Daizy Healthcare (B)

Daizy Healthcare Limited (Daizy) was one of the leading pharmaceutical firms of the country. The promoters of the company had nearly five decades of experience in the Indian healthcare industry. The company was growing rapidly and had recently acquired stake in Italian Remedies. With this acquisition, it was to become the 4th largest pharmaceutical company in India. It was launching new brands every year – by developing in-house formulations and by entering into joint ventures and collaborations. The Income statement of the company for the year ending March 31, 2001 is given in Exhibit 1. The Balance Sheet is given in Exhibit 2. There were several accounting standards that were being changed by the Institute of Chartered Accountants of India, from the ensuing financial year. The President Mr.Vinayak had called in Mr.Desai the Vice-President, Finance for a discussion.

Mr.Desai was quite happy to look into the impact of the changed standards. "I think we can recast our current year's accounts to look at the immediate impact if the standards were to be applied to the accounts we have put out to the share holders. There are major changes and in my opinion, what is going to impact us most is pertaining to the policy on deferred taxation."

"Let us go over this in a systematic manner" Desai said. "The major impact of deferred taxation is going to be on account of our depreciation policy. As you are aware, all fixed assets of the company are stated at historical cost of acquisition or construction less accumulated depreciation. We have been claiming depreciation as per the income tax rules for taxation purposes and have been depreciating assets in our books as per the provisions of the Companies Act. In addition we have changed the method of write off of trademarks in the current year."

"Yes" Vinayak said, "I see that we have made this disclosure in the annual report."

The annual report for the year ending March 31, 2001 had spelt the policy regarding fixed assets:

> *"None of the fixed assets of the company have been revalued during the year. However, the Company has valued the self-generated brands of veterinary products on the basis of the valuation report given by renowned valuers."*

"The trademarks have been valued at Rs.41,000* . We have added this amount to the Gross Block of the Company at the beginning of the year. You will recall that these are self-generated and self-valued brands and there is no payment involved. So we have not routed it through the Income Statement for the year, instead we have taken this amount directly into Capital Reserve account. This is not available for dividend distribution. However, I must admit that for the year, we have claimed depreciation on this amount in our tax returns as well as books. For tax purposes we can claim 25% under the written down value method and for books, we are depreciating this over a period of 17 years on straight-line basis" Desai said.

"How are we accounting this in the books? Do we reduce the capital reserve each year?" Vinayak asked. Desai responded: "No, we are charging this as an expense in the income statement and reducing the outstanding value of asset. Thereby our reported profits are reduced by the amount of

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Prepared by Professor M S Sriram.

* All figures in this case are in thousands.

depreciation charged. However, that may not be an issue as far as the standards and reporting are concerned. It has passed through our auditors and they have not commented on this."

"What about the other fixed assets? No problems with those I suppose?"

"No, none. Our Fixed Asset values are in keeping with the accounting principles. Asset Costs include all related expenditure and pre-operative expenses for the period upto completion of construction and the assets are put to use. It includes borrowing costs incurred in acquiring the asset. During the year we have added an amount of Rs.121, to the Gross Block as a consequence of change in exchange rate for loans in foreign currency for acquiring assets. This increased amount is shown as a liability and is yet to be paid, But that is an accepted method worldwide."

"But we have changed our policy of writing off intangible assets this year, right?" Vinayak asked.

"Yes, we did. Infact the amount of Rs.143,278 shown as depreciation has an amount of Rs.9,774 which is the depreciation on Technical Know-how and trademarks - including the amortization of the brands valued in the beginning of the year. This is the only category on which we have changed our depreciation policy – you can see that we have disclosed this also in our report."

The company had included the following information in its notes to accounts:

> *"Hitherto the Company used to amortise the trademarks and technical know-how over a period of five years. During the year the Company has reassessed the estimated economic life of the same as seventeen years and accordingly has amortised the trademarks and technical know-how over seventeen years. On account of the change, Rs.9,469 has been written back to Profit and Loss account. Had it been considered on earlier basis, the profit would have been lower by 22,595 and the net block would have been lower to that extent."*

"So what is its impact on income taxes?" Vinayak mused.

