TEERTHANKER MAHAVEER UNIVERSITY
MORADABAD, INDIA

CENTRE FOR ONLINE & DISTANCE LEARNING

Accredited with NAAC A Grade

12-B Status from UGC

Programme: Bachelor of Commerce

Course: Corporate Accounting-I

Course Code: BCPCC206

Semester-II

Syllabus

OBJECTIVE AND EXPECTED OUTCOME OF THE COURSE: To develop students' knowledge of accountancy, particularly in relation to company accounts through a more in-depth and broader study of its contents.

UNIT I

Concept and Scope of Corporate Accounting; Share Capital and its types; Shares: Types, Issue, forfeiture and re-issue of forfeited shares; Buy back of shares; Book building; Sweat equity; Employee stock option scheme; Rights issue; Bonus shares; Redemption of preference shares.

UNIT II

Debentures: Types, issue and redemption of debentures; Underwriting of shares and debentures including firm underwriting; Calculation of the liability of the underwriter; Sub- underwriting; Broker and brokerage; Acquisition of business and Profit prior to incorporation.

UNIT III

Goodwill: Meaning; Types; Factors determining goodwill; Need for valuation of goodwill; Methods for the valuation of goodwill. Valuation of shares: Need and methods.

UNIT IV

Preparation of final accounts of a corporate body as per the latest version of Schedule VI (Simple problems only); Main difference between the old format and the new one; Notable corporate scandals with special reference to India.

Table of Content

LESSON 1

INTRODUCTION TO CORPORATE ACCOUNTING

STRUCTURE

1.0 OBJECTIVES

After reading this lesson, you should be able to:

- Understand the meaning and scope of corporate accounting
- Understand the meaning of share and its types
- Differentiate between equity shares and preference shares
- Understand the meaning of share capital and its types
- Know about sweat equity shares and their related legal provisions.
- Learn about Employees Stock Option Scheme
- Learn about book building
- Understand rights issue and valuation of rights
- Learn about bonus shares and the legal provisions related to bonus shares
- Understand accounting treatment of bonus shares

1.1 MEANING OF CORPORATE ACCOUNTING

Corporate accounting means recording, classifying, summarizing, and communicating the results of financial transactions of **company form of organisations**. A company is an association of persons who contribute money or money's worth to a common stock and uses it for a common purpose. A company is an artificial person, created by law, having a separate legal entity, common seal and perpetual succession. Companies Act 2013 defines a company as "company formed and registered under this Act or an existing company".

CHARACTERISTICS OF A COMPANY

1. It is a voluntary association of persons.
2. It has a separate legal entity distinct from its members.
3. Since it is an artificial person created by law, it signs on official documents with a common seal.
4. It has a perpetual succession. Members may come amd members may go but the company goes forever.

KINDS OF COMPANIES

- **ON THE BASIS OF FORMATION**

1. **CHARTERED COMPANIES**: Those companies which are incorporated under a Special Charter by the king or sovereign such as East India Company.
2. **STATUTORY COMPANIES:** These companies are formed by the special Act of legislature or parliament like banking companies, insurance companies.
3. **REGISTERED COMPANIES:** Such companies are incorporated under the Companies Act.

- **ON THE BASIS OF LIABILITY**

1. **LIMITED COMPANIES:** In these companies, the liability of each member is limited. A limited

company can be further classified as a company limited by shares or company limited by guarantee.

2. **COMPANY LIMITED BY SHARES:** In this company, liability of its members is limited to the extent of face value of shares held by them.
3. Company Limited by guarantee: In this company, the liability of its members is limited to the amount they have undertaken to contribute to the assets of the company in the event of its winding up.
4. **UNLIMITED COMPANIES:** In these companies, the liability of the members is unlimited and members are personally liable to the creditors of the company for making up the deficiency. Such companies are rare these days.

- **ON THE BASIS OF OWNERSHIP**

1. **GOVERNMENT COMPANY:** Government company is accompany in which atleast fifty one percent of the share capital is held by either central government or state government or jointly by both.
2. **NON-GOVERNMENT COMPANY**: A company which is not a government company is a non government company. It can be a private company or a public company.
   - **(i)** **Private Company:** A private company is a company which has minimum paid up share capital of Rupees 1,00,000 and which (i) Except a one person company, limits the number of members to 200, (ii) prohibits the invitation to the public to subscribe for its shares or debentures, and (iii) restricts the transferability of their shares.
   - **(ii)** **One person Company:** Companies Act, 2013 has introduced ONE PERSON COMPANY in which there is only one member.
   - **(iii)** **Public company:** A company which is not a private company and which has minimum paid up share capital of rupees five lakhs or more, is a public company.

- **ON THE BASIS OF CONTROL**

1. **HOLDING COMPANY:** Holding company is a company which holds all or more than fifty percent shares in some other company.
2. **SUBSIDIARY COMPANY:** It is a company in which minimum fifty one percent of the shares are held by some other company.

1.2 SCOPE OF CORPORATE ACCOUNTING

Corporate accounting includes recording, classifying and communicating the results of business operations of companies to various stakeholders who need such information to take economic decisions. It includes the following areas:

ACCOUNTING OF SHARE CAPITAL

Total capital of a company is divided into units of small denomination. One such unit is called a share. As per **Section 43 of the Companies Act, 2013,** the shares of a company limited by shares can be of two kinds only: equity shares and preference shares. Companies Act, 2013 regulates the issue and redemption of such shares. So corporate accounting includes the accounting and redemption of shares, including bonus shares, rights shares.

ACCOUNTING OF DEBENTURES

The company can meet its requirement of finance by issue of debentures. Debenture is an acknowledgement of debt by the company. Again, Companies Act has contained provisions in respect of issue and redemption of such debentures in order to protect the interest of debenture holders. So corporate accounting includes accounting treatment of issue and redemption of debentures.

ACCOUNTING FOR MERGERS AND ACQUISITIONS

Companies keep on acquiring rival companies in order to grow and expand. Accounting for such mergers and acquisitions needs to carried out as per accounting standards formulates for this purpose.

ACCOUNTING OF BANKING COMPANIES

Banking companies are registered under Banking Companies Act. Their accounting has also been prescribed under their statutes.

ACCOUNTING OF INSURANCE COMPANIES

Insurance companies are also registered under special acts of parliament which govern the functioning and accounting of such companies.

PREPARATION OF FINANCIAL STATEMENTS

The preparation of financial statements of companies registered under Companies Act is prescribed in the companies Act. Therefore, while preparing their financial statements, the prescribed format and general instructions have to be followed.

CONSOLIDATED FINANCIAL STATEMENTS

Holding companies are required to present their financial statements for the group as a whole. This necessitates combining the financial statements of its subsidiaries with the financial statements of the holding company.

LIQUIDATION ACCOUNTS

Company is a legal entity created by law, therefore, its winding up takes place by the operation of law. The closure of the books of accounts after the closure of business of the company

Is again a matter of legal and accounting concern which forms an integral part of corporate accounting.

1.3 MEANING OF SHARE

SHARE

Total capital of a company is divided into units of small denomination. One such unit is called a share. According to **Section 2 (84) of the Companies Act, 2013,** 'share' means share in the share capital of a company and includes stock except where a distinction between stock and share is expressed or implied. Suppose a company has Rs. 8, 00,000 as share capital which is divided into 80,000 units, then one unit is called a share and value of that unit is Rs.10.

CLASSES OF SHARES

As per **Section 43 of the Companies Act, 2013,** the shares of a company limited by shares can be of two kinds only: equity shares and preference shares.

PREFERENCE SHARE

According to **Section 43 of the Companies Act, 2013,** a preference share carries both the following preferential rights: –

(i) the payment of dividend at a fixed rate before any payment of equity dividend; and

(ii) the return of capital on winding up of the company before payment of equity capital.

If the Articles of the company so provide, the preference shareholders may also be given the following rights in addition to the preferential rights mentioned above:

(a) To participate in the surplus profits remaining after the equity shareholders have received dividend at a fixed rate.

(b) To receive premium on redemption of preference shares.

(c) To participate in the surplus remaining after the equity shares are redeemed in winding up.

(d) To receive arrears of dividend at the time of winding up.

(e) Preference shareholders have no voting rights except when dividend is outstanding for more than two years.

EQUITY SHARE

A share which is not a preference share is an equity share. Equity shares do not carry any preferential right in respect of dividend or repayment of capital. So these are known as ordinary shares. There is no fixed rate of dividend to be paid on equity shares and this rate may vary from year to year. In winding up, the equity capital is repaid last. However, equity shareholders get voting power.

TYPES OF PREFERENCE SHARES

The preference shares may be classified into following categories:

1. REDEEMABLE PREFERENCE SHARES: The shares which can be redeemed after a fixed period or as desired by the company are called redeemable preference shares. According to **Section 55(2) of Companies Act, 2013** a company limited by shares can issue preference shares which would be redeemed within a period not exceeding 20 years from the date of their issue.

2. IRREDEEMABLE PREFERENCE SHARES: Irredeemable preference shares are those which are not to be redeemed unless the company goes into liquidation. **As a result of Companies Act, 2013, no company limited by shares can issue preference shares which are irredeemable or which are redeemable after the expiry of 20 years from the date of its issue.**

3. CUMULATIVE PREFERENCE SHARES: These are the shares on which dividend goes on accumulating till it is fully paid off. The arrears of any year's dividend are carried forward to coming years till paid off. So when the company wants to pay any dividend to equity shareholders, it must first pay arrears of such dividend to cumulative preference shareholders.

4. NON-CUMULATIVE PREFERENCE SHARES: Non-cumulative preference shares are those shares on which the dividend does not go on accumulating. If dividend is not paid for any year, the right to receive dividend for that year lapses.

5. PARTICIPATING PREFERENCE SHARES: The holder of these shares are entitled to

(a) a fixed dividend, and

(b) a share in the surplus profits remaining after paying dividend to the equity shareholders up to a specified rate.

(c) Participating preference shares may also be given the right to participate in the surplus of assets left after paying equity shares in the event of winding up.

6. NON-PARTICIPATING PREFERENCE SHARES: These shares are entitled to only a fixed rate of dividend. The holders of these shares do not carry any right to share in the surplus profits or surplus assets of the company.

7. CONVERTIBLE PREFERENCE SHARES: A convertible preference share is one which can be converted into an equity share within a specified period.

8. NON-CONVERTIBLE PREFERENCE SHARES: These are the shares which do not confer on their holder a right of conversion into equity shares.

1.4 DISTINCTION BETWEEN EQUITY SHARES AND PREFERENCE SHARES

Basis of Difference	Preference Shares	Equity Shares
1. Payment of Dividend	Preference shares are paid dividend before any dividend is paid on equity shares.	Dividend on equity shares are paid only after the payment of preferences dividend.
2. Repayment of Capital	In the event of winding up, preference shares are repaid before the repayment of equity capital.	Repayment of equity capital in winding up is made only after the repayment of preferential shares.
3. Rate of Dividend	Dividend on preference share is paid at a predetermined fixed rate.	The rate of dividend on equity shares vary from year to year depending on the availability of divisible profits and future fund requirements of the company.
4. Accumulation of Dividend	If the preference shares are cumulative, the dividend not paid in any year is accumulated till such arrears of dividend are paid.	The dividend on equity share is not cumulative.
5.Convertability	The preference shares may be convertible to equity shares or new preference shares or debentures.	An equity share is not convertible.

6. Redemption	Redeemable preference shares are redeemed by the company on the expiry of the stipulated period.	Equity shares are generally issued for the entire life of the company but it may be bought back and cancelled any time during the life of company at its discretion.

1.5 MEANING OF SHARE CAPITAL

The sum total of the nominal value of shares of a company is called as share capital. The share capital of a company can be:

Equity share capital: Capital raised through issue of equity shares is called equity share capital.

Preference share capital: Capital raised through preference shares is called preference share capital.

There are different terms used for share capitals which are discussed below:

1. **AUTHORISED SHARE CAPITAL:** It is the **maximum amount of share capital** which the Memorandum of Association allows the company to issue. It is also termed as **"Nominal"** or **"Registered"** capital.

2. **ISSUED SHARE CAPITAL:** Issued share capital refers to that part of authorised capital which has actually been offered to the public for subscription. The difference between the authorised capital and issued capital is called unissued capital.

3. **SUBSCRIBED SHARE CAPITAL:** It is that part of issued capital which is applied by the public and subsequently **allotted in shares by the company**.

4. **CALLED-UP SHARE CAPITAL:** It is that part of the face value of the subscribed share capital for which payment has been demanded by the company. The company need not call the whole of full value at once. The amount can be called in installments from time to time. For example, if on 20,000 shares of ` 100 subscribed by the public ` 60 have been demanded, then called up capital will be ` 12,00,000 *i.e.*, (20,000 ×60).

   If the full value of the shares is called up on application, then the subscribed capital and called up capital will be the same.

5. **PAID-UP SHARE CAPITAL:** It refers to that portion of called-up capital which has actually been paid by the shareholders. This is the actual capital of the company which is included in the total of the Balance Sheet. That part of the capital which has not been received is **called calls in arrears**. Thus,

   Paid-up capital = Called-up capital-Calls in arrear

6. **RESERVE CAPITAL:** It is that part of the uncalled capital which the company can call up only in the **event of its winding up**. A limited company may, by a special resolution, determine that a portion of its uncalled capital shall not be called up, except in the event of winding up.

Example

ABC Ltd. company has an authorised capital of ` 1,00,00,000 in shares of ` 100 each. It offered to the public 60,000 shares. The public subscribed for 50,000 shares & duly allotted. ` 80 per share has been called up. All money received except the call of ` 20 on 4,000 shares. Give the various kinds of share capital.

Solution

		`
Authorised Capital		
1,00,000 shares of ` 100 each		1,00,00,000
Issued Capital :		
60,000 shares of ` 100 each issued to public as fully paid		60,00,000
Subscribed Capital :		
50,000 shares allotted to public @ `100 each		50,00,000
Called up Capital :		
50,000 shares to public @ ` 80 each		40,00,000
Paid up Capital :		
50,000 shares to public @ ` 80 called up	40,00,000	
Less : Calls in arrear on 4,000 shares @ `` 20 each	80,000	39,20,000

1.6 SWEAT EQUITY SHARES

The sweat equity is a new equity instrument which is issued to reward directors and employees who contribute intellectual property right to the company. As per **Section 2(88) of the Companies Act, 2013**, Sweat Equity means equity shares issued by a company to its employees or directors at discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions by whatever named called.

A company which is incorporated, formed and registered under the Companies Act, 2013 or any previous Act can issue sweat equity shares. A subsidiary of such a company which is incorporated outside India is also allowed to issue sweat equity.

Lock in period for Sweat equity shares issued to directors or employees is 3 years from the date of allotment i. e. these shares cannot be transferred before the expiry of 3 years from the date of allotment.

CONDITIONS FOR ISSUING SWEAT EQUITY SHARES

According to **Section 54 of Companies Act, 2013** a company may issue sweat equity shares if the following conditions are fulfilled:

- ***(a)*** Sweat equity shares to be issued should be of **a class of shares already issued**
- *(b)* The issue of sweat equity shares is authorised by a resolution passed by the company in the general meeting;
- (b) The resolution should specify the number of shares to be issued, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity share are to be issued.
- (c) Not less than one year has elapsed since the date on which the company was entitled to commence business; and

(d) The sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board of India in this behalf, in case of a listed company. However, in the case of a company whose equity shares are not listed, the same must be issued in accordance with the guidelines as may be prescribed.

MAXIMUM AMOUNT OF SWEAT EQUITY SHARES

The Company shall not issue sweat equity shares for more than 15% of the existing paid-up equity share capital in a year or shares of the issue value of rupees five crores, whichever is higher. The issuance of sweat equity shares in the company shall not exceed 25% of the paid-up equity capital of the company at any time.

1.7 EMPLOYEES STOCK OPTION SCHEME (ESOS)

In order to encourage employees' participation in the company, employee stock option scheme has been introduced. This is an employee benefit plan which motivates the employee to be the stakeholder of the company. Under this scheme, the company grants option to the whole time directors, officers or employees of a company to apply for shares of the company at a pre-determined price. The employee can exercise the option after expiry of vesting period which is specified in the scheme.

'Vesting period' is the period during which the option cannot be exercised. Vesting period acts as a motivation to the employee not to leave the company before exercising the option. This is done so that employee does not leave the company. In case he leaves the company before exercising the option, the option lapses. In case of death of employee during the period of his employment in the company, the option can be exercised by the legal heirs of the employee. The employee usually exercises the option if he finds the market price of the shares more than the option price.

Suppose, a company offers on Ist April, 2012 the option to buy 500 shares of the company at a price of Rs. 50 per share. Vesting period is 3 years. This means the employee can buy the shares of the company on or after Ist April, 2015 if he finds the market price of the share higher than Rs. 50 offered by the company.

CONDITIONS FOR ISSUE OF EMPLOYEE STOCK OPTIONS

A listed company is required to comply with Securities and Exchange Board of India Employee Stock Option Scheme Guidelines. A company which is not listed on stock exchange will have to comply with the requirements:

a) The issue of Employees Stock Option Scheme has been approved by the shareholders of the company by passing a special resolution.
b) The company may by special resolution, vary the terms of ESOP not yet exercised by the employees. The notice for passing special resolution for variation of terms of ESOP shall disclose full details of the variation, the rationale therefore, and the details of the employees who are beneficiaries of such variation.
c) There shall be a minimum period of one year between the grant of options and vesting of option.

d) The company shall have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option.
e) The Employees shall not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to them, till shares are issued on exercise of option.
f) The amount, payable by the employees, at the time of grant of option may be forfeited by the company if the option is not exercised by the employees within the exercise period; or
g) The option granted to employees shall not be transferable.

1.8 BOOK-BUILDING

Book building is a price discovery mechanism and has become a popular method of issuing capital. It is a process used for marketing a public offer of equity shares of a company and is a common practice in most developed countries. However, it is of recent origin for the Indian Capital Market. It has been introduced by SEBI to provide for greater transparency in determination of price of securities being issued.

