence over decision-making.

◆ Equity owned by shareholders other than the parent company

Minority interest is important in financial analysis, mergers, and acquisitions. Investors and analysts consider it while evaluating a company's financial health, as it impacts overall profitability and ownership structure. During acquisitions, companies must decide whether to buy out minority shareholders or maintain the existing ownership distribution. Understanding minority interest is crucial for businesses to manage financial reporting, investor relations, and corporate governance effectively.

2.1.3.1 Minority interest is calculated as follows

	₹
Paid-up value of the shares held by outsiders
Add:(i) Proportionate share of the subsidiary company's profits and reserves
(ii) Proportionate increase in the value of the assets of the subsidiary company (if any)
Less:(i) Proportionate share of subsidiary company's losses

(ii) Proportionate decrease in the value of
 the assets of the subsidiary company _____
 Value of Minority Interest _____

◆ Treatment of preference shares

If preference shares are held by outsiders, the paid-up value of such shares, together with the dividend thereon (if there is profit), is also added to the value of minority interest or shown separately. A proportionate share of the subsidiary company's profit and reserves belonging to the outsiders is calculated keeping in view the value of equity shares held by them, and the value of the preference shares held is not considered because profits and reserves belong to equity shareholders and not to preference shareholders.

Having shown the amount of the minority interest in the consolidated balance sheet as a liability, all the assets and liabilities of the subsidiary company are merged up with those of the holding company, thereby eliminating investment in shares of the subsidiary company.

2.1.4 Cost of Control

◆ Cost of a company to take over another business

In the context of a holding company, "Cost of control" refers to the premium paid by the holding company for shares in its subsidiary company, exceeding the value of those shares as a mere investment, reflecting the benefit derived from controlling the subsidiary. Cost of control is the amount of money a company has to pay to take over another business. The cost is raised when a company buys more than 50% of another company's shares, which gives it control over operations and decisions. Because buyers usually pay more for control, the cost of control is generally higher than the book value of the net assets of the company acquired. In accounting, this premium is written down as "goodwill," which means the amount paid over the net assets' fair value.

◆ Treated as good will or
 ◆ Treated as capital reserve

When a parent company acquires a subsidiary, the total acquisition cost includes the price paid for shares, any transaction fees, and adjustments for liabilities or revaluation of assets. In consolidated financial statements, the cost of control is accounted for in two ways: (1) If the purchase price is higher than the net assets of the acquired company, the excess is recorded as goodwill, reflecting intangible benefits such as brand value, customer loyalty, or market advantage. (2) If the purchase price is lower than the paid-up value of shares, the less amount paid represents capital reserve or profit.

Thus, if 9000 shares of Rs 10 each are purchased at Rs 100000, the excess Rs 10000 is goodwill, which will be shown in the consolidated balance sheet as goodwill as an intangible asset. On the other hand, if the price paid for 9000 shares is Rs 80000, the less Rs 10000 is capital profit, which will be shown as capital reserve.

2.1.5 Pre-acquisition Profit

- ◆ Profit of subsidiary company in prior to acquisition by holding company

If there exist some reserves and profits of the subsidiary company on the date of acquisition of shares of the subsidiary company, the outsider's share of such reserves and profits is added to the non-controlling Interests as pointed out earlier and the balance of such reserves and profits are capital profits of the holding company and are shown as capital reserve in the consolidated balance sheet. In the case of cost of control or goodwill, the share of such profits belonging to the holding company is adjusted to goodwill and reduces the cost of control or goodwill.

Similarly, losses of the subsidiary company, such as the debit balance of the surplus account, preliminary expenses, discount on the issue of shares and debentures, underwriting commission, etc., shown in the balance sheet on the date of the purchase of shares are divided into two parts, i.e. the share of the minority shareholders and share of the holding company. Share of the outsiders is deducted from the amount of the non-controlling interest, and the share of the holding company is added to the cost of control or goodwill or reduced from capital profit, which has become available on purchase of shares of the subsidiary company at a price lower than the paid-up value.

2.1.6 Post-acquisition Profit

- ◆ Added to profit of holding company

Profits of the subsidiary company made after the date of the purchase of shares by the holding company are treated as revenue profits. The holding company's share of such profits is added to the profits of the holding company, and shares of such profits belonging to the minority shareholders are added to the amount of the non-controlling interest.

Thus, the date of purchase by the holding company is the deciding factor in deciding whether the subsidiary company's profits and reserves are capital profits or revenue profits. Profits or reserves shown in the subsidiary company's balance sheet on or before the date of purchase of shares are treated as capital profits, and profits earned by the subsidiary company after the purchase of shares by the holding company are called revenue profits.

Summarised Overview

A holding company is an entity that owns more than 50% of the shares of another company, giving it control over management and operations, while a subsidiary company is one in which the majority of shares are held by the holding company. According to Accounting Standard (AS) 21, consolidated financial statements are prepared to present the financial position of the holding and subsidiary as a single entity. The consolidation procedure involves combining assets, liabilities, income, and expenses of both companies while eliminating inter-company transactions. A key component of consolidation is minority interest, which represents the portion of the subsidiary's net assets and profits that belong to shareholders other than the holding company and is shown under equity in the consolidated balance sheet. Cost of control, also known as goodwill or capital reserve, arises when the purchase price paid by the holding company differs from the subsidiary's net assets; goodwill arises if the purchase price is higher, while a capital reserve is created if it is lower. Pre-acquisition profits refer to the subsidiary's retained earnings before acquisition and are considered capital profits, not included in the consolidated income statement but adjusted against capital reserves. In contrast, post-acquisition profits are profits earned after the holding company acquires the subsidiary and are included in the consolidated income statement based on the holding company's share. Proper elimination of inter-company balances, unrealized profits, and the correct calculation of minority interest and cost of control ensure that consolidated financial statements present an accurate picture of the financial health of the group.

Self-Assessment Question

1. What are the key steps involved in the consolidation of financial statements?
2. Why are inter-company transactions eliminated in the consolidation process?
3. How is the investment of the holding company in the subsidiary treated during consolidation?
4. Where is the minority interest shown in the consolidated balance sheet?
5. How are dividends paid by the subsidiary to the holding company treated in consolidation?
6. Minority Interest & Cost of Control
7. What is minority interest, and why is it important in consolidated accounts?
8. How is goodwill (cost of control) calculated in the process of consolidation?
9. What happens when the purchase price paid by the holding company is less than the net assets of the subsidiary?
10. How is pre-acquisition profit treated in the consolidated financial statements?

11. Why is post-acquisition profit included in the consolidated financial statements, and how is it allocated?

Assignments

1. Explain the consolidation procedure for preparing consolidated financial statements of a holding company and its subsidiary.
2. Prepare a step-by-step guide for the preparation of consolidated balance sheets as per AS 21 (Accounting Standard 21).
3. Discuss the importance of eliminating inter-company transactions during consolidation and provide examples.
4. Solve a numerical problem involving the consolidation of a holding and subsidiary company's balance sheet.

Suggested Reading

1. Jain, S. P., & Narang, K. L. (2023). *Advanced accountancy*. Kalyani Publishers.
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4. Anthony, R. N., Hawkins, D. F., & Merchant, K. A. (2019). *Accounting: Text & cases*. Tata McGraw Hill.
5. Shukla, M. C., & Grewal, T. S. (Year). *Advanced accounts*. S. Chand & Co. Ltd.
6. Paul, S. K. (2020). *Financial Accounting*. New Central Book Agency.

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1. Anthony, R. N., & Reece, J. S. (2019). *Accounting principles*. Richard Irwin, Inc.
2. Sehgal, A., & Sehgal, D. (2019). *Advanced accounting*. Taxman.
3. Porwal, L. S. (2013). *Accounting theory*. Tata McGraw Hill.
4. Maheshwari, S. N. (2022). *Corporate accounting*. Vikas Publishing House Pvt. Ltd.

Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

SGOU



Unit 2

Accounts of Holding Company and Subsidiary Company

Learning Outcomes

After completing this unit, the learner will be able to:

- ◆ analyse the revaluation of assets and liabilities
- ◆ comprehend unrealised profits
- ◆ aware of the accounting treatment of dividends & issue of bonus shares
- ◆ evaluate contingent liabilities
- ◆ preparation of consolidated balance sheet as per AS21

Background

In holding company accounting, revaluation of assets and liabilities ensures financial statements reflect true values, which is crucial for accurate decision-making, mergers and tax assessments, especially when dealing with subsidiaries. Revaluation ensures that the financial statements of the holding company and its subsidiaries accurately reflect the current market values of assets and liabilities. By providing a more realistic view of the company's financial position, revaluation aids in better financial management and strategic decision-making.

Keywords

Unrealised profit, Treatment of dividend, Contingent Liabilities

Discussion

2.2.1 Revaluation of assets

- ◆ Sharing of revaluation profit or loss
- ◆ Treatment of depreciation

If the assets and liabilities of the subsidiary company are revalued at the time of acquisition of shares in the subsidiary company, profit or loss on account of such revaluation is treated as capital profit or capital loss and is divided among outside shareholders and holding company according to the proportions of the equity shares held by them. The holding company's share of such profit is transferred to capital reserve or deducted from the cost of control or goodwill and vice versa if there is a loss on revaluation. Share of profit of minority shareholders is added to the non-controlling interest and a deduction is made from the non-controlling interest if there is a loss on revaluation. As the asset value increases or decreases because of revaluation at the time of acquisition, adjustment of depreciation must be made in the revenue profits of the subsidiary company. For appreciation on the value of assets, depreciation charge could be increased proportionately and would be deducted from the revenue profits of the subsidiary company. But if there is a decrease in the value of an asset, depreciation would be decreased proportionately and added to the revenue profits of the subsidiary company.

Illustration 2.2.1

Balance Sheet of A Ltd and B Ltd on 31st March 2023

1	Equity and liabilities	A Ltd Amount (₹)	B Ltd Amount (₹)
	1. Shareholders' funds		
	a. Share capital :		
	Equity shares of 100 each	1000000	400000
	10% preference shares of rs 100each	-	100000
	b. Reserves and surplus :		
	General reserve	100000	50000
	Surplus amount :		
	Balance on 1-4-2022	40000	30000
	Profit for 2022-2023	200000	80000
	2 Current liabilities		
	Creditors	150000	70000

		Total equity and liabilities	1490000	730000
2	Assets			
1	Non-current assets			
	a. Fixed assets :			
	Land and building at cost	310000		160000
	Machinery less 10 % depreciation	270000		135000
	b. Investments 3000 shares in B ltd	450000		-
2	Current assets			
	Stock at cost	220000		150000
	Sundry debtors	155000		90000
	Cash and bank balance	85000		195000
	Total assets	1490000		730000

A Ltd acquired 3000 equity shares in B Ltd on 1st October 2020. As on the date of acquisition A ltd found that the value of land and building and machinery of B Ltd should be ₹ 150000 and ₹ 192500 respectively.

Prepare the consolidated balance sheet of A Ltd and its subsidiary B Ltd as on 31st March 2021 taking into consideration the fact that assets are to be taken in their proper value.

Solution

Consolidated Balance Sheet of A Ltd and Its Subsidiary B Ltd.

As at 31st March 2021

		Note no	₹
1	Equity and liabilities		
	(1) Shareholders fund		
	Share capital	A	1000000
	Reserve and surplus	B	364375
	Total		1364375
	(2). Non-controlling interest (4)		256875
	(3) Current liabilities		
	Trade payable (creditors) ₹		
	A Ltd	150000	
	B Ltd	70000	220000

Total Equity and Liabilities(1) +(2)+(3)		1841250
2 Assets		₹
(1) Fixes assets		
Tangible assets	C	912500
In tangible assets	D	33750
Total		946250
(2) current assets		
inventories	E	370000
Trade receivables	F	245000
Cash and cash equivalents	G	280000
Total		895000
Total assets (1)+ (2)		1841250

Accompanying Notes to the Consolidated Balance Sheet

A. share capital

Authorised capital	1000000
Issued , subscribed and paid-up capital	
10000 shares of ₹ 100 each fully paid	

B. Reserves and Surplus

	Amount (₹)
General reserve	100000
Surplus a/c (5)	264375
	<u>364375</u>

C. Tangible Assets

	Amount (₹)	Amount (₹)
Land and building at cost	A Ltd	310000
	B Ltd	150000
		<u>460000</u>
Machinery	A Ltd	300000
	Less : Depreciation	30000
		₹ <u>270000</u>
	B Ltd	200000
	Less : Depreciation	17500
		<u>182500</u>
		<u>452500</u>
		<u>912500</u>



D. Intangible assets

	Amount (₹)
Goodwill on consolidation (3)	33750

E. Inventories

	Amount (₹)	Amount (₹)
Stock at cost : A Ltd	220000	
B Ltd	150000	
		370000

F. Trade receivable

	Amount (₹)	Amount (₹)
Sundry debtors A Ltd	155000	
B Ltd	90000	
		245000

G. Cash and Cash Equivalents

	Amount (₹)	Amount (₹)
Cash and Bank balance A Ltd	85000	
B Ltd	195000	
		280000

1. Working notes

Calculation of capital profits	Amount (₹)	Amount (₹)
General reserve		50000
Surplus account balance on 1-4-2022		30000
Profits up to 30 th September 2022		
Profit for the year ending 31-3-2023	80000	
Less preference dividend ($\frac{10}{100} * ₹ 100000$)	10000	
	70000	
Half of ₹ 70000		35000
Add increase in the value of machinery :		
Book value on 31-3-2021 after 10 % depreciation	135000	

Book value on 1-4-2022		
(₹ 135000 × $\frac{100}{90}$)		150000
Less 10% depreciation for $\frac{1}{2}$ year		7500
		<u>142500</u>
		<u>192500</u>
		<u>50000</u>
		165000
Less: reduction in the value of land and building (₹ 160000-₹150000)		<u>10000</u>
Capital profits		155000
Less: holding company's share ($\frac{3}{4}$)		<u>116250</u>
Outsider's interest		<u>38750</u>

2. Calculation of revenue profits

Profits (after deduction of preference dividend) after 30 th September , 2022		35000
Less: Depreciation @ 10%for 6 months from October 1 , 2022 to march 31, 2023 on the increase in the value of machinery (₹ 50000×10/100×1/2)		2500
Revenue profits		32500
Less: Holding company's share ($\frac{3}{4}$)		<u>24375</u>
Outsider's interest		<u>8125</u>

3. Calculation of goodwill or cost of control

	Amount (₹)	Amount (₹)
Amount paid for shares acquired in B Ltd		450000
Less: Face value of 3000 shares of 100 each	300000	
Capital profits	<u>116250</u>	
		<u>416250</u>
Goodwill		<u>33750</u>

4. Calculation of non-controlling interest

	Amount (₹)	Amount (₹)
10% preference share capital		100000



Add : 10% dividend for the year		10000
		<hr/> 110000
Add equity share holders 1000 shares of 100 ₹ each	100000	
Share of capital profit	38750	
Share of revenue profit	8125	
		<hr/> 146875
Total non-controlling interest		<hr/> 256875

5. Surplus account of A Ltd

	Amount (₹)
Balance on 1-4-2022	40000
Add: Profit for 2022-23	200000
Share of revenue profit of B Ltd.(2)	24375
Total Non-controlling interest	<hr/> 264375

2.2.3 Realised Profit

Realised profits are gains that have been converted into cash. In other words, a realised profit or loss occurs when an investment is actually sold for a higher or lower price than where it was purchased.

2.2.4 Unrealised Profit

When the value of your investment increases and you continue to hold onto it, the increased value above the cost is the unrealised profit. It often happens in the case of stocks where investors continue to hold their investments, and the value rises over time.

2.2.4.1 Treatment of Unrealised Profit

If the goods sold at a profit by the subsidiary company to the holding company or by the holding company to the subsidiary company remain unsold at the close of the financial year, the profit charged by the company on unsold goods remains unrealised. In such a case, it is not proper to take income in the Profit and Loss Statement for such unrealised profit. Therefore, a stock reserve is created and profit is reduced by the unrealised profit. Such unrealised profit has to be eliminated from the consolidated balance sheet in the following manner:

- a. The unrealised profit should be deducted from the current

revenue profit of the company which sold the goods.

- b. Again, the same should be deducted from the value of stock-in-trade of the company concerned.

For example, A Ltd. purchased from B Ltd. goods of the value of ₹50000, on which B Ltd. has charged a profit of 25% on cost and goods worth ₹.20000 remained unsold at the end of the financial year. Unrealised profit in this case will be Rs.4000 ($\frac{25}{125} \times 20000$). While preparing a Consolidated Balance Sheet, a Stock Reserve of Rs.4000 will be deducted from stock on the assets side, and the balance of Surplus A/c of the Holding Company will be reduced by ₹ 4000.

Illustration 2.2.2

Following is the balance sheet as on 31st March 2023

	A Ltd	B Ltd
I. (1) Equity and liabilities		
(1) Shareholders' Funds		
(a) Share Capital: Shares of 100 each	500000	200000
(b) Reserves and Surplus:		
General Reserve	100000	-
Surplus A/c	80000	(-)100000
		(Dr Bal)
(2) Non-current Liabilities		
6% Debentures	--	100000
(3) Current Liabilities		
Trade Creditors	75000	45000
Loan from A Ltd.	--	50000
Total Equity and Liabilities	<u>755000</u>	<u>295000</u>
II. Assets		
(1) Non-current Assets		
(a) Fixed Assets	303000	200000
Investment: 6% Debentures in S Ltd. at par	60000	--
1,500 Shares in S Ltd. @80	120000	---
(2) Current Assets		
Stock	90000	40000
Debtors	60000	30000

Bank	75000	25000
Loan to B Ltd.	47000	
Total Assets	755000	295000

A Ltd. acquired the shares on August 1, 2022. Surplus Account of B Ltd. showed a debit balance of ₹ 1,50,000 on April 1, 2022. During June, 2017 goods costing 6,000 were destroyed by fire and insurer paid only 2,000. Trade creditors of B Ltd. include ₹ 20,000 for goods supplied by A Ltd. on which the later company made a profit of ₹ 2,000. Half of the goods were still in stock. The difference in amounts in loan accounts of A Ltd. and B Ltd. is due to interest not yet recorded in the books of H Ltd. Prepare the Consolidated Balance Sheet.

Solution

Working Notes:

Total shares of B Ltd. (2,00,000+100)

Shares of B Ltd. held by A Ltd.

Therefore $\frac{3}{4}$ (i.e., $1,500 / 2,000$) shares of B Ltd. are held by H Ltd. and $\frac{1}{4}$ (ie, $500/2000$) shares are held by non-controlling interest.

1. Calculation of Capital (i.e. Pre-acquisition) Loss

	Amount (₹)	Amount (₹)
Debit balance in Surplus A/c on 1-4-2022		150000
Less capital profits (i.e. pre acquisition profit)		
Accumulated Loss on 1-4-2022	150000	
Less Accumulated Balance of Loss on 31-3-2023	100000	
Profit made during the year ending 31-3-2023	50000	
Add: Loss of stock by fire in June 2023 (6,000-2,000)	4000	
Adjusted Profit in 2022-23	54000	
Profit for pre-acquisition period of 1-4-2022 to 31-7-2023 (4 months) $54,000 \times \frac{4}{12}$	18000	
Less: Loss of stock by fire in June, 2017 (pre-acquisition period)	4000	14000

Capital Loss	136000
Share of A Ltd. in Capital Loss (1,36,000 x $\frac{3}{4}$)	102000
Share of Non-controlling Interest in Capital Loss (1,36,000 x $\frac{1}{4}$)	34000

2. Calculation of Revenue Profit (i.e., Post-acquisition Profit)

	Amount (₹)	Amount (₹)
Total adjusted profit in 2022-23		54000
Revenue profit for 8 months from 1-8-2022 to 31-3-2023 (ie. Post- acquisition Period) 54000 x $\frac{8}{12}$		36000
Share of Revenue Profit of A Ltd. (36000 Share of Revenue Profit of H Ltd). (36000x $\frac{3}{4}$)		27000
Share of Revenue Profit of Non- controlling Interest (36000 x $\frac{1}{4}$)		9000

3. Calculation of Cost of Acquiring Control or Goodwill

	Amount (₹)	Amount (₹)
Cost of acquiring shares in B Ltd.		120000
Less: Face value of 1,500 Shares of 100 each held	150000	
Less: Share in Capital Loss	102000	48000
Goodwill		72000

4. Calculation of Non-controlling Interest

	Amount (₹)	Amount (₹)
Paid up value of 500 shares of 100 each held		50000
Less Share of Capital Loss	34000	
Less: Share of Revenue Profit	9000	25000
Non-controlling Interest		25000

5. Surplus A/c of A Ltd

	Amount (₹)
A Ltd. 's Surplus A/c	80000
Share of Revenue	
Profit in B Ltd.	27000
Interest on Loan	3000
	<hr/>
	110000
Less: Unrealised Profit	1000
	<hr/>
	109000

2.2.5 Treatment of dividend

Dividends may be received out of capital or revenue profits of the subsidiary company. Dividends received by the holding company from the capital profits of the subsidiary company are credited to Investment in Shares of the Subsidiary Account thereby reducing the cost of control or increasing capital reserve. On the other hand, dividends received out of the revenue profits (i.e., post-acquisition profits) are treated as income and credited to the Surplus Account by the holding company. If a dividend is declared partly out of capital profits (i.e., pre-acquisition profits) and partly out of revenue profits (i.e., post-acquisition profits), the dividend received is divided into two parts in proportion to its declaration out of capital profits and revenue profits. The dividend pertaining to the first part (i.e., capital profits) is credited to the Investment Account, reducing the cost of control or increasing the capital reserve and the dividend pertaining to the second part (i.e., revenue profits) is credited to the Surplus Account.

◆ Credited to the investment in shares of subsidiary account

It may be noted that in the absence of information, whether the dividend has been declared out of pre-acquisition or post-acquisition profits, it is assumed that the dividend is out of profits for the year for which the dividend is declared.

If the dividend has simply been proposed by the subsidiary company and appears as 'Proposed Dividend in its Balance Sheet, the holding company's share of such dividend will appear with the Surplus Account balance in the Consolidated Balance Sheet and the share of such dividend belonging to the minority shareholders will be added to the non-controlling interest. The proposed dividend need not be shown in the Consolidated Balance Sheet because it has been added to the non-controlling interest and Surplus Account balance of the holding company.

If the proposed dividend is not given in the Balance Sheet of

the subsidiary company or directors of this company, have not appropriated the profits for the proposed dividend, then the following procedure is followed:

- i. Calculate the cost of control and non-controlling interest etc. in the usual manner without any adjustment for proposed dividend.
- ii. Deduct from non-controlling interest its share of proposed dividend and show the same as a separate item in the Consolidated Balance Sheet.

2.2.5.1 Interim Dividend

◆ Added to revenue profit of subsidiary company

The amount of interim dividend paid by the subsidiary company during the accounting year is to be added to the revenue profits of the subsidiary company before distribution among the holding company and outside shareholders. Afterwards, the holding company's share will be deducted from the profits of the holding company, and the minority share from the non-controlling interest. Interim dividend will not be shown anywhere in the Consolidated Balance Sheet.

