

FINANCIAL ACCOUNTING VI

Syllabus:

1. FINAL ACCOUNTS OF BANKING COMPANY
2. FINAL ACCOUNTS OF INSURANCE COMPANY(EXCL LIFE INSURANCE)
3. NON-BANKING FINANCIAL COMPANIES
4. VALUATION OF GOODWILL AND SHARES
5. ACCOUNTING FOR LIMITED LIABILITY PARTNERSHIP

FINAL ACCOUNTS OF BANKING COMPANY

- ▶ Legal provision in Banking Regulation Act,1949 relating to Accounts Ratio Bill purchase and discounted, rebate of bill discounted. Statutory reserves including Cash Reserve and Statutory Liquidity
- ▶ Final Accounts in prescribed form
- ▶ Non-performing assets and Income from non performing assets
- ▶ Capital Adequacy

- ▶ **Classification of Advances, standard, sub-standard, doubtful and provisioning requirement.**

FINAL ACCOUNTS OF INSURANCE COMPANY(EXCL. LIFE INSURANCE)

- ▶ **General Insurance- Various types of insurance like fire, marine, Miscellaneous, Special terms like premium, claims, commission, Management expenses, Reserve for unexpired risk, Reinsurance & Co-insurance.**
- ▶ **Final Accounts in a prescribed form. Revenue Statement- Form B-RA, Profit/Loss Account- Form B-PL and Balance Sheet Form B- BS**

NON-BANKING FINANCIAL COMPANIES

Introduction, Definition, Registration and Regulation, Classification, Income Recognition, Accounting of Investment, Applicability of Prudential Norms, Assets Classification, Non-Performing Assets, Capital Adequacy, Preparation of Financial Statement.

VALUATION OF GOODWILL AND SHARES

- ▶ **Valuation of Goodwill**
Future Maintainable Profit Method, Super Profit Method.
Capitalisation Method, No of Purchase Method.

▶ **Valuation of Shares**

Intrinsic Value Method, Yield Method and Fair Value Method

ACCOUNTING FOR LIMITED LIABILITY PARTNERSHIP

▶ **Statutory Provisions**

▶ **Conversion of Partnership business into Limited Liability Partnership**

Final Accounts

VALUATION OF GOODWILL AND SHARES

▶ **Definition:**

It means the reputation of a business concern which attracts customers.

▶ **Features/Characteristics:**

- 1. It is an intangible asset.**

2. It cannot be separated from the business.
3. It is subjective and is highly dependent on the judgement.
4. It is subject to fluctuations.
5. It is a valuable asset if the firm is earning profits.

CLASSES OF GOODWILL

- ▶ **LOCAL** : A retail shopkeeper in a busy market centre.
- ▶ **THE PERSONAL REPUTATION OF THE GOODWILL** :
Accountant or a Doctor thru his skills , influence and personality.
- ▶ **THE REPUTATION OF THE GOODS SOLD** : A well advertised brand of a good having a high standard of quality.
- ▶ **THE ABSENCE OF COMPETITION** : Absolute or partial monopoly.

FACTORS/CAUSES GIVING RISE TO GOODWILL:

1. **Location**: A particular location can give an immense advantage to a business. Ex: Fort Area or Nariman Point
2. **Owner or Manager**: The personality, reputation, contacts or skills of the owner plays an important role in creating

goodwill.Ex:Professionalslike Doctors, Architects,Lawyers,CAetc

3. Nature of Business:Ifa concern enjoys monopoly, it is able to earn high profits due to absence of competition giving rise to Goodwill.

Methods of Valuation of Goodwill:

1. FUTURE MAINTAINABLE PROFIT(FMP) METHOD
2. SUPER PROFIT METHOD
3. NUMBER OF YEARS PURCHASE METHOD
4. CAPITALISATION METHOD

FUTURE MAINTAINABLE PROFIT METHOD(FMP)

▶ Meaning of **FMP**: Income expected in future is called Future Maintainable Profit.