In the book building process, the Lead Managers known as the Book Runner appointed by the issuing company files prospectus and forms a syndicate of brokers, merchant bankers and other financial institutions who in turn procure bids from the clients. The record of bids is then consolidated with reference to number of shares, prices and list of bidders. On the basis of the careful evaluation of bids received from the investors, the issue price is determined by the book runner and the issuing company. The issue price is fixed after bid closing date. Once a price is determined, the applicants who have applied at that price or a higher price are allotted shares at the price fixed for the issue.

1.9 RIGHTS ISSUE

When an existing company wants to raise additional capital through further issue of shares, it is under a legal obligation to first offer the fresh issue of shares to the existing shareholders unless the company has resolved otherwise by a special resolution. This right of the existing shareholders to apply for the further issue of shares by the company is known as privileged subscription or right issue.

Section 62 of the Companies Act 2013 dealing with Rights Issue provides that when an existing company wants to raise additional capital through further issue of shares, then :

(a) Such further shares must be offered to the existing holders of equity shares in the company in proportion to the capital paid-up on those shares at the date of offer.
(b) A notice must be given to the existing shareholder specifying the number of shares offered.
(c) Minimum **15 days and maximum 30 days** from the date of the offer must be given to accept the offer. In case of private company, the time limit is minimum 7 days and maximum 15 days from the date of offer.
(d) The notice must also inform the shareholders that if the offer is not accepted within the specified time, it shall be deemed to have been declined.
(e) Unless the Articles of the company otherwise provide, the rights offer shall also give the right to renounce the shares offered to him in favour of another person ; and this should be stated in the notice.

(*e*) After the expiry of the time specified in the notice aforesaid or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept shares offered, the Board of Directors may dispose them off in such a manner which is not disadvantageous to the shareholders and the company.

Thus, the company is under legal obligation to first offer the further issue of shares to its existing shareholders. But these holders are not liable to necessarily accept the offer. They have the options of rejection and the renunciation.

In the earlier **Companies Act, 1956,** it was not necessary for a private company to issue shares on right basis, however in **Companies Act, 2013** even private companies have to issue further shares on right basis.

OBJECTIVES OR ADVANTAGES OF RIGHT SHARES

Issue of shares to existing shareholders on a preferential basis serves the following objectives :

1. It preserves the power of control of the present shareholders.

2. It prevents the loss to the existing shareholders on account of dilution of the value of their shareholders because value of the shares is likely to fall with fresh issues. The decrease in the value of the shares will be compensated by getting new shares at a price lower than the market price.

3. The cost of raising capital (floatation cost) through rights issue is less as compared to the public issue.

4. Issue of right shares has the positive impact on the shareholders. It depicts the future prosperity of the company. It also shows the management's concern towards its shareholders.

5. Rights issue avoids the misuse of position by the directors. It prevents them to issue further shares to their friends and relatives.

VALUATION OF RIGHTS

Valuation of rights means the average gain made by the shareholder if he subscribes to the right offer. It is important to note that the value of rights is calculated with reference to the market value of shares. The following procedure is followed to value rights in terms of money:

(a) **Calculate** the market value of the shares held by a shareholder.

(b) **Calculate** the price of the new shares which is required to be paid to the company.

(c) **Add** the market value of shares held with the price of the new shares to ascertain the total price of all the shares.

(d) **Find out** the average price (theoretical market price) of one share by dividing the total value of all the shares by the number of shares.

(e) The **value of right** is calculated by deducting the average price of the shares from the market value of the shares.

Example: A company offers 4 new shares for every 5 old shares as right to its shareholders. You are required to calculate the value of the right if the market price of the share is ` 320. The company decides to issue the new shares at a price of `180 per share.

Solution : **Computation of Value of Rights**

		`
	Market Value of 5 old share @ ` 320 each	1,600
Add :	Price to be paid for acquiring 4 rights shares @ ` 180 each	720
	Total Price for 9 shares	2,320

Average Price = $\frac{\text{` } 2{,}320}{9}$ = `257·78

Values of Rights = Market Price – Average Price

= `320 – ` 257·78 = `62·22

1.10 BONUS SHARES

Bonus shares are the shares issued to existing shareholders of the company free of cost. When company has huge amount of accumulated reserves which is much in excess of the needs of the company, it can distribute the excess amount among the existing shareholders of the company as bonus shares. Issue of bonus shares is a process of **capitalization of reserves** i.e. converting reserves into paid up share capital.

CONDITIONS OF BONUS ISSUE

Section 63 of the Companies Act, 2013 allows the companies to issue bonus shares only when the following conditions are satisfied:

(i) The company's Articles of Association permits issue of bonus shares.

(ii) The Board of Directors has recommended the bonus issue.

(iii) The proposal of the board of directors regarding bonus issue has been duly approved by the shareholders in the annual general meeting.

(iii) The company has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it.

(iv) The company has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus.

(v) The party paid shares, if any outstanding on the date of allotment, are made fully paid-up.

(vi) Bonus issue once recommended by the Board cannot be withdrawn.

(vii) The declaration of bonus issue, in lieu of dividend, is not allowed.

SOURCES OF BONUS SHARES

Section 63 of the Companies Act, 2013 provides that a company can issue fully paid bonus shares out of:

(a) its free reserves ;

(b) the securities premium account ; or

(c) the capital redemption reserve account

Section 63 provides that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

ACCOUNTING TREATMENT OF BONUS SHARES

(a) When fully paid bonus shares are declared

Capital Redemption Reserve Account Dr.

Securities Premium Account Dr.

General Reserve Account . Dr.

Profit & Loss Account . Dr.

To Bonus to Equity Shareholders Account

(b) When fully paid bonus shares are issued

Bonus to Equity Shareholders Account Dr.

To Equity Share Capital Account

Example.

A company had the following balances in share capital and reserves as on March 31, 2014.

Share capital 1,00, 000 shares of Rs. 10 each	` 10,00,000
Security Premium	` 70,000
General Reserve	` 4, 50, 000
Revaluation Reserve	` 2, 70,000

The company passed a resolution for issue of 1 bonus share for every 4 shares held. Pass necessary journal entries for the issue of bonus shares.

Solution

Journal

2014		`	`
Mar 31	Securities Premium Account Dr.	70,000	
	General Reserve Account Dr.	1,80.000	
	To Bonus to Shareholders Account		2,50,000
	(Being declaration of bonus in the ratio of 1 shares for every 4 held)		
Mar 31	Bonus to Shareholders Account Dr.	2,50,000	
	To Equity Share Capital Account		2,50,000
	(Being issue of 25,000 equity share of `10 each as bonus)		

Note: Students should note that revaluation reserve has not been used for issue of bonus shares as this is not allowed under section 63 of the Companies Act, 2013.

No. of bonus shares= 1 for every 4; So against 100,000 shares, bonus shares issued are 25,000.

1.11 SUMMARY

Corporate accounting means recording, classifying, summarizing, and communicating the results of financial transactions of **company form of organisations**. Corporate accounting includes accounting for companies registered under Companies Act or special acts of Parliament. It encompasses accounting for share capital, debentures, mergers and acquisitions, accounting for holding companies etc. The shares of a company limited by shares can be of two kinds only; equity shares and preference shares. Companies can also issue sweat equity shares to its directors and employees. Employees can also be given options to purchase shares under ESOS as an incentive to stay longer in the company. Shares can be issued at a fixed price or price can be discovered through book building process. Whenever company wants to raise additional capital through fresh issue of shares, it will have to first offer them to existing shareholders. This is called Rights Issue. If accompany finds excess amount of accumulated reserves, it can capitalize them by issuing bonus shares to the current equity shareholders.

1.12 SUGGESTED READINGS

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

1.13 ANSWER THE FOLLOWING QUESTIONS

1. What is corporate accounting? Discuss its scope.
2. Explain the meaning of different types of share capital.
3. State the legal requirements and accounting treatment of issue of bonus shares.
4. Explain different types of shares.
5. What do you mean by rights issue? How right is valued?
6. Explain briefly the provisions of Companies Act regarding Sweat Equity shares.
7. Discuss (i) Employees Stock Option Plan (ESOP) (ii) Book Building

LESSON 2

ACCOUNTING FOR SHARE CAPITAL

ISSUE, FORFEITURE AND REISSUE OF SHARES

STRUCTURE

2.0 OBJECTIVES

After reading this lesson, you should be able to:

- Understand the legal procedure for issue of shares
- Understand the accounting treatment for issue of equity as well as preference shares
- Know about the journal entries on forfeiture of shares
- Understand the accounting treatment of reissue of shares

2.1 LEGAL PROCEDURE FOR ISSUE OF SHARES BY PUBLIC COMPANIES

In the case of public issue of shares by a company, the following procedure is adopted:

1. **ISSUE OF PROSPECTUS:** First of all, public company issues the prospectus inviting offers from the public for the subscription or purchase of its shares. The prospectus contains the general information about the company and details of the amount which the applicant has to pay as application and allotment moneys.

2. **APPLICATION FOR SHARES:** In response to the issue of prospectus, applications for subscription of shares are submitted by prospective shareholders to the company. The company has to keep the amount of share application money in a scheduled bank under the name "Share Application Account."

3. **ALLOTMENT OF SHARES:** After the last day fixed for receipt of share applications, the directors of the company will process the applications and then allot shares to the applicants on some scientific basis.

4. MAKING CALLS ON SHARES: The directors may call the entire nominal value of the shares applied along with applications and allotment or may demand the amount in two or more installments termed as first call, second call and so on. There can be maximum of three calls only.

ACCOUNTING TREATMENT FOR ISSUE OF SHARES

Shares are said to be issued at par when the issue price of the shares is equal to the face value of shares.

THE FOLLOWING JOURNAL ENTRIES ARE PASSED:

I ON RECEIPT OF APPLICATION MONEY

Bank Account	Dr.	With number of shares applied
To Share Application Account		$\times$application money per share

II ALLOTMENT OF SHARES

(a) After allotment, application money being a part of share capital is transferred to share capital account by passing the following journal entry :

Share Application Account	Dr.	With the amount of application
To Share Capital Account		money on allotted shares

(b) If additional amount is **payable by shareholders on allotment**, then the entry will be :

Share Allotment Account	Dr.	Number of shares allotted
To Share Capital Account		$\times$allotment money per share

(c) Receipt of allotment money due.

Bank Account	Dr.
To Share Allotment Account	

(d) Refund of application money on rejected applications when shares are over-subscribed :

Share Application Account	Dr.
To Bank Account	

Note: Students must note that the Board of Directors cannot allot shares more than the number of shares offered to public in the prospectus even if it has received applications for a larger number.

III MAKING CALLS ON SHARES

(a) On making call money due :

Share First/Second/Third and Final Call Account	Dr.	Number of shares $\times$ call money

To Share Capital Account   per shares

(b) Receipt of call money :

Bank Account   Dr.

To Share First/Second/Third and Final Call Account

Note: Students must note that if the question requires the preparation of "Cash Book", in that case, 'Bank' transactions are not journalized, rather they are recorded in the "Cash Book" directly.

WHEN BOTH EQUITY AND PREFERENCE SHARES ARE ISSUED

When a company issues both type of share capital *i.e.* equity as well as preference, then it is desirable that separate entries should be passed for equity shares and preference shares. The journal entries as discussed earlier will be same for both types of shares except that the word "Equity" or "Preference" is prefixed with equity and preference share capital respectively. Students must note that it is customary to prefix the fixed rate of dividend with preference shares. This will be clear from the following illustration.

Illustration 1

A company issued 25,000, 12% preference shares of ` 20 each payable as follows:

On application	` 8
On allotment	` 7
On First call	` 5

The company also issued 50,000 equity shares of ` 100 each payable as follows:

On application	` 30
On allotment	` 40
On First call	` 30

Applications were received for whole of preference shares and equity shares. All the money due on shares was paid except the amount due on calls on 700 equity shares.

Show the cash book and journal entries.

Solution:

Journal

		`	`
1.	12% Preference Share Application Account ....Dr.	2,00,000	
	To 12% Preference Share Capital Account		2,00,000
	(Transfer of application money to 12% preference share capital		

	account)		
2.	Equity Share Application Account ....Dr. To Equity Share Capital Account (Transfer of equity share application money to equity share capital account)	15,00,000	 15,00,000
3.	12% Preference Share Allotment Account ....Dr. To 12% Preference Share Capital Account (Amount due on allotment on 25,000 preference shares @ `7 each)	1,75,000	 1,75,000
4.	Equity Share Allotment Account.................................Dr. To Equity Share Capital Account (Amount due on allotment on 50,000 Equity shares @`` 40 each)	20,00,000	 20,00,000
5.	12% Preference Shares First and Final call Account .....Dr. To 12% Preference Share Capital Account (Amount due on call on 25,000 preference shares @ ` 5 each)	1,25,000	 1,25,000
6.	Equity Share First and final Call Account ....Dr. To Equity Share capital Account (Amount due on call on 30,000 equity shares @ ` 30 each)	15,00,000	 15,00,000

Cash Book (Bank Column)

Particulars	`	Particulars	`
To 12% Preference Shares Application Account (Amount received on 25,000 shares @ each)	2,00,000	By Balance c/d	54,79,000
To Equity Share Application Account (Amount received on 50,000 shares @` 30 each)	15,00,000		
To 12% Preference Share Allotment Account (Amount received on 25,000	1,75,000		

shares @` 7 each)			
To Equity Share Allotment Account	20,00,000		
(Amount received on 50,000 shares @ ` 40 each)			
To 12% Preference Share First and Final Call Account	1,25,000		
(Amount received on 25,000 shares @ ` 5 each)			
To Equity Shares First and final Call Account	14,79,000		
(Being amount received on 49,300 shares @ ` 30 each)			
	54,79,000		54,79,000

Note: Students must note that the entries recorded directly in "Cash Book" have not been journalized.

UNDER-SUBSCRIPTION

A company may not receive applications for all the shares offered by it to the public. Thus applications received for less number of shares than offered to the public is known as under-subscription. In such a case, the company has to allot only that number of shares which have been actually applied by the public.

OVER-SUBSCRIPTION

A company may receive applications for a larger number of shares than offered by it to the public for subscription. Such a situation is termed as "over subscription". For example, a company offers 5,000 shares to the public, but applications are received for 8,000 shares. There is 'over subscription' to the extent of 3,000 shares. The company may treat the excess applications received in either of the following ways:

(a) **Rejection of Excess Applications:** The company straight way rejects all the excess applications received and full allotment is made to the balance of applicants. Application money has to be refunded in full to unsuccessful applicants at the time of allotment.

(b) **Allotment on Pro-rata Basis:** Pro-rata allotment means that allotment is made to applicants on a proportionate basis. In such a case, excess application money received is adjusted towards amount due on allotment, on calls etc.

Illustration 2

X Ltd. was registered with an authorised capital of ` 10, 00,000 divided into 1, 00,000 shares of ` 10 each. Out of this, the company offered 60,000 shares to the public which were payable as to `2 per share on application ; ` 4 per share each on allotment and the balance on first and final call. Applications for 92,000 shares were received which were allotted as follows:

Applicants for 40,000 shares – Full

Applicants for 50,000 shares – 40%

Applicants for 2,000 shares – Nil

` 1, 72,000 were realized on account of allotment money (excluding the amount carried from application money) and ` 2, 28,000 on first and final call.

Show the Journal entries recording the above.

Solution

Journal

Date	Particulars	L.F.	`	`
	Bank Account.. Dr.		1,84,000	
	To Share Application Account			1,84,000
	(Being application money received for 92,000 shares)			
	Share Application Account .... Dr.		1,84,000	
	To Share Capital Account			1,20,000
	To Share Allotment Account			60,000
	To Bank Account			4,000
	(Being the transfer of application money on 60,000 shares @ ` 2 per share to Share Capital Account, surplus application money on 30,000 shares to Share allotment Account and the refund on 2,000 shares)			
	Share Allotment Account .... Dr.		2,40,000	
	To Share Capital Account			2,40,000
	(Being the allotment amount due on 60,000 shares @ ` 4 per share)			
	Bank Account.. Dr.		1,72,000	

	To Share Allotment Account (Being the amount received on allotment)			1,72,000
	Share First and Final Call Account .... Dr. To Share Capital Account (Being the first and final call amount due on 60,000 shares @ ` 4 per share)		2,40,000	2,40,000
	Bank Account... Dr. To Share First and Final Call Account (Being the amount received on first and final call on 57,000 shares)		2,28,000	2,28,000

ISSUE OF SHARES AT A PREMIUM [SECTION 52]

Shares are said to be issued at premium when the issue price of shares is higher than the face value (or par value) of the shares. For example, if a share of `50 is issued for ` 60, then ` 10 is the amount of premium. **Section 52 of the Companies Act 2013** provides that where a company issues securities at a premium, a sum equal to the aggregate amount of premiums on those securities shall be transferred to the Securities Premium Account. The amount of premium received represents **capital profit** and thus **Securities Premium Account** must be shown separately on the liabilities side of balance sheet under the head **"Reserves and Surplus".**

A**s per recent guidelines issued by SEBI, a new company set up by entrepreneurs without a track record, will not be permitted to issue capital to public at premium.**

APPLICATION OF SECURITIES PREMIUM ACCOUNT

According to **Section 52 of Companies Act, 2013** Securities Premium Account can be applied by the company for:

(a) Issuing fully paid bonus shares to the members;

(b) Writing off the preliminary expenses of the company;

(c) Writing off the expenses or the commission paid or discount allowed on any issue of securities or debentures of the company; or

(d) Providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

(e) Buying back its own shares or securities.

If the company wants to utilize the premium for any other purpose, it will have to obtain the consent of the court.

ACCOUNTING TREATMENT OF SECURITIES PREMIUM

CASE (A) IF PREMIUM AMOUNT IS COLLECTED AT THE TIME OF APPLICATION

(i) RECEIPT OF APPLICATION MONEY

Bank Account Dr. | Amount Including premium

To Share Application Account

(ii) TRANSFER OF APPLICATION MONEY

Share Application Account Dr.

To Share Capital Account (with nominal value)

To Securities Premium Account (with premium)

CASE (B) IF PREMIUM AMOUNT IS COLLECTED AT THE TIME OF ALLOTMENT

(i) ALLOTMENT MONEY DUE:

Share Allotment Account Dr.