Unclaimed dividends appearing in the Balance Sheet of the Subsidiary Company will be added in full to the total non-controlling interest.

Illustration 2.2.3

On April 1 2022 B Ltd issued 10% preference shares of Rs 100000 at par. On this date, B Ltd.'s general reserve and surplus account showed balances of Rs. 80000 and Rs. 40000, respectively. On July 5, 2022, B Ltd paid a final dividend of 12% on equity shares for the year ended 31st March 2022.

On April 1 2022, A Ltd B Ltd acquired 80% equity shares in B Ltd for Rs. 300000 . On this date machinery of B Ltd was revalued at Rs. 250000. No entry for this was made in the books of B Ltd.

On March 31, 2018, Balance Sheets of H Ltd. and its subsidiary S Ltd. stood as follows:

	A Ltd ₹	B Ltd ₹
1. Equity and Liabilities		
(1) Shareholders' Funds		
(a) Share Capital:	800000	300000
Equity Shares of ₹.....		100000

10% Preference Shares of ₹....

(b) Reserves and Surplus:

General Reserve	400000	150000
Surplus Account	200000	80000
2) Current Liabilities		
Loans (Short-term)	110000	----
Creditors	170000	71000
Bills Payable		4000
Unclaimed Dividend		5000
Total Equity and Liabilities	<u>1680000</u>	<u>710000</u>

II. Assets

(1) Non-current Assets

(a) Fixed Assets

Machinery	625000	270000
Furniture	85000	5000
(b) Investment: Shares in S Ltd.	300000	---

(2) Current Assets

Stock	400000	190000
Debtors	150000	80000
Bank	120000	110000
Loan to H Ltd.	---	10000
Total Assets	<u>1680000</u>	<u>710000</u>

Following further information is furnished.

1. B Ltd. provides depreciation on Machinery 10% on written down value. No machine was sold or purchased during the year.
2. A Ltd. made payment by a cheque of 10,000 to B Ltd. on 27th March 2023 for repayment of a loan which was received by B Ltd. in April 2022.

Prepare the Consolidated Balance Sheet of A Ltd. and B Ltd. as of 31st March 2023.

Solution

Consolidated Balance Sheet of A Ltd. and Its Subsidiary B Ltd.

As at 31st March 2023

		Note No	Amount (₹)
1. Equity and Liabilities			
(1) Shareholders' Funds			
Share Capital		A	800000
Reserves and Surplus		B	684000
Total			<u>1484000</u>
(2) Non-controlling Interest	(4)		<u>210000</u>
3) Non-Current Liabilities			
Long-term Borrowings		c	<u>110000</u>
(4) Current Liabilities			
Trade Payables:			
Creditors:			
	A Ltd		170000
	B Ltd		71000
			<u>241000</u>
Bills Payable: B Ltd.			<u>4000</u>
Total Equity and Liabilities			<u>2049000</u>
(1) + (2) + (3) + (4)			<u>2049000</u>
II. Assets			
(1) Fixed Assets			
Tangible Assets		D	985000
Intangible Assets		E	4000
total			<u>989000</u>
(2) Current Assets			
Inventories		F	590000
Trade Receivables		G	230000
Cash and Cash Equivalent		H	240000
Total			<u>1060000</u>
Total Assets (1) + (2)			<u>2049000</u>

Accompanying Notes To The Consolidated Balance Sheet

A. share capital

	Amount (₹)
Authorised Capital	
Issued, Subscribed and Paid-up Capital	
80,000 Equity Shares of 10 (assumed) each fully called up and paid up	800000

B. Reserves and Surplus

	Amount (₹)
General Reserve	400000
Surplus A/c (5)	284000
	684000

C. Long-term Borrowings

	Amount (₹)
Unsecured (assumed) Loans	110000

D. Tangible Assets

	Amount (₹)
Machinery:	625000
A Ltd	270000
B Ltd	895000
Less: Loss on Revaluation	50000
	845000
Add extra depreciation written back	5000
	850000
Furniture	
A Ltd	85000
B Ltd	50000
	135000
	985000

E. Intangible asset

	Amount (₹)
Goodwill (3)	4000

F. Inventories

		Amount (₹)
Stock at cost		
A Ltd	400000	
B Ltd	190000	590000

G. Trade receivables

	Amount (₹)	Amount (₹)
Debtors		
A Ltd	150000	
B Ltd	80000	230000

H. Cash and cash equivalents

	Amount (₹)
Cash at bank : A Ltd Cash and cash equivalents (₹120000+₹110000 B ltd)	230000
Remittance in transit	10000
	<u>240000</u>

Working note

1. Analysis of capital profit

	Amount (₹)	Amount (₹)
Balance of surplus A/c on 1-4-2017	40000	
Less: Dividend @ 12% on ₹300000	36000	
		<u>4000</u>
Add: general reserve balance on 1-4-2022		80000
		<u>84000</u>
Less loss on revaluation of machinery value of machinery on 1-4-2022 ($27000 \times \frac{100}{90}$)	300000	
Less revalued figure	250000	50000
		<u>34000</u>
Less non-controlling interest ($34000 \times \frac{1}{5}$)		6800
Holding companies share		<u>27200</u>

2. Analysis of revenue profit

	Amount (₹)
Profit earned during the year (80000-4000)	76000
Add saving in dep ($50000 \times \frac{10}{100}$)	5000
	<hr/> 81000
Less preference dividend	10000
	<hr/> 71000
Increase in general reserve (150000-80000)	70000
	<hr/> 141000
Less: non- controlling interest ($141000 \times \frac{1}{5}$)	28200
Holding company's share	<hr/> 112800

3. Calculation of Cost of Control or Goodwill

	Amount (₹)	Amount (₹)
Cost of Investment		300000
Less: Paid up Value of Shares	240000	
Share of Capital Profit	27200	
Dividend from pre-acquisition profit (12% on 2,40,000)	28800	
	<hr/>	296000
Goodwill		<hr/> 4000

4. Calculation of Non-controlling Interest

	Amount (₹)	Amount (₹)
Paid-up Value of Equity Shares held:		60000
Add: Share of Capital Profit		6800
Add: Share of Revenue Profit		28200
Add: Paid-up Value of Preference Shares	100000	
Dividend due on Preference Shares	10000	110000
Add: Unclaimed Dividend		<hr/> 5000
		<hr/> 210000

5. Surplus A/c balance of holding co.	200000
Add: share of revenue profit	112800
	<u>312800</u>
Less: dividend wrongly credited to surplus A/c	28800
	<u>284000</u>

2.2.6 Bonus share

◆ Treatment of bonus shares depend upon the source from which that issued

Issue of bonus shares by the subsidiary company will increase the number of shares held by the holding company as well as the minority shareholders. Issue of bonus shares may or may not affect the cost of Control depending upon whether such shares are issued out of capital profits or revenue profits. Treatment of the issue of bonus shares by the subsidiary company will depend upon the source from which bonus shares are issued. Bonus shares may be issued out of pre-acquisition profits or reserves or post-acquisition profits or reserves of the subsidiary company.

2.2.6.1 Treatment of Issue of Bonus Shares out of Pre-acquisition Profits.

◆ No effect on consolidated balance sheet

Issue of bonus shares out of pre-acquisition profits or reserves will have no effect on the Consolidated Balance Sheet. It is so because the holding company's share in pre-acquisition profits is reduced on account of the issue of bonus shares, and on the other hand, the paid-up value of shares held by the holding company increases. Therefore, the cost of control or goodwill will remain the same as it was before the issue of bonus shares.

Illustration 2.2.4

X Ltd. acquired 8,000 shares of 100 each in Y Ltd. on 30th September 2012. Balance Sheets of the two companies as on 31st March, 2023 were as follows:

	A Ltd. Amount (₹)	B Ltd. Amount (₹)
I. Equity and Liabilities		
(1) Shareholders' Funds		
(a) Share Capital:		
30,000 Shares of ₹ 100 each	3000000	50000
10,000 Shares of 100 each		1000000
(b) Reserves and Surplus:		
Capital Reserve		550000
General Reserve	300000	50000



Surplus Account	382000	180000
(2) Current Liabilities		
Creditors	179000	70000
Bills Payable (including 5,000 to X Ltd.)	--	17000
Loan from Y Ltd.	21000	--
Note: On the Balance Sheet of A Ltd., there is a contingent liability for bills discounted of? 6,000)		
Total Equity and Liabilities	3882000	1867000

II. Assets

Non-current Assets		
Fixed Assets:	1500000	1447000
Investment in B Ltd. at Cost	1700000	---
(2) Current Assets		
Stock in hand	400000	200000
Debtors	250000	180000
Bills Receivable (including 5,000 from B Ltd.)	12000	----
Cash and Bank Balance	20000	20000
Loan to X Ltd.	--	20000
Total Assets	3882000	1867000

You are given the following information:

1. Y Ltd. made a bonus issue on 31st March, 2022 of one share for every two shares held, reducing the Capital Reserve equivalently but the accounting effect to this has not been given in the above Balance Sheet.
2. Interest receivable for the year (1,000) in respect of the loan due by X Ltd. to Y Ltd. has not been credited in the books of Y Ltd.
3. The credit balance in Surplus Account of Y Ltd. as on 1-4-2022 was 21,000.
4. The directors decided on the date of the acquisition that the fixed assets of Y Ltd. were overvalued and should be written down by 50,000. Consequential adjustments on depreciation is to be ignored.

Prepare Consolidated Balance Sheet as at 31st March, 2022 showing your work

Solution

Consolidated Balance Sheet of A Ltd. And Its Subsidiary B Ltd. at 31st March, 2023

	Note NO	Amount (₹)
1. Equity and Liabilities		
(1) Shareholders' Funds		
Share Capital	A	3000000
Reserves and Surplus	B	746000
Total		3746000
(2) Non-controlling Interest [See Working Note (4)]		346200
(3) Current Liabilities		
Trade Payables:		
Bills Payable		170000
Less: Mutual Owing		5000
		12000
Creditors: A Ltd		179000
B Ltd		70000
		249000
Total Equity and Liabilities (1) + (2) + (3)		4353200

II. Assets

(1) Fixed Assets

Tangible Assets

Intangible Assets

Total

(2) Current Assets

Inventories

Trade Receivables

Cash and Cash Equivalents

Total

Total Assets (1) + (2)

Contingent Liabilities and Commitments

C	2897000
D	379200
	3276200
E	600000
F	437000
G	40000
	1077000
	4353200
H	6000

Accompanying Notes to the Consolidated Balance Sheet

A. Share capital

	Amount (₹)
Authorised capital	
Issued, subscribed and paid-up capital	
30000 equity shares of 100 each fully paid up	3000000

B. Reserves and Surplus

	Amount (₹)
General Reserve	300000
Balance in Surplus A/c (H Ltd.)	382000
Add: Share of Revenue Profit of B Ltd.	64000
₹ 80,000 (2) x $\frac{4}{5}$	446000
	746000

C. Tangible Assets

	Amount (₹)
Fixed Assets:	1500000
X Ltd	1397000
Y td	2897000

D. Intangible Assets

	Amount (₹)
Goodwill (3)	379200

E. Inventories

	Amount (₹)
Stock at Cost:	
X Ltd	400000
Y Ltd	200000
	600000

F. Trade Receivables

	Amount (₹)
Debtors:	
X Ltd.	250000
Y Ltd.	180000
Bills Receivable	12000
	430000

Less: Mutual Debt	5000	7000
		<u>437000</u>

G. Cash and Cash Equivalents

	Amount (₹)
Cash & Bank Balance:	
X Ltd.	20000
Y Ltd.	20000
	<u>40000</u>

H. Contingent Liabilities and Commitments

	Amount (₹)
Contingent Liability for Bills Discounted	<u>6000</u>

Working Notes:

- After taking into consideration interest receivables on the loan to X Ltd ₹1000, the surplus A/c balance of Y Ltd is ₹ 181000 (ie 180000 as reported + ₹1000) and Loan to X Ltd becomes 21000 (₹20000 as given + ₹1000 interest receivable)

(2) Analysis of Reserve and Profit of B Ltd.	Capital Profit	Revenue Profit
Capital Reserve of Y Ltd.	550000	
Less: Utilised for bonus shares (Issue of 5,000 bonus shares of 100 each 1 bonus share for every 2 shares)	500000	
	50000	
Add General Reserve	50000	
	100000	
Surplus A/c		
Balance as on 1-4-2022	21000	
Profit during the year (1,81,000-21,000) (1,60,000 divided equally between pre-acquisition period and post acquisition period because pre-acquisition period 1-4-2022 to 30-9-2022 and post-acquisition period 1-10-2022 to 31-3-2023 are of equal duration)	80000	80000
	<u>201000</u>	<u>80000</u>



Less Loss on fixed assets	50000
	<u>151000</u>

(3) Calculation of Goodwill/Capital Reserve	Amount (₹)
Cost of acquiring 8,000 shares of Y Ltd.	1700000
Less: Face value of 8,000 shares of 100 each	800000
Face value of 4,000 bonus shares of 100 each	400000
Share of capital profit ($\frac{4}{5} \times 151000$)	120800
Goodwill	<u>1320800</u>

(4) Calculation of Non-controlling Interest	Amount (₹)
Face value of 2,000 shares of 100 each	200000
Add Face value of 1,000 bonus shares of 100 each	100000
1/5 Share of revenue profit($\frac{1}{5} \times 151000$)	30200
1/5 Share of capital profit($\frac{1}{5} \times 80000$)	16000
	<u>346200</u>

2.2.6.2 Treatment of Bonus Shares out of Post-acquisition Profits.

- ◆ Revenue profit will be decreased
- ◆ Paid up value of shares will increase

Issue of bonus shares out of the post-acquisition profits will have an effect on the Consolidated Balance Sheet in that share of the holding company's revenue profit earned after the date of purchase of shares will be reduced, and the paid-up value of shares held by the holding company will increase because of issue of bonus shares. Increased paid-up value of shares held will reduce the cost of control or increase the capital profits.

2.2.7 Accounting Standard 21 (AS 21)

Accounting Standard 21 (AS 21) governs the preparation and presentation of Consolidated Financial Statements (CFS) in India. It applies when a company (holding company) owns more than 50% of the voting power in another company (subsidiary), thereby exercising control over its financial and operating policies. The primary objective of AS 21 is to ensure that financial statements reflect the true financial position and performance of a corporate group as a single economic entity rather than as

- ◆ To reflect the true financial position as a single entity
- ◆ Consideration for minority interest
- ◆ Treatment of good will or capital reserve

separate legal entities. AS 21 mandates that consolidation is required when a parent company has control over a subsidiary, except when control is temporary or when the subsidiary operates under severe long-term restrictions. The consolidation process involves combining the assets, liabilities, income, and expenses of the holding and subsidiary companies while eliminating inter-company transactions to avoid double counting. The consolidated balance sheet also accounts for minority interest, which represents the portion of a subsidiary's net assets and profits not owned by the holding company. Another key aspect is the treatment of goodwill or capital reserve, which arises when the acquisition price differs from the subsidiary's net assets.

- ◆ Eliminating inter co.transactions

AS 21 also specifies disclosure requirements to enhance transparency and comparability. It requires holding companies to clearly disclose the basis of consolidation, the treatment of unrealized profits, inter-company balances, and contingent liabilities. Furthermore, it mandates that dividends from subsidiaries to the holding company be eliminated in consolidation, as they are considered an internal transfer. The standard ensures that financial statements reflect a true and fair view of the entire group's financial position, providing better insights for investors and stakeholders. The adoption of AS 21 aligns Indian accounting practices with global reporting standards, promoting fair representation, financial clarity, and informed decision-making in the corporate sector. By eliminating inter-company transactions and ensuring a uniform financial presentation, AS 21 helps create more reliable and comprehensive financial reports for business evaluation and analysis.

- ◆ Revaluation of assets and liabilities

The revaluation of assets and liabilities is crucial during consolidation to reflect the fair value of a subsidiary's assets and liabilities at the acquisition date. Any increase is recorded as a revaluation reserve, while a decrease is adjusted against reserves or profits. Unrealized profit arises from inter-company transactions when goods or assets remain unsold at year-end. Such profits must be eliminated in consolidation to prevent overstating group earnings. The treatment of dividends depends on their timing—pre-acquisition dividends are deducted from the investment account, whereas post-acquisition dividends are treated as income but eliminated in consolidation to avoid duplication. The issue of bonus shares by a subsidiary increases its share capital by capitalizing reserves but does not change the ownership percentage of the holding company or impact the group's net assets. Contingent liabilities, such as pending legal claims and guarantees, are not recorded in the balance sheet but disclosed in the notes to financial statements to inform stakeholders about potential financial risks. The preparation of a consolidated bal-

ance sheet involves combining the assets, liabilities, income, and expenses of the holding and subsidiary company while eliminating inter-company transactions and unrealized profits. Minority interest, representing the portion of net assets not owned by the holding company, is separately disclosed in shareholders' equity. Accounting Standard 21 (AS 21) governs consolidated financial statements (CFS) in India, requiring their preparation when a company owns more than 50% voting rights in a subsidiary. This ensures accurate reporting of the group's financial position by eliminating inter-company adjustments and providing a transparent view of overall financial health. Adhering to AS 21 ensures reliability in financial reporting, aiding investors and stakeholders in decision-making.

Summarised Overview

The revaluation of assets and liabilities is an essential step in the consolidation process, ensuring that the subsidiary's assets and liabilities are recorded at their fair value at the time of acquisition. If the fair value is higher than the book value, a revaluation reserve is created; if lower, the difference is adjusted against reserves. This ensures that the goodwill or capital reserve is accurately determined in the consolidated balance sheet. Unrealized profit arises from inter-company transactions, such as when a holding company sells goods to a subsidiary or vice versa, and these goods remain unsold at year-end. Since these transactions do not generate profits for the group as a whole, the unrealized profits must be eliminated to avoid overstating group profits. The treatment of dividends in consolidation depends on whether the dividend is pre-acquisition or post-acquisition. Pre-acquisition dividends (declared from profits before acquisition) are adjusted against the investment cost, while post-acquisition dividends (declared from profits after acquisition) are considered income for the holding company but eliminated in consolidation, as they represent an internal transfer within the group. The issue of bonus shares occurs when a subsidiary converts its reserves into share capital. Since it does not impact the group's overall net assets, the holding company's proportionate ownership remains unchanged. However, the reserves of the subsidiary decrease, and its share capital increases accordingly. Contingent liabilities refer to potential obligations that may arise in the future, such as pending legal claims or guarantees. These liabilities are not recorded in the balance sheet but are disclosed in the notes to financial statements to inform stakeholders about potential risks. The preparation of a consolidated balance sheet involves combining the assets, liabilities, and equity of the holding and subsidiary companies while eliminating inter-company balances, unrealized profits, and internal transactions. Minority interest, representing the share of net assets not owned by the holding company, is presented separately under shareholders' equity. Accounting Standard 21 (AS 21) provides guidelines for preparing consolidated financial statements (CFS) in India. It mandates consolidation when a company holds more than 50% of voting rights in another company. AS 21 ensures transparency, comparability, and accurate representation of financial data by eliminating internal transactions and providing a true picture of the financial position of the entire corporate group.

Self-Assessment Question

1. Why is revaluation of assets and liabilities necessary during consolidation?
2. What is meant by unrealized profit in holding and subsidiary company accounts?
3. How is unrealized profit treated in consolidated financial statements?
4. What is the difference between pre-acquisition and post-acquisition dividends?
5. Why are inter-company dividends eliminated in consolidated financial statements?
6. How does the issue of bonus shares by a subsidiary impact the consolidated balance sheet?
7. Where are contingent liabilities recorded in the consolidated financial statements?
8. How is minority interest presented in the consolidated balance sheet?
9. What are the key steps in the preparation of a consolidated balance sheet?
10. What is the main objective of Accounting Standard 21 (AS 21) in financial reporting?

Assignments

1. Explain the significance of revaluation of assets and liabilities in consolidated accounts.
2. Discuss the concept of unrealized profit and how it is treated in consolidated financial statements.
3. Analyze the impact of inter-company transactions on the accuracy of consolidated financial reports.
4. Explain the accounting treatment of pre-acquisition and post-acquisition dividends in consolidation.
5. Discuss the effects of the issue of bonus shares on the financial position of the group.
6. Explain the importance of disclosing contingent liabilities in financial statements.

Suggested Reading

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Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

SGOU



03 BLOCK

Liquidation Of Companies

Block Content

Unit - 1	Liquidation
Unit - 2	Preparation of Statement of Affairs
Unit - 3	Insolvency and Bankruptcy code 2016

Unit 1

Liquidation

Learning Outcomes

After completing this unit, the learner will be able to:

- ◆ gain knowledge of liquidation, its meaning, and its significance in corporate insolvency
- ◆ analyse various modes of liquidation
- ◆ examine Contributories, and their role in settling outstanding liabilities during liquidation

Background

Liquidation is the process of winding up a company's operations, settling its liabilities, and distributing the remaining assets among creditors and shareholders. This process is undertaken when a company is unable to continue its business due to financial difficulties, insolvency, or legal orders. Liquidation ensures that a company's obligations are properly settled before it ceases to exist as a legal entity. The importance of liquidation lies in its role in protecting the interests of creditors, shareholders, and other stakeholders. It helps ensure the fair distribution of a company's assets and prevents financial mismanagement. Moreover, liquidation plays a crucial role in corporate governance by providing a structured exit strategy for companies that can no longer operate efficiently. There are various modes of liquidation, including voluntary liquidation (initiated by the company itself), compulsory liquidation (ordered by a court), and creditors' voluntary liquidation (where creditors take control due to insolvency). Each mode follows a different legal process but ultimately leads to the dissolution of the company.

Keywords

liquidation, contributories, clean exit, investor confidence, Voluntary liquidation, Compulsory liquidation, Liquidation under insolvency laws

3.1.1 Introduction

Liquidation is the process of winding up a company's affairs, realizing its assets, and distributing the proceeds to its creditors and shareholders. It marks the end of a company's existence and is a complex legal process governed by laws. Companies may face liquidation due to various reasons, including insolvency, business failure, or voluntary exit. There are two main types of liquidation: compulsory liquidation and voluntary liquidation. The liquidation process typically involves the appointment of a liquidator, asset realization, creditor claims, distribution of proceeds, and dissolution. The liquidator plays a crucial role in the liquidation process, ensuring compliance with legal requirements, maximizing asset realization, and fairly distributing proceeds to creditors.

3.1.2 Meaning of Liquidation

Liquidation or winding up is a legal term and refers to the procedure through which the affairs of a company are wound up by law. Winding up of a company has been defined in the Companies Act, 2013 as "the process whereby its life is ended and its property is administered for the benefit of its creditors and members. An Administrator, called a Liquidator, is appointed and he takes control of the Company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights."

A company being a creation of law, cannot die a natural death. It comes to an end by law through the process of liquidation or winding up. Even a solvent company may be wound up. After winding up, a company is "Dissolved formally and will not have any assets or liabilities" The legal personality of the company shall come to an end. When a company is unable to pay its debts, its liquidation will be under the newly passed "Insolvency and Bankruptcy Code 2016". The code relates to insolvency, liquidation, voluntary liquidation or bankruptcy.