▶ Steps:

1. Find **Average Profit before tax** (Total Profit before tax / No of years)

2. Find **Past Adjusted Average Profit**

= Average Past profit before Tax + Loss by fire or theft or Expenses no longer payable(Unusual Expenses) – Profit on sale of asset or Income no longer receivable(Unusual Income)

3. Find **FMP**

=Past Adjusted Average Profit – Future expenses + Future Income-Non Trading Income-Tax

Points to be remembered in determination of FMP

- ▶ If there is any **abnormal loss** in a particular year and that is not likely to occur in future, the same should be added back to past profits
- ▶ All **operational expenses** including the interest on debentures should be provided and depreciation of fixed assets should be charged.
- ▶ If any **capital receipts** has already been adjusted in profits, that must be subtracted from the earnings of the business.
- ▶ If **directors or managers remuneration or commission** is not adjusted in the profits, the same must be subtracted from the profits.
- ▶ From the past profits, the necessary **income tax** must be deducted

SUPER PROFIT METHOD

Meaning: It indicates the extra income arising out of Goodwill as compared to the normal income earned by an average concern in the same industry.

Formula:

Super Profit = FMP – Normal Profit

Find **Normal Profit** = Capital Employed x NRR/100 where NRR= Normal Rate of Return, Reasonable Rate of Return, Standard Rate of Return.(It is always given in % form).It is the normal yield expected by an investor from investment in a particular industry.This may be the actual rate earned or an estimated rate.

COMPUTATION OF CAPITAL EMPLOYED

▶ 1) ASSETS BASIS:

Assets(Fixed + Current)-External Liabilities=Trading Capital Employed

Trading Capital Employed – 1/2 of Net Profit(After Tax)earned during the year= Average Capital Employed.

Alternatively Average Capital Employed=Opening + Closing Capital Employed/ 2

Note: It is recommended that Average Capital should be computed only if the problem specifically requires it.

COMPUTATION OF CAPITAL EMPLOYED:

▶ 2) LIABILITIES BASIS:

Share Capital(Equity + Preference) + Reserves & Surplus –
Miscellaneous Expenditure/Losses= Net Assets

Net Assets – Goodwill(If appearing in Balance Sheet)-Non Trading

Assets(Investments)=Trading Capital Employed

Trading Capital Employed – $\frac{1}{2}$ of Profit earned after tax during the year= Average Capital Employed.

NO OF YEARS PURCHASE METHOD:

► **Meaning:** It is a lump sum advance payment made today to be recovered in the form of future profits over a number of years.

A) As per **FMP** Method

Goodwill= FMP X No of years Purchase

B) As per **Super Profit Method**

Goodwill= Super Profit x No of years Purchase

CAPITALISATION METHOD

► **Meaning:** It means the value of investment, which at the normal rate of return will yield the amount of the expected future earnings.

► **A)** As per **FMP** Method:

FMP/NRR – Capital Employed

▶ **B) As per Super Profit Method:**

Super Profit/NRR

VALUATION OF SHARES:

Methods of Valuation of Shares:

- 1. INTRINSIC VALUE METHOD**
- 2. YIELD METHOD**
- 3. FAIR VALUE METHOD**

TYPES OF SHARE VALUES

- 1. Book Value:** Value of share shown in the books of accounts and Balance Sheet.
- 2. Par Value:** Nominal or Face Value of a share.
- 3. Value at a Premium**
- 4. Value at a Discount**
- 5. Quoted Value:** Value stated by the stock exchange at the end of a days trade.

6. Market Value: Price at which the share is purchased or sold in the market(stock market)
7. Fair Market Value: Price which is agreed in an open and unrestricted transactions.
8. Intrinsic Value: Realisable value of total net assets divided by the number of shares outstanding.
9. Yield Value: Value is based on Yield i.e. Dividends or Earnings.

ASSUMPTIONS

1. Sufficient number of buyers and sellers of the shares are available in the market.
2. The seller does not sell his shares due to his urgent needs.
3. The purchaser of the shares does not like to pay a higher price in comparison with the reasonable price or market price of the shares.

Valuation of shares would be meaningful if the above assumptions are satisfied.