To Share Capital Account (with nominal value)

To Securities Premium Account (with premium)

(ii) ALLOTMENT MONEY RECEIVED:

Bank Account Dr. | Including premium

To Share Allotment Account

CASE (C) IF PREMIUM AMOUNT IS COLLECTED AT THE TIME OF A CALL

(i) CALL MONEY DUE

Share First/Second/Final Call Account Dr.

To Share Capital Account

To Securities Premium Account

(ii) CALL MONEY RECEIVED

Bank Account Dr. | Includin g

To Share First/Second/Final Call Account

ISSUE OF SHARES AT A DISCOUNT

When shares are issued at a price lower than the face value, they are said to be issued at discount. For example, if a share of ` 10 is issued at ` 9 then it is said to be issued at 10% discount. **Section 53 the Companies Act, 2013 prohibits issue of shares at discount** except in case of sweat equity shares where in shares are issued to employees in lieu of their services. **Any shares issued by a company at a discounted price shall be void**.

CALLS IN ARREARS

Some shareholders may not pay allotment money or call money within the date fixed for such payment. The amount thus not paid is called “Calls in Arrears”. The company may accept late payment of allotment money or call money with interest for late payment as per the provisions in this regard in Articles. But if the Articles of Association is silent, **Table F** of the Companies Act, 2013 will apply which states that a company can charge interest on all such Calls in Arrears from the last date fixed for payment to the time of actual payment @10% per annum.

CALLS IN ADVANCE

When a company receives from shareholders the amount remaining unpaid on shares held by them even though the amount has not been called up, the amount so received is called “calls-in-advance.” Such a call-in- advance, according to **Section 50 of Companies Act, 2013** can be accepted only when company is so authorised by its Articles. If the company has adopted **Table F,** then it is required to pay interest @12% per annum on such calls-in-advance from the date of receipt to the due date of call. The shareholder is not entitled to any dividend on the amount paid as call-in-advance.

ACCOUNTING ENTRIES FOR CALLS IN ARREARS AND CALLS IN ADVANCE:

(i) When call money or allotment money is in arrears

Generally no entry is passed and entries for receipt of allotment money and call money is passed with the amount actually received.

(ii) On receipt of unpaid allotment or call money on a later date

Bank Account	Dr.	
To Share Allotment Account/Share Call Account		

(iii) Receiving interest on calls in arrears

Bank Account	Dr.	
To Interest on Calls in Arrears Account		

(iv) On receipt of Call money in advance

Bank Account	Dr.	with amount of money received in advance
To Calls-in-Advance Account		

(v) When calls are made and calls in advance is adjusted

Share Call Account	Dr.	(with net amount due)
Calls in Advance Account	Dr.	(with calls in advance)
To Share Capital Account		(with total-amount due)

(*vi*) On payment of interest on calls-in-advance

Interest on Calls in Advance Account	Dr.	
To Bank Account		

Illustration 4

A limited company invited applications for 5,000 Equity shares of ` 100 each payable as follows:

On application	` 30
On allotment (Ist. April, 2014)	` 20
On Ist Call (Ist July, 2014)	` 30
On IInd call (Ist October, 2014)	` 20

All the shares were applied and allotted. A shareholder holding 200 shares paid the whole of the amount due along with allotment. Another shareholder did not pay the allotment money on his 300 shares but which he paid with first call. Directors have decided to adopt Table F. Journalise the transactions.

Solution

Journal

2014		`	`
?	Bank Account .... Dr.	1,50,000	
	To Equity Share Application Account		1,50,000
	[Being application money received]		
April 1	Equity Share Application Account .... Dr.	1,50,000	
	To Equity Share Capital Account		1,50,000
	[Being application money transferred to share capital on allotment]		
April 1	Equity Share Allotment Account.............................. Dr.	1,00,000	
	To Equity Share Capital Account		1,00,000
	[Being allotment money due]		
April 1	Bank Account .... Dr.	1,04,000	
	To Equity Share Allotment Account		94,000
	To Calls in Advance Account		10,000
	[Being allotment money received on 4,700 shares @ ` 20 each and calls in advance received on 200 shares @ ` 50 each]		
July 1	Equity Share First Call Account .... Dr.	1,50,000	
	To Equity Share Capital Account		1,50,000
	[Being first call money due]		
July 1	Bank Account .... Dr.	1,44,000	
	Calls in Advance Account .... Dr.	6,000	
	To Equity Share First Call Account		1,50,000

	[Being first call money received on 4800 shares and calls in advance on 200 shares @ ` 30 adjusted]		
July 1	Bank Account .... Dr.	6,000	
	To Equity Share Allotment Account		6,000
	(Being allotment money received on 300 shares @ ` 20 per share)		
Oct. 1	Equity Share Second and Final Call Account............ Dr.	1,00,000	
	To Equity Share Capital Account		1,00,000
	[Being second and final call money due]		
Oct. 1	Bank Account .... Dr.	96,000	
	Calls in Advance Account .... Dr.	4,000	
	To Equity Share Second and Final Call Account		1,00,000
	[Being final call money received and calls in advance adjusted]		
Oct. 1	Bank Account .... Dr.	150	
	To Interest on Calls in Arrears Account		150
	[Being interest received on calls in arrears on ` 6,000 for 3 months @ 5% p.a]		
Oct. 1	Interest on Calls in Advance Account .... Dr.	420	
	To Bank Account		420
	[Being Interest paid on calls in advance @ 6% p.a.]		

Working Notes:

Calculation of Interest On Calls in Advance

On First Call in Advance of ` 6,000 for 3 month (Ist April to Ist July) @ 12%	180
On Second and Final Calls in Advance of ` 4,000 for 6 months (Ist April to Ist Oct.) @ 10%	240
Total Interest On Calls in Advance	420

2.3 FORFEITURE OF SHARES

A member is liable to pay the full issue price of his shares as and when called by the company. If a member of the company does not pay the allotment or call money on the day fixed for payment thereof, the Board may at any time thereafter, forfeit those shares and the amount received thereon. However, the following conditions must be satisfied before the directors proceed to forfeit the shares:

(a) There should be a default by the shareholder in payment of a valid call.

(b) A notice must be served upon the shareholder to pay calls including interest and expenses within the specified period. Atleast 14 days must be given to the defaulting shareholder to pay the called money.

(c) The notice must mention that if the payment is not received within the specified period, the shares would be forfeited.

(d) The power to forfeit shares must be expressly given by the company's Articles of Association.

(e) The Board of Directors must pass a resolution for forfeiture of shares.

(f) The power to forfeit the shares must be exercised bonafide and in the interest of the company.

The shareholder, whose shares have been forfeited, shall cease to be the member of the company. He/she also loses whatever amount he has already paid to the company.

2.4 ACCOUNTING TREATMENT OF FORFEITURE OF SHARES

The amount already received from the defaulting shareholder stands forfeited, so the amount forfeited is a gain to the company and is credited to a special account called "Share Forfeited Account".

FORFEITURE OF SHARES ISSUED AT PAR

The journal entry in this case will be as follows:

Share Capital Account Dr. (With number of shares forfeited ×**Called up amount** per share).

To Unpaid Calls Account (With unpaid amount)

To Share Forfeited Account (With amount already paid by shareholders)

Note: Students must note that Share Capital Account is debited with called-up amount only and not with the face value of shares. Face value is debited only if full face value has been called up

FORFEITURE OF SHARES ISSUED AT PREMIUM

(A) WHEN PREMIUM MONEY HAS NOT BEEN RECEIVED ON FORFEITED SHARES

In case Securities Premium money has not been received on the shares to be forfeited, then any credit already given to "Securities Premium Account" at the time of making the allotment or call must be cancelled at the time of forfeiture of shares by debiting "Securities Premium Account".

The accounting entry will be as follows:

Share Capital Account Dr. (With number of shares forfeited × called up amount per share)

Securities Premium AccountDr. (With premium amount unpaid on shares forfeited)

To Shares Unpaid Call Account (With unpaid call)

To Shares Forfeited Account (With amount already paid)

(B) WHEN PREMIUM MONEY HAS ALREADY BEEN RECEIVED ON FORFEITED SHARES

When premium money was duly received on the shares to be forfeited, then the “Securities Premium Account” already credited at the time of making allotment or call will not be debited at the time of forfeiture of shares.

Note: The accounting entry on forfeiture when the premium has already been received on forfeited shares would be the same as the one passed in the case of forfeiture of shares issued at par.

Illustration 5

ABC Limited issued shares of ` 10 each at a premium of `2 per share payable as ` 3 on application; ` 4 on allotment (including premium) ; `` 2 on first call and ` 3 on final call. Sunder, holder of 100 shares, failed to pay the allotment money and first call. Binder, holder of 200 shares failed to pay the first call, Their shares are forfeited after first call. Pass the journal entries of forfeiture.

Solution:

Journal Entries

Date	Particulars	Debit	Credit
		`	`
	Share Capital Account ....Dr.	700	
	Securities Premium Account ....Dr.	200	
	To Share Allotment Account		400
	To Share First Call Account		200
	To Share Forfeiture Account		300
	[Being forfeiture of 100 shares of Sunder for non payment of allotment and first call]		
	Share Capital Account ....Dr.	1,400	
	To Share First Call Account		400
	To Share Forfeiture Account		1,000
	Being forfeiture of 200 shares held by Binder for non-payment of first call]		

Note: Students are advised to note the difference between the two entries. In the first case, the amount of premium is not received; hence the Securities Premium Account has been debited. In the second case, the amount of premium has been realised, hence

Illustration 6

AC Ltd. issued for public subscription 30,000 equity shares of ` 10 each at a premium of ` 2 per share payable as under:

On Application	` 2 per share
On Allotment	`5 per share (including premium)
On First Call	` 2 per share
On Second Call	`3 per share

Applications were received for 50,000 equity shares. Allotment was made pro-rata to the applicants for 40,000 shares and the remaining applications were rejected. Money overpaid on application was applied towards sums due on allotment.

X to whom 750 shares were allotted failed to pay the allotment money and two calls. Y to whom 1,000 shares were allotted failed to pay the two calls. These shares were forfeited after the second call was made.

Pass journal entries in the books of the company to record the above transactions.

Solution:

JOURNAL

Date	Particulars	L.F.	Debit Amount	Credit Amount
(*a*)	Bank Account ....Dr.		1,00,000	
	To Equity Share Application Account			1,00,000
	(Being application money received on 50,000 equity shares @ Rs. 2 each)			
(*b*)	Equity Share Application Account...........................Dr.		1,00,000	
	To Equity Share Capital Account			60,000
	To Equity Share Allotment Account			20,000
	To Bank Account			20,000
	(Being shares allotted and excess amount adjusted on allotment and balance refunded to rejected applicants for 10,000 shares)			
(*c*)	Equity Share Allotment Account.............................Dr.		1,50,000	
	To Equity Share Capital Account			90,000
	To Securities Premium Account			60,000
	(Being allotment money due on 30,000 equity shares			

	@ Rs. 5 per share including Rs. 2 per share as premium)		
(*d*)	Bank Account ....Dr.	1,26,750	
	To Equity Share Allotment Account		1,26,750
	(Being allotment money received except on 750 shares hold by X)		
(*e*)	Equity Share First Call Account ....Dr.	60,000	
	To Equity Share Capital Account		60,000
	(Being first call money due on 30,000 equity shares @ Rs. 2 per share)		
(*f*)	Bank Account ....Dr.	56,500	
	To Equity Share First Call Account		56,500
	(Being first call money received except on 1,750 shares hold by X and Y)		
(*g*)	Equity Share Second and Final Call Account ....Dr.	90,000	
	To Equity Share Capital Account		90,000
	(Being second and final call money due)		
(*h*)	Bank Account ....Dr.	84,750	
	To Equity Share Second and Final Call Account		84,750
	(Being final call money received except on 1,750 shares held by X and Y)		
(*i*)	Equity Share Capital Account.................................Dr.	17,500	
	Securities Premium Account..................................Dr.	1,500	
	To Equity Share Allotment Account		3,250
	To Equity Share First Call Account		3,500
	To Equity Share Second and Final Call Account		5,250
	To Share Forfeited Account		7,000
	(Being shares of X and Y forfeited)		

Working Notes

1. CALCULATION OF AMOUNT RECEIVED ON ALLOTMENT

		`
Gross Allotment money due		1, 50,000
Less:	Surplus application money adjusted on allotment	20,000
	Net Allotment Money Due	1,30,000
Less:	Allotment money unpaid by X:	

Gross Allotment money due (750 shares @ ` 5)	3,750	
Less: Excess Rs.2 per share received on 250 shares from X	500	3,250
Amount Received on Allotment		1,26,750

Shares Applied by X $\left(750 \times \frac{40,000}{30,000}\right)$	1,000
Share Allotted	750
Excess Shares Applied	250

REISSUE OF FORFEITED SHARES

The Companies Act allows the reissue of forfeited shares subject to the provisions of the Articles of Association. These shares may be issued at par or at premium or at a discount. However, **the maximum amount of discount on reissue cannot exceed the amount already received from defaulting shareholders**. In other words, there cannot be any loss on account of reissue of forfeited shares.

NOTE: Reissue of forfeited shares is a sale of shares and it does not amount to allotment. This implies that Section 53 of Companies Act, 2013 which prohibits issue of shares at a discount will not be applicable on reissue of forfeited shares. Thus, reissue of forfeited shares can be made a price lower than face price.

JOURNAL ENTRIES FOR REISSUE OF FORFEITED SHARES

CASE I: WHEN THE ENTIRE FORFEITED SHARES ARE REISSUED :

(i) ON REISSUE OF SHARES

Bank Account	Dr.(with amount received on reissue)
Share Forfeited Account	Dr.(with discount allowed on reissue)
To Share Capital Account	(with paid up value of share)
To Securities Premium Account	(if reissued at premium)

(ii)TRANSFER OF BALANCE IN SHARE FORFEITED ACCOUNT TO CAPITAL RESERVE

ANY BALANCE LEFT IN SHARE FORFEITED ACCOUNT WILL BE TRANSFERRED TO CAPITAL RESERVE ACCOUNT BECAUSE IT IS A PROFIT OF CAPITAL NATURE

Share Forfeited Account	Dr.	with net gain on shares reissued
To Capital Reserve Account		

CASE II: WHEN ONLY A PART OF FORFEITED SHARES ARE REISSUED

When only part of forfeited shares are reissued, only the proportionate amount representing the net gain on the shares reissued should be transferred to Capital Reserve Account and the balance representing the amount received on forfeited shares not yet reissued should be left in the Shares Forfeited Account itself. This amount is shown as addition to the paid up capital on the liabilities side of the balance sheet.

CALCULATION OF PROPORTIONATE AMOUNT TO BE TRANSFERRED TO CAPITAL RESERVE:

Step I: Calculate proportionate profit as :

$$\frac{\text{Total Forfeited Amount}}{\text{Total Shares Forfeited}} \times \text{Number of Shares Reissued}$$

Step II: Capital Reserve = Proportionate Profit – Discount on Reissue

Illustration 7

Give journal entries to record the forfeiture of shares and their reissue:

a. Z. Ltd. forfeited 100 shares of ` 100 each, `` 70 per share called up on which ` 50 per share has been paid by Akash, the amount of first call of ` 20 per share being unpaid. The directors reissued the forfeited shares to Shama crediting ` 70 per share paid for a payment of `50 per share.

b. The directors of A Ltd. forfeited 500 shares of `50 each, `40 being called up, on which Rakesh**,** a shareholder paid application and allotment money of ` 25 per share but did not pay first call money of `15 per share. Of these forfeited shares, the company subsequently reissued 350 shares as fully paid up for ` 40 per share.

c. The directors of D. Ltd. forfeited 100 shares of `100 each, fully called up for non-payment of final call money of ` 50 per share. Half of these shares were subsequently reissued at ` 120 per share as fully paid.

d. Y. Ltd. forfeited 200 shares of ` 100 each (issued at a premium of 10%) for non-payment of first call of `25 and final call of `15. Of these 150 shares were reissued for ` 90 per share.

Solution

Journal Entries

		`	`
a)	Share Capital Account (100 × `70).............................. Dr.	7,000	
	To Share Forfeited Account (100 ×`50)		5,000
	To Share First Call Account (100 × `20)		2,000
	[Forfeiture of 100 shares of `100 each, ` 70 being called up for non-payment of first call money at ` 20 per share]		
	Bank Account (100 × `50)... Dr.	5,000	
	Share Forfeited Account (100 × `20) .... Dr.	2,000	
	To Share Capital Account		7.000
	[Reissue of 100 forfeited shares of ` 100 each, ` 70 paid up at ` 50 per share]		
	Share Forfeited Account... Dr.	3,000	
	To Capital Reserve Account		3,000
	[Being capital profit on reissue of forfeited shares transferred to Capital reserve Account]		
b)	Share Capital Account (500 ×` 40).............................. Dr.	20,000	
	To Share Forfeited Account (500 ×` 25)		12,500
	To Share First Call Account (500×`15)		7,500
	[Forfeiture of 500 shares of `50 each, ` 40 being called up for non-payment of first call money of ` 15 per share]		
	Bank Account (350 ×` 40) .... Dr.	14,000	
	Share Forfeited Account (350 ×` 10) .... Dr.	3,500	
	To Share Capital Account		17,500
	[Reissue of 350 forfeited shares of ` 50 fully paid at ` 40 giving a discount of ` 10 per share]		
	Share Forfeited Account... Dr.	5,250	
	To Capital Reserve Account		5,250

	[Transfer of capital profit proportionate to forfeited shares reissued *i.e.,* on 350 shares @ ` 15 each to Capital Reserve Account]		
***c*)**	Share Capital Account (100 × ` 100) .... Dr.	10,000	
	To Share Forfeited Account		5,000
	To Share Final Call Account		5,000
	[Forfeiture of 100 shares at `100 called up for non-payment of final call of ` 50 per share]		
	Bank Account .... Dr.	6,000	
	To Share Capital Account		5,000
	To Securities Premium Account		1,000
	[Reissue of 50 forfeited shares of ` 100 each at a premium of ` 20]		
	Share Forfeited Account .... Dr.	2,500	
	To Capital Reserve Account		2,500
	[Transfer of proportionate capital profit on reissue of forfeited shares to Capital Reserve Account]		
***d*)**	Share Capital Account (200 × ` 100)............................ Dr.	20,000	
	To Share First Call Account (200 × ` 25)		5,000
	To Share Second and Final Call Account (200 × ` 15)		3,000
	To Share Forfeited Account (200 × ` 60)		12,000
	[Forfeiture of 200 shares for non-payment of first call and final call respectively]		
	Bank Account (150 × ` 90) .... Dr.	13,500	
	Share Forfeited Account (150 × ` 10) .... Dr.	1,500	
	To Share Capital Account (150 × `100)		15,000
	[Reissue of forfeited shares of ` 100 each at ` 90 per share]		
	Share Forfeited Account (150 × ` 50) .... Dr.	7,500	
	To Capital Reserve Account		7,500
	[Profit on reissue of shares transferred to Capital reserve		

	Account]		

2.5 SUMMARY

A joint stock company can raise funds by issue of share capital. Share capital can be equity share capital or preference share capital. Amount to be raised through share capital is based on the authorized capital. A company firstly invites share applications with application money, then allots shares and receives allotment money. Finally, calls are made for balance of the amount. Interest can be paid on calls in advance and can be received on calls in arrears. In case of default in payment, shares can be forfeited and reissued to someone else. Preference shares are generally issued for fixed period, after which these are redeemed.