The process of winding up a company is that a liquidator is appointed who is entrusted with the following duties:

- a. Selling of the company's assets.
- b. Paying off its liabilities.
- c. If there is any deficiency to pay to the creditors, the share-

holders (now called contributories) are called upon to pay the unpaid amount on their shares.

- d. If there is any surplus after clearing off the liabilities, it may be distributed to the contributories according to their rights under the articles.
- e. After going through the above process, the Registrar of Companies removes the name of the company from the Register of Companies maintained by his office.

Liquidation of a company can take place under both cases, namely, when the company is insolvent and when the company is not insolvent.

3.1.2.1 Difference between Insolvency and Liquidation

1. The term 'insolvency' is applicable to individuals, partnership firms and Hindu undivided families, whereas the term 'liquidation' is applicable to a joint stock company. However, it may be mentioned that the insolvency of a company is not a necessary condition for its liquidation, whereas an individual or a partnership firm or Hindu undivided family is said to be insolvent when liabilities exceed assets or has committed an act of insolvency. A solvent company can also be liquidated as we will see in the course of discussion.
2. Insolvency is governed by the Insolvency Act but liquidation is governed by the Companies Act.

3.1.3 Importance of Liquidation

Liquidation, while marking the end of a company's existence, plays a crucial role in the economic ecosystem. Here are some of its key importance:

► Protecting Creditor Interests

Liquidation ensures a fair and orderly distribution of a company's remaining assets to its creditors. It provides a structured process for creditors to recover outstanding debts, maximizing their chances of recouping at least a portion of what they are owed.

► Facilitating Market Efficiency

Liquidation allows for the removal of non-viable businesses from the market. This frees up resources, such as capital and labour, which can be reallocated to more productive and efficient enterprises. This contributes to a healthier and more dynamic economy.



► Promoting Financial Discipline

The possibility of liquidation serves as a deterrent for companies to engage in irresponsible financial practices. It encourages businesses to maintain sound financial management, avoid excessive risk-taking, and honour their contractual obligations.

► Providing a Clean Exit

Liquidation offers a formal and legally recognized process for closing down a company's operations. This provides clarity and certainty for all stakeholders, including creditors, shareholders, employees, and customers. It also limits potential liabilities for directors and shareholders, provided they have acted in accordance with the law.

► Enhancing Investor Confidence

A robust liquidation framework assures investors that their investments are protected, even in the event of a company's failure. This encourages investment and promotes economic growth.

► Facilitating Restructuring

In some cases, liquidation can be a precursor to restructuring. By clearing the debts and liabilities of an old company, it can pave the way for a new, more viable entity to emerge from its ashes, preserving jobs and economic activity.

► Enforcing Corporate Governance

Liquidation can serve as a mechanism to address corporate misconduct or mismanagement. By investigating the reasons for a company's failure, liquidators can uncover potential wrongdoings and hold directors or officers accountable for their actions.

While liquidation is undoubtedly a difficult process for all involved, it is an essential part of a healthy market economy. It provides a mechanism for dealing with business failure, protecting stakeholder interests, and promoting financial discipline.

3.1.4 Modes of Liquidation

Liquidation means closing a company and selling its assets to pay debts. After paying debts, any remaining money is given to shareholders. There are different ways a company can be liquidated. The process depends on whether the company is closing by choice or by force. The main types of liquidation are:

- ▶ Voluntary liquidation
- ▶ Compulsory liquidation
- ▶ Liquidation under insolvency laws.

3.1.4.1 Voluntary Liquidation

Voluntary liquidation is the process of closing a company by choice, rather than being forced by a court. It happens when a company's owners or creditors decide to wind up operations, sell assets, and settle debts. This process allows for an orderly closure and ensures that liabilities are handled properly. Voluntary liquidation can be of two types:

- ▶ Members' Voluntary Liquidation (MVL)
- ▶ Creditors' Voluntary Liquidation (CVL)

3.1.4.1.1 Members' Voluntary Liquidation (MVL)

MVL occurs when a company is financially solvent but chooses to close for strategic reasons. The directors must sign a declaration of solvency, confirming that the company can pay all its debts within a specified period, usually 12 months. After this, shareholders pass a resolution for liquidation, and a liquidator is appointed to handle asset distribution. Once all liabilities are settled, the remaining funds are given to shareholders, and the company is officially dissolved.

3.1.4.1.2 Creditors' Voluntary Liquidation (CVL)

CVL takes place when a company is insolvent and cannot pay its debts. Instead of waiting for creditors to take legal action, the company voluntarily decides to close. The shareholders approve the liquidation, and a meeting is held with creditors. A liquidator is appointed to sell the company's assets and distribute the proceeds to creditors in order of priority. Once debts are settled, the company is formally shut down.

Voluntary liquidation is a structured way for companies to close down operations. MVL is used by companies that can pay off their debts, while CVL is for those facing financial difficulties. This process helps businesses exit legally while ensuring fair treatment of creditors and stakeholders.

3.1.4.2 Compulsory Liquidation

Compulsory liquidation is a legal process where a company is forced to close by a court order. This happens when the company is unable to pay its debts, violates laws, or operates against public interest. The process ensures that the company's assets are sold,

and the money is used to repay creditors as per legal priority. In India, compulsory liquidation is governed by the Companies Act of 2013 and the Insolvency and Bankruptcy Code (IBC), 2016.

3.1.4.2.1 Reasons for Compulsory Liquidation

A company may be ordered to undergo compulsory liquidation due to the following reasons:

► Inability to Pay Debts

If a company fails to pay its creditors despite repeated demands, creditors can file a petition in the National Company Law Tribunal (NCLT) to initiate liquidation.

► Court Order for Misconduct

If a company is involved in fraud, mismanagement, or illegal activities, the court can order its closure.

► Failure to Follow Legal Requirements

Companies that do not file financial statements, pay taxes, or follow statutory compliance may face liquidation.

► Public Interest Concerns

If a company's operations harm the public, the government can request liquidation through the NCLT.

3.1.4.2.2 Process of Compulsory Liquidation

The process of compulsory liquidation involves the following steps:

1. **Filing a Petition** : A creditor, shareholder, government agency, or regulatory authority files a petition with the NCLT to liquidate the company.
2. **Court Hearing** : The tribunal reviews the case and allows the company to present its defense. If the company fails to justify its financial position, the court orders liquidation.
3. **Appointment of Liquidator** : The court appoints an official liquidator who takes control of the company's assets, records, and financial affairs.
4. **Asset Sale and Debt Settlement** : The liquidator sells the company's assets and distributes the proceeds based on the waterfall mechanism, which gives priority to secured creditors, followed by unsecured creditors, em-

ployees, and finally, shareholders.

- 5. Company Dissolution** : After all assets are liquidated and debts are settled, the company is removed from the official corporate registry and ceases to exist.

Compulsory liquidation is a legal measure to close financially distressed or non-compliant companies. While it protects creditors' rights, it also has serious consequences for employees, directors, and shareholders. Understanding this process helps businesses and financial professionals handle corporate insolvency more effectively.

3.1.5 Procedure of Liquidation

The liquidation procedure, whether voluntary or compulsory, follows a general sequence of steps, though specific details may vary depending on the jurisdiction and the mode of liquidation.

3.1.5.1 Initiation

Voluntary Liquidation

Initiated by the company's members (MVL) or directors with creditor consent (CVL) through resolutions and declarations.

Compulsory Liquidation

Started by a creditor petitioning the court (or NCLT in India) due to unpaid debts. The court issues a winding-up order.

3.1.5.2 Appointment of Liquidator

A licensed insolvency professional or official receiver is appointed as the liquidator. Their role is crucial in managing the entire process.

3.1.5.3 Taking Control of Assets

The liquidator takes possession and control of all company assets, including tangible property, receivables, and intangible assets.

3.1.5.4 Asset Realization

The liquidator sells the company's assets to generate cash. This can be done through auctions, private sales, or other methods.

3.1.5.5 Investigation (if applicable)

In cases of insolvency, the liquidator investigates the compa-

ny's financial affairs, the causes of insolvency, and the conduct of directors. This may involve examining records and interviewing stakeholders.

3.1.5.6 Creditor Claims

Creditors are notified of the liquidation and invited to submit their claims with supporting documentation.

3.1.5.7 Verification and Priority of Claims

The liquidator verifies the creditor claims and determines their priority based on legal provisions. Secured creditors have priority, followed by preferential creditors (e.g., employee dues, taxes), and then unsecured creditors.

3.1.5.8 Distribution of Proceeds

The liquidator distributes the realized funds to creditors according to the established priority. If any surplus remains after paying all creditors, it is distributed to shareholders.

3.1.5.9 Finalization and Dissolution

Once all assets are realized and distributions are made, the liquidator prepares a final report. In voluntary liquidation, final meetings are held. In compulsory liquidation, the liquidator applies to the court for dissolution. Upon dissolution, the company ceases to legally exist.

3.1.5.10 Post-Liquidation

Certain records may need to be retained as per legal requirements. There may be further investigations if any misconduct is suspected.

3.1.6 Contributory

A contributory is "every person liable to contribute to the assets of a company in the event of its being wound up". A contributory can be either a present member or past member. According to the Companies Act a contributory is "every person liable to contribute to the assets of a company in event of its being wound up, and includes a holder of fully paid-up shares and also any person alleged to be contributory". In the event of liquidation of a company, the liquidator prepares two lists of contributories

List A

This list consists of those persons who are members of the

company on the date of the winding up. In simple, List 'A' contributories is the list of the present members of the company. They are liable to contribute the amount remaining unpaid on the shares held by them if the amount is needed to make payment to legal claimants. The holders of fully paid-up shares are also treated as contributories even though they are not required to contribute anything to the company. This is necessary because in such a case, the court will know, not only those who will contribute but also who will share the surplus, if any.

List B

This list consists of those persons who were members of the company during the 12 months preceding the date of winding up. In case the assets of the company are not sufficient to pay the liabilities of the company in the event of company's winding up liquidator can ask List 'B' contributories to contribute towards the assets of the company, subject to certain conditions. However their liability is restricted to the amount not called up when the shares were transferred.

Summarised Overview

Liquidation is the process of legally winding up a company by selling its assets, settling liabilities, and distributing any remaining funds to shareholders before dissolution. It is necessary when a company becomes insolvent, unable to meet its financial obligations, or when stakeholders decide to cease operations. The importance of liquidation lies in ensuring a structured closure, protecting creditors' rights, and preventing financial mismanagement. There are three modes of liquidation: voluntary liquidation, initiated by shareholders; compulsory liquidation, ordered by a court due to insolvency or legal violations; and creditors' voluntary liquidation, where creditors take control when the company cannot pay its debts. The liquidation procedure involves appointing a liquidator, realizing assets, paying debts in order of priority, and distributing any surplus to shareholders. The process also includes compliance with legal and regulatory requirements before the company is formally dissolved. During liquidation, contributories are responsible for settling unpaid share capital and are classified into List A and List B contributories. List A contributories include current shareholders liable to pay any unpaid amount on their shares, while List B contributories consist of past shareholders who were members within a certain period before liquidation and may be liable if the company fails to meet its obligations. Understanding the concept of liquidation is essential for ensuring fair and systematic corporate dissolution, maintaining transparency in financial settlements, and protecting the interests of all stakeholders involved.

Self-Assessment Question

1. What is the meaning of liquidation, and why is it necessary for companies?
2. What are the main modes of liquidation? Briefly describe each.
3. How does voluntary liquidation differ from compulsory liquidation?
4. What are the key steps involved in the liquidation procedure?
5. What is the role of a liquidator in the liquidation process?
6. Who are contributories in the context of liquidation?
7. What is the difference between List A and List B contributories?
8. How are the liabilities of contributories determined during liquidation?
9. What happens to a company's assets and liabilities after liquidation is completed?

Assignments

1. Explain how liquidation ensures fair settlement of liabilities, protects stakeholders, and maintains financial transparency.
2. Compare voluntary liquidation, compulsory liquidation, and creditors' voluntary liquidation with examples.
3. Explain the responsibilities, powers, and duties of a liquidator in corporate liquidation.
4. Analyze a real-life example of a company that underwent liquidation, highlighting the reasons and outcomes.
5. Explain the relevant laws and regulations, including the Companies Act and Insolvency and Bankruptcy Code (IBC).

Suggested Reading

1. Lela, R. K., & Jawaharlal. (1997). *Accounting theory*. Himalaya Publishing House.
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4. Shukla, M. C., & Grewal, T. S. (2020). *Advanced accounts*. S. Chand & Co. Ltd.
5. Paul, S. K. (2009). *Accountancy* (Vols. I & II). New Central Book Agency.

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1. Anthony, R. N., & Reece, J. S. (2018). *Accounting principles*. Richard Irwin, Inc.
2. Jain, S. P., & Narang, K. L. (2021). *Advanced accountancy*. Kalyani Publishers.
3. Maheshwari, S. N., Maheshwari, Suneel K & Maheshwari, Sharad K (2018). *Corporate accounting*. Vikas Publishing House Private Limited.
4. Portal, L. S. (2007). *Accounting theory*. Tata McGraw-Hill.
5. Sehgal, A., & Sehgal, D. (2008). *Advanced accounting*. Taxmann.

Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.



SGOU

Unit 2

Preparation of statement of affairs

Learning Outcomes

After completing this unit, the learner will be able to:

- ◆ recognize the significance of preferential payments
- ◆ interpret deficiency and surplus accounts
- ◆ discuss liquidator's final statement of accounts
- ◆ analyze the liquidator's role and remuneration
- ◆ understand the limitations of conventional financial statements

Background

The process of liquidation involves settling a company's financial obligations by paying off liabilities, distributing remaining assets, and dissolving the entity. The order of payment of liabilities is crucial, as it determines the priority in which creditors and stakeholders are paid. Preferential payments refer to specific liabilities, such as employees' wages, government dues, and secured creditors, which must be settled before other claims. If a company lacks sufficient assets to cover its liabilities, a deficiency account is prepared to show the shortfall, whereas a surplus account is used if there are excess funds available after settling debts. The liquidator's final statement of accounts is a comprehensive record summarizing all receipts, payments, asset realizations, and distributions made during the liquidation process. The liquidator's remuneration is an essential aspect, as it is based on the realization and distribution of assets, and it must be determined as per legal and contractual agreements. While financial statements provide valuable information about a company's financial position, conventional financial statements have limitations in the context of liquidation, as they do not adequately reflect the company's ability to meet obligations in a liquidation scenario. They are based on the going concern principle and may not show the actual realizable value of assets. Understanding these concepts is essential for businesses, investors, creditors, and regulatory authorities to ensure a structured and transparent liquidation process that safeguards the interests of all stakeholders involved.

Keywords

preferential payments, deficiency account, surplus account

Discussion

3.2.1 Statement of Affairs (SOA)

During the liquidation of a limited company, the SOA is presented during the creditor's meeting. It provides an estimation of the funds which the liquidator believes will be realisable from the sale of company assets which helps creditors determine whether they are likely to receive a dividend from the liquidation. For the preparation of the statement of affairs, the following points are to be followed.

- ▶ First of all, take all assets which are not specifically pledged. These assets are taken at their realisable value
- ▶ Add any surplus from assets specifically pledged
- ▶ From the total obtained (1+2) above deduct the amount of preferential creditors, then the amount of creditors having a floating charge (eg. Debentures) and the result will be surplus or deficiency as regards debenture holders.
- ▶ Deduct the amount of unsecured creditors from the figure obtained in (3) above; the result will be either surplus or deficiency as regards unsecured creditors.
- ▶ Deduct the amount of paid-up share capital to the figure as obtained in (4) above; the result will be either surplus or deficiency as regards members or contributories.
- ▶ Any unrecorded assets or liability should be shown both in the statement of Affairs and the Deficiency or surplus account to make the double entry complete.

3.2.2 Order of Payment of Liabilities in Liquidation

After receiving the amounts realised on assets, surplus from fully secured creditors and by making calls from the unpaid

amount on the shares held by the shareholders, the liabilities are paid out by the Liquidator in the following order. The liquidation of a company, whether voluntary or compulsory, involves a structured distribution of its assets to various stakeholders. This distribution follows a strict legal hierarchy, ensuring a fair and orderly process.

3.2.2.1 Secured Creditors

Secured creditors occupy the highest priority in the distribution process. They hold a charge or mortgage over specific assets of the company, providing them with a direct claim on those assets. Upon realization of the secured asset, the secured creditor is paid directly from the proceeds of that specific asset's sale. If the sale of the secured asset generates less than the total debt owed to the secured creditor, the remaining amount becomes an unsecured claim, ranking alongside other unsecured debts. Conversely, if the sale exceeds the debt, the surplus goes into the general pool of assets for distribution to other claimants.

3.2.2.2 Liquidation / legal Expenses

These expenses are the direct costs incurred during the liquidation process itself. They are essential for the liquidation to proceed and are therefore paid immediately after secured creditors are satisfied.

Liquidation expenses typically include

► Liquidator's fees and expenses

Remuneration for the liquidator's services, including their time, expertise, and any expenses incurred during the process.

► Legal and professional fees

Costs associated with legal advice, accounting services, and other professional assistance required for the liquidation.

► Valuation fees

Expenses for valuing the company's assets to facilitate their sale.

► Other administrative costs

Expenses related to managing the liquidation process, such as advertising costs for asset sales, postage, and stationery.

3.2.2.3 Payment to Preferential Creditors

Certain unsecured creditors are granted preferential treatment by law due to their specific circumstances. These preferential creditors are paid before other unsecured creditors and after secured creditors and liquidation expenses.

Common categories of preferential creditors include:

- ◆ Employee dues: Outstanding wages, salaries, and other employee benefits, often up to a specified limit. Employee claims are prioritized due to their vulnerability in insolvency situations and the need to protect their livelihoods.
- ◆ Government dues: Unpaid taxes, duties, and other dues owed to the government. The government's claim is prioritized due to its role in providing essential services and its interest in collecting revenue.
- ◆ Certain statutory dues: Other specific dues prescribed by law, which may vary depending on the jurisdiction. These could include contributions to social security schemes or other statutory funds.

3.2.2.4 Unsecured Creditors

Unsecured creditors are those who do not hold any security over the company's assets. They include trade creditors, unsecured lenders, and the unsecured portion of debts owed to secured creditors. Unsecured creditors are paid proportionally, based on the amount of their respective claims, after secured, liquidation expenses, and preferential creditors are paid. In many insolvency scenarios, unsecured creditors receive only a fraction of what they are owed, or nothing at all, if the company's assets are insufficient.

3.2.2.5 Deferred Creditors

Certain debts, such as those owed to directors, related parties, or connected persons, are often classified as deferred creditors. These claims rank below unsecured creditors and are typically paid only if any funds remain after satisfying all other higher-priority claims. This subordination reflects the potential for conflicts of interest and the need to protect the interests of arm's-length creditors.

3.2.2.6 Shareholders

Shareholders are the residual owners of the company. Their claims are subordinate to all other creditors, including deferred

creditors. Shareholders receive any remaining funds only after all creditors have been paid in full. In most insolvency scenarios, especially in compulsory liquidation, shareholders receive little to nothing, as the company's assets are typically insufficient to cover all liabilities.

The order of payment in liquidation is a critical aspect of insolvency law. It establishes a clear hierarchy for distributing assets, protecting the interests of different stakeholders. Understanding this hierarchy is crucial for creditors to assess their potential recovery, for shareholders to understand the risks of equity ownership, and for anyone involved in insolvency proceedings. The specific rules governing this order can vary by jurisdiction, so professional legal advice is always recommended.

3.2.3 Preferential Payments on Liquidation of Companies

Preferential payments refer to specific debts that are given priority over unsecured creditors but may still rank below secured creditors. The concept of preferential payments is crucial in insolvency law as it ensures fairness in the distribution of a company's remaining assets.

Preferential payments are debts that receive priority during the liquidation process. These payments are mandated by insolvency laws to protect certain stakeholders, such as employees and government authorities, ensuring that they are compensated before general unsecured creditors.

3.2.3.1 Legal Framework for Preferential Payments

The specific rules governing preferential payments vary by jurisdiction, but they are generally outlined in a country's insolvency or bankruptcy laws. In many legal systems, preferential payments are categorized into different classes, typically including:

1. Employee Wages and Benefits

Most jurisdictions prioritize unpaid wages, salaries, and certain employee benefits, ensuring that employees receive compensation before other unsecured creditors. The law may specify a maximum amount that qualifies as preferential.

2. Taxes and Government Dues

Taxes owed to the government are commonly classified as preferential debts.

3. Contributions to Pension Funds

Many legal systems ensure that outstanding contributions to employee pension or retirement funds are given priority.

4. Compensation and Insurance Payments

Some jurisdictions prioritize unpaid compensation related to workplace injuries or insurance benefits owed by the company to its employees.

3.2.3.2 Challenges in Preferential Payments

While preferential payments protect certain stakeholders, challenges may arise, including:

- ▶ **Limited Assets:** In cases where the company's assets are insufficient, even preferential creditors may receive partial or no payment.
- ▶ **Disputes Over Priority:** There may be conflicts over which claims qualify as preferential, requiring legal interpretation.
- ▶ **Impact on Unsecured Creditors:** Since preferential payments take precedence, unsecured creditors often receive minimal or no repayment.

Preferential payments in company liquidation ensure that certain creditors, such as employees and tax authorities, receive priority over general unsecured creditors. These payments are legally mandated to provide financial protection to specific stakeholders. However, the exact classification and treatment of preferential debts vary across jurisdictions, requiring careful consideration of the applicable insolvency laws.

3.2.4 Deficiency / Surplus Account (list H)

A deficiency/ surplus account is a statement prepared during the liquidation process of a company to explain the shortfall in assets available to meet liabilities. It reconciles the difference between the book value of assets and the actual realizable value, identifying the reasons for the deficiency. This statement must cover at least a 3-year period preceding the date of winding up the order.

This statement starts with capital and liabilities in excess of assets as on a given date. The primary purpose of the deficiency/ surplus account is to provide transparency by showing how the losses/surplus occurred. It helps creditors, shareholders, and liq-

auditors understand why the company has insufficient funds to meet its obligations. Net surplus/ deficiency must tally with the figures shown in the Statement of Affairs.

The deficiency/surplus account is divided into two parts:

1. The first part starts with the deficit (on the given date) and contains every item that increases deficiency or reduces surplus such as losses, dividend etc.
2. The second part starts with the surplus on the given date and indicates all profits.