FACTORS AFFECTING SHARE VALUE:

INTERNAL

1. Net Worth

EXTERNAL

1. General Business Conditions

2. Earning Capacity of Assets
3. NPAT(Net Profit After Tax)
4. EPS(Earning Per Share)
5. Earnings to ESH(Equity Share Holders)
6. Rate of Dividend
7. Return on Investment
8. Nature of business activities
9. Debt equity proportion

INTRINSIC VALUE METHOD:

2. Social Conditions
3. Political Conditions
4. International Environment
5. Demand & Supply
6. Future Growth of the company
7. Insiders Trading
8. Capital market Conditions

This is called as Net Asset Value or Liquidation Value or Break Up Value or Asset backing Value method. This method is based on the assumption that the company will be liquidated. Therefore value of a share depends upon the amount that could be available to Equity Shareholders. Amt available to Equity Share Holders depends upon the market value of all assets & Liabilities to be paid for. Assets & Liabilities recorded or unrecorded in Balance Sheet at the present value are to be recorded.

Value Per Equity Share=Net Assets Available to Equity Share Holders

No of Equity Shares
YIELD METHOD

Equity shares may be purchased in a small lot for earning dividends. Such small lots of Equity Shares are valued on the basis of the expected dividends. If on the other hand, Equity Shares are acquired in a large number the purchaser is more concerned with the total earning capacity of the company rather than the Dividends paid. Thus, valuation of shares on 'Yield' basis may mean either (1) "Expected Dividend Basis" (2) "Expected Earnings Basis".

2)YIELD METHOD / MARKET PRICE

1) Value of shares = ERR/NRR * Paid up value per share

where ERR=Expected Rate of Dividends & NRR= Normal Rate of dividends OR

2) Value of Shares = $\frac{\text{Dividends(Rs)}}{\text{Normal Rate of dividend}} * 100$

Normal Rate of dividend where ERR= Net Profit

Avlb/Paid up

Equity capital *100

► FMP (As per Expected Dividend

Basis)

FMP	xx	
Add: Non Trading Income	xx	
		x
x Less: Preference Dividend	xx	
Less: Transfer to Reserves/Funds	xx	
Net Profit Available to Eq shr hold	xx	

YIELD METHOD

► **FMP (As per Earnings Basis)**

	FMP	XX
Add: Non Trading Income	xx	
Less: Tax on Above	xx	Less: Preference dividends xx
Net Profit Avlb to Eq shr Holders	xx	

3) FAIR VALUE METHOD:

- This is not a Method, but a compromise formula which arbitrarily fixes the value of shares as the Average of the values obtained by the Intrinsic Value Method & the Yield Method. Thus the value of shares under this method is : $\text{Fair Value} = \text{Intrinsic Value} + \text{Yield Method Value}$

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ACCOUNTS FOR LIMITED LIABILITY PARTNERSHIP

- **Meaning:** Limited Liability Partnership entities, the world wide recognized form of business organization has been introduced in India by way of Limited Liability Partnership Act, 2008 that came into effect by way of notification dated 31st March 2009. It is popularly known as LLP combines the advantages of both the Company and Partnership into a single form of organisation. In an LLP one partner is not responsible or liable for another partner's misconduct or negligence. This is an important difference from that of a unlimited partnership. The liability of the partners would be limited to their agreed contribution in the LLP.
- **Agreement/Schedule I:** It is managed as per LLP Agreement; however in the absence of such agreement the LLP would be governed by the framework provided in Schedule 1 of LLP Act 2008 which describes the matters relating to mutual rights and duties of LLP partners.

ADVANTAGES

1. Well known and accepted form of business worldwide in comparison to Company.
2. Low cost of formation.
3. Easy to establish
4. Easy to manage and run.
5. No requirement of any minimum capital contribution.
6. No restrictions as to maximum numbers of partners.
7. LLP & Its partners are distinct from each other

8. Partners are not liable for Act of other partners.
9. Less compliance level
10. Less requirement as to maintenance of statutory records.
11. Less Govt intervention.
12. Easy to dissolve or wind up
13. No requirement as to Minimum Alternate Tax
14. Audit requirement only in case of contribution exceeding Rs 25 lakhs or turnover exceeding Rs 40 lakhs.

DISADVANTAGES

1. Under some cases, liability may extend to personal assets of partners.
2. LLP cannot raise money from Public like companies.