2.6 SUGGESTED READINGS/BOOKS:

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

2.7 ANSWER THE FOLLOWING QUESTIONS

1. Can a company issue shares at discount?
2. State the legal requirements and accounting treatment of issue of shares at premium.
3. How does a company deal in accounts with?
   (i) Calls in arrears (*ii*) Calls in advance.
4. What do you mean by forfeiture of shares? Can forfeited shares be issued at a discount and to what extent?
5. Explain briefly the provisions of Companies Act regarding the following:
   (i) Forfeiture of shares (*ii*) Reissue of Forfeited shares
6. What is forfeiture of shares? What are the legal requirements necessarily followed by the Board before forfeiture of shares? What are the effects of forfeiture? How forfeited shares can be reissued? Show journal entries for recording forfeiture and reissue of forfeited shares.

LESSON 3

Redemption Of Preference Shares

and BUY BACK OF SHARES

STRUCTURE

3.0 OBJECTIVES

After reading this lesson, you should be able to:

- Understand the legal procedure for redemption of preference shares
- Understand the accounting treatment for redemption of preference shares
- Learn about the meaning of buy back of shares
- Understand the accounting treatment of buy back of shares

INTRODUCTION

Redemption of preference shares means repayment of capital to the preference shareholders. Section 55 of Companies Act, 2013 provides that a company limited by shares has the power to issue Redeemable Preference Shares provided it is so authorised by its Articles. Such shares can be redeemed either at the option of the company or after the expiry of the fixed period of time stipulated at the time of issue. The period of redemption, however, **cannot exceed 20 years** from the date of issue of such shares. However, a company engaged in the setting up and dealing with of **infrastructural projects** may issue preference shares for a period **exceeding twenty years** but **not exceeding thirty years**.

3.1 LEGAL PROVISIONS REGARDING REDEMPTION OF PREFERENCE SHARES

Section 55 of the Companies Act, 2013 prescribes the following **legal restrictions** with regard to the redemption of preference shares:

(a) Shares can be redeemed out of :

- **(i)** **out of profits of the company** which would otherwise be available for dividend, or
- **(ii)** **out of the proceeds of a fresh issue of shares** made for the purpose of redemption,or
- **(iii)** **partly out of profits and partly out of fresh issue of shares.**

(b) **Only fully paid** preference shares can be redeemed. If they are partly paid, then first of final call should be made to make them fully paid.

(c) If they are to be redeemed at premium, then such premium must be provided for out of the profits of the company or out of the security premium account.

(d) If such shares are redeemed out of profits, then a sum **equal to the nominal amount of the shares so redeemed** must be transferred out of the profits of the company to a reserve called "**Capital Redemption Reserve Account**".

(e) The Capital Redemption Reserve Account can only be used for the purpose of issue of **fully paid bonus shares**. Otherwise, capital redemption reserve account must be maintained intact unless otherwise sanctioned by the court.

INTERPRETATION OF "PROCEEDS OF A FRESH ISSUE"

The term **proceeds of a fresh issue of shares** has not been defined in Section 55 or elsewhere in the Companies Act. Consensus view upon this point is that nominal value shall constitute proceeds when new shares are issued at premium or at par.

PROFITS THAT CAN BE USED FOR REDEMPTION

Since Section 55 permits the redemption of preference shares out of **profits which would otherwise be available for dividend,** hence **Capital Redemption Reserve Account** must be created only out of such divisible profits. The following table gives some instances of profits which are available for redemption and which are not available for redemption:

Profits available for Redemption	Profits not available for Redemption
1. General Reserve	1. Security Premium Account
2. Reserve Fund	2. Share Forfeited Account
3. Profit & Loss Account (credit)	3. Profits Prior to Incorporation
4. Dividend Equalization Fund	4. Capital Reserve
5. Insurance Fund	
6. Workmen Compensation Fund (if there is no specific liability)	

7. Workmen Accident Fund (if there is no specific liability) 8. Voluntary Debenture Sinking Fund 9. Debenture Redemption Reserve 10. Investment Reserve	

AMOUNT TO BE CREDITED TO CAPITAL REDEMPTION RESERVE ACCOUNT

The amount to be credited to Capital Redemption Reserve Account is arrived as follows:

(a) When the redeemable preference shares are redeemed wholly out of profits:

Capital Redemption Reserve Account = N**ominal value** of redeemable preference shares so redeemed.

(b) When the redeemable preference shares are redeemed partly out of profits and partly out of proceeds of fresh issue of shares:

In such a case, Capital Redemption Reserve Account= Nominal value of redeemable preference shares redeemed- Nominal value of fresh issue of shares

3.2 ACCOUNTING TREATMENT ON REDEMPTION OF PREFERENCE SHARES

The following accounting procedure is followed on redemption of preference shares:

1. MAKING PREFERENCE SHARES FULLY PAID:

If preference shares which are to be redeemed are partly paid, then following entries are passed to make them fully paid:

(a) MAKING FINAL CALL ON PREFERENCE SHARES

Preference Shares Final Call Account Dr.
    To Redeemable Preference Share Capital Account

(b) RECEIPT OF FINAL CALL MONEY

Bank Account Dr.
    To Preference Share Final Call Account

2. ENTRY FOR FRESH ISSUE OF SHARES

Bank Account Dr. (with actual amount received)
    To Share Capital Account (with nominal value)
    To Security Premium Account (if issued at premium)

3. TRANSFER OF PREMIUM ON REDEMPTION ACCOUNT

Security Premium Account Dr.
General Reserve Account Dr.
Profit & Loss Account Dr.
    To Premium on Redemption of Preference Shares Account

4. TRANSFER TO CAPITAL REDEMPTION RESERVE ACCOUNT

If whole or some of the preference shares are redeemed out of profit, then as per law, an amount equal to face value of shares so redeemed will be transferred to capital redemption reserve account from divisible profits. The journal entry will be

Profit & Loss Account	Dr.	
General Reserve Account	Dr.	
Dividend Equalisation Reserve Account etc.	Dr.	
To Capital Redemption Reserve Account		

5. SALE OF ASSET TO PROVIDE CASH FOR REDEMPTION

If sufficient cash or bank balance is not available for making payment to preference shareholders, then some assets can be sold to arrange funds for redemption. The requisite journal entry will be

Bank Account	Dr.	
To Concerned Asset Account		(With book value of asset)
To Profit & Loss Account		(Selling Price-book value)

Note: If asset is sold at a loss then such loss will be debited to Profit & Loss Account.

6. ENTRY FOR AMOUNT DUE TO PREFERENCE SHAREHOLDERS

Redeemable Preference Share Capital Account	Dr.	(with nominal value)
Premium on Redemption of Preference Shares Account	Dr.	(with the premium)
To Preference Shareholders Account		(with total amount due)

7. PAYMENT TO PREFERENCE SHAREHOLDERS

Preference Shareholders Account	Dr.
To Bank Account	

8. DECLARATION OF BONUS SHARES

(a) When fully paid bonus shares are declared

Capital Redemption Reserve Account	Dr.
Securities Premium Account	Dr.
Profit & Loss Account/ General Reserve Account etc.	Dr.
To Bonus to Equity Shareholders Account	

(b) When fully paid bonus shares are issued

Bonus to Equity Shareholders Account	Dr.
To Equity Share Capital Account	

Illustration 1

A company has 25,000, 11% redeemable preference shares of ` 100 each, fully paid. The company now decides to redeem the shares at a premium of 20 per cent. The company makes the following issues of shares and debentures:–

(a) 10,000 equity shares of ` 100 each at a premium of 10 per cent.

(b) 8,000, 12 % debentures of ` 100 each.

The issue was fully subscribed and the entire amount was received. The redemption was duly carried out. The company has sufficient profits. Give journal entries.

Solution:

Journal

Date	Particulars	Dr.	Cr.
		`	`
1.	Bank Account..Dr.	11,00,000	
	To Equity Share Capital Account		10,00,000
	To Securities Premium Account		1,00,000
	[Being fresh issue of equity shares at a premium]		
2.	Bank Account..Dr.	8,00,000	
	To 12% Debentures Account		8,00,000
	[Being issue of 8,000, 12% Debentures of ` 100 each]		
3.	Securities Premium Account ....Dr.	1,00,000	
	Profit & Loss Account ....Dr.	4,00,000	
	To Premium on Redemption of Preference Shares Account		15,00,000
	[Being premium on redemption provided out of Securities Premium Account & Profit & Loss Account]		
4.	Profit & Loss Account ....Dr.	15,00,000	
	To Capital Redemption Reserve Account		15,00,000
	[Being nominal value of shares redeemed out profit transferred to capital redemption reserve account]		
5.	11% Redeemable Preference Share Capital Account.....Dr.	25,00,000	
	Premium on Redemption of Preference Shares AccountDr.	5,00,000	
	To Preference Shareholders Account		30,00,000
	[Being amount due to preference shareholders @ 20% premium]		

6.	Preference Shareholders Account.................................Dr.	30,00,000	
	To Bank Account		30,00,000
	[Being amount due to preference shareholder paid].		

Note: Since proceeds from issue of debentures cannot be used for redemption of preference shares, hence only proceeds from issue of equity shares are used for redemption & the balance amount of preference shares are redeemed out of profit.

Illustration 2

Markanda Ltd. had as part of its share capital 40,000, 12% Redeemable Preference shares of ` 25 each fully paid up to be redeemable at a premium of 8%. When the shares become due for redemption, the company had ` 6,00,000 in the reserve fund. The company issued necessary equity shares of ` 10 specifically for the purpose of redemption and received cash in full. The redeemable preference shares were then paid out of the new issue, the balance being met from the reserve fund.

Make necessary journal entries recording the above transactions.

Solution

Journal

		`	`
(*a*)	Reserve Fund Account Dr.	80,000	
	To Premium on Redemption of Preference Shares		80,000
	[Being use of reserve fund to provide premium on redemption of preference shares.]		
(*b*)	Reserve Fund Account Dr.	5,20,000	
	To Capital Redemption Reserve Account		5,20,000
	[Being transfer of ` 5,20,000 from reserve fund to capital redemption reserve being redemption out of profit]		
(*c*)	Bank Account Dr.	4,80,000	
	To Equity Share Capital Account		4,80,000
	[Being issue of 48,000 shares of ` 10 each fully paid]		
(*d*)	12% Redeemable Preference Share Capital Dr.	10,00,000	
	Premium on Redemption of Preference Shares Dr.	80,000	
	To Redeemable Preference Shareholders Account		10,80,000

	[Being amount due on redemption]		
(*e*)	Redemption Preference Shareholders Account Dr.	10,80,000	
	To Bank Account		10,80,000
	[Being redemption of preference shares]		

Working Notes:

Calculation of amount and number of fresh shares to be issued

	`
Amount of redeemable preference shares	10,00000
Less : Amount available in reserve fund (after adjusting premium on redemption)	5,20,000
Balance amount to be collected from the fresh issue of shares	4,80,000

$$\text{Number of Shares to be issued} = \frac{\text{Amount Required}}{\text{Issue Price per Share}} = \frac{\text{` 4,80,000}}{\text{` 10}}$$

$$= 48,000$$

Illustration 3

The following is the Balance Sheet of B Limited as at 31st March, 2014

Liabilities	**Amount**	**Assets**	**Amount**
	`		`
Share Capital :			
1,000 Equity Shares of ` 100 each	1,00,000	Investment	40,000
8,000, 10% Preference Shares of ` 10		Patents	1,00,000
each ` 8 paid up	64,000	Other Fixed Assets	1,60,000
Securities Premium Account	3,000	Bank Balance	60,000
Profit & Loss Account	10,000		
General Reserve	40,000		
Capital Reserve	50,000		
Sundry Creditors	93,000		
	3,60,000		3,60,000

The company decided to redeem the preference shares at a premium of 5 %. In order to finance the redemption, the company sold all its investment for ` 42,000. The preference shares are duly redeemed partly out of available funds (profits) and partly out of fresh issue of equity shares of ` 100 each at par. Pass Journal entries and prepare Balance Sheet after redemption.

Solution:

Journal Entries

			`	`
	Preferences Share Final Call Account Dr. To Preference Shares Capital Account [Being Final call money due on 8,000 preference shares @ ` 2 per share]		16,000	16,000
	Bank Account Dr. To Preference Share Final Call Account [Being final call money received]		16,000	16,000
	Bank Account Dr. To Investment Account To Profit & Loss Account [Being investment sold at a profit of ` 2,000]		42,000	40,000 2,000
	Securities Premium Account Dr. Profit & Loss Account Dr. To Premium on Redemption of Preference Shares Account [Being premium on redemption provided out of securities premium & profit & loss account]		3,000 1,000	4,000
	Profit & Loss Account Dr. General Reserve Account Dr. To Capital Redemption Reserve Account [Being profit and reserve transferred to capital redemption reserve Account]		11,000 40,000	51,000
	Bank Account Dr. To Equity Share Capital Account [Being 290 new equity shares issued at par]		29,000	29,000

10% Redeemable Preference Share Capital Account Dr.		80,000	
Premium on Redemption of Preference Shares Dr.		4,000	
To Redeemable Preference Shareholders Account			84,000
[Being amount due on redemption]			
Redeemable Preference Shareholders Dr.		84,000	
To Bank Account			84,000
[Being payment made to preference shareholders]			

Working Note:

Calculation of equity shares to be issued for redemption:

		`
Amount of preference shares to be redeemed (after fully paid)		80,000
Less : Amount available in funds :		
Profit & Loss Account (10,000 + 2,000 – 1,000)	11,000	
General Reserve	40,000	51,000
Balance to be raised by issue of equity shares		29,000

Balance Sheet of B Ltd. As at April 1, 2014

Particulars	Note No.	Amount `
A Equity and liabilities		
1. SHAREHOLDER'S FUNDS		
(*A*) SHARE CAPITAL		
1,290 EQUITY SHARES OF ` 100 EACH		1,29,000
(*B*) RESERVES AND SURPLUS :		
CAPITAL REDEMPTION RESERVE		51,000
CAPITAL RESERVE		50,000
2. CURRENT LIABILITIES		
(*A*) TRADE PAYABLES :		
SUNDRY CREDITORS		93,000
TOTAL		3,23,000

B	**Assets**		
	1. Non-current Assets		
	(*a*) **Fixed Assets :**		
	(i) Tangible Assets :		
	Other Fixed Assets		1,60,000
(ii)	**Intangible Assets :**		
	Patents		1,00,000
	2. Current Assets		
	(a) Cash and Cash Equivalents :		
	Cash at Bank		63,000
TOTAL			3,23,000

Note: Students should note that Balance Sheet has to be prepared as per prescribed format given in Companies Act, 2013.

Illustration 4

D Limited has the following Balance Sheet as on March 31, 2014.

Liabilities	`	**Assets**	`
Subscribed Share Capital :		Furniture & Fixture	4,15,000
30,000 Equity Shares of ` 100 each fully paid	30,00,000	Stock	40,65,000
		Debtors	12,30,000
20,000, 10% Redeemable Preference Shares of ` 100 each, fully paid	20,00,000	Cash at Bank	33,60,000
Capital Reserve	25,000		
Securities Premium	10,000		
General Reserve	10,00,000		
Profit & Loss Account	20,000		
Sundry Creditors	18,05,000		
Provision for Taxation	12,10,000		
	90,70,000		90,70,000

The company decided to redeem all the preference shares at a premium of 10%. For this purpose, it issued new equity shares of ` 100 each at a premium of 5% to the **minimum possible extent** utilising the accumulated profits to the maximum possible extent.

Pass journal entries. Show your working clearly.

Solution:

Journal

		Dr.	Cr.
		`	`
1.	Bank Account Dr.	11,70,015	
	To Equity Share Capital Account		11,14,300
	To Securities Premium Account		55,715
	[Being issue of 11,143 equity shares of ` 100 each at a premium of 5%]		
2.	Securities Premium Account Dr.	65,715	
	General Reserve Account Dr.	1,34,285	
	To Premium on Redemption of Preference Shares Account		2,00,000
	[Being use of securities premium & general reserve to provide premium on redemption of preference shares]		
3.	General Reserve Account Dr.	8,65,700	
	Profit & Loss Account Dr.	20,000	
	To Capital Redemption Reserve Account		8,85,700
	[Being creation of capital redemption reserve being redemption partly out of profit]		
4.	10% Redeemable Preference Share Capital Account Dr.	20,00,000	
	Premium on Redemption of Preference Shares AccountDr.	2,00,000	
	To Preference Shareholders Account		22,00,000
	[Being amount due to preference shareholder]		
5.	Preference Shareholders Account Dr.	22,00,000	
	To Bank Account		22,00,000
	[Being payment to preference shareholders on redemption]		

Working Notes :

The students should note that whenever in a question, it is mentioned that "minimum number of shares" to be issued for the purpose of redemption and the amount of premium to be received on minimum new shares together with the existing share premium amount is insufficient to fully provide for premium on redemption of redeemable preference shares then following method should be followed:

Minimum number of equity shares to be issued for the purpose of redemption can be obtained with the help of **an equation** as follows :

$$\begin{bmatrix}\text{Reddemable Preference}\\ \text{Shares +}\\ \text{Premium on Redemption}\end{bmatrix} = \begin{bmatrix}\text{Premium in the}\\ \text{Balance Sheet}\end{bmatrix} + \begin{bmatrix}\text{Profits available for}\\ \text{redemption in the}\\ \text{Balance Sheet}\end{bmatrix} + [x] + [x \times \text{Rate of Premium}]$$

Where, *x* stands for value of fresh shares to be issued.