If the total of the first exceeds that of the second there could be a deficiency to the extent of the difference and if the total of the second part exceeds that of the first, there could be a surplus. The form of deficiency or surplus account is given below:

Form of Deficiency or Surplus Account (List H)

	Amount (₹)
<p>Items contributing to Deficiency or Reducing Surplus:</p> <ol style="list-style-type: none"> 1. Excess (if any) of Capital and Liabilities over Assets on the..... as shown by Balance Sheet (copy annexed) 2. Net dividend and bonus declared during the period from..... the date of statement. 3. Net trading losses (after charging items shown in note below) for the same period. 4. Losses other than trading losses written off or for which provision has been made in the books during the same period (give particulars or annex schedule) 5. Estimated losses not written off or for which provision has been made for purposes of preparing the statement (give particulars or annex schedule) 6. Other items contributing to Deficiency or reducing Surplus: 	
<p>Items reducing Deficiency (or Contributing) to Surplus:</p>	

7. Excess (if any) of assets over capital and liabilities on the.....as shown in the Balance Sheet (copy annexed)

8. Net trading profit (after charging items shown in note below) for the period from the to the date of Statement.

9. Profits and income other than trading profits during the same period (give particulars or annex schedule)

10. Other items reducing Deficiency or contributing to Surplus...

Deficiency/Surplus as shown by the Statement of Affairs

NOTE. as to Net Trading Profits and Losses;

Particulars are to be inserted here (so far as applicable) of the items mentioned below, which are to be taken into account in arriving at the amount of net trading profits or losses shown in this account.

Provisions for depreciation, renewals or diminution in value of fixed assets

Charges for Income-tax and other Indian taxation on profits

Interest on debentures and other fixed loans

Payments to directors made by the company required by law to be disclosed in the accounts Exceptional or non-recurring expenditure

Less Exceptional or non-recurring receipts:

Balance, being other trading profits or losses

Net trading profits or losses as shown in Deficiency or Surplus Account above

Signature

Date

NOTE. In case the company in liquidation has not maintained

proper books of accounts after a certain date, a trial balance should be prepared with available information by taking items at their book values. Any difference found in the trial balance is the profit or loss made by the company during the period the company did not maintain books of accounts.

Illustration 3.2.1

The following information is extracted from the books of X Ltd. on 31st July, 2023 on which date a winding-up order was made

Unsecured Creditors	350000
Salaries due for five months	20000
Managing Director's Remuneration due	30000
Bills Payable	106000
Debtors Good	430000
-Doubtful (estimated to produce 62,000)	130000
-Bad	88000
Bills Receivable (Good ₹ 10,000)	16000
Bank Overdraft	40000
Land (estimated to produce ₹ 5,00,000)	360000
Stock (estimated to produce ₹ 5,80,000)	820000
Furniture and Fixtures	80000
Cash in hand	4000
Estimated liabilities for bills discounted	60000
Secured creditors holding first mortgage on land	400000
Partly secured creditors holding second mortgage on land	200000
Weekly wages unpaid	6000
Liabilities under Workmen's Compensation Act, 1925	2000
Income-tax due	8000
5,000 9% Mortgage Debentures of 100 each interest payable to 30th June and 31st December, paid to 30th June, 2023	500000
Share Capital:	
20,000 10% Preference Shares of ₹ 10 each	200000
50,000 Equity Shares of ₹ 10 each	500000
General Reserve since 31st December, 2019	100000

In 2019, the company earned profit of 4,50,000 but thereafter it suffered trading losses totalling 5,84,000. The company also suffered a speculation loss of 50,000 during the year 2020. Excise authorities imposed a penalty of 73,50,000 in 2021 for evasion of tax which was paid in 2020.

From the foregoing information, prepare Statement of Affairs and Deficiency Account.

Unsecured Creditors as per List E	Amount (₹)
Unsecured Creditors	350000
One month's Salaries (4 months' salaries are preferential)	4000
Managing Director's Remuneration	30000
Bills Payable	106000
Bank Overdraft	40000
Liability on Bills Discounted	60000
Amount uncovered in respect of partly secured creditors (200,000-1,00,000 value of security of second mortgage on land)	100000
	690000
Preferential Creditors as per List C	
	₹
Salaries for 4 months	16000
Weekly Wages	6000
Liabilities under Workmen Compensation Act, 1925	2000
Income Tax due	8000
	32000

X Ltd

**Statement Of Affairs
as on 31st July, 2023**

	Assets	Estimated Realisable Value
		₹
Assets not specifically pledged (as per List A):		
Cash in hand		4000
Bills Receivable		10000
Trade Debtors		492000
Stock		580000
Furniture and Fixtures		80000

		Estimated realisable value	Due to secured creditors	Deficiency ranking as	Surplus carried to last column
		₹	₹	₹	₹
Assets specifically pledged (as per List B)					
	Land	500000	600000	100000	----
	Estimated surplus from assets specifically pledged				Nil
	Estimated total assets available for preferential creditors, debenture holders secured by a floating charge and unsecured creditors				1166000
Summary of Gross Assets					
	Specifically pledged				50000
	Others				1166000
					1666000
Gross liabilities	Liabilities (to be deducted from surplus or added to deficiency as the case may be) Secured Creditors (as per list B) to the extent to which claims are estimated to be covered by assets specifically pledged				
₹					
500000	Preferential Creditors (as per list C)				32000
32000					1134000
	Estimated balance of assets available for debenture holders secured by a floating charge and unsecured creditors Debenture holders secured by a floating charge (as per list D)				500000
	Interest due for 1 month (July, 2023) @ 9% pa				3750
	Estimated surplus as regards debenture holders				503750
	Estimated deficiency as regards creditors, being the difference between gross liabilities and gross assets				630250
					690000
Issued and Called-up Capital					
	20,000 10% Preference Shares of 10 each fully paid (as per list F)				200000
	50,000 Equity Shares of 10 each fully paid (as per list G)				500000
	Estimated Deficiency as regards Contributories (as per list H)				759750

Deficiency Account (List)

A	Items contributing to Deficiency:	₹
	1. Excess of capital and liabilities over assets on 31st December, 2019 shown by the Balance Sheet	Nil
	2. Net dividend and bonus declared during the period from 1st January, 2020 to 31st July, 2023	Nil

	3. Net trading losses after charging depreciation, taxation, interest on debentures etc. (loss after 2019 5,84,000+3,750 interest on debentures for 1 month)	587750
	4. Losses other than trading losses written off or for which provision has been made in the books during the same period:	
	Speculation Loss	50000
	Penalty imposed by excise authorities	350000
		400000
	5. Estimated losses now written off or for which provision has been made for the purpose of preparing the statement	
	Bills Receivable	6000
	Debtors	156000
	Stock	240000
	Contingent liability of bills discounted	60000
		462000
	6. Other items contributing to deficiency	nil
	Total (A)	1449750
B.	Items reducing Deficiency	₹
	7. Excess of assets over capital and liabilities on 31st December, 2019 as shown in the Balance Sheet (General Reserve)	100000
	8 Net trading profits (after charging depreciation, taxation, interest on debenture etc.)	450000
	9. Profits and income other than trading profits	Nil
	10. Other items reducing deficiency-profit expected on realisation of land	140000
	Total (B)	690000
	Deficiency as shown by the Statement of Affairs (A)-(B)	759750

3.2.5 Liquidator's Final Statement of Account

The main job of the liquidator is to collect the assets of the company and realise them and distribute the money realised among right claimants. For this purpose he maintains a Cash Book for recording the receipts and payments and is required to submit an abstract of the Cash Book to the court in compulsory winding up and to the company in case of voluntary winding up. The liquidator is also required to prepare an account of winding up known as Liquidator's Final Statement of Account after the affairs of the company are fully wound up. This account takes the form of Cash Account.

Liquidator's Final Statement of Account

(For the period from ___ to ___)

Liquidator's remuneration

A liquidator is an individual or firm appointed to oversee the winding-up process of a company. The liquidator's primary role is to collect and sell the company's assets, settle liabilities, and distribute any remaining funds to creditors and shareholders. For performing these duties, the liquidator is entitled to remuneration, which is a fee or commission for their services. The liquidator normally gets the remuneration in the form of a commission, which is usually based on a percentage of the value of assets realised and the amount paid to unsecured creditors. In calculating the liquidator's remuneration, the following points may be noted:

1. Commission on assets given as securities to secured creditors. The liquidator gets a commission on the surplus from such assets left after making the payment to secured creditors because he makes an effort to realise the surplus of such assets from secured creditors. However, if he sells the assets himself, he gets a commission on the total proceeds of such assets.
2. Cash and Bank Balance. If the liquidator is to get a commission on assets realised, he also gets a commission on cash and bank balance unless otherwise stated.
3. Unsecured Creditors. If the liquidator is to get a commission on the amount paid to unsecured creditors, unsecured creditors will also include preferential creditors for the purpose of calculation of remuneration unless otherwise stated. If the amount available is sufficient to make the full payment of unsecured creditors, the commission is calculated as follows:

$$\frac{\text{Amount due to unsecured creditors} \times \% \text{ of commission on creditors}}{100}$$

If the amount available is not sufficient to make the full payment of unsecured creditors, the commission is calculated as below:

$$\frac{\text{Amount available for unsecured creditors} \times \% \text{ of commission}}{100 + \% \text{ of commission}}$$

For example, if the amount due to unsecured creditors is 5,00,000 and the amount available for unsecured creditors before charging a commission on amount paid to unsecured creditors is 2,06,000. Suppose 3% commission is to be paid on the amount paid to unsecured creditors, the commission in this case will be calculated as below:



$$\frac{2,06,000 \times 3}{100 + 3}$$

$$\frac{2,06,000 \times 3}{103}$$

$$\frac{2,06,000 \times 3}{103}$$

$$6000$$

Illustration 3.2.2

Following is the Balance Sheet of Arun Limited as on 31-3-2022:

I. Equity and Liabilities

(1) Shareholders' Funds	
(a) Share Capital	
8,000 Equity Shares of 100 each, 60 per share paid up	480000
14% 4,000 Preference Shares of 100 each fully paid	400000
(b) Reserves and Surplus:	
Surplus A/c (Negative Balance)	(-)240000
(2) Non-current Liabilities	
Secured Loans:	
(1)14% Debentures (having a floating charge on all assets)	230000
Interest Accrued on Debentures (also having a floating charge as above)	32200
(ii) Loan on Mortgage of Land and Building	150000
3) Current Liabilities	
Sundry Creditors	117800
Total Equity and Liabilities	1170000
II. Assets	₹
(1) Non-current assets	
Fixed asset	
Land	40000
Building	160000
Plant and machinery	540000
Intangible assets : Patents	40000
(2) Current assets	
Stock at cost	100000

Debtors	230000
Cash at bank	60000
Total assets	1170000

On 31-3-2022 the company went into voluntary liquidation. The dividend on 14% preference shares was in arrears for one year. Sundry creditors include preferential creditors amounting to 30,000.

The assets realised the following sums:

Land 80,000, Buildings 2,00,000; Plant and Machinery 5,00,000, Patents 50,000; Stock 1,60,000, Sundry Debtors 2,00,000.

The expenses of liquidation amounted to 29,434. The liquidator is entitled to a commission of 2% on all assets realised (except cash at bank) and 2% on amounts distributed among unsecured creditors other than preferential creditors. All payments were made on 30th June, 2021. Interest on mortgage loans shall be ignored at the time of payment.

Prepare the Liquidator's Final Statement of Account.

Solution

Arun Ltd. liquidator's final statement of account

	Amount (₹)		Amount (₹)
To Assets Realised		By Loan on Mortgage	150000
Cash at Bank	60000	By Liquidation Expenses	29434
Sundry Debtors	200000	By Liquidator's Remuneration	
Stock	160000	2% of 11,90,000 Assets Realised	23800
Land	80000	2% of 87,800 Unsecured Creditors	1756
Buildings	200000		
Plant and Machinery	500000	By Debenture holders:	
Patents	50000	14% Debentures	230000
		Interest Accrued (32200+8050)	

1-4-2022 to 30-6-2022 @ 14% p.a. on 2,30,000)	40250	270250
By Preferential Creditors		30000
By Unsecured Creditors		87800
By Preference Shareholders		
Preference Capital	400000	
Arrears of Dividend	56000	45600
By Equity shareholders (@25.12 per share on 8,000 shares)		200960
1250000		1250000

3.2.6 Limitations of Conventional Financial Statements

The limitations of financial statements refer to factors whose awareness a user should have before relying on them excessively. Perhaps the biggest drawback of conventional financial statements is that they do not reflect the current situation to the fullest extent as they are based on past data of the previous period. Financial statement limitations involve concerns that assets may not be realised and fraudulent financial practices. Some of the limitations are listed below, to understand how they do not reflect the current situation.

3.2.6.1 Historical cost

Financial reports are dependent on historical cost as per G A A P requirement. As such, a change occurs in the value of the assets and liabilities concerning time. So you may not get the current value of such assets and liabilities.

3.2.6.2 Inflation Adjustments

Inflation adjustments of the assets and liabilities of an organisation do not take place. Hence, financial statements do not reflect the current situation during such time.

3.2.6.3 Non-financial issues are not addressed

There is no discussion of non-financial issues while preparing a conventional financial statement which may be;

- ▶ The Environment
- ▶ Social and governance concerns
- ▶ Steps were taken by the company to improve the same

These issues are highly relevant, but the financial statements do not cover them.

3.2.6.4 Bias

Conventional financial statements are often based on personal judgements, that is another reason why financial statements do not reflect the exact situation in all the cases.

3.2.6.5 Fraudulent practices

People can skew the result of financial statements for their benefit. Therefore they are not 100% trust worthy.

3.2.6.6 Intangible Assets

Sometimes intangible assets are not recorded in the balance sheet such as Brand Value, Goodwill, Patents etc.

The limitations of financial statements are certain factors that reduce their effectiveness of financial statements. A user must have an awareness of them before trusting financial statements excessively.

Summarised Overview

The process of liquidation involves the structured settlement of a company's financial obligations, ensuring fair distribution of assets among creditors and stakeholders. The order of payment of liabilities is a crucial aspect, prioritizing secured creditors, preferential creditors, and then unsecured creditors before distributing any remaining funds to shareholders. Preferential payments include obligations such as employees' wages, government dues, and secured loans, which must be settled before paying other creditors. If the company's assets are insufficient to cover its liabilities, a deficiency account is prepared to show the shortfall, while a surplus account is created when there are excess funds available after settling all liabilities. The liquidator's final statement of accounts provides a detailed summary of all receipts, payments, realized assets, and distributed funds, ensuring transparency in the liquidation process. A liquidator's re-

muneration is an essential component, typically determined as a percentage of asset realizations or distributions, and governed by legal provisions or agreements. Despite the importance of financial reporting in liquidation, conventional financial statements have limitations as they are based on the going concern principle and do not reflect the actual realizable value of assets in liquidation. Traditional balance sheets and profit & loss statements fail to provide an accurate assessment of a company's ability to meet its liquidation obligations. Understanding these aspects is essential for financial professionals, investors, and regulatory authorities to ensure a fair, transparent, and legally compliant liquidation process that safeguards the interests of creditors, employees, and shareholders.

Self-Assessment Question

1. What is the importance of determining the order of payment of liabilities during liquidation?
2. What are preferential payments, and which liabilities are typically included in this category?
3. How does a deficiency account differ from a surplus account?
4. What is the purpose of preparing a liquidator's final statement of accounts?
5. How is a liquidator's remuneration calculated, and what factors influence it?
6. What is the role of the liquidator in the liquidation process?
7. How are secured and unsecured creditors treated during liquidation?
8. What are the key financial reports prepared during the liquidation process?

Assignments

1. Prepare a detailed report on the order of payment of liabilities in liquidation with relevant legal provisions.
2. Analyze the concept of preferential payments and discuss its significance in corporate liquidation.
3. Prepare a sample deficiency account and surplus account for a hypothetical company undergoing liquidation.
4. Draft a liquidator's final statement of accounts, including asset realization and liability settlements.
5. Examine the factors affecting a liquidator's remuneration and methods used to determine it.

Suggested Reading

1. Lela, R. K., & Jawaharlal. (1997). *Accounting theory*. Himalaya Publishing House.
2. Gupta, R. L., & Swamy, R. (2015). *Advanced accountancy*. Sultan Chand & Co.
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SGOU

Unit 3

Insolvency and Bankruptcy code 2016

Learning Outcomes

After completing this unit, the learner will be able to:

- get an idea on the Role of the Insolvency and Bankruptcy Board of India (IBBI)
- explain the role of adjudicating authorities
- comprehend how Insolvency Professional Agencies (IPAs) regulate and oversee Insolvency Professionals (IPs)
- assess the different outcomes of insolvency cases, insolvency, resolution process

Background

Businesses need efficient and speedy procedures for entry and exit. Internationally insolvency procedures help organisations to close down unviable and constantly loss making concerns and start new ones. The Indian system provides an opportunity for speedy and effective rehabilitation for an efficient exit under the Insolvency and Bankruptcy Code 2016(code/IBC). The Insolvency and Bankruptcy Board of India (IBBI) is a regulatory authority established under the Insolvency and Bankruptcy Code, 2016 (IBC). The IBBI plays a pivotal role in overseeing insolvency resolution processes for companies, individuals, and partnership firms in India. The establishment of the IBBI marked a significant reform in India's financial sector, aimed at addressing corporate distress and promoting ease of doing business.

Before the introduction of the IBC in 2016, India lacked a unified framework for insolvency and bankruptcy proceedings. Different laws such as the Companies Act, the Sick Industrial Companies Act (SICA), and the Recovery of Debts Due to Banks and Financial Institutions Act, governed insolvency matters. However, these laws were fragmented, leading to delays, legal uncertainty, and financial inefficiencies. The need for a comprehensive and time-bound resolution mechanism led to the introduction of the Insolvency and Bankruptcy Code, 2016. The IBC consolidated multiple laws into a single, streamlined framework, and the IBBI was established as the regulator to implement and monitor insolvency proceedings efficiently.



Keywords

Insolvency and Bankruptcy Board of India, Adjudicating authorities, Corporate insolvency, IPs, IPA, NCLT & NCLAT

Discussion

The objective of the bankruptcy process is to create a platform for negotiation between creditors and external financiers which can create the possibility of such rearrangements. A sound bankruptcy process is one that helps creditors and debtors realize and agree on whether the entity is facing financial failures and business failures. The conflicts and multiple proceedings that have arisen from the multi-layered Insolvency framework pointed towards a strong need for a unified bankruptcy code that could be applicable to all aspects of a Company in distress and for all stake holders.

3.3.1 The Insolvency and Bankruptcy Code 2016

A host of legislation and forum combined with potentially conflicting jurisdictional issues had resulted in systematic delays and complexities in the solvency and bankruptcy process. As the existing legislations have been identified as inadequate by themselves, the Insolvency and Bankruptcy code 2016 (I B C 2016) was enacted. This code is considered as the biggest economic reform next only to GST.

3.3.1.1 Salient Features of IBC 2016

- i. Clear, coherent and speedy process for early identification of financial distress and resolution of companies
- ii. Two distinct processes for resolution of individuals namely – “fresh start” and “Insolvency resolution”
- iii. Debt Recovery Tribunal and National Company Law Tribunal to act as adjudicating authority
- iv. Establishment of Insolvency and Bankruptcy Board of India (IBBI) to exercise regulatory oversight over insolvency professionals (IPs), Insolvency Professional Agencies (IPA)
- v. I P would handle the commercial aspects of Insolvency resolution process. IPA will develop professional standards, code of ethics, and be first level regulator for IPs.

- vi. Information utilities would collect, collate, authenticate and disseminate financial information to be used in Insolvency, liquidation and bankruptcy proceedings.

3.3.1.2 Four Pillars of Institutional Infrastructure under IBC 2016

The IBC 2016 in India introduced a robust institutional infrastructure to support the effective implementation of the insolvency resolution process. This infrastructure consists of four key pillars that play essential roles in the functioning of the IBC 2016.

A. Insolvency Professionals (IPs) & Insolvency Professional Agencies (IPAs)

The first pillar of institutional infrastructure is a class of regulated persons, the insolvency professionals. They play a key role in the efficient working of the bankruptcy process and are regulated by Insolvency Professional Agencies.

An IP may hold any of the following roles under the code.

- ▶ Resolution Professional (RP)
- ▶ Bankruptcy Trustee
- ▶ Liquidator

Institutional professionals act as the driving force behind the insolvency resolution process, employing their expertise to facilitate efficient and fair resolutions.

B. Information Utilities (IUs)

Information utilities are entities established under the IBC to serve as centralised repositories of financial and credit –related information of the Borrowers. The key functions of IUs are

- ▶ Data collection and verification
- ▶ Information sharing
- ▶ Authentication and Preservation

Information utilities play a crucial role in reducing information asymmetry, maintaining transparency, and expediting the insolvency resolution process.

C. Adjudicating Authorities; National Company Law Tribunal (NCLT) and Appellate Tribunal (NCLAT)

The third important pillar in the Infrastructure is NCLT & NCLAT, they are Quasi-judicial bodies established under IBC.



They serve as the adjudicating authorities for insolvency cases and handle appeals against the decisions of NCLT.

D. Insolvency and Bankruptcy Board of India (IBBI)

The IBBI is the fourth pillar in the institutional infrastructure of IBC 2016. It serves as the apex authority responsible for overseeing, regulating, and developing the insolvency and bankruptcy eco system in India. The key functions are;

- ▶ Regulatory Framework
- ▶ Registration and oversight
- ▶ Education and Training.

3.3.3 Insolvency and Bankruptcy Board of India (IBBI)

3.3.3.1 Objectives of IBBI

The IBBI was created to ensure a structured and efficient insolvency resolution process in India. Its primary objectives include:

- ◆ Regulating insolvency professionals (IPs), insolvency professional agencies (IPAs), and information utilities (IUs).
- ◆ Overseeing the resolution process for corporate and individual debtors.
- ◆ Ensuring transparency and efficiency in insolvency proceedings.
- ◆ Promoting market discipline and protecting stakeholders' interests.
- ◆ Minimizing delays and maximizing asset value recovery.

3.3.3.2 Scope of the Insolvency and Bankruptcy Board of India (IBBI)

▶ Regulating the Insolvency Process

One of the key responsibilities of IBBI is to regulate and oversee the insolvency process in India. When companies or individuals are unable to repay their debts, IBBI ensures that there is a proper mechanism to either restructure the debts or liquidate assets fairly. This is crucial for maintaining financial stability in the economy and protecting the interests of both lenders and borrowers. By setting clear guidelines and monitoring insolvency cases, IBBI helps in speeding up the resolution process and minimizing financial losses.

► Supervision of Insolvency Professionals (IPs)

IBBI is responsible for overseeing Insolvency Professionals (IPs), who are key players in managing insolvency cases. IPs are responsible for handling companies in financial distress, facilitating negotiations between creditors and debtors, and ensuring that insolvency laws are followed correctly. To ensure the efficiency and credibility of these professionals, IBBI regulates Insolvency Professional Agencies (IPAs) that register and supervise IPs. By maintaining strict standards and conducting regular evaluations, IBBI ensures that only qualified and ethical professionals handle insolvency cases.

► Regulation of Information Utilities (IUs)

Information Utilities (IUs) play a crucial role in the insolvency process by storing financial details of companies and individuals. These utilities maintain accurate credit and debt-related information, which helps creditors make informed decisions before lending money. IBBI ensures that IUs function efficiently by setting regulations and monitoring their operations. This helps in reducing fraudulent activities and ensuring transparency in financial transactions, making it easier to assess the financial health of companies and individuals.