"None. We continue to file returns by calculating the depreciation as per the provisions of the Income Tax act. However, if the deferred taxation standard was in place we had to show the taxed deferred due to the difference between income-tax rates of depreciation and that of our books. The accumulated depreciation on the entire block of Fixed Assets as on 31st March 2001 as per the income-tax accounts were Rs.542,688 as against the accounting figure of Rs.348,947."

"Fine, are there any other items of significance?" Vinayak asked.

"Yes, a number of small items which we may have to consider. Take for instance the write off of the share issue expenses that we incurred last year. We had originally intended to write off the expenses over a period of 60 months. We wrote off for two months pro-rata last year. But this year we wrote off the entire amount by reducing the Share Premium account." Desai said.

The company has the following notes to accounts in its annual report:

> *"During the year the company has adjusted the balance amount of Rs.128,289 of public issue expenses against the share premium account under the head "Reserves & Surplus". Had it been considered on earlier basis, the profit would have been lower by Rs.26542."*

"So, what is the implication, I fail to understand." Vinayak said.

Desai responded: "There are no tax implications of this change, since for taxation purposes, the Act provides that the preliminary expenses be written off pro-rata over a period of 5 years. Therefore, the expenses as per tax returns are still recorded as per the old method."

"But there is one item which I would also like to get to your notice" Desai said. "You would recollect the private placement of debentures we made in September 1998. We had issued unsecured zero interest debentures bearing a face value of Rs.50,000 at a discount of 50% - This discount was recorded as "discount on debentures" under the head Miscellaneous Expenditure. These are due to be redeemed at face value in May 2003. We had determined a period of 56 months for this discount on the basis of an imputed interest of 16%, which was the going rate at that time. Every year, instead of charging 16%, we are writing off the discount on a flat basis. So this year's interest expenses includes an amount of Rs.5,357 being written off as deferred expenses on debentures issued in 1998."

"Infact, I had asked Milind my executive assistant to compute the difference in allocation of the interest costs if we had calculated 16% interest compounded per annum and our current method. He has given me this table."

Year ending	Interest written off equally over the tenor	Interest computed at 16% per annum
Mar-99	2902	2167
Mar-00	5357	4347
Mar-01	5357	5042
Mar-02	5357	5849
Mar-03	5357	6708
May-03	670	888
Total	25000	25000

"What is your discomfort with this? Are there any differences with the Tax Department on the treatment of the interest expenses as we are currently following?" Vinayak asked.

"No, tax authorities have accepted the accounts calculated as per the books in the tax returns as well. The accounting standards are silent on the method of computing borrowing costs. However, we are recognising this finance charge on a flat basis. It does no justice to time value of money."

"What about revenue recognition? I see that we have a policy of recognising sale even for products sent to other divisions – while that is okay for our profit centre concept, is it not double counting?" Vinayak asked.

On revenue recognition, the company had the following policy:

> *"The company recognises sale of products when they are invoiced to customers including excise duty and inter unit transfer of Bulk Drugs for captive consumption, but excluding sales tax and trade discounts."*

"No I do not think it would make a very big impact. I have done calculations and found that of the total sales during the year only 5% of the sales was invoiced for captive consumption. The units usually source bulk-drug material not only from within the company, but also from outside. Our practice is that the amount of procurement by the units is recorded as purchases of that particular unit. We have an estimated mark up of 25% in all sales to the other divisions. But I do not think it makes a difference in the profit calculation. In any case, that is the purchase price that the units would have paid, if they had sourced the material from outside, so I think it is fair."

"Okay, but what do we do with the inventory that is still in stock?"

"The inventory valuation of all the divisions of the company is done on the basis of first-in-first-out method – and was valued at lower of cost or net realisable value, for each significant class of inventory. So even there, I do not see a problem." Desai clarified.

"Desai, you told me that standards on lease have changed. You remember that we had taken equipment on lease in April, 1998 for a period of 10 years. Does the accounting for that change?"

"Yes, it does. We had classified the lease as an operating lease – but under the new definition, it will be treated as a finance lease. The annual rental we are paying on the lease is Rs.4,000. At the time of entering into the lease agreement if this was classified as a financial lease, we would have used an interest rate of 12% to calculate finance charges. The company does not have any rights to the residual value of the machinery. I have made calculations using a discount rate of 12% and the present value of the future lease payments would have been Rs. 22,601 as on 1st April 1998. I have checked on the tax implications and the income tax department has clarified that there was no need to change the classification of the assets for the tax purposes."