Using the values given in illustration in the equation, we get,

$$\text{` }20,00,000 + \text{` }2,00,000 = \text{` }10,000 + \text{` }10,20,000 + x + x \times \frac{5}{100}$$

or $$\frac{105x}{100} = \text{` }11,70,000$$

or $$x = \frac{\text{` }11,70,000 \times 100}{105} = \text{` }11,14,286 \text{ (approx.)}$$

and No. of equity shares to be issued = $$\frac{\text{` }11,14,286}{100} = 11142{\cdot}86 \text{ or } 11143 \text{ shares (approx.)}$$

BUY-BACK OF SHARES

Buy-back of shares means the repurchase of its own securities by a company. **Section 68 of the Companies Act, 2013** empowers a company to purchase its own shares or other specified securities in certain cases. Specified securities may include Employees Stock Option or other securities as may be notified by the Central Government.

3.3 Legal Provisions FOR Buy-back

The following terms and conditions are required to be fulfilled by company in order to become eligible to buy-back its own securities:

(a) There must be a provision in the Articles of Association authorizing the company to buy-back its own shares; otherwise the articles must be amended by a special resolution to incorporate a suitable provision in this regard.

(b) The buy-back of equity shares in any financial year shall not exceed 25% of its total paid-up capital in that financial year.

(c) As per provisions of **Section 68(1) of the Companies Act, 2013,** the buy-back of shares and securities can be made:

(i) out of its free reserves, or

(ii) out of the securities premium account, or

(iii) out of the proceeds of fresh issue of shares or other specified securities.

(d) The ratio of the aggregate secured and unsecured debts owned by the company after buy-back is not more than twice the paid-up capital and its free reserves *i.e.* the debt equity ratio, after the buy-back, should not be more than 2 : 1.

(e) The existing shares or other securities for buy-back should be fully paid.

(f) The buy-back of the shares or other specified securities, if listed in stock exchange must be carried out is in accordance with the **SEBI** guidelines.

(g) No offer of buy-back under this section shall be made within a period of one year from the date of the closure of the preceding offer of buy-back, if any.

(h) Every buy-back shall be completed within **12 months** from the date of passing the special resolution mentioned above.

(i) Shares bought back shall be extinguished & physically destroyed within 7 days from the date of buy-back.

Prohibition on Buy-Back of Shares

Section 70 of Companies Act, 2013 has imposed some restrictions on buy back of shares which are given below:

(a) No company is allowed to purchase directly or indirectly its own shares or other specified securities, through any subsidiary company, or any investment company; or

(c) If the company commits a default in

- the repayment of deposits or
- payment of interest, or
- redemption of debentures or preference shares, or
- payment of dividend to any shareholder, or
- repayment of any term loans, or
- payment of interest to any financial institution or banking company,

Then, it cannot buy back its shares. However, the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.

(d) A company shall not be allowed to buy back its own shares if it has not complied with the provisions of Section 92 regarding non-filing of annual return; Section 123 regarding transfer of the amount to unpaid dividend account; Section 127 regarding failure to pay dividend within 30 days of declaration and section 129 regarding disclosure of true and fair view in the balance sheet.

Methods of Buy-Back of Shares

Section 68(5) of Companies Act, 2013 states that a company may buy-back its shares by any of the following methods:

(a) from the existing shareholders or security holders on a proportionate basis ;

(b) from the open market ;

(c) by purchasing the securities issued to employees of the company under a scheme of stock option or sweat equity.

However, if the company wants to buy back fifteen percent or more of the paid-up capital and reserves of the company then it will have to buy from the open market.

3.4 ACCOUNTING TREATMENT OF BUY_BACK OF SHARES

Before resorting to buy-back of shares and its accounting treatment the following points are to be kept in mind by a company :

(a) The securities which are to be bought-back must be fully paid. If they are not fully paid, then they should be made fully paid by making a final call.

(b) There must be sufficient balance in free reserves if buy-back is not made through fresh issue.

(c) If buy-back is made out of free reserves, then an amount equal to nominal values of shares bought back must be transferred to "Capital Redemption Reserve Account".

(d) The balance of "Capital Redemption Reserve Account" can be used only for issuing fully paid bonus shares.

(e) If buy-back of securities is done at a premium, then such premium must be written off to securities premium account or free reserves.

(f) If buy-back of securities is done at a discount, then such discount earned must be transferred to "Capital Reserve Account".

The following accounting entries are passed on buy-back of shares :

I. SALE OF INVESTMENTS FOR BUY-BACK OF SHARES

Bank Account	Dr.	With nominal Value
Profit and Loss Account	Dr.	(If sold at a loss)
To Investment Account		
To Capital Reserve Account		(If sold at a profit)

II. ISSUE OF DEBENTURES OR OTHER SPECIFIED SECURITIES FOR BUY-BACK OF SHARES

Bank Account	Dr.	
To Debentures Account		
To Specified Securities Account		

III. ENTRY FOR PAYMENT FOR BUY-BACK OF SHARES

(i) When the buy-back of shares is at a par

Equity Share Capital Account	Dr.	With nominal Value
To Bank Account		

(*ii*) When the buy-back of shares is at a premium

Equity Share Capital Account	Dr.	(With nominal Value)
Premium on Buy-back Account	Dr.	(With the additional amount paid)
To Bank Account		(With total amount paid)

(*iii*) When the buy-back of shares is at a discount

Equity Share Capital Account	Dr.	(With nominal Value)

To Bank Account (With amount paid)

To Capital Reserve Account (With amount of discount)

IV. CREATION OF CAPITAL REDEMPTION RESERVE :

If buy-back is out of free reserves or out of securities premium account, then following entry will be passed :

General Reserve Account Dr.

Profit & Loss Account etc. Dr.

To Capital Redemption Reserve Account

V. WRITING OFF PREMIUM ON BUY-BACK ACCOUNT

Securities Premium Account Dr.

General Reserve Account Dr.

Profit & Loss Account etc. Dr.

To Premium on Buy-back Account

Illustration 5

The following figures have been extracted from the books of ABC Ltd. as on 31-3-2015.

	`
Paid up capital	1,80,000
18,000 equity shares of Rs. 10 each	
General Reserve	30,000
Profit and Loss Account	10,000
Securities Premium	6,000
14% Debentures	20,000
Bank Balance	40,000

The company decided to buyback 25% of the paid up equity share capital at Rs. 13per share. It was also decided to issue further 14% debentures of Rs. 20,000 at par for the purpose of buyback of shares. Journalise the above transactions relating to buyback of shares.

Solution:

. **Journal**

Date	Particulars	L.F.	Amount	Amount
2014				
Mar.31	Bank Account ....Dr.		20,000	
	To 14% Debentures Account			20,000
	(Being issue of debentures of ` 20,000 at par for the purpose of buyback of shares)			

Equity Share Capital Account.................................Dr.	45,000	
Premium on Buy Back Account................Dr.	13,500	
To Equity Shareholders Account		58,500
(Being cancellation of 25% of the paid up capital on account of 25% shares bought back)		
General Reserve Account.......................................Dr.	25,000	
To Capital Redemption Reserve Account		25,000
(Being transfer of general reserve to Capital Redemption Reserve Account to meet the requirement of law for buyback of shares)		
Security Premium Account ....Dr.	6,000	
Profit & Loss Account..........................Dr.	7,500	
To Premium on Buy Back Account		13,500
(Being premium paid on buy back written off out of security premium and free reserves)		
Equity Shareholders Account.................................Dr.	58,500	
To Bank account		58,500
(Being payment made for shares bought back)		

Working Note :

	`
Total Face Values of Share Bought Back	45,000
Less : Issue of Debentures for buyback	20,000
Balance amount to be transferred from General Reserve	25,000

Premium on buy back = Rs. 3 on 4500 shares=Rs.13,500

3.5 SUMMARY

Redemption of preference shares means repayment of capital to the preference shareholders. The period of redemption, however, **cannot exceed 20 years** from the date of issue of such shares. **Section 55 of the Companies Act, 2013** prescribes the **legal restrictions** with regard to the redemption of preference shares: Shares can be redeemed **out of profits of the company** which would otherwise be available for dividend, or **out of the proceeds of a fresh issue of shares** made for the purpose of redemption,**Only fully paid** preference shares can be redeemed. If they are partly paid, then first of final call should be made to make them fully paid. If they are to be redeemed at premium, then such premium must be provided for out of the profits of the company or out of the security premium account. If such shares are redeemed out of profits, then a sum **equal to the nominal amount of the shares so redeemed** must be transferred out of the profits of the company to a reserve called "**Capital Redemption Reserve Account**". The Capital Redemption Reserve Account can only be used for the purpose of issue of **fully paid bonus shares**.

Buy-back of shares means the repurchase of its own securities by a company. **Section 68 of the Companies Act, 2013** empowers a company to purchase its own shares or other specified securities in certain cases. Only fully paid shares can be bought back. Listed companies should follow **SEBI** guidelines for buy back. The buy-back of shares and securities can be made: (i) out of its free reserves, or (ii) out of the securities premium account, or (iii) out of the proceeds of fresh issue of shares or other specified securities. If buy-back is made out of free reserves, then an amount equal to nominal values of shares bought back must be transferred to "Capital Redemption Reserve Account". The balance of "Capital Redemption Reserve Account" can be used only for issuing fully paid bonus shares. Some restrictions have been imposed on buy back of shares in case of default in the payment of debt or interest thereon.

3.6 SUGGESTED READINGS/BOOKS:

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

3.7 ANSWER THE FOLLOWING QUESTIONS

1. What do you mean by Preference Shares? What procedure is adopted by the company for the redemption of Preference Shares?
2. Explain the accounting treatment (along with the journal entries) for redemption of Preference Shares.
3. Explain clearly the legal requirements for the redemption of preference shares as laid down in Section 55 of the Companies Act, 2013.
4. Explain the following terms with the help of suitable examples:
   (i) "Proceeds" of the fresh issue of share capital
   (ii) Profits which would otherwise be available for redemption.
5. What is Capital Redemption Reserve? How is it created? How it can be utilised?
6. Define buy-back of shares? What are the provisions of Companies Act, 2013 for buy-back of shares?
7. What do you mean by buy-back of shares? State the accounting treatment for buy back of shares.

LESSON 4

Issue of Debentures

STRUCTURE

4.0 Objectives

4.1 Meaning and characteristics, and types of debentures

4.2 Difference between share and debenture

4.3 Accounting treatment for issue of debentures for cash

4.4 Accounting treatment for issue debentures for consideration other than cash

4.5 Accounting treatment for debentures issued as collateral security

4.6 Journal entries for issue of shares from the view point of terms of issue and redemption of debentures

4.7 Summary

4.8 Suggested readings

4.9 Model questions

4.0 OBJECTIVES

After reading this lesson, you should be able to:

- ✓ Understand the meaning and various types of debentures
- ✓ Differentiate between share and debenture
- ✓ Understand the accounting treatment for issue of debentures for cash
- ✓ Learn accounting treatment for issue debentures for consideration other than cash
- ✓ Understand the meaning accounting treatment for debentures issued as collateral security
- ✓ Learn journal entries for issue of shares from the view point of terms of issue and redemption of debentures

4.1 MEANING OF DEBENTURE

The term 'debenture' has been derived from the Latin word 'debere', which means 'to borrow'. Debenture is an instrument in writing given by a company acknowledging debt received from the holder of the instrument. According to Section 2 (30) of Companies Act, 2013, **"Debenture**

includes debenture stock, bonds and any other securities of the company whether constituting a charge on the company's assets or not". Debenture represents loaned capital. Hence, the company has to pay interest to debenture holders at the agreed rate on or after a specified date.

CHARACTERISTICS OR FEATURES OF DEBENTURES

The characteristic features of a debenture are as follows:

1. It is a written acknowledgement of debt taken by the company.
2. It is issued under the common seal of the company.
3. It contains a contract for the repayment of the principal sum on a specified date.
5. Interest is paid on debentures at a fixed rate on specified dates even if there is no profit or insufficient profit.
6. Debentures are issued for long term.
7. Debenture holders are loan creditors of the company.

KINDS OF DEBENTURES

Debentures may be classified according to the following characteristics, viz., (1) Negotiability, (2) Priority, (3) Permanence, (4) Security and (5) Convertibility.

1. FROM NEGOTIATION POINT OF VIEW:

(a) REGISTERED DEBENTURES: **A registered debenture is one which is only payable to the registered holder i.e. those persons whose name, address, particulars of holdings etc. are recorded in the Register of debenture-holders.**

(b) BEARER DEBENTURES: **A bearer debenture is one which is payable to its bearer or holder. Bearer debentures are transferable by mere delivery because the company keeps no record of their holders.**

2. FROM PRIORITY POINT OF VIEW:

(a) FIRST DEBENTURES: **The debenture which is repayable in priority to other debentures is termed as First Debenture.**

(b) SECOND DEBENTURES: **The debentures which will be paid and on which interest will be paid after the first debentures have been dealt with are known as Second Debentures.**

3. FROM PERMANENCE POINT OF VIEW:

(a) REDEEMABLE DEBENTURES: **A debenture which can be redeemed or the payment of which is made after a specified time is called a redeemable debenture.**

(b) IRREDEEMABLE DEBENTURES: Irredeemable debentures are those debentures that are not repayable during the life time of the company and hence will be repaid only when the company goes into liquidation. This type of debenture, however, is not common.

4. FROM SECURITY POINT OF VIEW:

(a) SECURED OR MORTGAGE DEBENTURES: **Secured or Mortgage debentures are those debentures on which a charge is created on the assets of the company in favour of debenture holders. This charge may be fixed or floating.**

(b) UNSECURED DEBENTURES: **These debentures are not secured as the company does not give any security to its holder for the payment of interest and the repayment of the loan. However, such a debenture is not very common.**

5. FROM CONVERTIBILITY POINT OF VIEW:

(a) CONVERTIBLE DEBENTURES: Convertible debentures are those debentures which are convertible into shares according to the terms of the issue. When only a part of the debenture amount is convertible into equity shares, such debentures are known as **'Partly Convertible Debentures'** and when full amount of debentures is convertible into equity shares, then such debentures are known as **'Fully Convertible Debentures'.**

(b) NON-CONVERTIBLE DEBENTURES: Non-convertible debenture is not exchangeable with any share over its entire life.

4.2 DIFFERENCE BETWEEN SHARE AND DEBENTURE

The main differences between Share and Debenture are as under :

Point of Difference	Share	Debenture
1. Meaning	Share is part of owned capital. The subscribers to the shares are called shareholders.	Debenture is part of borrowed capital. The subscribers to the debentures are called debenture holders.
2. Status	The shareholder is one of the owners or proprietors of the company.	A debenture holder is a loan creditor of the company.
3. Return	Dividend is paid on shares out of profits of the company.	Interest is paid on debentures.
4. Regularity of Return	A shareholder may not get dividend if the company suffers from losses or profit is inadequate.	Interest on debentures must be paid whether the company earns the profit or not.
5. Voting Rights	Shareholders have voting rights.	A debenture holder does not have any voting rights.
6. Priority of Refund	At the time of liquidation of the company, share-holders are paid after meeting all outside liabilities.	Debenture holders have a priority of the refund of their loan prior to payment to shareholders.
7. Security	A share is always unsecured.	A debenture is generally secured.

ISSUE OF DEBENTURES

The procedure for issuing debentures by a company is very much similar to that of an issue of shares. Applications for debentures are invited from the public through the prospectus and letters of allotment are issued. The applicants may be required to pay the whole of the amount along with the application or by installments.

The debentures may be issued by a company in the following ways:

(1) for cash,

(2) for consideration other than cash, and

(3) as collateral security

4.3 ISSUE OF DEBENTURES FOR CASH

When the debentures are issued for cash, the amount to be collected on them may be payable in installments or in lump sum. When debenture money is received in installments, the journal entries are similar to entries passed on issue of shares. Instead of share capital account, Debentures Account will be opened. Rate of interest payable on debentures is always prefixed to the Debenture Account like 12% Debentures Account.

<u>IF DEBENTURES ARE ISSUED AT PAR</u>

(i) On receipt of Application Money

Bank Account Dr. | with total money received on applications
To Debentures Application Account

(ii) On Allotment i.e. Acceptance of Applications

Debenture Application Account Dr. | **with application money on allotted**
To Debentures Account | debentures

(iii) On making Allotment Money due

Debenture Allotment Account Dr.
To Debentures Account

(iv) On receipt of Allotment Money

Bank Account Dr. | with money received on allotment
To Debentures Allotment Account

(v) On making calls

Debenture First / Second / Final Call Account Dr.
To Debentures Account

(vi) On receipt of Call Money

Bank Account Dr.
To Debentures First/ Second / Final Call Account

Illustration 1

ABC Ltd. issued 1,000 14% debentures of ` 100 each, payable as to ` 20 on application and balance on allotment. Applications were received for 1,500 debentures out of which applications for 900 were allotted fully, applications for 400 were allotted 100 debentures and the remaining rejected. All sums due were received. Joumalise.

Solution :

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			`	`
	Bank Account ....Dr.		30,000	
	To Debenture Application Account			30,000
	(Being receipt of application money on 1,500 Debentures @ ` 20 per debentures)			
	Debenture Application Account..............................Dr.		30,000	
	To 14% Debentures Account			20,000
	To Debenture Allotment Account			6,000
	To Bank Account			4,000
	(Being Application money transferred to debenture account, allotment account & application money of 200 rejected applicants refunded)			
	Debenture Allotment Account................................Dr.		80,000	
	To 14% Debentures Account			80,000
	(Being allotment money due on 1,000 debentures @ ` 80 per debenture)			
	Bank Account ....Dr.		74,000	
	To Debenture Allotment Account			74,000
	(Being balance of allotment money received)			

IF DEBENTURES ARE ISSUED A PREMIUM

The accounting treatment of issue of debentures at a premium depends whether the premium amount is received along with application money or at the time of allotment.