3.3.4 Corporate Insolvency Resolution Process (CIRP)

For companies struggling with debt, IBBI oversees the Corporate Insolvency Resolution Process (CIRP), which provides a structured approach to either revive the business or liquidate its assets. If a company is unable to pay its debts, creditors can file for insolvency, and a resolution professional is appointed to manage the process. IBBI ensures that CIRP is conducted within a fixed timeline, preventing long delays that could negatively impact businesses, creditors, and employees. The goal is to maximize asset value while ensuring fair treatment for all stakeholders.

3.3.4.1 Individual and Partnership Firm Insolvency

IBBI is not limited to corporate insolvency; it also manages insolvency and bankruptcy processes for individuals and partnership firms. If an individual or a small business owner is unable to repay loans, IBBI ensures that a structured debt resolution or bankruptcy process is followed. This helps protect individuals from unfair debt collection practices while ensuring that creditors recover their dues in a fair manner. By setting rules for personal insolvency, IBBI plays a vital role in supporting small

businesses and self-employed individuals.

3.3.4.2 Protecting Stakeholders' Interests

One of the primary objectives of IBBI is to balance the interests of all stakeholders, including creditors, employees, investors, and borrowers. When a company goes bankrupt, it affects not only the creditors but also employees who may lose their jobs and investors who may lose their money. IBBI ensures that all parties involved get a fair and transparent resolution process. It prevents fraudulent activities, unfair liquidations, and unnecessary delays in the insolvency process, making the system more reliable and efficient.

3.3.5 Functions and Responsibilities of IBBI

3.3.5.1 Regulatory Oversight

The Insolvency and Bankruptcy Board of India (IBBI) plays a crucial role in regulating and supervising the insolvency ecosystem. It oversees insolvency professionals, insolvency professional agencies, and information utilities to ensure their proper functioning. It enforces compliance with the provisions of the Insolvency and Bankruptcy Code (IBC) and takes disciplinary actions against entities that fail to adhere to prescribed norms.

3.3.5.2 Policy Development and Refinement

IBBI is responsible for formulating rules, regulations, and guidelines that govern insolvency resolution processes. These policies are periodically reviewed and updated in response to market developments, industry feedback, and stakeholder suggestions. This ensures that the regulatory framework remains effective and aligned with evolving business and economic conditions.

3.3.5.3 Monitoring and Process Supervision

To maintain transparency and efficiency in insolvency proceedings, IBBI actively monitors cases to identify and prevent potential delays or malpractices. It ensures that insolvency professionals and other stakeholders adhere to defined timelines and procedural requirements, thereby safeguarding the integrity of the resolution process.

3.3.5.4 Capacity Building and Professional Development

IBBI invests in the training and development of insolvency professionals, policymakers, and other stakeholders. It organizes awareness programs, workshops, and certification courses to

enhance understanding of insolvency laws. It collaborates with academic institutions and professional bodies to foster a skilled workforce adept at handling insolvency cases.

3.3.5.5 Facilitation of Adjudication and Appeals

IBBI works in coordination with judicial bodies such as the National Company Law Tribunal (NCLT) and the National Company Law Appellate Tribunal (NCLAT) to ensure the smooth adjudication of insolvency cases. It provides interpretative guidance on legal provisions within the IBC and assists in the consistent application of insolvency laws to resolve disputes effectively.

The Insolvency and Bankruptcy Board of India (IBBI) has been a game-changer in India's financial landscape. By ensuring an efficient and transparent insolvency resolution process, the IBBI has contributed to financial stability, increased investor confidence, and improved credit markets. While challenges remain, continuous reforms and regulatory advancements will further strengthen India's insolvency regime, making it more effective and globally competitive.

3.3.6 Adjudicating Authority under the Insolvency and Bankruptcy Code (IBC), 2016

The Insolvency and Bankruptcy Code (IBC), 2016 provides a well-structured framework for resolving financial distress faced by individuals, companies, and partnership firms. A key component of this framework is the adjudicating authority, which plays a crucial role in hearing insolvency cases, approving resolution plans, and overseeing liquidation proceedings. These authorities ensure that insolvency cases are resolved in a fair and time-bound manner, benefiting both debtors and creditors.

Under the IBC, two primary adjudicating authorities handle different types of insolvency cases:

1. **National Company Law Tribunal (NCLT):** Responsible for corporate insolvency cases.
2. **Debt Recovery Tribunal (DRT):** Responsible for individual and partnership firm insolvency cases.

3.3.6.1 National Company Law Tribunal (NCLT) – Adjudicating Authority for Corporate Insolvency

The National Company Law Tribunal (NCLT) serves as the primary adjudicating authority for insolvency cases related to

companies and limited liability partnerships (LLPs). It plays a pivotal role in the Corporate Insolvency Resolution Process (CIRP) under the IBC by ensuring that businesses facing financial distress either restructure their debts or undergo a fair liquidation process.

Key Functions of NCLT in Insolvency Cases

NCLT is responsible for accepting or rejecting insolvency applications filed by either creditors or corporate debtors. Once an application is admitted, it appoints an Interim Resolution Professional (IRP) who takes control of the debtor's business and oversees its operations during the insolvency process.

A critical function of NCLT is supervising the formation of the Committee of Creditors (CoC), which consists of financial creditors who decide on the best course of action for the company. NCLT also evaluates and approves or rejects resolution plans, which may include debt restructuring or liquidation.

If the resolution process fails, NCLT oversees liquidation proceedings, ensuring that the company's assets are distributed fairly among creditors. It also plays a role in addressing fraudulent or preferential transactions, preventing unfair advantages to specific creditors.

NCLT has multiple benches across India to facilitate quick disposal of insolvency cases and reduce delays in the resolution process. If any party is dissatisfied with NCLT's decision, they have the right to appeal to the National Company Law Appellate Tribunal (NCLAT). If necessary, further appeals can be made to the Supreme Court of India.

3.3.6.2 Debt Recovery Tribunal (DRT) – Adjudicating Authority for Individual and Partnership Firm Insolvency

The Debt Recovery Tribunal (DRT) is responsible for handling insolvency cases related to individuals and partnership firms under the IBC. Unlike NCLT, which deals with corporate insolvency, DRT focuses on personal insolvency cases where the default amount is ₹10 lakh or more.

Key Functions of DRT in Insolvency Cases

DRT plays a crucial role in resolving insolvency cases by accepting applications filed by either creditors or individual debtors. It carefully examines the debtor's financial condition and initiates resolution or bankruptcy proceedings if necessary.

To assist in the process, DRT appoints a Resolution Profes-

sional (RP) who helps manage the insolvency resolution. If a repayment plan is possible, DRT approves and enforces agreements between the debtor and creditors. However, if a settlement cannot be reached, DRT has the authority to order the liquidation of personal assets to recover outstanding dues.

If any party is dissatisfied with DRT's decision, they can file an appeal with the Debt Recovery Appellate Tribunal (DRAT). In some cases, further appeals can be made to the Supreme Court of India to ensure justice is served.

3.3.7 Insolvency Professional Agencies (IPAs) and Their Role

The Insolvency and Bankruptcy Code (IBC), 2016 established a structured framework for resolving insolvency and bankruptcy cases in India. A key component of this framework is the Insolvency Professional Agencies (IPAs), which are responsible for regulating and overseeing Insolvency Professionals (IPs). These professionals play a crucial role in managing insolvency resolution processes, ensuring compliance with legal provisions, and facilitating a fair and transparent insolvency system.

IPAs function under the supervision of the Insolvency and Bankruptcy Board of India (IBBI), which is the regulatory authority for insolvency and bankruptcy matters in the country. Their primary role is to ensure that insolvency professionals are well-trained, competent, and adhere to ethical guidelines while handling insolvency cases.

Insolvency Professional Agencies (IPAs) are organizations registered with the IBBI to regulate and monitor insolvency professionals. They are responsible for ensuring that IPs are properly trained, follow professional conduct, and operate in compliance with the legal framework under the IBC.

There are currently three recognized IPAs in India:

- ▶ **Indian Institute of Insolvency Professionals of ICAI (III-PI)** : Affiliated with the Institute of Chartered Accountants of India (ICAI).
- ▶ **ICSI Institute of Insolvency Professionals (ICSI IIP)**: Affiliated with the Institute of Company Secretaries of India (ICSI).
- ▶ **Insolvency Professional Agency of Institute of Cost Accountants of India (IPA ICAI)**: Affiliated with the Insti-



tute of Cost Accountants of India (ICMAI).

These agencies ensure that insolvency professionals meet the necessary qualifications and uphold high ethical and professional standards.

3.3.8 Role of Insolvency Professional Agencies (IPAs)

3.3.8.1 Registration and Regulation of Insolvency Professionals

IPAs are responsible for registering qualified individuals as Insolvency Professionals (IPs). They ensure that only individuals with the required qualifications, experience, and training are allowed to practice as IPs.

3.3.8.2 Monitoring and Disciplinary Actions

IPAs monitor the conduct of insolvency professionals and take disciplinary action if an IP violates professional ethics or legal guidelines. Actions may include warnings, fines, suspension, or cancellation of registration.

3.3.8.3 Training and Capacity Building

IPAs conduct training programs, workshops, and certifications to help insolvency professionals stay updated with changes in insolvency laws and best practices. This enhances their ability to handle insolvency cases effectively.

3.3.8.4 Ensuring Compliance with IBC and IBBI Guidelines

IPAs ensure that all insolvency professionals strictly follow the rules laid down by the IBC and IBBI. This maintains uniformity, transparency, and accountability in the insolvency resolution process.

3.3.8.5 Promoting Professionalism and Ethical Conduct

IPAs enforce a code of conduct that insolvency professionals must follow. This ensures ethical behaviour, impartiality, and fairness in managing insolvency cases, which strengthens the overall insolvency framework.

3.3.9 Corporate Insolvency

Corporate insolvency occurs when a company is unable to meet its financial obligations and repay its debts. This situation arises when a company's liabilities exceed its assets, making it difficult to continue operations. Insolvency can result from poor financial management, economic downturns, legal liabilities, or

operational inefficiencies.

The Insolvency and Bankruptcy Code (IBC), 2016 provides a legal framework for resolving corporate insolvency in a structured and time-bound manner. It ensures that financially distressed companies either undergo restructuring to revive operations or are liquidated to repay creditors. The goal is to maximize asset value while protecting the interests of stakeholders, including creditors, employees, and investors.

Corporate insolvency can be initiated by financial creditors, operational creditors, or the corporate debtor itself. Once the insolvency process begins, the company's management is transferred to a Resolution Professional (RP), and a moratorium is imposed to prevent legal proceedings against the company. If the company cannot be revived within the stipulated timeframe, it proceeds to liquidation.

3.3.9.1 Corporate Insolvency Resolution

The Corporate Insolvency Resolution Process (CIRP) is a mechanism under the IBC, 2016 to resolve corporate insolvency in a structured manner. The primary objective of CIRP is to revive the company while ensuring that creditors recover their dues efficiently.

Once a company is admitted into CIRP, an Interim Resolution Professional (IRP) takes control and manages operations. The Committee of Creditors (CoC) is formed, comprising financial creditors who assess resolution plans submitted by interested investors or promoters. The resolution plan must ensure the company's viability while addressing creditor claims.

If a resolution plan is approved by at least 66% of CoC members and the National Company Law Tribunal (NCLT), the company is restructured, and its operations continue. If no viable resolution plan is accepted, the company is liquidated, and its assets are sold to repay creditors.

3.3.9.2 Corporate Insolvency Resolution Process (CIRP)

The Corporate Insolvency Resolution Process (CIRP) follows a step-by-step approach as defined under the IBC, 2016. The process begins when a creditor or the debtor itself files an application before the National Company Law Tribunal (NCLT) to initiate insolvency proceedings.

Once the application is admitted, the NCLT appoints an Interim Resolution Professional (IRP) to take charge of the company. The IRP then verifies claims, manages company affairs, and con-

stitutes the Committee of Creditors (CoC). During this period, a moratorium is imposed, preventing legal actions or asset seizures against the company.

Resolution applicants submit their plans to the CoC, which evaluates and selects the best proposal. The chosen plan is then approved by the NCLT. If no resolution is reached within 180 days (extendable to 330 days), the company enters liquidation, where assets are sold, and proceeds are distributed among creditors as per the priority list under the IBC.

Summarised Overview

The Insolvency and Bankruptcy Code (IBC), 2016 was introduced to streamline insolvency resolution in India, providing a structured, time-bound, and transparent process for businesses and individuals facing financial distress. The Insolvency and Bankruptcy Board of India (IBBI) is the key regulatory body responsible for overseeing insolvency cases, ensuring compliance, and regulating insolvency professionals. The Adjudicating Authorities play a crucial role in the insolvency process.

The National Company Law Tribunal (NCLT) handles corporate insolvency cases, while the Debt Recovery Tribunal (DRT) deals with individual and partnership firm insolvencies. These authorities approve insolvency applications, oversee resolution plans, and facilitate liquidation proceedings. Insolvency Professional Agencies (IPAs) regulate and train Insolvency Professionals (IPs), who manage the resolution process. These professionals assess financial conditions, oversee asset management, and ensure fair treatment of creditors and stakeholders. The Corporate Insolvency Resolution Process (CIRP) is a structured mechanism where creditors and stakeholders attempt to resolve financial distress. Once NCLT admits an insolvency case, a Resolution Professional (RP) is appointed, and a moratorium is imposed. The Committee of Creditors (CoC) evaluates resolution plans to either revive the company or liquidate its assets if no viable solution is found. The IBC has significantly improved India's ease of doing business, enhancing creditor recovery and promoting financial stability by ensuring efficient insolvency resolution.

Self-Assessment Question

1. What is the main objective of the Insolvency and Bankruptcy Code (IBC), 2016?
2. What is the role of the Insolvency and Bankruptcy Board of India (IBBI)?
3. What are the key functions of Adjudicating Authorities under the IBC?
4. How does the National Company Law Tribunal (NCLT) handle corporate insolvency cases?

5. What is the role of the Debt Recovery Tribunal (DRT) in insolvency cases?
6. What are Insolvency Professional Agencies (IPAs), and why are they important?
7. Who are Insolvency Professionals (IPs), and what are their responsibilities?
8. What is the Corporate Insolvency Resolution Process (CIRP)?

Assignments

1. Discuss the regulatory framework established by IBBI.
2. Analyze how IBBI ensures compliance with the Insolvency and Bankruptcy Code (IBC), 2016.
3. Compare their functions in handling corporate and individual insolvency cases.
4. Discuss how IPAs regulate and train Insolvency Professionals (IPs).
5. Explain their role in maintaining the efficiency and transparency of the insolvency process.

Suggested Reading

1. Anthony, R. N., Hawkins, D. F., & Merchant, K. A. (2018). *Accounting: Text & cases*. Tata McGraw-Hill.
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SGOU

04 BLOCK

Human Resource Accounting

Block Content

- Unit - 1 Introduction to Human Resource accounting
- Unit - 2 Methods and models of HR Accounting



Unit 1

Introduction to Human Resource Accounting

Learning Outcomes

After completing this unit, the learner will be able to:

- ◆ comprehend Human Resource Accounting
- ◆ get an idea of the importance of Human Resource Accounting
- ◆ be aware of the objectives of Human Resource Accounting

Background

Human Resource Accounting (HRA) arose in reaction to the increasing acknowledgement of personnel as essential assets in organisational performance. Conventional accounting methods predominantly emphasise tangible assets like real estate, equipment, and inventories, neglecting the assessment of human capital in financial statements. Nonetheless, the emergence of knowledge-based economies and the growing significance of intangible assets have underscored the necessity for comprehensive evaluation and reporting of human resource value. The concept gained traction in the 1960s, propelled by research initiatives by economists and accountants like Rensis Likert and Eric Flamholtz, who established frameworks to evaluate the value of human resources and their impact on organisational success. The principal aim of HRA is to establish a framework for recognising, quantifying, and reporting the costs and benefits related to human resources. This encompasses costs associated with recruiting, training, and cultivating people, along with their prospective economic contributions. By regarding human resources as assets, HRA seeks to reconcile standard accounting methods with the strategic significance of personnel in fulfilling business goals. It provides essential information for decision-making in workforce planning, performance assessment, and investment in employee development. Despite its theoretical allure, HRA has not achieved general adoption due to constraints such as the absence of standardisation, measurement complexities, and ethical dilemmas with the monetary valuation of humans.

Numerous models and methodologies have been devised to execute HRA, encompassing both cost-based and value-based approaches. Despite facing critiques, HRA continues to develop, offering a crucial perspective that regards employees as strategic assets whose worth transcends the traditional balance sheet.

Keywords

Human resource accounting, Strategic Human Resource Management

Discussion

4.1.1 Introduction

For an organization to grow and develop, it is crucial to boost the efficiency of human resources, as all other resources rely on people for their practical use and effectiveness. Organizational resources include people (human resources), materials, machines, money, and methods, divided into animate (human) and inanimate (physical) resources. Human resources play an active role in utilizing physical resources, making organizational success largely dependent on the qualities, abilities, and character of the workforce. More broadly, human resources represent the collective skills, creativity, innovative thinking, intuition, knowledge, and experience of all employees. While ample physical resources are necessary, they cannot ensure success without capable human resources to guide them. Historically, human resources did not receive the attention they deserved from management, but with their importance now clear, it has become vital for organizations to focus on their development. This shift highlights the relevance of Human Resource Accounting (HRA), which provides a framework for valuing and strategically managing human resources as essential organizational assets.

◆ Human Resource Efficiency is crucial

◆ Workforce is an essential asset

Human Resource Accounting (HRA) is a modern accounting method that acknowledges the personnel as one of a company's most significant assets. Accounting systems have traditionally focused on physical and financial assets, paying little consideration to the value of human resources. In today's knowledge-based economy, employees' skills, expertise, experience, and motivation are critical to an organization's productivity, creativity, and overall growth. HRA aims to measure and report the financial worth of human capital by accounting for investments in employee recruitment, training, and retention. HRA presents a more complete picture of organisational value by adding human capital into an organization's financial statements, therefore guiding management in decisions on workforce investments and talent management practices.

◆ Approaches to assess human capital

The main objective of HRA is to create a methodical framework for evaluating the advantages and disadvantages of an organization's human resources. HRA uses a variety of measurement techniques, each of which captures a distinct facet of human capital, to do this. For instance, the historical cost approach concentrates on actual expenses related to hiring, training, and developing employees. The replacement cost method estimates the cost of substituting the current workforce with new hires of equivalent skills and experience. Another common method is the present value approach, which evaluates the expected future earnings of employees over their anticipated tenure with the organization. These measurement techniques offer different perspectives on workforce value and provide management with insights into the return on investment (ROI) of human resource activities, helping them optimize the allocation of resources toward workforce development.

◆ HRA's role in guiding organizational decisions

HRA facilitates long-term organisational planning and strategic decision-making in addition to measuring human capital. HRA data can guide companies in aligning their human resource strategies with overall business goals, such as identifying areas where additional training or development is required, projecting future workforce needs, and improving succession planning efforts. The insights from HRA can also be used to assess and improve employee engagement, as they demonstrate the organization's commitment to investing in its workforce. A visible investment in human resources reinforces a culture of recognition and support, motivating employees to contribute more effectively toward organizational objectives. HRA thus enables organizations to leverage human capital as a strategic asset, integrating workforce management into broader planning processes and creating a competitive advantage.

◆ Importance of HRA for external stakeholders and CSR alignment

Human Resource Accounting also enhances transparency and accountability for external stakeholders, including investors, regulatory bodies, and the broader community. As stakeholders increasingly recognize the importance of intangible assets, HRA provides a standardized means to report on the workforce's financial value. By including human resource data in financial reports, companies can communicate their commitment to workforce development, thereby building investor trust and improving organizational reputation. HRA also supports corporate social responsibility (CSR) efforts, as it emphasizes the importance of employee welfare, ethical HR practices, and sustainable talent development. HRA is still a vital tool for contemporary businesses looking to fully utilise their resources and create lasting value, despite its ongoing development and obstacles, which

include the requirement for standardised procedures and the challenge of measuring the subjective components of employee contributions.

◆ Human Resource as Asset

Human Resource Accounting (HRA) emerged from accounting and finance research, focusing on the idea that human resources are assets whose value increases over time when managed effectively. Historically, organizations made little effort to assign a monetary value to human resources in their accounting practices, treating human capital expenditures as charges against revenue instead of investments. Behavioural scientists criticized this approach, emphasizing the need to develop methodologies to properly value human resources alongside physical assets. Traditional accounting viewed human resource costs as non-capital expenditures, but the modern perspective recognizes these as capital investments, as they generate long-term benefits. HRA has gained attention for its ability to provide reliable and comprehensive management information about human resources, as well as for expanding traditional accounting frameworks to include broader measurements. Despite being the most important assets, human resources remain undervalued in financial statements and management information systems. The conventional accounting methods that only record human capital formation expenses fail to capture the true value of human resources. HRA aims to measure the cost and value of human capital to the organization by assessing the costs of recruitment, selection, training, and development, as well as evaluating their economic contribution to the organization's success.

4.1.2 Meaning - Human Resource Accounting (HRA)

◆ Valuing Employees as asset

Human Resource Accounting (HRA) is a framework for assessing and recording the value of an organization's human capital, treating employees as key assets whose skills, experience, and potential impact can be quantified. This approach goes beyond traditional accounting, which typically focuses on financial assets, to include the costs of hiring, training, and retaining employees as well as the value they bring through productivity and innovation. By measuring these factors, HRA provides insights that support better decision-making in talent management, aligning human resource policies with strategic objectives to foster organizational growth.

Human Resource Accounting (HRA) is a specialized field within accounting that quantifies the economic value of employees to an organization. Unlike traditional accounting, which focuses on tangible assets like machinery, cash, and real estate, HRA considers human resources—the employees—as valuable

assets that contribute to the company's long-term success. By assigning a financial value to aspects like employees' skills, experience, and knowledge, HRA helps companies understand the true costs and benefits associated with recruiting, training, and retaining talent. This method highlights that people are just as vital to organizational growth and profitability as physical assets, acknowledging that a company's strength lies in its human capital.

4.1.3 Definitions - Human Resource Accounting (HRA)

The American Accounting Society Committee on Human Resource Accounting defines it as "the process of identifying and measuring data about human resources and communicating this information to interested parties". In simple terms, it is an extension of the accounting principles of matching costs and revenues and of organizing data to communicate relevant information in financial terms.

Mr. Woodruff Jr. Vice President of R. G. Batty Corporation defines that "Human Resource Accounting is an attempt to identify and report investments made in human resources of an organization that are presently not accounted for in conventional accounting practice. Basically it is an information system that tells the management what changes over time are occurring to the human resources of the business."

M.N. Baker defines Human Resource Accounting as "the term applied by the accountancy profession to quantify the cost and value of employees to their employing organization".

Stephen Knauf has defined HRA as: "The measurement of quantification of human organization inputs such as recruitment, training, experience and commitment."

4.1.4 Importance of Human Resource Accounting

Human Resource Accounting is an integral aspect of modern management in organizations. This involves identifying, measuring, and reporting the value of human resources as an organizational asset. Since knowledge and innovation are the two most important success drivers in a knowledge-based society, it has become imperative for companies to acknowledge and account for human resources.