DISTINGUISH BETWEEN LLP & PARTNERSHIP

- | | |
|-------------------------------------------------------------------|------------------------------------------------|
| 1. Applicable Law: Limited Liability Partnership Act 2008. | 2. Partnership Deed. |
| 2. Charter Documents: LLP Agreement | 3. Minimum – 2 and Maximum – 20 |
| 3. Number of Members: Minimum-2 and Maximum-No Limit | 4. Unlimited. |
| 4. Liability of Partners/Members: Limited. | 5. No separate legal entity. |
| 5. Legal Entity: Yes,can sue or to be sued in name of LLP. | 6. As prescribed in the Partnership Agreement. |
| 6. Partners Meeting: Asprescribed in the LLP agreement. | 7. Not Applicable. |
| 7. Maintenance of Statutory Registers: Notapplicable. | 8. Can be converted to LLP or a Co. |
| 8. Conversion: Can be converted into a Co. | |
| 1. Partnership Act 1932 | |

PARTNERS OF LLP

- ▶ Any new person can be admitted to the LLP as per the provisions of LLP Agreement. There should be atleast 2 persons (natural or artificial) required to form a LLP. In case any Body Corporate is a partner, then it will be required to nominate any person (natural) as its nominee for the purpose of the LLP.
- ▶ Following can become a partner in the LLP:
 1. Company incorporated in and outside India.

2. LLP incorporated in and outside India.
3. Individuals resident in and outside India.

RIGHTS & DUTIES OF LLP PARTNERS

- ▶ Partners have the rights to participate in the management of the LLP though they are not entitled to any remuneration for participating in the management of LLP unless otherwise provided in the LLP Agreement. The partners would be entitled to share equal profits in the LLP or as may be provided by LLP agreement.
- ▶ Partners are required to comply with all the provisions of LLP Act and LLP agreement and not to indulge in any fraudulent transaction with the creditors or outsiders. In case there is any change in name and address of partner he shall inform the same to LLP with 15 days of such change. If any partner desires to resign from the partnership he shall inform the same by giving a 30 days notice to other partners.

DESIGNATED PARTNER

- ▶ **Meaning:** Designated partner means any partner designated as partner as per section 7 of Limited Liability Partnership Act 2008. Every limited liability partnership shall have at least two designated partners who are individuals and at least one of them shall be a resident in India. In case no partner is designated as such, or if at any time there is only one designated partner, each partner shall be deemed to be a designated partner of the LLP.
- ▶ The Designated partner is also required to obtain a Designated Partner Identification Number (DPIN). Their role is similar to that of Directors as they are directly responsible for the compliances of all provisions of LLP Act 2008. They are not entitled to any remuneration for their participation in LLP management unless otherwise specifically provided for.
- ▶ Any vacancy arising in the office of Designated Partner shall be filled within 30 days and the change shall be intimated to the Registrar of Companies.

LLP AGREEMENT

- ▶ **Meaning:** LLP Agreement means any written agreement between the partners of the LLP or between LLP and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that of LLP. It is not necessary to enter into an LLP Agreement as per the LLP Act 2008. In absence of LLP Agreement, the mutual rights of their partners and in relation to LLP will be determined as per Schedule I of the LLP Act 2008.
- ▶ **Clauses that can be added to the LLP agreement are:** Form and Manner of Contribution between parties, Profit & loss sharing ratio, Rights & Liabilities of Partners, Duties of Partners, Admission & Cessation of partners etc. The LLP Agreement if executed is required to be registered with the Registrar of Companies.
- ▶ The LLP Agreement once entered into can be amended as per the terms and conditions mentioned in the Agreement and any change must be intimated to the Registrar of Companies within 30 days of the change.

DESIGNATED PARTNERS IDENTIFICATION NUMBER (DPIN)

Every Designated Partner is required to obtain a DPIN from the Central Government. DPIN is an eight digit numeric number allotted by the Central Government in order to identify a particular partner and can be obtained by making an online application in Form 7 to Central Government and submitting the physical application along with necessary identity and Address proof of the person applying with prescribed fees.

STEPS INVOLVED IN CONVERSION OF PARTNERSHIP/COMPANY INTO LLP

1. Deciding the Partners and Designated Partners for Forming
2. Obtaining the Designated Partner Identification Number (DPIN) and Digital Signatures Certificate.

3. Checking Name availability for LLP
4. Drafting of LLP Agreement.
5. Filing of Incorporation Document
6. Filing of Conversion Application
7. Certificate of Registration
8. Information for Conversion to the Registrar of Firms.