(a) IF PREMIUM IS RECEIVED ALONG WITH APPLICATION

(i) Receipt of Application Money

Bank Account Including Premium **Dr.**

To Debenture Application Account

(ii) Transfer of Debenture Application

Debenture Application Account Dr.

To Debenture Account

To Debenture Premium Account

(b) IF PREMIUM IS RECEIVED ON ALLOTMENT

(i) Allotment Money Due

Debenture Allotment Account Dr.

To Debenture Account

To Debenture Premium Account

(ii) Receipt of Allotment Money

Bank Account Dr.

To Debenture Allotment Account

Illustration 2.

XYZ Ltd. issued 50,000, 15% Debentures of ` 100 each at a premium of 10% payable ` 30 on Application due on 15th Jan. 2014) ; ` 50 on Allotment due on 10th Feb. 2014 and balance on final call payable on 28th April, 2014). The public applied for 60,000 debentures. The directors rejected applications for 10,000 debentures. All amount due is received except final call on 200 debentures.

Journalise the above transactions.

Solution :

JOURNAL

		Debit Amount	Credit Amount
2014		`	`
Jan. 15	Bank Account .... Dr.	18,00,000	
	To Debenture Application Account		18,00,000
	(Being application money received on 60,000 debentures @ ` 30 per debenture)		
Feb. 10	Debentures Application Account .... Dr.	18,00,000	
	To 15% Debenture Account		15,00,000
	To Bank Account		3,00,000
	(Being transfer of application money and refund of application money on rejected application)		
Feb. 10	Debenture Allotment Account................................ Dr.	25,00,000	
	To 15% Debenture Account		20,00,000
	To Debenture Premium Account		5,00,000
	(Being allotment money due on 50,000 debentures @ `		

	50 including ` 10 for premium per debentures)		
Feb. 10	Bank Account .... Dr.	25,00,000	
	To Debenture Allotment Account		25,00,000
	(Being allotment money received)		
April 28	Debenture First and Final Call Account.................... Dr.	15,00,000	
	To 15% Debenture Account		15,00,000
	(Being first and final call money due on 50,000 debentures @ ` 30 per debentures)		
April 28	Bank Account .... Dr.	14,94,000	
	To Debenture First and Final Call Account		14,94,000
	(Being first and final call money received except on 200 debentures)		

IF DEBENTURES ARE ISSUED AT A DISCOUNT

There is no prohibition on issue of debentures at a discount. When debentures are issued at a discount, the amount of discount is debited to an account termed as **"Discount on Issue of Debentures Account"**.

The discount on issue of debentures is always treated on allotment if not otherwise stated.

(i) ALLOTMENT MONEY DUE

Debenture Allotment Account Dr.

Discount on Issue of Debenture Account Dr.

To Debenture Account

(ii) ALLOTMENT MONEY RECEIVED

Bank Account Dr.

To Debenture Allotment Account

Illustration3

ABC Ltd. issued 1,000 debentures of ` 100 each at a discount of 10%. The amount was payable as follows :

On Application	` 25
On Allotment	` 35
On First & Final Call	` 30

Applications for 1,200 debentures were received. Applications for 600 debentures were accepted in full. One applicant who had applied for 500 debentures was allotted 400 debentures and rests of the applications were rejected. The entire amount due were received in time.

Give journal entries in the books of company.

Solution :

JOURNAL

Date	Particulars	L.F.	Dr.	Cr.
			`	`
(*a*)	Bank Account ....Dr.		30,000	
	To Debenture Application Account			30,000
	(Being receipt of application money @ ` 25 on 1,200 debentures)			
(*b*)	Debenture Application Account....................Dr.		30,000	
	To Debenture Account			25,000
	To Debenture Allotment Account			2,500
	To Bank Account			2,500
	(Being application money of 1,000 debentures transferred to debentures account, allotment account and excess amount to 100 debentures refunded)			
(*c*)	Debenture Allotment Account....................Dr.		35,000	
	Discount on issue of Debentures Account ....Dr.		10,000	
	To Debenture Account			45,000
	(Being allotment due & discount on issue credited to debentures Account)			
(*d*)	Bank Account ....Dr.		32,500	
	To Debenture Allotment Account			32,500
	(Being allotment money received)			
(*e*)	Debenture First & Final Call Account ....Dr.		30,000	
	To Debenture Account			30,000
	(Being first call money due)			
(*f*)	Bank Account ....Dr.		30,000	
	To Debentures First & Final Call Account			30,000
	(Being First & Final call money received)			

4.4. DEBENTURES ISSUED FOR CONSIDERATION OTHER THAN CASH

Just like shares, the debentures may be issued to vendors for consideration other than cash. It may so happen that the company acquires some assets from the vendor and issues debentures in payment of purchase consideration. In such a case, the following journal entries are made to record the transactions:

1. ON PURCHASE OF ASSETS

Sundry Assets (Individually) Account Dr. (With cost price)
To Vendor's Account (With purchase consideration)

Note: If the amount of purchase consideration is more than the value of the assets acquired, the difference is to be treated as capital loss and should be debited to **Goodwill Account.** On the other hand, if the amount of purchase consideration to be paid is less than the value of net assets acquired, the difference will be treated as capital gain & hence credited to **Capital Reserve Account.**

2. ON ALLOTMENT OF DEBENTURES

Vendor's Account Dr. (With purchase consideration)
Discount on Issue of Debentures Account Dr. (If issued at discount)
To Debentures Account (With nominal value)
To Debentures Premium Account (If issued at a premium)

Illustration 4

Journalise the following transactions:

(a) ABC Limited purchased Stock worth `21, 000, plant and machinery worth ` 19,000 and furniture for ` 7,000 from Sham & Co and took over the liabilities of ` 7,000 for a purchase consideration of ` 46000. The company paid the purchase consideration by issuing sufficient 12% debentures of `100 each at a premium of 15%.

(b) XYZ Limited purchased assets of `1,82,000 and took over liabilities of `17,000 at an agreed value of ` 1,61,500. The company issued 10% debentures of ` 100 each at a discount of 5% in full satisfaction of the purchase price.

Solution.

Books of ABC Ltd.

(a) Journal Entries

			Dr.	Cr.
1.	Stock Account	Dr.	2,1,000	
	Plant and Machinery Account	Dr.	19,000	
	Furniture Account	Dr.	7000	
	Goodwill Account	Dr.	6000	

	To Liabilities Account		7,000
	To Raj & Co.		46,000
	[Being the purchase of assets & taking over the liabilities of Raj & Co.]		
2.	Raj & Co. Dr.	46000	
	To 12% Debentures Account		40000
	To Debenture Premium Account		6000
	[Being issue of debentures at a premium of 15%]		

Notes.

1. Since the value of net assets taken i.e. ` 40,000 (`47,000 – ` 7,000) is less than the purchase consideration `46,000, hence difference *i.e.*, `6000 has been debited to Goodwill Account.
2. Calculation of face value of debentures to be issued to discharge purchase consideration:

	`
Purchase Consideration Due	46000
Issue Price per debenture (`100 + 15)	115

∴ Number of debentures to be issued = $\frac{\text{Total Purchase Consideration due}}{\text{Issue Price per debenture}}$

$$= \frac{\text{` }46000}{\text{` }115} = 400$$

∴ Face value of debentures to be issued = 400 @ ` 100 = `40,000

(b)

Journal Entries in the books of XYZ Ltd.

		Dr.	Cr.
1.	Assets Account ....Dr.	18,20,000	
	To Liabilities		1,70,000
	To Vendors Account		16,15,000
	To Capital Reserve Account		35,000
	[Being the purchase of assets & taking over of liabilities]		
2.	Vendors Account ....Dr.	16,15,000	
	Discount on Issue of Debentures Account ....Dr.	85,000	
	To 10% Debentures Account		17,00,000
	[Being issue of 17,000 debentures @ ` 100 each at 5% discount to discharge purchase consideration]		

Notes : (*i*) Since value of net assets *i.e.*, `16,50,000 ( 18,20,000 – 1,70,000) more than the purchase consideration *i.e.*, ` 16,15,000, hence the difference `5,000 being capital gain transferred to Capital Reserve Account.

(*ii*) Number of debentures to be issued has been calculated as follows :

			`
	Purchase Consideration due		`16,15,000
	Issue price per debenture [100 –5]		` 95
∴	Number of debentures to be issued	=	$\frac{\text{` } 16{,}15{,}000}{\text{` } 95}$
		=	17,000
	Face value of debentures to be issued	=	$17{,}000 \times 100$
		=	` 17,00,000

4.5 ISSUE OF DEBENTURES AS A COLLATERAL SECURITY

A collateral security means additional security in addition to the principal security. When a company takes a loan or overdraft from a bank or from other financial institutions, it may deposit its own debentures with the lending agency as collateral security in addition to any other security that it may give. When the loan is paid back, the debentures issued as collateral security are returned to the company. But in case, the loan is not repaid by the company on due date or in the event of any other breach of agreement, the lender has the right to retain these debentures and to realise them in the market. The holder of debentures held as collateral security is not entitled to receive any interest on debentures.

No accounting entry is required at the time of issue of such type of debentures. However, the fact of such debentures issued as collateral security has to be mentioned by way of a note on the liability side of Balance Sheet of the company under the specific loan account.

4.6 ISSUE OF DEBENTURES FROM THE POINT OF VIEW OF TERMS OF REDEMPTION

A company is free to issue debentures on any term or specific condition as to its redemption which it likes. There may be the following five possibilities:

CASE NO.	CONDITIONS OF ISSUE	CONDITIONS OF REDEMPTION
(i)	Issue at Par	Redeemable at Par
(ii)	Issue at Discount	Redeemable at Par
(iii)	**Issue at Premium**	Redeemable at Par
(iv)	Issue at Par	Redeemable at Premium
(v)	Issue at Discount	Redeemable at Premium

Journal entries for different terms of issue and redemption are as follows:

Case (*i*) WHEN DEBENTURES ARE ISSUED AT PAR AND REDEEMABLE AT PAR

(a) On issue of debentures

(i) Bank Account	**Dr.**	with the nominal value
To Debentures Application and Allotment Account		
(ii) Debenture Application & Allotment Account	**Dr.**	
To Debentures Account		

(b) On redemption of debentures

Debentures Account	**Dr.**	with the nominal value
To Bank Account		

Case (*ii*) WHEN DEBENTURES ARE ISSUED AT DISCOUNT AND REDEEMABLE AT PAR

(a) On issue of debentures

(i) Bank Account	Dr.	With Net Amount
To Debenture Application & Allotment Account		
(ii) Debenture Application & Allotment Account	Dr.	
Discount on Issue of Debentures Account	Dr.	With discount
To Debentures Account		With nominal value

(b) On redemption of debentures

Debentures Account	**Dr.**	with nominal value
To Bank Account		

Case (*iii*) WHEN DEBENTURES ARE ISSUED AT PREMIUM AND REDEEMABLE AT PAR

(a) On issue of debenture

(i) Bank Account	Dr.	Including Premium
To Debentures Application & Allotment Account		
(ii) Debenture Application & Allotment Account	Dr.	
To Debentures Account		
To Debenture Premium Account		

(b) On redemption of debentures

Debentures Account	Dr.	with the nominal value of debentures
To Bank Account		

Case (*iv*) WHEN DEBENTURES ARE ISSUED AT PAR & REDEEMABLE AT PREMIUM

(a) On issue of debentures

(i) Bank Account	Dr.	With nominal value

To Debenture Application & Allotment Account

(ii) Debenture Application & Allotment Account Dr. (with the amount received)
Loss on Issue of Debentures Account Dr. (with premium on redemption)
To Debentures Account (with nominal value)
To Premium on Redemption of Debentures Account
(with premium on redemption)

(b) On redemption of debentures

Debentures Account Dr. (with nominal value)
Premium on Redemption of Debentures Account Dr. (with premium on redemption)
To Bank Account (with total amount)

Case (*v*) WHEN DEBENTURES ARE ISSUED AT DISCOUNT AND REDEEMABLE AT PREMIUM

(a) On issue of debentures

(i) Bank Account Dr. With Amount received
To Debenture Application & Allotment Account

(ii) Debenture Application & Allotment Account Dr. (with the amount received)
Loss on issue of Debentures Account Dr.(discount and premium on redemption)
To Debentures Account (with nominal value)
To Premium on Redemption of Debentures Account(with premium on redemption)

(*b*) On redemption of debentures

Debentures Account Dr. (with the nominal value)
Premium on Redemption of Debentures Account Dr. (with premium on redemption)
To Bank Account (with total amount paid)

NOTES: (*i*) Premium on redemption of debentures account is shown on the liabilities side until the debentures are repaid.

(*ii*) Loss on issue of debenture account is written off gradually every year during the life of the debentures.

Illustration 15.

(a) What journal entries would be made at the time of issue of debentures in the following cases:

(i) A company issued ` 1,00,000 6% debentures at par redeemable at par.

(ii) A company issued ` 1,00,000 6% debentures at a discount of 10% redeemable at par.

(iii) A company issued ` 1,00,000 6% debentures at a premium of 5% redeemable at par.

(iv) A company issued ` 1,00,000 6% debentures at par redeemable at 10% premium.

(v) A company issued ` 1,00,000 6% debentures at a discount of 5% redeemable at 5% premium.

(b) What journal entries will you make (in the above case) at the time of redemption ?

Solution.

(*a*) ENTRIES TO BE MADE AT THE TIME OF ISSUE OF DEBENTURES

JOURNAL ENTRIES

		Dr.	Cr.
(*i*)	Bank Account .... Dr.	1,00,000	
	To 6% Debentures Application & Allotment Account		1,00,000
	(Being receipt of application money)		
	Debenture Application & Allotment Account .... Dr.	1,00,000	
	To 6% Debentures Account		1,00,000
	(Being application and allotment money transferred)		
(*ii*)	Bank Account .... Dr.	90,000	
	To Debenture Application & Allotment Account		90,000
	(Being application money received)		
	Debenture Application & Allotment Account .... Dr.	90,000	
	Discount on issue on Debentures Account .... Dr.	10,000	
	To 6% Debentures Account		1,00,000
	(Being issue of debentures at a discount of 10%)		
(*iii*)	Bank Account .... Dr.	1,05,000	
	To Debenture Application & Allotment Account		1,05,000
	(Being application money received)		
	Debenture Application & Allotment Account .... Dr.	1,05,000	
	To 6% Debentures Account		1,00,000
	To Debentures Premium Account		5,000
	(Being issue of debentures at a premium of 5%)		
(*iv*)	Bank Account .... Dr.	1,00,000	
	To Debenture Application & Allotment Account		1,00,000
	(Being application money received)		
	Debenture Application & Allotment Account .... Dr.	1,00,000	
	Loss on issue of Debentures Account .... Dr.	10,000	
	To 6% Debenture Account		1,00,000
	To Premium on Redemption of Debentures Account		10,000
	(Being issue of debentures at par but redeemable at 10%		

	premium)		
(*v*)	Bank Account .... Dr.	95,000	
	To Debenture Application & Allotment Account		95,000
	(Being application money received)		
	Debenture Application & Allotment Account .... Dr.	95,000	
	Loss on issue of Debentures Account .... Dr.	10,000	
	To 6% Debentures Account		1,00,000
	To Premium on Redemption of Debentures Account		5,000
	(Being issue of debentures at a discount and redeemable at premium)		

4.7 SUMMARY

Debenture is an instrument in writing given by a company acknowledging debt received from the holder of the instrument. Debenture represents loaned capital. Hence, the company has to pay interest to debenture holders at a fixed rate on specified dates even if there is no profit or insufficient profit. Debentures may be classified according to the following characteristics, viz., (1) Negotiability, (2) Priority, (3) Permanence, (4) Security, and (5) Convertibility. The procedure for issuing debentures by a company is very much similar to that of an issue of shares. Applications for debentures are invited from the public through the prospectus and letters of allotment are issued. The applicants may be required to pay the whole of the amount along with the applicationor by installments. The debentures may be issued by a company (1) for cash, or (2) for consideration other than cash, and (3) as collateral security. Accounting treatment of debentures also depenupon the terms of issue and redemption of debentures.

4.8 SUGGESTED READINGS

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

4.9 ANSWER THE FOLLOWING QUESTIONS

1. Define debentures. Explain briefly different types of debentures.
2. What is meant by the issue of debentures as a collateral security ? Give its accounting treatment.
3. Describe the various ways of issuing debentures.

LESSON 5

REDEMPTION of Debentures

STRUCTURE

5.0 OBJECTIVES

After reading this lesson, you should be able to:

- ✓ Learn about the methods of redemption of debentures
- ✓ Know the sources of redemption of debentures
- ✓ Understand the accounting treatment for redemption of debentures

REDEMPTION OF DEBENTURES

Redemption of debentures means the payment of amount due on debentures to the debenture holders. Debentures are normally redeemed at the expiry of the period for which they were originally issued. But the company may also, it so authorized by its Articles of Association, and the terms of issue as stated in the prospectus, redeem the debentures before the expiry of the fixed period either by instalments or by purchasing them in the open market.

5.1 METHODS OF REDEMPTION OF DEBENTURES

The company may adopt any one of the following methods for redeeming debentures:

1. The company may redeem all the debentures in one lot at the expiry of a specified period.
2. The debentures may be redeemed in installments by drawing lots annually.
3. The company can redeem its debentures by purchasing them in the open market if it seems to be profitable to the company.

5.2 SOURCES OF REDEMPTION

Debentures can be redeemed out of the following sources:

1. Redemption out of profit.

2. Redemption out of capital.
3. Redemption by conversion.
4. Redemption out of provisions.

1. REDEMPTION OUT OF PROFITS: Redemption of debentures out of profits means that the amount equal to the nominal value of debentures redeemed will be transferred from Profit & Loss Appropriation Account to a newly opened account called **Debenture Redemption Reserve Account**. This will reduce the amount of profit which can be distributed as dividend. The required journal entries under this method will be as follows:-

(a) ENTRY FOR REDEMPTION

Debentures Account Dr.
To Debenture holders Account

(b) Debenture holders Account Dr.
To Bank Account

(c) ENTRY FOR TRANSFER OF PROFITS

Profit & Loss Appropriation Account Dr.
To Debenture Redemption Reserve Account

Debenture redemption reserve account is shown on the liabilities side of the balance sheet and will go on increasing with each redemption. When all the debentures are redeemed, this account is closed by passing the following entry:

(d) Debenture Redemption Reserve Account Dr.
To General Reserve Account

Illustration 1

On 1.1.2010 a public limited company issued 25,000, 10% Debentures of ` 100 each at par which were repayable at a premium of 10% on 31.12.2014. On the date of maturity, the company decided to redeem the above mentioned 10% Debentures as per the terms of issue, out of profits. The Profit and Loss Account shows a credit balance of ` 30,00,000 on this date. The offer was accepted by all the debenture-holders and all the debentures were redeemed.