4.1.4.1 Improves Decision Making

Human Resource Accounting provides quantified information about the workforce, thereby improving decision-making at all

◆ Informed Decisions

levels of an organization. Organizations can make informed decisions by quantifying the costs and contributions of human resources. For example, HRA helps in resource allocation through the identification of departments or teams that generate the highest returns. It also enables organizations to decide whether to invest in further training or hire new employees to meet business objectives. Human capital metrics included in strategic planning will ensure long-term success by aligning workforce capabilities with organizational goals.

◆ Investment Justification

4.1.4.2 Justifies Human Resource Investments

Training, development, and welfare programs for employees are usually looked at as overheads rather than investments by an organization. HRA changes the perspective of how these initiatives yield returns on investments. For instance, employee development programs will validate the expenses towards recruitment, retention, and skill upgradation due to employee satisfaction and the performance of an organization. These justifications ensure that stakeholders get more confident and more investments are made into human capital and, hence, help in creating sustainable workforce management strategies.

◆ Workforce valuation

4.1.4.3 Helps Determine the Value of the Workforce

Human resource accounting puts value on employees' contributions, which increases the accuracy of the financial statement issued because human resources are considered to be an asset. This determination is very relevant in mergers, acquisitions, and partnerships because there is a proper evaluation of an organization's value. It, therefore, brings about investor confidence because the organizations are showing their value to the workforce. In knowledge-driven industries such as IT or pharmaceuticals, workforce valuation is a substantial part of the company's intangible assets. This makes the employees the prime factor in developing a competitive advantage.

◆ Employee Engagement

4.1.4.4 Employee Motivation

When employees realize that their contributions are measured and valued, it enhances their sense of belonging and commitment to the organization. This recognition encourages continuous improvement and skill development, aligning personal goals with organizational objectives. By valuing employees as assets, organizations can foster a culture of appreciation and acknowledgement, boosting morale and productivity. Employees feel more engaged and are likely to contribute effectively to organizational growth.

4.1.4.5 Supports Performance Evaluation

- ◆ Performance Assessment

HRA facilitates the evaluation of employee performance by quantifying individual and team contributions to the organization's success. It helps identify areas for improvement and aligns them with training programs, ensuring continuous development. Data-driven evaluations promote fairness and transparency, fostering trust between employees and management. Measurable goals set through HRA ensure accountability and alignment with broader organizational objectives, ultimately enhancing overall performance.

4.1.4.6 Improves Organizational Accountability

- ◆ Organisational responsibility

The incorporation of human resource data in financial reporting shows an emphasis on transparency and proper management of all assets, human capital is one of them. There is, thus, an inalienable commitment to ethical practices as it fosters fair treatment towards employees. Responsible management of human resources enhances the organization's reputation and instills stakeholders, including workers, investors, and society at large, with trust in the same. HRA acts as a bridge and creates a link between organizational practices and ethical and sustainable management principles.

4.1.4.7 Aids in Managing Attrition

- ◆ Employee Retention

High employee turnover is expensive and a disturbance. HRA helps organizations quantify the costs of lost employees, such as recruitment, training, and productivity losses. Analysing historical data provides an opportunity to predict attrition trends and adopt proactive retention strategies. Some of these may be targeted employee engagement plans, competitive packages with compensation, or career development activities. This knowledge will enable organizations to resource their way in retaining high-performing employees and minimizing costs due to turnover.

4.1.4.8 Aligns with Knowledge Economy Requirements

- ◆ Meets the Demands of a Knowledge

In the knowledge economy, intellectual capital often outweighs physical assets. HRA aligns with this shift by recognizing employees' intellectual contributions and valuing skills, innovation, and creativity as critical assets. This recognition supports a transition from traditional asset-based valuation to knowledge-based valuation. Organizations that adopt this approach are better equipped to remain competitive in markets where innovation and expertise drive success. Valuing human resources enables companies to tap into their intellectual capital

effectively.

4.1.4.9 Promotes Sustainable Practices

HRA promotes sustainability by encouraging long-term investments in employee well-being and development. It encourages ethical treatment of employees as valuable resources rather than expendable inputs. The integration of social responsibility into business practices through HRA metrics allows organizations to demonstrate their commitment to sustainable human resource management. For instance, as such companies support diversity, inclusion, and employee wellness, they can use HRA data to highlight their efforts and achievements in such endeavours. Such issues of sustainability improve the organizational reputation and offer long-term success.

4.1.4.10 Helps Benchmark and Compare

HRA allows organizations to compare their human capital metrics with industry standards and identify where they are behind the competition. Knowing these gaps allows organizations to create targeted strategies to bridge performance differences and attain excellence. Benchmarking also allows for continuous improvement, keeping an organization competitive in a dynamic business environment. With HRA, companies can evaluate the effectiveness of their workforce compared to industry peers and implement best practices.

◆ Comparison

4.1.4.11 Enhances Strategic Human Resource Management (SHRM)

HRA supports SHRM by integrating human resource data into organizational strategy. It helps align workforce capabilities with business goals, thus enabling predictive analysis for workforce planning. Organizations that use HRA as part of their SHRM practices are better equipped to respond to market changes and seize opportunities. Human resources, combined with strategic management, are best applied to maximize the utilization of human resources, design innovation, and achieve other long-term objectives. This integration ensures that human resources add value and are significantly directed towards the success of the organization.

◆ Human Resource Management

4.1.4.12 Innovation and Creativity

HRA recognizes the value of intangible assets like innovation and creativity by measuring the impact of these elements on organizational performance. It values employees who are involved in developing products or process improvement, creating

◆ Novelty and Creativity

an innovative culture. By making rewards dependent on creative contributions, HRA challenges employees to be creative and spur organizational growth. Rewarding and valuing innovation through HRA ensures that the employees are encouraged to contribute their ideas and expertise, thereby developing a culture of continuous improvement.

4.1.4.13 Influences Organizational Culture

◆ Organizational Culture

HRA fosters a culture where employees are valued as integral to organizational success. This culture enhances employee engagement and loyalty, attracting top talent by showing a commitment to human resource development. Strong organizational culture supported by HRA improves relationships between employees and management, creating a collaborative and productive work environment. By emphasizing the value of human resources, organizations can build a culture that aligns with their mission and values, driving success at every level.

4.1.4.14 Bridges the gap between theory and practice

◆ Align business practices management theories

Traditional accounting focuses on tangible assets, often overlooking human resources. HRA bridges this gap by integrating human capital metrics into financial systems. This integration supports a holistic approach to organizational management, ensuring that human resources are valued alongside physical and financial assets. HRA encourages academic research and practical applications in valuing human resources, advancing the field of management accounting. By adopting HRA, organizations can align their practices with modern management theories, enhancing overall efficiency.

4.1.4.15 Facilitates Stakeholder Communication

◆ Communication

HRA improves stakeholder communication by making transparent data about human resource investments. It shows the organization's commitment to value its workforce and the relationship between human capital and financial performance. This transparency builds trust with stakeholders, including investors, employees, and customers, thereby creating stronger relationships. Organizations can improve their reputation and gain long-term support from stakeholders by using HRA to communicate the value of human resources.

Human Resource Accounting is essential for organizations that want to succeed in today's dynamic environment. It quantifies the value of human resources, enhances decision-making, promotes sustainability, and drives organizational success. Every aspect of HRA—from workforce valuation to innovation pro-

motion-plays a crucial role in shaping the future of businesses. As companies continue to evolve, the integration of HRA into strategic management will remain a cornerstone for fostering growth, innovation, and long-term value creation.

4.1.5 Objectives of Human Resource Accounting (HRA)

Human Resource Accounting (HRA) aims to quantify and report the value of human resources in financial statements, recognizing employees as key assets rather than just expenses. The primary objectives of HRA include:

Valuation of human resources

HRA seeks to assign a monetary value to human assets, similar to physical and financial assets. This helps organizations understand the financial impact of their workforce.

Cost identification and measurement

Organizations incur significant costs in hiring, training, and developing employees. HRA systematically records these costs, allowing firms to assess their return on human capital investments.

Performance evaluation

By tracking human resource value over time, HRA helps in evaluating the productivity and efficiency of employees. It enables managers to analyze workforce contributions to organizational growth.

Facilitating managerial decision-making

HRA provides valuable insights for decision-making regarding workforce planning, compensation strategies, and employee development programs. Organizations can allocate resources more effectively based on human asset valuation.

Enhancing employee motivation and development

When employees are recognized as valuable assets, organizations tend to invest more in training and career development. This fosters job satisfaction, motivation, and retention.

Improving transparency in financial reporting

Traditional accounting overlooks human resources in financial statements. HRA enhances transparency by including employee-related investments and valuations in reports, benefiting stakeholders.



Benchmarking and organizational comparisons

HRA facilitates comparisons between organizations regarding workforce efficiency and human capital management, aiding investors and policymakers in decision-making.

4.1.6 Advantages of Human Resource Accounting (HRA)

The key advantages of HRA are

Recognition of Human Capital as an Asset

Traditional accounting treats human resources as expenses rather than assets. HRA acknowledges employees as valuable organizational assets, highlighting their role in long-term growth and sustainability.

Improved Decision-Making

HRA provides managers with essential data to make informed decisions regarding workforce planning, recruitment, training, and compensation. By quantifying human capital, businesses can allocate resources more effectively.

Enhanced Employee Motivation and Productivity

When employees see that their value is recognized and measured, it enhances their motivation, job satisfaction, and commitment. Organizations that invest in employee development tend to have a more engaged and productive workforce.

Better Workforce Planning and Talent Management

By tracking the value and performance of human resources, HRA helps organizations identify skill gaps, forecast future talent needs, and implement effective training programs to enhance employee capabilities.

Increased Transparency in Financial Reporting

Traditional financial statements often overlook human capital. HRA improves transparency by including the costs and benefits of human resource investments, giving stakeholders a clearer picture of an organization's true value.

Cost-Benefit Analysis of HR Investments

Organizations spend significant amounts on hiring, training, and retaining employees. HRA enables companies to evaluate the return on investment (ROI) for these expenditures, helping them optimize workforce-related costs.

Competitive Advantage

Organizations with a strong focus on human resource accounting can better manage their workforce, leading to higher efficiency, innovation, and overall competitiveness in the market.

Facilitates Organizational Comparisons and Benchmarking

HRA allows businesses to compare workforce efficiency and human capital valuation with industry peers. This helps investors, policymakers, and stakeholders assess an organization's human resource effectiveness.

Supports Strategic Planning and Policy Formulation

With data-driven insights from HRA, organizations can develop better HR policies, succession planning, and long-term strategies to enhance workforce performance and sustainability.

Summarised Overview

Human Resource Accounting (HRA) is a branch of accounting focused on quantifying, valuing, and reporting the contributions of an organization's workforce, acknowledging personnel as vital intangible assets rather than mere expenses. Conventional accounting neglects the significance of human resources, concentrating mostly on tangible assets such as real estate and equipment. Conversely, HRA aims to measure the expenses associated with recruiting, training, and retention while assessing the economic advantages that employees contribute to the organisation. The significance of HRA is in its capacity to include human capital in financial reporting, offering a comprehensive perspective on organisational assets. It facilitates decision-making by assessing the return on investment (ROI) of workforce-related initiatives, including training programs, development efforts, and retention tactics. HRA increases strategic alignment by ensuring HR practices match business objectives, enabling organisations to allocate resources more effectively to maximise employee performance and organisational growth. It facilitates performance assessment by providing insights into the contributions of employees, thereby allowing for the identification of skill deficiencies and areas requiring enhancement. By regarding workers as strategic assets, HRA underscores their significance in establishing enduring competitive advantages, especially in knowledge-driven economies where innovation and expertise are paramount. Despite encountering obstacles such as subjective assessment techniques, absence of standardisation, and ethical dilemmas, Human Resource Accounting (HRA) continues to evolve, equipping organisations with tools to manage and report human capital efficiently, hence underscoring its significance in the contemporary competitive corporate landscape.

Self-Assessment Question

1. What is Human Resource Accounting (HRA), and how does it differ from traditional accounting?
2. Why is it important to consider human resources as assets in an organization?
3. How does Human Resource Accounting define the value of human resources?
4. What is the role of HRA in measuring the costs associated with recruiting, training, and retaining employees?
5. Explain the definition of HRA as provided by the American Accounting Association.
6. What are the primary objectives of Human Resource Accounting?
7. How does HRA contribute to strategic decision-making in organizations?
8. Why is the inclusion of human capital in financial reporting significant?
9. How does HRA help organizations evaluate the return on investment (ROI) in human resource initiatives?
10. What are the key challenges associated with implementing Human Resource Accounting?

Assignments

1. Analyze a real-world case study of an organization that has implemented HRA. Discuss the methods used and the outcomes achieved.
2. Compare and contrast traditional accounting practices with Human Resource Accounting. Highlight the benefits and limitations of HRA.
3. Develop a hypothetical model for valuing human resources in an organization of your choice. Describe the steps and methods you would use.
4. Imagine you are the HR manager of a company. Draft a policy on implementing HRA in your organization, outlining its purpose, scope, and expected benefits.

Suggested Reading

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Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

SGOU

Unit 2

Methods and models of HR Accounting

Learning Outcomes

After completing this unit, the learner will be able to:

- ◆ get an awareness of different methods of valuation of human resource capital
- ◆ comprehend different models in human resource accounting
- ◆ get an idea of the objections against human resource capital
- ◆ examine the human resource accounting in India

Background

Human Resource Accounting (HRA) is a system for assessing, measuring, and documenting an organization's personnel as a crucial asset, highlighting their significance in attaining organisational objectives. Various methods are employed for assessing human resources, each providing distinct viewpoints. Techniques for assessing human resources concentrate on determining the economic value of employees to an organisation. Common methods encompass the Historical Cost Approach, which assesses recruitment and training expenditures, and the Replacement Cost Approach, which evaluates the expenses associated with substituting individuals with equivalent skills. Alternative methods, such as the Present Value Approach and the Opportunity Cost Method, emphasise the anticipated future advantages that individuals are expected to produce or their worth in different positions. The increasing acknowledgement of human resources as strategic catalysts for success highlights the significance of HRA. Implementing standardised rules and legal frameworks may assist organisations in India in incorporating Human Resource Accounting into strategic planning and decision-making processes, hence optimising their workforce for sustainable growth.

Keywords

Historical cost approach – Opportunity cost method- Replacement Cost Approach Reward valuation



Discussion

4.2.1 Methods of Valuation of HR

- ◆ Human resource is considered as one of the most valuable assets

In the modern business environment, human resources are considered one of the most valuable assets of an organization. Unlike physical or financial assets, human capital is unique because it appreciates over time with experience, skill development, and training. However, traditional accounting systems do not recognize human resources as assets in financial statements, treating expenses related to employees as operational costs rather than investments. This limitation has led to the development of Human Resource Accounting (HRA), which aims to measure and report the value of human capital in monetary terms.

- ◆ Valuation of human resource is crucial for organisations

The valuation of human resources is crucial for organizations as it helps in effective workforce planning, training and development, compensation strategies, and overall decision-making. By assigning a financial value to employees, companies can assess their contribution to organizational growth and measure the return on investment in human capital. HRA enhances transparency in financial reporting, helping stakeholders understand the organization's true worth beyond tangible assets.

- ◆ There are various methods of human resource valuation

There are various methods of human resource valuation. Each method has its advantages and limitations, and organizations may choose the most suitable approach depending on their specific industry, workforce characteristics, and strategic goals. By implementing effective human resource valuation methods, businesses can make better-informed HR policies, optimize talent management, and enhance long-term competitiveness.

The two primary methods of Human Resource (HR) valuation are:

- ◆ Cost-Based Methods
- ◆ Value-Based Methods

4.2.2 Cost-Based Methods

Cost-based methods assess HR value based on the expenses incurred in acquiring, training, and maintaining employees. Cost-based methods are the following.

4.2.2.1 Historical cost approach

Under this method, the basic contributing factors for develop-

◆ Focusing on actual costs

ing the human resources of the organization have been equated to the actual cost incurred. This approach was originally developed by William (Pyle & R G Barry Corporation Columbia – USA) assisted by Brummet & Eric G Flamholtz. The historical cost approach in HRA is the most widely recognized method of valuation for human resources, focusing on actual costs to recruit, train, and develop employees. The costs include all the expenses that go into recruiting, selecting, orienting, professional development programs, and other skill enhancement activities. In doing so, these organizations are hoping to account for the expenses so that their investment in human capital is reflected as employees are viewed as critical organizational assets rather than as operational costs. Unlike other valuation models that estimate future potential or market value of employees, the historical cost approach uses tangible financial data from past transactions. This trait makes it an easy-to-use method by the organizations to put into place because it evades the problems and subjectiveness of predictive models. This can, therefore be taken by organizations in a systemic approach tracking their financial commitment towards human capital and accounting for them through the accounting system of the organizations that will follow through with greater recognition of employee's value toward organizational objectives.

◆ Proper record of expenditure on human resource is maintained

A proper recording of the expenditure made on hiring, selecting, training and developing the employees is maintained, and a proportion of it is written off to the income of the next few years during which human resources will provide service. If the human asset is liquidated prematurely, the whole of the amount not written off is charged to the income of the year in which such liquidation takes place. If the useful life is recognised to be longer than originally expected, revisions are effected in the amortisation schedule. The historical cost of human resources is very similar to the book value of the other physical assets. When an employee is recruited by a firm, he is employed with the obvious expectation that the return from him will far exceed the cost involved in selecting, developing and training in the same manner as the value of fixed assets is increased by making additions in them. Such additional costs incurred in training and developing are also capitalised and are amortised over the remaining life. The unexpired value is an investment in human assets.

Advantages of the Historical Cost Approach

1. Simplicity and Objectivity

The historical cost method is direct and depends on actual expenditures, hence reducing subjective estimations and specula-

tive computations. This objectivity guarantees that the valuation process is transparent and comprehensible to stakeholders.

2. Alignment with Traditional Accounting Principles

Since it focuses on tangible costs, this approach aligns seamlessly with established accounting practices, making integration into existing financial systems more feasible.

3. Cost Tracking and Accountability

Organisations may systematically monitor their investments in recruitment, training, and development, fostering accountability and informed decision-making.

4. Improved Financial Reporting

By considering human resource expenditures as assets, organisations may provide a more holistic representation of their financial well-being, demonstrating their dedication to sustainable growth.

5. Foundation for HRA Practices

The historical cost approach serves as a fundamental strategy, offering organisations unfamiliar with human resource accounting a starting point to establish a basic framework for valuing human capital.

Limitations of the Historical Cost Approach

1. Inability to Capture Intangible Contributions

This approach neglects qualitative aspects such as employee creativity, leadership, teamwork, and adaptation, which are essential for organisational success.

2. Underestimation of Current and Future Value

It may not reflect the increasing value of people as they develop experience, skills, and knowledge, thereby leading to undervaluation of human resources over time.

3. Static Nature of Valuation

This method, dependent on historical data, fails to adapt to shifting market conditions, economic trends, or technology breakthroughs that could affect the value of human resources.

Illustration 1

ABC Ltd is a firm that specialise in offering technical consulting services. ABC reported operating income (EBIT) of ₹ 51.5

lakh and net income of ₹23 lakh in the most recent years. In the most recent year, the firm had ₹14 lakh training and recruitment expenses. A consultant who joins ABC stays with the firm on average, 4 years. Training and recruitment expenses are amortisable over 4 years, and over the past 4 years they are:

Year	Training and recruitment expenses(in lakhs)
Current	14
1	12
2	10.40
3	9.10
4	8.30

Assuming a linear amortisation schedule (over 4 years) you are required to estimate

1. The value of human capital asset
2. The adjustment net income.

Year	Training and recruitment expenses (₹ in lakhs)	Unamortised portion (₹ in lakhs)	Amortisation this year (rs ₹ in lakhs)
Current	14	14(for 4 year)	-
1	12	9(for 4 year)	3(12/4)
2	10.4	5.20(for 2 year)	2.60(10.4/4)
3	9.10	2.28(for 1 year)	2.28(9.10/)
4	8.30	(1) 0	2.07(8.30/4)
Total		30.48	9.95

The value of human capital assets is ₹30.48

Net income = ₹23 lakh + ₹14 lakh – ₹9.95 lakh

=₹ 27.05.

Note total period of amortisation is over

4.2.2.2 Opportunity cost method

To meet the deficiencies of the Replacement cost, Hekimain and Jones have suggested the use of the opportunity cost concept. Under this method, the value of an employee in his alternative use is determined, and that value is taken as the basis for estimating. The opportunity cost method in human resource accounting is a unique way of valuing employees within an organi-

♦ The true cost of any decision lies in the value of best fore-gone alternative



zation. It is premised on the economic principle that the true cost of any decision lies in the value of the best-foregone alternative. In human resources, this would mean determining the value of an employee by seeing what other departments in the company would be willing to pay for their services. The basic idea is to simulate a competitive bidding process.

◆ The actual value one may bring to the firm aside from particular position and salary

Imagine that different departments in a company are bidding for the services of a particular employee. Each department would carefully evaluate the employee's skills, experience, and potential contributions to their respective goals. Then, they would submit a "bid" – essentially a statement of how much they would be willing to "pay" to acquire the employee's services. This "payment" could be expressed in various ways, such as increased budget allocations, additional resources, or even adjustments to departmental priorities. Then, the highest bid would be a way to outline the opportunity cost of using that particular person in his or her current position. The approach gives various useful insights. For instance, this shows the actual value one may bring to the firm aside from the particular position and the salary.

◆ Opportunity cost indicate the need for salary adjustment

It has implications on compensations. Recognizing the value an employee could add to other units of the organization further benefits the firm's overall utilization of the individual. If an employee's opportunity cost significantly exceeds their current salary, it may indicate a need for a salary adjustment to retain their valuable services. The method can aid in workforce planning and resource allocation. By identifying employees with high opportunity costs, companies can strategically deploy their talent to maximize overall organizational performance.

Advantages of the Opportunity Cost Method

i. Efficient Resource Allocation

Encourages organizations to allocate human resources where they can generate the highest value, leading to better workforce utilization.

ii. Market-Driven Valuation

Since different departments compete for employees, the method reflects the real worth of employees based on demand within the organization.

iii. Encourages Internal Competition

Promotes healthy competition among departments, ensuring that employees are placed in roles where they can maximize their potential.

iv. Improves Decision-Making

Helps management in strategic workforce planning by identifying employees with high potential and ensuring they are positioned effectively.

v. Flexible Approach

Can be adapted to different organizational structures and industries, making it a versatile method for human resource valuation.

Disadvantages of the Opportunity Cost Method

i. Limited Applicability

Only applicable in organizations where internal bidding for employees is feasible, making it unsuitable for many industries and job roles.

ii. Ignores Employee Potential

Focuses on current alternative uses rather than long-term employee development or future potential.

iii. Subjective Valuation

The value assigned to an employee is based on managerial perceptions and departmental needs, which can lead to biased or inconsistent valuations.

iv. Creates Internal Conflict

Competition for key employees among departments may lead to internal disputes and imbalances in workforce distribution.

v. Difficult to Implement

Requires a structured internal bidding system, which may be complex to establish and manage effectively.