"And what would be our depreciation policy on the machinery if it was a finance lease?"

"Well, it would be the same as for all machinery. We use straight-line method based on the economic life of the asset. We will also have to bring it into our balance sheet unlike in the past."

"Is there anything else which has a tax angle which we have left out?"

"Yes, the taxation department does not allow our provisioning for doubtful debts as an allowable expense. So while we show this as an expense in our books, we cannot show this in taxation accounts. However, bad debts written off are allowed to be expensed. During the year we created an additional provision of Rs.3,969 to get the total provision to Rs.23,927. The write offs effected during the year was debited directly to the income statement and was not taken out of the provision account. So the tax effect will be only on the amount of provisions that we have created for the year."

"Well, thanks a lot for all the information. I will await Milind's calculations and his recasting of income statement for the current year. That will give us an idea as to what is awaiting us for the next year. Thanks a lot for spending time with me."

Assume a stable income tax rate of 35%. Ignore rounding off errors.

Exhibit 1

Daizy Healthcare Limited		**Amount**
Income Statement for the Period Ending March 31, 2001		**Rs.'000s**
Income		
Sales		5087927
Other Income		
Miscellaneous income	227189	
Excess provision of depreciation written back	9469	236658
Total		**5324585**
Expenses		
Cost of Goods Sold		3153791
Gross Profit		2170794
Other Administrative Expenses		
Miscellaneous Administrative expenses	1166464	
Rent, Rates and Taxes (including lease rentals Rs.4,000)	9540	
Bad Debts Written Off	9990	
Provision for Bad Debts	3969	1189963
Profit Before Depreciation Interest and Tax		980831
Less Depreciation on Fixed Assets		143278
Profit before Interest and Tax		837553
Less Interest (including Rs.5357 on discount on zero interest debentures)		129418
Profit Before Tax		708135
Less Taxation pertaining to the current year		55000
Profit After Tax		653135
Add Adjustment of Prior Year Taxation		2519
Net Profit		**655654**

Appropriation Statement		
Net Profit for the year		655654
Add Balance available in Profit and Loss Account		122573
Total Profit available for Appropriation		778227
Less Transfer to Debenture Redemption Reserve		10724
		767503
Dividends on Equity Shares	178624	
Dividends on Preference Shares	2400	
	181024	
Corporate dividend on Distributed Profit	18464	199488
		568015
Transfer to General Reserve		306670
Balance Carried to Balance Sheet		**261345**

Exhibit 2

Daizy Healthcare Limited
Balance sheet as at 31st March, 2001

Particulars		As at 31st March 2001		As at 31st March 2000	
		Rupees in '000		Rupees in '000	
Sources of Funds:					
Shareholders' Funds					
Share Capital					
59,541,368 Equity Shares of Rs.5 each fully paid up		297707		297707	
200,000 12% Cumulative Redeemable Preference Shares of Rs.100 each fully paid up		20000	317707	20000	317707
Reserves and Surplus					
Capital Reserve		292435		251435	
Share Premium account		3545471		3673760	
General Reserve		1000000		59900	
Debenture Redemption Reserve		27294		650000	
Balance in Profit and Loss Account		261345	5126545	122573	4757668
Loan Funds			520922		2289389
Total			**5965174**		**7364764**
Application of Funds					
Fixed Assets					
Gross Block		2734659		2521467	
Less Accumulated Depreciation		348947	2385712	223264	2298203
Capital Work in Progress			246345		240731
Preoperative and Project Expenses pending allocation			633		8606
Investments			1766046		100970
Net Current Assets					
Sundry Current Assets		2006353			
Sundry Debtors	540032				
Less Provision for doubtful debts	(23927)	516105			
Total Current Assets		2522458		5708055	
Less Current Liabilities and Provisions		967404	1555054	1142266	4565789
Miscellaneous Expenditure to be written off:					
Public Issue Expenses				128289	
Debenture Issue expenses/Discount on Debentures		11384		16741	
Deferred Revenue Expenditure			11384	5435	150465
Total			**5965174**		**7364764**