Pass the necessary journal entries in the books of the company only for the redemption of debentures.

Solution:

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Date	Particulars	F.	Dr. (`)	Cr. (`)
31.12.14	Profit and Loss Appropriation Account ....Dr.		25,00,000	
	To Debenture Redemption Reserve Account			25,00,000
	(Being adequate reserve created out of profits as per Sec. 117 C)			
31.12.14	10% Debentures Account ....Dr.		25,00,000	

	Premium on Redemption of Debentures Account Dr.		2,50,000	
	To Debenture holders Account			27,50,000
	(Being amount payable to debentureholders on redemption)			
31.12.14	Debenture holders Account..................................Dr.		27,50,000	
	To Bank Account			27,50,000
	(Being payment made to debentureholders)			
31.12.14	Debenture Redemption Reserve Account ....Dr.		25,00,000	
	To General Reserve Account			25,00,000
	[Being Debenture redemption reserve account closed]			

2. **REDEMPTION OUT OF CAPITAL:** When profits are not utilized for the purpose of redemption, redemption is said to be out of capital. However, in view of the recent SEBI's guidelines, it will not be possible for a company to redeem debenture purely out of capital. A company has to create Debenture Redemption Reserve equivalent to 25% of the amount of debenture issue before debenture redemption commences.

However, creation of Debenture Redemption Reserve is not required in the following cases:

(i) Debentures with a maturity of 18 months or less.

(ii) Fully convertible debentures. However, in case of partly convertible debentures, Debenture Redemption Reserve is to be created for the non-convertible part on the same lines as applicable for fully non-convertible debentures.

Illustration 2

Y Ltd. has 6,000, 15% Debentures of ` 100 each due for redemption out of capital on 31.3.2014. The company has a debenture redemption reserve of ` 2,00,000 on that date. Assuming that no interest is due, pass the necessary journal entries at the time of redemption of debentures.

Solution.

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Date	Particulars		Dr. (`)	Cr. (`)
31.3.14	15% Debentures Account ....Dr.		6,00,000	
	To Debenture holders Account			6,00,000
	(Being redemption of debentures due to debenture holders)			
31.3.14	Debenture holders Account..................................Dr.		6,00,000	

	To Bank Account (Being payment made to debenture-holders)			6,00,000
31.3.14	Debenture Redemption Reserve Account ....Dr.		3,00,000	
	To General Reserve Account			3,00,000
	(Being Debenture Redemption Reserve balance transferred to General Reserve Account after redemption)			

NOTE: Students should note that company already has more than 25% in Debenture Redemption Reserve

3. REDEMPTION BY CONVERSION: Generally, companies redeem their debentures in cash. But sometimes the company issues convertible debentures which may be redeemed by converting them into shares. The option to convert the debentures into equity or preference shares would obviously be exercised by the debenture holders only if the offer is beneficial to them.

The following journal entry will be made at the time of conversion:

Debentures Account (old)	Dr.	(With nominal value)
Discount on Issue of Shares Debentures Account Dr.		(If new shares or debentures issued at discount)
To Share Capital Account (new)		(With nominal value)
To Securities Premium Account		(If new shares are issued at a premium)

Illustration 2

On January, 2011 a company had issued 10,000 debentures of ` 100 each at ` 110, bearing interest 11% p.a. One of the terms of the issue was that debentures could be reclaimed after three years at a premium of 2%.

The necessary notice was given on January 1, 2014, informing the debenture holders about the intention of the company to redeem debentures on July 1, 2014, either payment of cash or by allotment of 10% preference shares of ` 100 each at ` 120 per share.

Holders of 2,000 debentures accepted the offer of preference shares, and rest demanded cash.

Give journal entries.

Solution.

Journal

Date	Particulars	L.F.	Debit	Credit
2014			`	`
July 1	11% Debentures Account....................................... Dr.		10,00,000	
	Premium on Redemption of Debentures Account... Dr.		20,000	

	To Debenture holders Account [Being amount due on redemption of 10,000 debentures of ` 100 each at a premium of 2%]			10,20,000
July 1	Debenture holders Account.................................... Dr.		2,04,000	
	To 10 % Preference Share Capital Account			1,70,000
	To Securities Premium Account			34,000
	[Being issue of 1,700 preference shares @20% premium to the holder of 2,000 debentures]			
July 1	Debenture holders Account.................................... Dr.		8,16,000	
	To Bank Account			8,16,000
	[Being payment of cash to remaining debentureholders]			

Working Notes :

1. Calculation of number of 10% preference shares to be issued for redemption

Amount due on 2000 debentures @`102 = ` 2,04,000

Issue price per preference shares = ` 120

$$\text{Number of preference shares to be issued} = \frac{\text{Amount Due}}{\text{Issue price per share}}$$

$$= \frac{\text{` } 2{,}04{,}000}{120} = 1{,}700$$

4. REDEMPTION OUT OF PROVISION: Sometimes the company creates provision to make necessary arrangement from the very beginning to ensure the availability of sufficient cash required for the redemption of debentures at the end of stipulated period for which debentures are issued. In the absence of such a provision, it becomes difficult for the company to find lump sum funds to repay the debentures. This provision can be made by adopting any of the following two methods:

(a) Sinking Fund Method

(b) Insurance Policy Method

SINKING FUND METHOD

To provide adequate funds for the redemption of debentures on a specified date, a company usually creates a sinking fund out of profits every year and invests it in securities carrying a fixed rate of interest. The amount to be appropriated every year is determined by the sinking fund table. Interest received from Sinking Fund Investment is credited to Sinking Fund Account and is also invested. Thus investment to be made in sinking fund investment is equal to annual appropriation plus interest received from investment. At the time of redemption of debentures, investment is sold and the funds received from their sale are utilised for redemption of debentures.

The following is the accounting treatment in case of redemption out of Sinking Fund:

ENTRIES AT THE END OF THE FIRST YEAR

(1) ON TRANSFER OF PROFIT TO SINKING FUND

Profit & Loss Appropriation Account	Dr.	With the annual appropriation of profit
To Sinking Fund Account		

(2) ON INVESTMENT OF SINKING FUND

Sinking Fund Investment Account	Dr.	With the amount invested
To Bank Account		

SECOND AND SUBSEQUENT YEARS EXCEPT THE LAST YEAR (AT THE END)

(1) ON RECEIPT OF INTEREST ON SINKING FUND INVESTMENT

Bank Account

Dr.

To Interest on Sinking Fund Investment Account

(2) ON TRANSFER OF INTEREST TO SINKING FUND

Interest on Sinking Fund Investment Account Dr.

To Sinking Fund Account

(3) ON TRANSFER OF PROFIT TO SINKING FUND

Profit & Loss Appropriation Account	Dr.	With the annual appropriation of profit
To Sinking Fund Account		

(4) ON INVESTMENT OF ANNUAL APPROPRIATION OF PROFIT AND INTEREST RECEIVED ON INVESTMENT

Sinking Fund Investment Account	Dr.	With the annual appropriation plus interest received on investment
To Bank Account		

LAST YEAR *i.e.* YEAR OF REDEMPTION (AT THE END)

(1), (2), (3) entries are same as above

(4) ON SALE OF INVESTMENT

Bank Account	Dr.	With amount realised on investment
To Sinking Fund Investment Account		

(5) IF THERE IS ANY PROFIT OR LOSS ON REALISATION OF INVESTMENTS, THE SAME HAS TO BE TRANSFERRED TO SINKING FUND ACCOUNT.

(a) IF THERE IS A PROFIT

Sinking Fund Investment Account	Dr.	With the amount of profit
To Sinking Fund Account		

(b) IF THERE IS A LOSS

Sinking Fund Account	Dr.	With the amount of loss

To Sinking Fund investment Account

(6) ON REDEMPTION OF DEBENTURES

Debentures Account Dr.

Premium on Redemption of Debenture Dr.

To Bank Account

(7) TRANSFER OF PREMIUM ON REDEMPTION

Sinking Fund Account Dr.

To Premium on Redemption of Debenture

OR

Loss on Issue of Debenture Account

(if entry is passed at the time of issue)

(8) ON TRANSFER OF THE BALANCE OF SINKING FUND ACCOUNT

Sinking Fund Account Dr.

To General Reserve Account (with revenue profits)

To Capital Reserve Account (with capital profits)

sinking fund account is also known as debenture redemption fund account and sinking fund investment account is also called as debenture redemption fund investment account.

Note: The students should note that profit on redemption of debentures is transferred to the credit side of Sinking Fund Account. Since this profit is of capital nature, hence at the time of transferring the balance of sinking fund amount, the amount of this capital profit, viz. profit on redemption of debentures should be transferred to Capital Reserve Account and the remaining balance representing revenue profits to be transferred to General Reserve Account.

Illustration 3

On 1st April, 2011, ABC Limited issued `4, 00,000 debentures redeemable at the end of three years at a premium of 10 per cent. A sinking fund was formed and invested in 5% tax free Government securities. At the end of 3rd year, investments were realized at a loss of ` 500 and debentures were duly redeemed.

You are required to give journal entries and ledger accounts to deal with the redemption assuming investments to be made to the nearest hundred rupees. Sinking fund table shows that ` .31720856 invested every year at 5% compound interest will amount to `1 at the end of three year.

Solution.

Total amount required for redemption = `4,40,000 (including premium)

Annual appropriation (provision) required = 4, 40,000 $\times$0.31720856

= `1, 39,571.77 or ` 1, 39,572 (approximately)

Journal

		Debit	Credit
2011		`	`
April 1	Bank Account .... Dr.	4,00,000	
	Loss on Issue of Debentures Account .... Dr.	40,000	
	To Debentures Account		4,00,000
	To Premium on Redemption of Debenture Account		40,000
	(Being issue of ` 4,00,000 debenture at par redeemable at premium)		
2012 March 31	Profit & Loss Appropriation Account .... Dr.	1,39,572	
	To Sinking Fund Account		1,39.572
	(Being annual provision required for redemption of debentures)		
2012 March 31	Sinking Fund Investment Account .... Dr.	1,39,600	
	To Bank Account		1,39,600
	(Being amount invested in tax free Government securities to the nearest hundred rupees)		
2013 March 31	Bank Account .... Dr.	6,980	
	To Interest on Sinking Fund Investment Account		6,980
	(Being interest received on `1,39,600 investment @ 5 percent for one year)		
2013 March 31	Interest On Sinking Fund Investment Account .... Dr.	6,980	
	To Sinking Fund Account		6,980
	(Being the transfer of interest to sinking fund Account)		
2013 March 31	Profit & Loss Appropriation Account .... Dr.	1,39,572	
	To Sinking Fund Account		1,39,572
	(Being annual provision made)		
2013 March 31	Sinking Fund Investment Account .... Dr.	1,46,600	
	To Bank Account		1,46,600
	(Being amount Invested in tax free Government securities to		

	the nearest rupees)		
2014 March 31	Bank Account .... Dr. To Interest on Sinking Fund Investment Account (Being Interest received on ` 2,86,200 investment @5% p.a. for one year)	14,310	14,310
2014 March 31	Interest on Sinking Fund Investment Account.................... Dr. To Sinking Fund Account (Being interest received on investment transferred)	14,310	14,310
2014 March 31	Profit & Loss Appropriation Account .... Dr. To Sinking Fund Account (Being annual provision made)	1,39,572	1,39,572
2014 March 31	Bank Account .... Dr. Sinking Fund Account... Dr. To Sinking Fund Investment Account (Being sale of investment and loss transferred to sinking fund account)	2,85,700 500	2,86,200
2014 March 31	Debentures Account .... Dr. Premium on Redemption of Debentures Account .... Dr. To Bank Account (Being debentures redeemed at a premium on due date)	4,00,000 40,000	4,40,000
2014 March 31	Sinking Fund Account... Dr. To Loss on Issue of Debentures Account (Being loss on issue of debenture transferred)	40,000	40,000
2014 March 31	Sinking Fund Account... Dr. To General Reserve Account (Being balance of sinking fund account transferred)	3,99,506	3,99,506

Debentures Account .

Date	PARTICULARS	Amount `	Date	Particulars	Amount `
2012 March 31	To Balance c/d	4,00,000	2011 April 1	By Bank Account	4,00,000
		4,00,000			4,00,000
2013 March 31	To Balance c/d	4,00,000	2012 April 1	By Balance b/d	4,00,000
		4,00,000			4,00,000
2014 March 31	To Bank Account (Redemption)	4,00,000	2013 April 1	By Balance b/d	4,00,000
		4,00,000			4,00,000

Sinking Fund Account

2012 March 31	To Balance c/d	1,39,572	2012 March 31	By Profit & Loss Appropriation Account	1,39,572
		1,39,572			1,39,572
2013 March 31	To Balance c/d	2,86,124	2012 April 1	By Balance b/d	1,39,572
			2013 March 31	By Interest on Sinking Fund Investment Account	6,980
			March 31	By Profit & Loss Appropriation Account	1,39,572
		2,86,124			2,86,124
2014 March 31	To Sinking Fund Investment Account (loss on sale)	500	2012 **April 1**	By Balance b/d	2,86,124
March	To Loss on Issue of	40,000	2014 March 31	By Interest on Sinking Fund Investment	14,310

31	Debentures Account			By Profit & Loss Appropriation Account	1,39,572
March 31	To General Reserve Account (transfer)	3,99,506	March 31		
		4,40,006			4,40,006

Sinking Fund Investment Account

2012 March 31	To Bank Account	1,39,600	2012 March 31	By Balance c/d	1,39,600
		1,39,600			1,39,600
2012 April 1	To Balance b/d	1,39,600	2013 Mar. 31	By Balance c/d	2,86,200
2013 March 31	To Bank Account	1,46,600			
		2,86,200			2,86,200
2013 April 1	To Balance b/d	2,86,200	2014 March 31	By Bank Account	2,85,700
			2014 March 31	By Sinking Fund Account (Loss on Sale)	500
		2,86,200			2,86,200

Calculation of Interest:

At the end of second year, Interest on `139600@5%=`6980

At the end of third year, interest on `286200@5%=`14310

INSURANCE POLICY METHOD

Under this method, an insurance policy for an amount necessary to pay off debentures after the fixed period is taken out. The company pays the premium annually or six monthly to the insurance company. After the expiry of certain specified period, the policy matures and insurance company repays the insured amount to the company. The debentures are, thus, redeemed from the proceeds received from insurance company.

When insurance policy method is adopted, the procedure of book-keeping entries becomes somewhat different from the procedures adopted under the Sinking Fund method. This is because, insurance premium is paid at the commencement of the year and appropriation from profits is made at the end of the year. Further, unlike sinking fund method, interest is never paid by the insurance company on the premium paid.

5.3 ACCOUNTING TREATMENT

I. FIRST YEAR & SUBSEQUENT YEARS (EXCEPT LAST YEAR)

(a) ON PAYMENT OF INSURANCE PREMIUM IN THE BEGINNING OR DURING THE YEAR

Debenture Redemption Fund Policy Account	Dr.	With the Amount of Annual Premium
To Bank Account		

(b) FOR ANNUAL APPROPRIATION OF PROFIT AT THE END OF THE YEAR

Profit & Loss Appropriation Account	Dr.	With the Amount of Profit Set Aside
To Debenture Redemption Fund Account		

IN THE LAST YEAR

In addition to the above two entries, the following entries are also required on maturity of the policy at the end of the last year:

(c) ON REALISATION OF POLICY AMOUNT FROM THE INSURANCE COMPANY

Bank Account	Dr.	With the Amount of Policy
To Debenture Redemption Fund Policy Account		

(d) FOR THE TRANSFER OF PROFIT ON REALIZATION

Debenture Redemption Policy A/c	Dr
To Debenture Redemption Fund A/c	

(e) ON REDEMPTION OF DEBENTURES

Debentures Account	Dr.
To Bank Account	

(f) ON TRANSFER OF THE BALANCE OF DEBENTURE REDEMPTION FUND ACCOUNT

Debenture Redemption Fund Account	Dr.
To General Reserve Account	

Illustration 4

A Ltd. has made an issue of ` 5,00,000, 9% debentures on 1st April, 2010 the terms of which include that the company must take a 4 years sinking fund insurance policy of the same amount for the redemption of debentures at a premium of 5%. The annual premium is ` 1,15,000. Give journal entries for four years and also show Sinking Fund Insurance Policy Account.

Solution

Books of A Ltd.