4.2.2.3 The Replacement cost approach

The Replacement Cost Approach is a method used in human resource valuation to determine the monetary value of an employee by estimating the cost of replacing them with another individual of similar skills, experience, and qualifications. This approach considers all the expenses associated with recruiting, hiring, and training for an existing employee. This approach was propounded by Renis Likert and was further developed by Eric G. Flamholtz. This approach recognises that substituting a valuable employee is both expensive and time-intensive, involving costs that extend beyond just income. These expenses generally

- ◆ Cost of replacing an employee with another individual with similar skills, experience & qualification



encompass recruitment fees, advertising costs, screening and selection procedures, on boarding expenditures, and the possible decline in productivity during the vacancy and training phase.

- ◆ Underscores actual expenses of staff turnover and stresses the significance of retaining staff

The replacement cost method can yield significant insights for organisations. It underscores the actual expense of staff turnover and stresses the significance of retaining essential talent. By comprehending the possible expenses linked to staff replacement, organisations can make more informed decisions concerning employee remuneration, training and development initiatives, and retention measures. If the replacement cost of a highly trained person is substantial, the organisation may be more motivated to spend in retention strategies, including competitive compensation, appealing benefits packages, and career advancement chances.

- ◆ It may not accurately represent an employee's genuine worth

Nonetheless, the replacement cost method possesses several drawbacks. It may not accurately represent an employee's genuine worth, as it predominantly emphasises replacement costs rather than the distinctive contributions and value they provide to the organisation. Precisely assessing replacement costs can be difficult, since it necessitates meticulous evaluation of multiple criteria, including industry benchmarks, labour market dynamics, and the particular skills and experience of the individual. Notwithstanding these constraints, the replacement cost methodology can serve as a valuable instrument for HR professionals to evaluate the economic worth of their personnel and facilitate more informed decisions for talent management.

Advantages

i. Realistic and Market-Driven Valuation

Unlike historical cost methods, which record past expenses, the replacement cost approach considers current labour market conditions, providing a more accurate and up-to-date valuation of human capital.

ii. Reflects Employee Skills and Experience

This method accounts for the cost of hiring employees with similar experience, skills, and expertise, making it a more practical measure of workforce value.

iii. Better Decision-Making for Workforce Planning

Organizations can use replacement cost data to plan for employee turnover, succession planning, and talent acquisition, ensuring smooth business operations.

iv. Encourages Investment in Employee Development

By understanding the high cost of replacing employees, companies are more likely to invest in employee training and retention strategies to minimize turnover costs.

v. Useful for Cost-Benefit Analysis

Helps management assess whether investing in existing employees (through training and development) is more cost-effective than hiring new employees.

vi. Enhances Financial Reporting Transparency

Provides stakeholders with a clearer picture of human capital value, contributing to improved financial reporting and decision-making.

Disadvantages of the Replacement Cost Approach

While the Replacement Cost Approach is useful for valuing human resources, it has several limitations

i. Difficult to Accurately Estimate Costs

The actual cost of replacing an employee varies depending on factors like industry trends, skill availability, and labour market conditions. Estimating costs for highly specialized or senior employees is complex and uncertain.

ii. Ignores Employee Contributions beyond Cost

This method focuses only on the expense of replacement rather than the value an employee adds through experience, innovation, or leadership. Employees with unique knowledge or deep institutional memory may not be easily replaceable.

iii. Fluctuations in Lab or Market Conditions

The cost of hiring and training fluctuates over time due to economic conditions, inflation, and demand for specific skills. A valuation based on current replacement costs may become outdated quickly.

iv. Overlooks Intangible Factors

Factors like employee morale, teamwork, and company culture are not considered, even though they impact overall productivity. Soft skills, such as communication and problem-solving, are difficult to quantify in monetary terms.

v. Not Suitable for Long-Term Planning

Since replacement costs focus on immediate hiring and train-

ing expenses, this method does not account for an employee's long-term potential and career progression within the company.

4.2.2.4 The standard cost approach

- ◆ Emphasises calculating anticipated or standard cost of acquiring workforce

The standard cost approach in human resource accounting emphasises calculating the anticipated or "standard" expenses related to the acquisition, development, and maintenance of a workforce. It entails setting predefined expenditures for diverse HR tasks, including recruiting, selection, training, and development. Standard costs are subsequently compared to actual costs incurred, enabling organisations to pinpoint areas of cost overruns or inefficiencies.

- ◆ Standard cost may be established for recruitment process

A standard cost may be established for the recruitment process, encompassing expenses for advertising, resume screening, interview conduction, and background verification. By comparing actual expenditures to this benchmark, organisations can ascertain whether recruitment costs exceed expectations and explore possible reasons. This information can subsequently enhance recruitment processes, facilitate improved negotiations with recruitment agencies, or optimise hiring methods to minimise expenses.

The standard cost method offers significant insights into the cost determinants of human resources and aids organisations in effectively managing HR expenditures. By recognising and rectifying cost inefficiencies, firms may enhance their financial performance and deploy resources more efficiently. Establishing precise standard costs necessitates meticulous investigation and may require periodic revisions to accommodate evolving market conditions and organisational requirements.

Advantages

i. Simplicity and Ease of Implementation

The method is straightforward as it assigns predefined costs to employees based on job roles, eliminating the complexity of calculating individual valuations.

ii. Uniformity in Workforce Valuation

By using standardized cost structures, organizations ensure consistency in human resource valuation, making it easier to compare workforce investments over time or across industries.

iii. Facilitates Budgeting and Workforce Planning

Standardized costs help organizations estimate workforce-related expenses, allowing for better financial planning, cost con-

trol, and resource allocation.

iv. Enhances Financial Reporting and Transparency

Provides a structured and uniform method for including human resource costs in financial statements, improving transparency for stakeholders and decision-makers.

v. Reduces Subjectivity in Valuation

Since costs are predefined based on industry standards or organizational benchmarks, this method minimizes bias and inconsistencies in employee valuation.

vi. Supports Performance Measurement

Helps organizations evaluate the efficiency of HR investments by comparing actual workforce costs with standard benchmarks, enabling better decision-making.

Disadvantages of the Standard Cost Approach

i. Lack of Individual Employee Consideration

This approach applies uniform cost estimates to employees in similar roles, ignoring individual differences in productivity, skills, and contributions.

ii. Difficulty in Setting Accurate Standards

Determining a realistic standard cost for each job role is challenging due to market fluctuations, evolving skill requirements, and industry changes.

iii. Ignores Employee Growth and Development

Employees improve over time through experience and training, but the standard cost approach does not account for such growth, leading to undervaluation.

iv. Not Suitable for Dynamic Work Environments

In industries where job roles and skill demands frequently change, this approach becomes outdated quickly and may not reflect actual workforce value.

v. Does Not Consider Intangible Contributions

Employee attributes such as leadership, teamwork, and creativity are not factored in, leading to an incomplete valuation of human resources

4.2.3 Value-based models

Under this approach, the value of the human resources of an organization can be found by discounting the future salaries and other capital costs by a certain rate of discount or by discounting the future earnings of the organisation at a certain date by a suitable rate and allocating a part of the present value of earnings to human resources.

4.2.3.1 Present value approach

- ◆ Used to estimate the worth of human resources

The Present Value Approach is a method used to estimate the economic worth of human resources by calculating the present value of an employee's future earnings. It is based on the concept of the time value of money, which states that a rupee received today is worth more than a rupee received in the future due to inflation, investment opportunities, and risk factors. In this method, employees are considered as assets who generate financial benefits for the organization over their tenure. The organization estimates their future earnings and applies a discount rate to calculate the present value of these earnings. This approach helps businesses make informed decisions regarding human resource investments, training, and workforce planning.

Application of the Present Value Approach in Human Resource Accounting

i. Valuation of Human Capital

This method estimates the monetary worth of employees by calculating the present value of their future earnings. It helps in financial reporting, justifies HR expenditures, and enhances investor confidence by showcasing workforce investments.

ii. Decision-Making in HR Investments

Businesses invest in recruitment, training, and employee development, and this approach evaluates the return on these investments. It aids in assessing training effectiveness, identifying high-value employees, and deciding between internal promotions and external hires.

iii. Performance Appraisal & Compensation Planning

This approach ensures fair compensation by aligning salaries with employees' expected future contributions. It supports performance-based incentives, salary adjustments, and prevents pay disparities.

iv. Strategic Workforce Planning

Helps in making informed decisions on promotions, layoffs, and succession planning. Organizations can use this approach to identify future leaders, plan for retirements, and evaluate outsourcing needs.

Mergers & Acquisitions (M&A)

During M&A, businesses assess the value of human capital to determine employee contributions and restructuring needs. It ensures better workforce integration and evaluates whether the acquisition will be financially beneficial.

Advantages of the Present Value Approach

- i. **Accurate Financial Valuation:** This approach provides a structured and quantitative measure of an employee's worth by considering their future earnings, making HR valuation more precise.
- ii. **Incorporates Time Value of Money:** By discounting future earnings, this method acknowledges that money received today is more valuable than the same amount received in the future.
- iii. **Supports HR Investment Decisions:** Helps organizations evaluate the return on investment (ROI) for hiring, training, and retaining employees, ensuring better resource allocation.
- iv. **Facilitates Compensation Planning:** Assists in determining fair compensation and incentives by aligning salaries with employees' potential contributions and productivity.
- v. **Enhances Workforce Planning:** Aids in making data-driven decisions regarding promotions, retirements, succession planning, and layoffs.
- vi. **Useful for Mergers & Acquisitions:** Helps assess the financial worth of employees in an acquisition, allowing businesses to evaluate human capital assets before making investment decisions.

Disadvantages of the Present Value Approach

- i. **Relies on Assumptions & Estimates:** Future earnings, discount rates, and employee tenure are estimated, making the valuation subjective and uncertain.
- ii. **Ignores Non-Monetary Contributions:** Employee skills, creativity, leadership, teamwork, and other intangi-



ble benefits are not fully captured in financial terms.

- iii. **Sensitive to Discount Rate Selection:** Different discount rates can significantly impact the valuation, leading to inconsistencies in HR accounting.
- iv. **Fails to Account for Productivity Variations:** Assumes a steady income stream, overlooking fluctuations in individual performance, job changes, or economic conditions.
- v. **Complexity in Calculation:** Requires detailed data and financial modelling, making it difficult for organizations without expertise in HR valuation.

4.2.3.3 Rewards valuation model

According to this model, the ultimate measure of an individual's value to an organisation is the expected realisable value. The model has been suggested by Flamholtz. Here it tries to identify the major variables that determine an individual's value to an organization. This model outlines the main variables that influence an individual's value to an organisation, namely, their expected realisable value. The expected realisable value of an individual is the present value of future services expected to be provided during the period of their tenure within the company. The model is based on the assumption that an individual's worth to an organisation is dependent upon the position they will assume within it. The transition of individuals between organisational roles is a stochastic process accompanied by rewards. As individuals move and occupy various organisational responsibilities, they contribute to the organisation. The positions they will assume in the future must be ascertained probabilistically for each individual.

◆ Ultimate measure of an individual's value is the expected realisable value

Advantages of the Rewards Valuation Model

i. Comprehensive Employee Valuation

This model considers both financial and non-financial rewards, giving a complete picture of an employee's value to the organization. By including salary, incentives, benefits, training, and career growth opportunities, it provides a more holistic assessment than traditional cost-based approaches.

ii. Aligns HR Strategy with Business Goals

The Rewards Valuation Model ensures that employee compensation aligns with organizational objectives, promoting a performance-driven culture. It helps in designing reward systems that attract and retain top talent while maintaining financial stability.

iii. Improves Employee Satisfaction & Retention

By evaluating the total rewards offered to employees, companies can identify gaps in their compensation packages and improve them accordingly. A well-structured rewards system enhances job satisfaction, motivation, and employee loyalty, reducing turnover rates.

iv. Facilitates Compensation Planning

This model assists HR managers in developing fair and competitive compensation structures based on employee contributions and industry standards. By ensuring equitable pay, organizations can reduce wage disputes and enhance overall workforce morale.

v. Supports HR Budgeting & Forecasting

By assessing the financial impact of employee rewards, businesses can better plan and allocate HR budgets. This helps in forecasting future costs related to salaries, bonuses, and benefits, ensuring long-term financial stability.

Disadvantages of the Rewards Valuation Model

i. Difficult to Measure Intangible Benefits

While financial rewards can be easily quantified, intangible factors such as job satisfaction, leadership, and workplace culture are harder to measure accurately. Since these non-monetary benefits significantly influence employee performance, their exclusion can lead to incomplete valuations.

ii. Subjective Assessment

The valuation of rewards often relies on assumptions about future compensation trends and employee contributions. Since these predictions can be influenced by economic fluctuations, individual performance variations, or policy changes, they may not always be reliable.

iii. Complexity in Implementation

Gathering data on all forms of employee rewards and benefits requires extensive tracking and analysis, making the model time-consuming and resource-intensive. Organizations need advanced HR systems and financial expertise to implement it effectively.

iv. Vulnerable to Economic Changes

Employee rewards are often influenced by external factors

such as inflation, market demand, and company financial health. Since these elements can change unpredictably, valuations based on current rewards may not accurately reflect future financial realities.

4.2.3.4 The Net Benefit Model

The Net Benefit Model, created by William Morse in 1973, is a significant method in Human Resource Accounting (HRA). It emphasises measuring the economic worth of human resources to an organisation. The concept asserts that the worth of human resources corresponds to the present value of the net advantages obtained from their services. It aims to ascertain the surplus of the value of prospective human resource contributions relative to the value of future employee remuneration.

The following steps involved in this approach

- i. Estimating Gross Value of Services:** This entails forecasting the future economic contributions of personnel, taking into account elements such as productivity, innovation, and client interactions.
- ii. Estimating Future Expenditures:** This encompasses the assessment of forthcoming financial obligations related to personnel, including salaries, wages, benefits, and training costs.
- iii. Calculating Net Benefits:** The net benefit is ascertained by deducting the projected future payments from the anticipated gross value of services.
- iv. Calculating Present Value:** The total benefit is subsequently discounted to its present value via a suitable discount rate, which accounts for the time value of money and the risk linked to future cash flows.

Advantages of the Net Benefit Model

- i. Strategic Decision Making:** Offers critical insights for strategic HR decisions, including investments in employee development, remuneration plans, and succession planning.
- ii. Enhanced Resource Allocation:** Facilitates the effective distribution of resources by emphasising the significance of investments in human capital.
- iii. Improved Communication:** Enables interaction with stakeholders, such as investors and employees, by offering a quantitative assessment of human resource worth.
- iv. Performance Assessment:** Utilised to assess the efficacy

of HR services and their influence on organisational success.

Limitations of the Net Benefit Model

- i. **Subjectivity:** Depends significantly on estimates and assumptions, potentially leading to mistakes and bias.
- ii. **Difficulty in the measurement:** Precisely measuring the worth of intangible assets, such as staff morale and creativity, can be difficult.
- iii. **Data requirements:** Necessitates extensive data collecting and processing, which can be laborious and resource-demanding.

4.2.3.5 Certainty Equivalent Model

The Certainty Equivalent Model is a financial approach used in Human Resource Accounting (HRA) to value employees by adjusting their expected future earnings based on risk factors. This model helps organizations estimate the true worth of their human capital by incorporating uncertainty, making it more realistic than traditional valuation methods. The model is based on the principle that future earnings from an employee are uncertain and subject to risks such as market changes, economic fluctuations, and individual performance variations. Instead of using the full expected value of future earnings, the model applies a certainty equivalent factor—a risk-adjusted percentage that reflects the probability of achieving those earnings.

◆ Financial approach to value employees

Advantages of the Certainty Equivalent Model

- i. **Incorporates Risk in HR Valuation:** Unlike traditional models that assume fixed earnings, this model adjusts for uncertainty, making it a more reliable method for valuing employees.
- ii. **Provides a Realistic Employee Valuation:** By applying a certainty equivalent factor, the model ensures that companies do not overestimate employee contributions. This helps in making better HR investment decisions.
- iii. **Useful for Workforce Planning:** Organizations can use this model to decide on promotions, layoffs, and hiring by assessing the risk-adjusted value of employees.
- iv. **Helps in Mergers & Acquisitions (M&A):** The model is useful in determining the financial worth of employees in M&A deals, ensuring that human capital valuation reflects real business risks.
- v. **Supports Strategic HR Decisions:** It assists in HR bud-

getting, compensation planning, and training investments by offering a more accurate estimate of employee value.

Disadvantages of the Certainty Equivalent Model

- i. **Difficulty in Determining the Certainty Equivalent Factor:** Estimating an accurate certainty equivalent factor is subjective and complex, requiring expertise in risk assessment.
- ii. **May Lead to Conservative Estimates:** Since the model discounts future earnings based on risk, it may undervalue employees, potentially affecting HR investment decisions.
- iii. **Ignores Non-Monetary Contributions:** The model primarily focuses on financial aspects, overlooking intangible factors such as leadership, teamwork, and innovation.
- iv. **Requires Extensive Data Analysis:** Implementing this model requires accurate financial projections and risk assessments, which can be time-consuming.
- v. **Sensitive to External Economic Factors:** The certainty equivalent factor is influenced by inflation, market stability, and company performance, making valuations subject to external fluctuations.

4.2.3.6 The Aggregate Approach

This model of Human resources accounting was evolved by Prof. S. K. Chakraborty in 1976. According to him, human resources are valued in aggregate and not on an individual basis. However, he suggested that managerial and non-managerial manpower can be evaluated separately. The aggregate technique in Human Resource Accounting (HRA) evaluates the total value of an organization's workforce as a cohesive entity rather than analysing individuals independently. This methodology emphasises the combined input of all employees towards the organization's performance, offering a comprehensive view of human resources as a vital intangible asset. This approach assesses workforce value by summing the cost or worth of all employees at a given moment. It takes into account elements such as recruitment expenditures, training costs, remuneration, and benefits. Furthermore, it may encompass the prospective economic value that employees contribute to the organisation through their pooled skills, expertise, and productivity.

◆ Evaluate the total value of the workforce

Advantages of the Aggregate Approach

i. Simplifies Human Capital Valuation

The Aggregate Approach reduces the complexity involved in valuing employees individually by considering the workforce as a single unit. This makes the valuation process more manageable, especially for large organizations with thousands of employees. By aggregating employee data, companies can avoid the challenges of subjectivity and inconsistencies that arise in individual valuation methods, leading to more standardized results.

ii. Useful for Financial Reporting

The approach allows organizations to estimate and report the total value of their human capital as an intangible asset in financial statements. This provides investors and stakeholders with insights into the company's workforce strength and future potential. Since businesses often invest heavily in human resources, including training, salaries, and benefits, recognizing this value in financial reports helps justify HR expenditures and improves overall financial transparency.

iii. Facilitates HR Budgeting and Planning

Organizations can use the Aggregate Approach to assess total employee costs, including wages, benefits, and training expenses, to make informed budgeting decisions. This helps in long-term HR planning and workforce investment strategies.

iv. Reduces Subjectivity in Individual Valuation

Individual-based valuation models often involve biases and inconsistencies, as different employees may be valued based on subjective criteria. The Aggregate Approach eliminates this issue by treating the workforce as a whole.

v. Supports Organizational Decision-Making

The model provides a macro-level view of human capital, which helps businesses make strategic decisions regarding workforce management, expansion, and restructuring. Companies can assess overall workforce trends rather than focusing on individual employee metrics.

Disadvantages of the Aggregate Approach

i. Ignores Individual Employee Contributions

One of the biggest limitations of this approach is that it does not differentiate between high-performing and low-performing

employees. Since all employees are valued collectively, their individual contributions to organizational success are overlooked.

ii. Lacks Precision in Workforce Valuation

The model provides a broad estimate of human capital value rather than an accurate valuation of specific job roles or skill sets. This lack of precision makes it unsuitable for organizations that need detailed workforce analytics.

iii. May Not Reflect Workforce Diversity

The approach does not take into account the diversity of skills, experience, and productivity levels among employees, which can lead to a generalized and sometimes misleading valuation. Employees with unique skill sets or specialized expertise may not receive proper recognition under this model.

iv. Challenges in Applying to Decision-Making

While the Aggregate Approach provides a collective valuation of employees, it does not offer insights into individual performance or potential. This makes it difficult to use for HR functions such as performance appraisals, promotions, and compensation planning.

v. Affected by Workforce Turnover

The valuation derived from this approach may become unstable due to frequent workforce changes, such as resignations, retirements, and new hires. Employee turnover affects the total human capital value, making it difficult to maintain an accurate and consistent valuation over time.

4.2.4 Disclosure in financial statements

Disclosure in financial statements refers to the process of providing essential financial and non-financial information to stakeholders, including investors, creditors, and regulatory bodies. It ensures transparency, improves decision-making, and complies with legal and accounting standards. Companies must disclose all relevant information that could impact users' understanding of their financial position, performance, and risks.

4.2.4.1 Key Areas of Disclosure in Financial Statements

- i. Financial Performance and Position:** Organizations must disclose key financial statements, including the Balance Sheet, Income Statement, and Cash Flow Statement, to present their financial health. Revenue, expenses, net

profit, and retained earnings should be clearly outlined to help stakeholders assess profitability and financial sustainability.

- ii. Accounting Policies and Estimates:** Companies must disclose the accounting principles, methods, and estimates used in preparing financial statements, such as depreciation methods, revenue recognition policies, and inventory valuation techniques. Any changes in accounting policies must be clearly stated, along with their impact on financial results.
- iii. Contingent Liabilities and Commitments:** Businesses should disclose potential liabilities that could arise from lawsuits, tax disputes, or contractual obligations. Future commitments, such as leases, loans, and guarantees, must also be included to provide a full picture of financial responsibilities.
- iv. Risk Management and Financial Instruments:** Companies must disclose financial risks, including credit risk, market risk, and liquidity risk, affecting their operations. Information on the use of financial instruments like derivatives, hedging strategies, and investment portfolios should also be provided.
- v. Related Party Transactions:** Transactions between the company and its directors, executives, shareholders, or affiliated entities must be disclosed to prevent conflicts of interest. Details should include transaction amounts, terms, and the nature of the relationship.

Advantages of Disclosure in Financial Statements

- i. Enhances Transparency and Trust:** Proper financial disclosure increases transparency, allowing investors, creditors, and stakeholders to understand a company's financial position and performance. It builds trust in the company's management, fostering stronger investor relationships and market confidence.
- ii. Improves Investor Decision-Making:** Investors rely on disclosed financial information to assess a company's profitability, risk factors, and growth potential before making investment decisions. Accurate and detailed disclosures help in comparing different companies, making investment decisions more data-driven.
- iii. Ensures Regulatory Compliance:** Financial disclosures are required by law under regulations such as IFRS (International Financial Reporting Standards) and GAAP

(Generally Accepted Accounting Principles). Compliance with disclosure standards helps avoid legal penalties and improves corporate governance.

- iv. **Aids in Risk Management:** Companies disclose financial risks, contingent liabilities, and commitments, allowing stakeholders to assess potential threats to business sustainability. Investors and creditors can use this information to evaluate a company's ability to handle future uncertainties.
- v. **Facilitates Better Credit Decisions:** Banks and financial institutions use disclosed financial data to assess creditworthiness before approving loans or extending credit. Transparent financial reporting ensures fair interest rates and better borrowing terms for businesses.

4.2.5 Objections against Human Resource Accounting (HRA)

Human Resource Accounting (HRA) is a crucial instrument for assessing and disclosing the value of human assets in financial statements. Nonetheless, it encounters numerous challenges and criticisms, encompassing intellectual, practical, and ethical issues:

Here are some common objections raised against Human resource accounting

- i. **Subjectivity and measurement challenges:** Human Resource Accounting frequently depends on subjective assessments to appraise human resources, including anticipated earnings potential, replacement costs, or projected contributions. Such assessments may result in inconsistent and incorrect valuations. Unlike tangible assets such as machinery or buildings, human resources value is intangible and difficult to quantify accurately. Critics argue that subjective assessments can undermine the credibility and reliability of Human Resource Accounting.
- ii. **Lack of universal measurement of standards:** There are no widely recognised procedures or frameworks for executing HRA. The absence of standardisation hinders comparison among organisations and diminishes their credibility. Different firms may adopt different methods and assumptions, leading to inconsistency and incomparability.
- iii. **Ethical Issues:** Treating employees as "assets" may provoke ethical issues, as it could view human resources as

a commodity and disregard their inherent worth as human beings. Concerns are raised about the potential for employees to be treated purely as financial entities rather than as individuals with dignity and rights.

- iv. **Valuation issues:** Valuing human resources based solely on their monetary value neglects other important aspects such as employee wellbeing, job satisfaction and overall organizational culture.
- v. **Non-Financial Contributions:** HRA emphasises measurable financial advantages, frequently overlooking non-financial contributions like as organisational culture, employee morale, and team dynamics.
- vi. **Dynamic work environment:** In today's dynamic work environment, where skills, job roles and work arrangements evolve rapidly, human resources valuation becomes even more challenging. The main criticism is that traditional accounting methods may not capture the true value of skills, knowledge and capabilities that are crucial in a knowledge-based economy.

These objections are basically discussed because H R A is a relatively new concept. In the course of time, proper techniques are bound to be developed for the valuation of human resources, and generally acceptable formats will be evolved by the accountants for disclosure of this vital information in the financial statements of the organisation.

4.2.6 Human Resource Accounting (HRA) in India

Human Resource Accounting (HRA) in India is a burgeoning field that seeks to measure and report the value of an organization's human capital. This goes beyond traditional accounting, which primarily focuses on tangible assets, by recognizing the significant contribution of employees' skills, knowledge, and experience to an organization's success. In the Indian context, where a burgeoning workforce is a key driver of economic growth, HRA offers valuable insights for businesses. By evaluating the worth of human capital, firms may make better-informed decisions regarding recruiting, training, and employee development. This can lead to greater labour productivity, lower attrition, and, ultimately, enhanced organizational performance. HRA can also aid in strategic decision-making, such as identifying and developing critical talent, improving staff planning, and connecting human capital initiatives with overall corporate objectives.

◆ Workforce is a key driver

◆ Challenges

The implementation of HRA in India confronts various problems. One key challenge is the lack of defined assessment procedures and reporting standards. This unpredictability makes it difficult to evaluate human capital across different firms and industries, hampering meaningful analysis and benchmarking. Many Indian organisations, particularly smaller and medium-sized enterprises (SMEs), may lack the means and experience to install complex HRA systems. This can be attributed to factors such as limited access to skilled HR professionals, lack of awareness about the benefits of HRA, and concerns about the cost and complexity of implementation. Addressing these challenges requires a multi-pronged approach involving collaboration between academic institutions, professional accounting bodies, and government agencies.

◆ Better decision-making

Despite these limitations, the potential benefits of HRA in India are enormous. By giving a more holistic perspective of organizational value, HRA can help Indian organisations negotiate the difficulties of the modern workforce. It can also promote better decision-making in areas such as talent management, succession planning, and strategic human resource management. For instance, by precisely analysing the return on investment (ROI) of employee training programs, firms may optimize their training budgets and ensure that training initiatives are aligned with business needs. HRA can help firms find and keep elite people, thereby gaining a competitive advantage in the increasingly dynamic and competitive global market.

As the Indian economy continues to change, HRA is positioned to play an increasingly vital role in supporting sustainable growth and competitiveness. By implementing HRA concepts and practices, Indian firms may unlock the full potential of their human capital, cultivate a high-performing staff, and achieve long-term success. This will require a coordinated effort from all stakeholders, including businesses, academic institutions, and policymakers, to promote awareness, establish relevant methodology, and create a supporting ecosystem for the efficient implementation of HRA in India.

Summarised Overview

Human Resource Accounting (HRA) encompasses diverse methods for appraising human resources to signify their impact on organisational success. The historical cost technique emphasises documenting expenses associated with recruiting, training, and developing personnel, whereas the opportunity cost method attributes value based on the benefits forfeited if people were assigned to different tasks. The replacement cost strategy calculates the expenses necessary to substitute an employee with an individual possessing comparable skills and experience, while the standard cost approach employs predetermined costs for particular tasks, assuring uniformity at the sacrifice of precision. The present value method computes the discounted future profits of employees, providing a prospective valuation. The reward valuation model determines value based on concrete rewards such as pay and perks. Alternative models, such as the net benefit model, evaluate the benefits produced by employees in relation to their expenses, while the certainty equivalent model modifies future revenues to account for risk concerns. The aggregate method streamlines valuation by assessing the total value of the workforce, providing an organisational viewpoint while omitting specifics regarding individual contributions. Notwithstanding these varied approaches, disclosure in financial statements is constrained by the absence of standardised norms and apprehensions around subjectivity. Critics contest HRA, highlighting issues such as the limitations in precisely measuring intangible benefits, dependence on assumptions, and the lack of globally recognised frameworks. In India, the implementation of HRA is still developing, with only a limited number of organisations integrating these practices into their financial reporting. Despite growing recognition of its significance, Human Resource Accounting (HRA) in India encounters obstacles, including legislative deficiencies, insufficient expertise, and a conventional emphasis on tangible assets. As organisations acknowledge the strategic significance of human capital, Human Resource Accounting techniques are progressively gaining traction, especially in knowledge-intensive sectors.

Self-Assessment Question

1. What is the primary goal of using methods for valuing human resources in HRA?
2. How do cost-based methods differ from value-based methods in HRA?
3. What are the key components considered in the historical cost approach to valuing human resources?
4. What is a major limitation of the historical cost approach in reflecting employee contributions?
5. How does the opportunity cost method assign value to human resources?



6. Why the opportunity cost method is not widely adopted in organizations?
7. What factors are considered when calculating the replacement cost of an employee?
8. How does the standard cost approach ensure consistency in valuing human resources?
9. How does the present value approach account for future earnings of employees?
10. Why might the reward valuation model underestimate the true value of human resources?

Assignments

1. Conduct a case study on a company that uses the historical cost approach to value its human resources. Discuss the advantages, limitations, and impact on decision-making.
2. Develop a hypothetical scenario where the opportunity cost method is applied to a specific industry. Evaluate its feasibility and implications for resource allocation.
3. Compare and contrast the replacement cost and standard cost approaches in valuing human resources. Provide practical examples and suggest scenarios where each method would be more
4. Design a project comparing the net benefit and certainty equivalent models in valuing human resources. Highlight the mathematical and practical challenges in implementing these methods.
5. Aggregate Approach for Organizational Valuation

Suggested Reading

1. Anthony, R. N., & Reece, J. S. (1988). *Accounting principles*. Richard Irwin, Inc.
2. Sehgal, A., & Sehgal, D. (2008). *Advanced accounting*. Taxmann.
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1. Jain, S. P., Narang, K. L., Agarwal, S. & Sehgal, M. (2021). *Advanced accountancy*. Kalyani Publishers.
2. Lele, R. K., & Jawaharlal. (1997). *Accounting theory*. Himalaya Publishing House.
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4. Anthony, R. N., Hawkins, D. F., & Merchant, K. A. (2017). *Accounting: Text and cases*. Tata McGraw-Hill.
5. Shukla, M. C., & Grewal, T. S. (2020). *Advanced accounts*. S. Chand & Co. Ltd.
6. Paul, S.K. (2009). *Financial Accountancy*. New Central Book Agency.

Space for Learner Engagement for Objective Questions

Learners are encouraged to develop objective questions based on the content in the paragraph as a sign of their comprehension of the content. The Learners may reflect on the recap bullets and relate their understanding with the narrative in order to frame objective questions from the given text. The University expects that 1 - 2 questions are developed for each paragraph. The space given below can be used for listing the questions.

SGOU

MODEL QUESTION PAPER SETS





SREENARAYANAGURU OPEN UNIVERSITY

Model Question Paper (SET- A)

QP CODE:

Reg. No :

Name:

THIRD SEMESTER MASTER OF COMMERCE (M.COM) DEGREE EXAMINATION

DISCIPLINE SPECIFIC ELECTIVE

M21CM01DE ADVANCED CORPORATE ACCOUNTING

Time: 3 Hours

Max Marks: 70

Section A

Answer any five of the following questions in one or two sentences each. Each question carries 2 marks.

(2 x 5 = 10)

1. Define accounting standards?
2. Distinguish between AS1 and AS 2
3. Define IFRS.
4. What are the advantages of adopting IFRS in India?
5. What is amalgamation?
6. Calculate the amount available to equity shareholders after liquidation provided that realised assets, preferential creditors, debentures and expenses are ₹2,00,000, ₹40,000, ₹1,00,000, and ₹10,000 respectively.
7. Define Human resource accounting.
8. What are the two primary methods of Human resource valuation.

Section B

Answer any six of the following questions. Each question carries 5 marks.

(5 x 6 = 30)

9. Explain the need for Accounting Standards
10. Following is the Balance Sheet of 'P' Ltd. as of 31.03.2025:

Liabilities	Amount	Assets	Amount
150 Equity Shares of 10 each fully paid	1500	Sundry assets	2000



General reserve	20	Discount	20
10% Debentures	300	Preliminary expenses	30
Sundry creditors	200	P&L A/c	30
Bank overdraft	20		
Bills Payable	40		
	2080		2080

‘Q’ Ltd. agreed to take over the business of ‘P’ Ltd. Calculate purchase consideration under the Net assets method after considering the following:

- i. The market value of 30% of the sundry assets is estimated to be 5% less than the book value. The liabilities are taken over at book values. There is an unrecorded liability of 3000.
11. Explain the structure and characteristics of IFRS.
 12. Classify the following items into Current and Non-current assets as per IFRS norms:
 - a. Trade receivables ₹5000
 - b. Building ₹25000
 - c. Inventory ₹4000
 - d. 5-Year term loan ₹12000
 - e. Cash and bank ₹3000
 13. Following information have been extracted from the Balance sheet of H Ltd. and its subsidiary S Ltd. as on 31st March 2025:
 - a. H Ltd. holds 80% of the equity shares of S Ltd.
 - b. Share capital of S Ltd. ₹100000
 - c. Reserves and surplus of S Ltd. (at acquisition): ₹20000
 - d. Reserves and surplus of S Ltd (at consolidation): ₹30000
 - e. Goodwill on acquisition ₹5000

You are required to calculate the minority interest and capital profit to be shown in the consolidated balance sheet.

14. C Ltd. Holds 75% of the shares of F Ltd. During the financial 2024-2025 F Ltd. sold goods costing ₹20000 to C Ltd. for ₹25000. At the end of the year, 40% of such goods were still in stock with C Ltd. Calculate the amount of unrealised profit to be eliminated from the consolidated accounts and show the adjusting journal entry.
15. The following information is extracted from the books of accounts of D Ltd., which is going for liquidation:
 - a. Fully secured creditors ₹100000
 - b. Partly secured creditors ₹60000
 - c. Estimated value of security ₹40000
 - d. Unsecured creditors ₹80000



- e. Preference creditors ₹20000
- f. Debtors (good) ₹50000
- g. Stock ₹30000
- h. Furniture ₹10000
- i. Cash at bank ₹5000
- j. Plant & machinery ₹25000

You are required to prepare a statement of affairs showing the estimated surplus or deficiency as regard creditors.

16. The following information is extracted from the books of PQR Ltd. which is being wound up:

- a. Plant and machinery ₹120000
- b. Furniture ₹40000
- c. Stock ₹60000
- d. Debtors ₹80000
- e. Cash ₹10000
- f. Secured loan ₹90000
- g. Preferential creditors ₹20000
- h. Unsecured creditors ₹150000
- i. Fully paid equity shares (10000 shares) ₹100000
- j. 1000 shares with ₹2 calls in arrears (Face value ₹10)

Estimate realisable value:

- 1. Plant ₹100000
- 2. Furniture ₹25000
- 3. Stock ₹50000
- 4. Debtors ₹60000

You are required to prepare a statement of affairs showing expected deficiency to unsecured creditors and shareholders.

17. Briefly explain the importance of Human resource accounting.

18. ABC Ltd. is a firm that specialise in offering technical consulting services. ABC reported operating income (EBIT) of ₹51.5 lakh and net income of ₹23 lakh in the most recent years. In the most recent year, the firm had ₹14 lakh training and recruitment expenses. A consultant who joins ABC stays with the firm on average 4 years. Training and recruitment expenses are amortisable over 4 years, and over the past 4 years they were:

Year	Training and recruitment expenses (in lakhs)
Current	14

1	12
2	10.40
3	9.10
4	8.30

Assuming a linear amortisation schedule (over 4 years) you are required to estimate:

- The value of human capital asset
- The adjustment net income.

Section C

Answer any two of the following. Each question carries 15 marks.

(15 x 2 = 30)

- Write a note on trading strategies and the best practices in trading.
- Balance Sheet of A Ltd and B Ltd on 31s March 2025 is as follows:

1 Equity and Liabilities	A Ltd	B Ltd
1. Shareholders' funds		
a. Share capital:		
Equity shares of ₹50 each	100000	40000
10% preference shares of ₹50 each	-	10000
b. Reserves and surplus		
General reserve	10000	5000
Surplus amount:		
Balance on 1-4-2024	4000	3000
Profit for 2024-2025	20000	8000
2. Current liabilities		
Creditors	15000	7000
Total equity and liabilities	149000	73000

2 Assets		
1. Non-current assets		
a. Fixed assets;		
Land and buildings at cost	31000	16000
Machinery less 10% depreciation	27000	13500
b. Investments 300 shares in B Ltd	45000	-
2. Current assets		
Stock at cost	22000	15000
Sundry debtors	15500	9000
Cash and bank balance	8500	19500
Total assets	149000	73000

A Ltd acquired 3000 equity shares in B Ltd on 1st October 2022. As on the date of acquisition A Ltd found that the value of land and building and machinery of B Ltd should be ₹15000 and ₹19250 respectively. Prepare the consolidated balance sheet of A Ltd and its subsidiary B Ltd as on 31st March 2025 taking into consideration the fact that assets are to be taken in their proper value.

21. The following information is extracted from the books of X Ltd. on 31st July, 2024 on which date a winding up order was made:

Unsecured creditors	₹350000
Salaries due for five months	₹20000
Managing director's remuneration due	₹30000
Bills payable	₹106000
Debtors	
1. Good	₹430000
2. Doubtful (estimated to produce 62000)	₹130000
3. Bad	₹88000
Bills receivable (Good ₹10000)	₹16000
Bank overdraft	₹40000
Land (estimate to produce ₹500000)	₹360000
Stock (estimated to produce ₹580000)	₹820000
Furniture and fixtures	₹80000
Cash in hand	₹4000
Estimated liabilities for hills discounted	₹60000

Secured creditors holding first mortgage on land	₹400000
Partly secured creditors holding second mortgage on land	₹200000
Weekly wages unpaid	₹6000
Liabilities under workmen's compensation Act 1925	₹2000
Income tax due	₹8000
5000 9% mortgage debentures of 100 each interest payable to 30 th June and 31 st December, paid to 30 th June 2024	₹500000
Share capital:	
a. 20000 10% preference shares of ₹10 each	₹200000
b. 50000 Equity shares of ₹10 each	₹500000
General reserve since 31 st December 2020	₹100000

In 2020 the company earned profit of ₹450000, but thereafter it suffered trading losses totaling ₹584000. The company also suffered a speculation loss of ₹50000 during the year 2021. Excise authorities imposed a penalty of ₹350000 in 2022 for evasion of tax which was paid in 2020. Based on this information, prepare Statement of Affairs and Deficiency account.

22. Explain the cost-based methods of Human resource valuation.



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Model Question Paper (SET- B)

QP CODE:

Reg. No :

Name:

THIRD SEMESTER MASTER OF COMMERCE (M.COM) DEGREE EXAMINATION
DISCIPLINE SPECIFIC ELECTIVE
M21CM01DE ADVANCED CORPORATE ACCOUNTING

Time: 3 Hours

Max Marks: 70

Section A

Answer any five of the following questions in one or two sentences each. Each question carries 2 marks.

(2 x 5 = 10)

1. What is the role of Accounting Standard Board (ASB)?
2. A Ltd takes over the business of B Ltd. The fixed assets were valued at 20000, and current assets 15000. Current liabilities and debentures amounted to 5000 and 10000. Calculate the purchase consideration.
3. Define subsidiary company.
4. What do you mean by revaluation of assets?
5. What do you mean by Members' Voluntary Liquidation?
6. What are preferential payments
7. What is the main objective of Insolvency and Bankruptcy Code (IBC), 2016?
8. What do you mean by Certainty Equivalent Model?

Section B

Answer any six of the following questions. Each question carries 5 marks.

(5 x 6 = 30)

9. Briefly explain amalgamation in the nature of merger.
10. Following is the Balance Sheet of 'X' Ltd. as of 31.03.2025:

Liabilities	Amount	Assets	Amount
50 Equity Shares of 100 each fully paid	5000	Sundry assets	4000



General reserve	50	Discount	100
10% Debentures	500	Preliminary expenses	500
Sundry creditors	250	P&L A/c	1360
Bank overdraft	60		
Bills Payable	100		
	5960		5960

‘Y’ Ltd. agreed to take over the business of ‘P’ Ltd. Calculate purchase consideration under the Net assets method after considering the following:

- i. The market value of 40% of the sundry assets is estimated to be 10% less than the book value. The liabilities are taken over at book values. There is an unrecorded liability of 3500.
11. Briefly explain the stages in the consolidation process of holding and subsidiary companies.
 12. A Ltd acquired 3000 equity shares in B Ltd on 1st October 2020. As on the date of acquisition A Ltd. found that the value of land and building, and machinery of B Ltd should be 150000 and 192500 respectively. You are required to calculate the capital profit based on the following information extracted from the books of B Ltd:
 - a. 10% preference shares of 100 each – 100000
 - b. Land and building at cost – 160000
 - c. Machinery less 10% depreciation – 135000
 - d. General reserve – 50000
 - e. Profit for 2024-2025 – 80000
 - f. Surplus account balance as on 1/4/2024 – 30000
 13. Briefly explain the importance of liquidation.
 14. Calculate the liquidators’ commission for the amount due to unsecured creditors which amounted to 500000, provided that the commission to be paid to unsecured creditors is 3%, in the following situations:
 - a. The amount available for unsecured creditors before charging a commission on amount paid to unsecured creditor is 206000.
 - b. The amount available for unsecured creditors before charging a commission on amount paid to unsecured creditor is 806000.
 15. Explain the four pillars of Institutional Infrastructure under IBC 2026.
 16. Briefly explain the scope of Insolvency and Bankruptcy Board of India (IBBI).
 17. Explain the objectives of Human Resource Accounting (HRA).
 18. Describe the advantages of the Opportunity Cost Method of Human Resource valuation.

Section C

Answer any two of the following. Each question carries 15 marks.

(15 x 2 = 30)

19. Following are the balance sheets of X Ltd. and Y Ltd. as on 31st December 2024.

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
Share capital:			Fixed assets	150000	100000
10,000 shares of 10 each	100000	100000			
Reserves	90000	50000	Current assets	100000	100000
Debentures	50000	-	Shares in Y Ltd. 4000 shares	50000	-
Creditors	60000	50000			
	300000	200000		300000	200000

X Ltd. takes over the business of Y Ltd. The purchase consideration is to be computed on the basis of intrinsic value of each company's shares as recorded in the balance sheets. It is to be satisfied by issue of shares.

20. Balance Sheet of A Ltd and B Ltd on 31s March 2025 is as follows:

1 Equity and Liabilities	XY Ltd	AB Ltd
1. Shareholders' funds		
a. Share capital:		
Equity shares of ₹50 each	1000	400
10% preference shares of ₹50 each	-	100
b. Reserves and surplus		
General reserve	160	50
Surplus amount:		
Balance on 1-4-2024	60	30
Profit for 2024-2025	120	80
2. Current liabilities		
Creditors	150	70
Total equity and liabilities	1490	730

2 Assets		
1. Non-current assets		
a. Fixed assets;		
Land and buildings at cost	310	160
Machinery less 10% depreciation	270	135
b. Investments 300 shares in B Ltd	450	-
2. Current assets		
Stock at cost	220	150
Sundry debtors	155	90
Cash and bank balance	85	195
Total assets	149000	730

XY Ltd acquired 30 equity shares in AB Ltd on 1st October 2022. As on the date of acquisition A Ltd found that the value of land and building and machinery of AB Ltd should be ₹150 and ₹192.5 respectively. Prepare the consolidated balance sheet of XY Ltd and its subsidiary AB Ltd as on 31st March 2025 taking into consideration the fact that assets are to be taken in their proper value.

21. The following information is extracted from the books of JK Ltd. on 31st July, 2024 on which date a winding up order was made:

Unsecured creditors	₹500000
Salaries due for five months	₹50000
Managing director's remuneration due	₹60000
Bills payable	₹206000
Debtors	
1. Good	₹630000
2. Doubtful (estimated to produce 62000)	₹330000
3. Bad	₹90000
Bills receivable (Good ₹10000)	₹32000
Bank overdraft	₹80000
Land (estimate to produce ₹500000)	₹720000
Stock (estimated to produce ₹580000)	₹100000
Furniture and fixtures	₹120000
Cash in hand	₹10000
Estimated liabilities for bills discounted	₹120000

Secured creditors holding first mortgage on land	₹800000
Partly secured creditors holding second mortgage on land	₹400000
Weekly wages unpaid	₹12000
Liabilities under workmen's compensation Act 1925	₹4000
Income tax due	₹16000
5000 9% mortgage debentures of 100 each interest payable to 30 th June and 31 st December, paid to 30 th June 2024	₹1000000
Share capital:	
a. 40000 10% preference shares of ₹10 each	₹400000
b. 100000 Equity shares of ₹10 each	₹1000000
General reserve since 31 st December 2020	₹200000

In 2020 the company earned profit of ₹900000, but thereafter it suffered trading losses totaling ₹684000. The company also suffered a speculation loss of ₹100000 during the year 2021. Excise authorities imposed a penalty of ₹700000 in 2022 for evasion of tax which was paid in 2020. Based on this information, prepare Statement of Affairs and Deficiency account.

22. Define Human Resource Accounting (HRA). Explain the aim and importance of HRA.

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