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Date	Particulars	L.F.	Debit Amount	Credit Amount
			`	`
2010				
April 1	Bank Account ....Dr.		5,00,000	
	To 9% Debentures Account			5,00,000
	(Being amount received from issue of debentures)			
April 1	Sinking Fund Insurance Policy Account..................Dr.		1,15,000	
	To Bank Account			1,15,000
	(Being payment of premium on sinking fund insurance policy)			
2011				
Mar. 31	Profit & Loss Appropriation Account ....Dr.		1,15,000	
	To Sinking Fund Account			1,15,000
	(Being annual appropriation of profit equal to annual premium paid)			
April 1	Sinking Fund Insurance Policy Account..................Dr.		1,15,000	
	To Bank Account			1,15,000
	(Being payment of annual premium)			
2012				
Mar. 31	Profit & Loss Appropriation Account ....Dr.		1,15,000	
	To Sinking Fund Account			1,15,000
	(Being annual appropriation of profit)			
April 1	Sinking Fund Insurance Policy Account..................Dr.		1,15,000	
	To Bank Account			1,15,000
	(Being payment of annual premium)			
2013				
Mar. 31	Profit & Loss Appropriation Account ....Dr.		1,15,000	
	To Sinking Fund Account			1,15,000
	(Being annual appropriation of profit)			
April 1	Sinking Fund Insurance Policy Account..................Dr.		1,15,000	
	To Bank Account			1,15,000
	(Being payment of annual premium)			

2014				
Mar. 31	Profit & Loss Appropriation Account ....Dr.		1,15,000	
	To Sinking Fund Account			1,15,000
	(Being annual appropriation of profit)			
Mar. 31	Bank Account ....Dr.		5,00,000	
	To Sinking Fund Insurance Policy Account			5,00,000
	(Being amount received on maturing of sinking fund insurance policy)			
Mar. 31	9% Debentures Account ....Dr.		5,00,000	
	To Bank Account			5,00,000
	(Being redemption of debentures)			
Mar. 31	Sinking Fund Account...Dr.		5,00,000	
	To General Reserve Account			5,00,000
	(Being balance of sinking fund account transferred to General Reserve Account)			

Dr. **Sinking Fund Insurance Policy Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
2010		`	2010		`
April 1	To Bank Account	1,15,000	Mar. 31	By Balance c/d	1,15,000
		1,15,000			1,15,000
2011			2012		
April 1	To Balance b/d	1,15,000	Mar. 31	By Balance c/d	2,30,000
April 1 2012	To Bank Account	1,15,000			
		2,30,000			2,30,000
2012			2013		
April 1	To Balance b/d	2,30, 000	Mar. 31	By Balance c/d	3,45,000
April 1 2013	To Bank Account	1,15,000			
		3,45,000			3,45,000
2013			2014		

April 1	To Balance b/d	3,45,000	Mar. 31	By Bank Account	5,00,000
April 1	To Bank Account	1,15,000		(Policy matured)	
2014					
Mar. 31	To Sinking Fund Account	40,000			
	(Excess of policy amount over premium paid i.e. 5,00,000-4,60,000)				
		5,00,000			5,00,000

PURCHASE OF DEBENTURES FROM THE OPEN MARKET

If authorised by its Articles, a company can buy its own debentures in the open market for immediate cancellation or keeping them as investment. The debenture may be so purchased with the following objectives in mind:

(a) for immediate cancellation or redemption

(b) for investment

(a) PURCHASE OF DEBENTURES FOR IMMEDIATE CANCELLATION OR REDEMPTION

When debentures are to be redeemed at maturity, the company must redeem them either at par or at premium as per the terms of the issue. When company finds that its debentures are available below par, it makes a considerable saving by purchasing them from open market and cancel them at any date before the date on which debentures become due.

ACCOUNTING TREATMENT FOR PURCHASE OF DEBENTURE FOR IMMEDIATE CANCELLATION

(1) ON PURCHASE AND CANCELLATION OF DEBENTURES

Debentures Account	Dr.	(With the nominal value)
To Bank Account		(With the amount paid)
To Profit on Redemption of Debentures Account		(With the profit if any)

(2) ON TRANSFER OF PROFIT ON REDEMPTION

Profit on Redemption of Debentures Account	Dr.	
To Capital Reserve Account		(When no sinking fund exists)
OR		
To Sinking Fund Account		(When sinking fund exists)

(b) PURCHASE OF OWN DEBENTURES AS INVESTMENT

When a company purchases debentures in the open market **not for immediate cancellation,** but for keeping them as investment, then such debentures are popularly called **'Own Debentures.'** The debentures purchased as investment can be reissued when the company requires additional cash in future or may be canceled in future if the company does not need additional finance.

ACCOUNTING TREATMENT

I. WHEN OWN DEBENTURES ARE PURCHASED AS A PART OF GENERAL INVESTMENTS

When own debentures are purchased as a part of general investments, then following entries will be passed :

(1) ON PURCHASE OF DEBENTURES AS GENERAL INVESTMENT

Own Debentures Account	Dr.	With the amount paid for the debenture
To Bank Account		

(2) WHEN OWN DEBENTURES ARE SUBSEQUENTLY CANCELLED

Debentures Account	Dr.	(With the nominal value of debentures cancelled)
To Own Debentures Account		(With book value of own debentures)
To Profit on Redemption of Debentures		(With profit if any)

(3) TRANSFER OF PROFIT ON REDEMPTION

Profit on Redemption of Debentures	Dr.
To Capital Reserve Account	

II WHEN OWN DEBENTURES ARE PURCHASED AS A PART OF SINKING FUND INVESTMENTS

If own debentures are purchased as a part of sinking fund investments, the following entries will be passed :–

(1) AT THE TIME OF PURCHASE

Sinking Fund Investment (Own Debentures) Account	Dr	
To Bank Account		

(2) AT THE TIME OF SUBSEQUENT CANCELLATION

Debentures Account	Dr	
To Sinking Fund Investment (Own Debentures) Account		
To Sinking Fund Account		**(Profit on Redemption)**

INTEREST ON OWN DEBENTURES

When a company purchases its Debentures as investment, it has to make adjustments of interest payable on these debentures. As soon as the company purchases it own debentures, it saves the interest which would have been payable on them. When debentures are purchased as investment, the total debentures (including own debentures) are deemed to be outstanding. The interest, therefore, becomes payable on the whole amount of debentures including own debentures but amount of interest on debentures held by the outsides will be actually paid by the company. The accounting entry is such a case will be :

(1) ON PAYMENT OF INTEREST

Debenture Interest Account .... Dr.	(with total Interest on all debentures)
To Bank Account	(with interest paid to outside)
To Interest On Own Debenture Account	(with interest on own debentures)

(2) TRANSFER OF INTEREST ON OWN DEBENTURES

Interest on Own Debenture Account ....Dr.	
To Sinking Fund Account	(when sinking fund exists)
OR	
To Profit & Loss Account	(when sinking fund does not exist)

Illustration 4

On 1st April, 2012, Roy Limited made an issue of 10,000 12% Debentures of `100 each at `98 per debenture. According to the terms of issue, commencing from the year 2013-14 the company should redeem 500 debentures either by purchasing them from the open market or by drawing lots at par at the company's option. Profit, if any, on redemption is to be transferred to capital reserve. The company's accounting year ends on 31st March. Interest is payable on 30th September and 31st March.

During 2012-13, and 2013-14, the company wrote off ` 5,000 from debenture discount account.

During 2013-14, the company purchased and canceled the debentures as given below:

(i) ` 20,000 at `97 per debenture on 30th September, 2013.

(ii) ` 30,000 at `96 per debenture on 31st March, 2014.

Give the journal entries for the above said transactions.

Solution.

Journal

		Dr.	**Cr.**
		`	`
2012			
April 1	Bank Account..Dr.	9,80,000	
	Discount on Issue of Debenture Account....................Dr.	20,000	
	To 12% Debentures Account		10,00,000
	(Being Issue of 10,000, 12% Debentures of ` 100 each at a Discount of `2)		
2012			
30th Sept.	Debenture Interest Account.......................................Dr.	60,000	

	To Bank Account		60,000
	(Being Payment of half yearly Debenture Interest)		
2013 31st March	Debenture Interest Account.......................................Dr.	60,000	
	To Bank Account		60,000
	(Being Payment of half yearly Debenture Interest)		
31st March	Profit & Loss Account ....Dr.	1,25,000	
	To Debenture Interest Account		1,20,000
	To Discount on Issue Of Debenture Account		5,000
	(Being Debenture Interest for the year & Discount on Debenture Transferred)		
2013 30th Sept.	Debenture interest Account.......................................Dr.	60,000	
	To Bank Account		60,000
	(Being payment of half yearly debenture interest)		
2013 30th Sept.	12% Debentures Account ....Dr.	20,000	
	To Bank Account		19,400
	To Capital Reserve Account		600
	(Being Purchase of Debentures in the open market for cancellation & Profit Transferred to Capital Reserve)		
2014 31st March	Debenture Interest Account.......................................Dr.	58,800	
	To Bank Account		58,800
	(Being Half Yearly Interest paid on ` 9,80,000 Debentures @12%)		
2014 31st March	12% Debentures Account ....Dr.	30,000	
	To Bank Account		28,800
	To Capital Reserve Account		1,200
	(Being Purchase for Cancellation `30,000 Debentures at		

	`96 and Profit on Cancellation Transferred to Capital Reserve)		
2014 31st March	Profit & Loss Account ....Dr.	1,23,800	
	To Debenture Interest Account		1,18,800
	To Discount on Issue of Debentures Account		5,000
	(Being Debenture Interest for the Year & Discount on Debentures Transferred)		

5.4 SUMMARY

Redemption of debentures means the payment of amount due on debentures to the debenture holders. Debentures are normally redeemed at the expiry of the period for which they were originally issued. But the company may also, it so authorized by its Articles of Association, and the terms of issue as stated in the prospectus, redeem the debentures before the expiry of the fixed period either by installments or by purchasing them in the open market. Debentures can be redeemed out of profit, or out of capital or can be redeemed by converting them into shares or new debentures. Companies can also maintain sinking fund or take an insurance policy to redeem debentures. If authorised by its Articles, a company can buy its own debentures in the open market for immediate cancellation or keeping them as investment.

5.5 SUGGESTED READINGS

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

5.6 ANSWER THE FOLLOWING QUESTIONS

1. What do you mean by 'Redemption of debentures'? Describe the various methods of redeeming debentures.
2. Give the accounting treatment of redemption of debentures either through sinking fund method or insurance policy method.
3. Explain the following:
   - (i) Redemption of debentures out of capital.
   - (ii) Redemption of debentures out of profit.

State the impact of latest SEBI guidelines in this regard.

4. What is sinking fund? Give the accounting treatment of the maintenance of sinking find for the redemption of debentures by a joint stock company.

5. What do you mean by purchase of debentures in the open market for immediate cancellation & for investment? Give its accounting treatment.

LESSON 6

Underwriting OF SHARES AND DEBENTURES

STRUCTURE

6.0 OBJECTIVES

After reading this lesson, you should be able to:

- ✓ Understand the meaning of underwriting and its types
- ✓ Determine the liability of underwriters
- ✓ Know about the accounting aspect of acquisition of business
- ✓ To learn about accounting treatment of profit prior to incorporation=

6.1 MEANING OF UNDERWRITING

Underwriting may be defined as a contract entered into by the company with individuals, firms, or financial institutions, called underwriters, who guarantee the subscription of shares or debentures offered to the public. Underwriter undertakes to take up the portion of such of the offered shares or debentures as may not be subscribed for by the public For this undertaking or guarantee, they receive a consideration called underwriting commission.

Thus, underwriting is an undertaking or guarantee given by the underwriters to the company that the shares or debentures offered to the public will be subscribed for in full. In case, the public response is poor, the underwriters will have to take up the balance of the shares or debentures not subscribed for by the public and to pay for them. Thus, the underwriters take over the risk of uncertainty of a public issue of shares or debentures of a company and the company is assured of the success of the issue.

UNDERWRITERS AND BROKERS

The persons or institutions underwriting a public issue of shares or debentures are called ‘Underwriters‘. The underwriters may be individuals, partnership firms or joint stock companies. Generally, an issue of shares or debentures of a company is underwritten by two or more firms jointly as it involves more risk and attaches greater responsibility.

Broker is a middleman who merely acts as a connecting link between the company and the subscriber. He does not take any responsibility of subscribing to the shares or debentures of the company. He simply procures subscriptions for shares or debentures from the public on behalf of the company and in exchange of their service rendered to the company, they get remuneration called brokerage.

TYPES OF UNDERWRITING

An underwriting contract may be of any one of the following types:

PURE UNDERWRITING

Pure underwriting refers to a contract whereby the underwriter guarantees the subscription of shares or debentures upto a specified limit. If the subscription is not received from the public upto that limit, the underwriter takes up the shares unsubscribed. In case full subscription is received, the liability of the underwriter is nil. Pure underwriting can be further put into two categories

- Complete underwriting
- Partial underwriting

COMPLETE UNDERWRITING

If **whole of the issue** of shares or debentures of a company is underwritten, it is said to be complete underwriting. In such a case, the whole of the issue of shares or debentures may be underwritten by -

(i) one firm or institution, agreeing to take the entire risk;

(ii) a number of firms or institutions, each agreeing to take risk only to a limited extent.

PARTIAL UNDERWRITING

If **only a part of the issue** of shares or debentures of a company is underwritten, it is said to be partial underwriting. The part of the issue of shares or debentures may be underwritten by -

(i) one person or institution;

(ii) a number of firms or institutions each agreeing to take risk only to a limited extent.

In case of partial underwriting, the company is treated as underwriter for the remaining part of the issue.

FIRM UNDERWRITING

It refers to a **definite commitment** by the underwriter or underwriters to take up a specified number of shares or debentures of a company irrespective of the number of shares or debentures subscribed for by the public. In such a case, the underwriters are committed to take up the agreed number of shares or debentures in addition to unsubscribed shares or debentures, if any. Even if the issue is over-subscribed, the underwriters are liable to take up the agreed number of shares or debentures.

6.2 UNDERWRITING COMMISSION

The consideration payable to the underwriters for underwriting the issue of shares or debentures of a company is called underwriting commission. Such a commission is paid at a specified rate on the issue price of whole of the shares or debentures underwritten whether or not the underwriters are called upon to take up any shares or debentures.

LEGAL PROVISIONS FOR THE PAYMENT OF UNDERWRITING COMMISSION

According to Section 40 (6) of the Companies Act 2013, a company is permitted to pay commission to any person in connection with the subscription or procurement of subscription to its securities. The following conditions which are prescribed under Companies (Prospectus and Allotment of Securities) Rules, 2014 have to be fulfilled:

(i) the payment of the commission is authorised by the Articles of Association of the company;

(ii) In the case of underwriting commission on issue of shares, maximum amount of commission paid or agreed to be paid should not exceed 5% of the price at which the shares are issued, or the amount or rate authorized by the Articles, whichever is less.

(iii) In the case of debentures, underwriting commission which can be paid by the company is 2.5% of the price at which the debentures are issued or the amount or rate authorised by the Articles, whichever is less;

(iv) the amount or rate of commission should be disclosed in the prospectus or statement in lieu of prospectus as the case may be or in a statement filed with the Registrar before the payment of the commission;

(v) the number of shares or debentures which persons have agreed to subscribe absolutely or conditionally should be disclosed in the prospectus;

(vi) a copy of the contract relating to the payment of the commission should be delivered to the Registrar;

(vii) no underwriting commission can be paid if the issue is privately placed, in other words, underwriting commission is payable only on such shares or debentures as are offered to the general public.

MARKED AND UNMARKED APPLICATIONS

When the issue of shares or debentures of a company is underwritten by two or more persons, it is usual that the applications for shares or debentures sent through the underwriters should bear a stamp of the respective underwriters. Otherwise, it would be very difficult for the company to determine how many applications have been received through a particular underwriter. Unless this is determined properly, the company would face a problem in determining the liability of the individual underwriters. Thus, the applications bearing the stamp of the respective underwriters are called Marked Applications while the applications received directly by the company which do not bear any stamp of the underwriters are called ―Unmarked Applications‖.

If the entire issue of shares or debentures is underwritten by only one underwriter, the marking of applications is immaterial since he is to get credit of all the applications whether sent through him or received directly by the company for determining his liability.

6.3 DETERMINING THE LIABILITY OF UNDERWRITERS

The liability of the underwriter or underwriters would be determined in the following ways:

COMPLETE UNDERWRITING

IF WHOLE OF THE ISSUE OF SHARES OR DEBENTURES IS UNDERWRITTEN BY ONE UNDERWRITER ONLY

In such a case, the underwriter will be liable to take up all the shares or debentures that have not been subscribed for by the public. For determining his liability, it is not material to know how many applications are sent through him (marked) and how many applications are received directly by the company (unmarked). Thus, the liability of the underwriter in such a case will be as follows:

Liability of the underwriter = Shares or debentures offered to the public minus shares subscribed by the public

Note: Students must note that if the shares or debentures are oversubscribed or fully subscribed by the public, the underwriter is free from his liability and cannot be called upon to take up any shares or debentures of the company.

But he will be entitled to get his commission on the total issue price of the shares or debentures.

IF THE WHOLE OF THE ISSUE OF SHARES OR DEBENTURES IS UNDERWRITTEN BY A NUMBER OF UNDERWRITERS IN AN AGREED RATIO:

In such a case, the liability of the respective underwriters can be determined as per the following steps:

Step I: Determine the gross liability of each underwriter according to the agreed ratio.

Step II: Reduce the gross liability by the marked applications.

Step III: Give credit in respect of unmarked applications in the ratio of their gross liability by way of deduction from the balance left.

Note: In case any underwriter has some figure in minus, then distribute that surplus to other underwriters' account in the ratio of their gross liability.

Last figure so arrived gives the liability of underwriters on account of short fall in the public subscription.

Illustration 1

ABC Ltd. issued 50,000 equity shares. The whole of the issue was underwritten as follows:

Red 40%; White 30%; Blue 30%

Applications for 40,000 shares were received in all, out of which applications for 10,000 shares had the stamp of Red; those for 5,000 shares that of White and those for 10,000 shares that of Blue. The remaining applications for 15,000 shares did not bear any stamp.

Determine the liability of the underwriters.

Solution:

Statement of liability of underwriters

Particulars	**Red**	**White**	**Blue**
Gross liability (No. of shares underwritten)	20000	15000	15000
Less marked applications	10000	5000	10000
Balance	10000	10000	5000
Less unmarked applications 40000-25000 (divided in the ratio of 40:30:30)	6000	4500	4500
Net Liability	**4000**	**5500**	**500**

Thus, Red will have to buy 4000 shares, White 5500 shares, and Blue 500 shares

PARTIAL UNDERWRITING

If a part of the issue of shares or debentures is underwritten only by one underwriter: In such a case, for the balance of shares not underwritten, the company itself is said to have underwritten the same. In such a case, the net liability will be determined as follows:

Net liability = Gross liability – Marked applications.

Students must not that if the marked applications exceed or equal the number of shares or debentures underwritten; the underwriter is free from his liability and cannot be called upon to take up any shares or debentures of the company.

Similarly, if all the shares or debentures are subscribed the underwriter is free from his liability in spite of the fact the marked applications are less than the number of shares or debentures underwritten.

Illustration 2

X Ltd., issued 50,000 equity shares of which only 60% was underwritten by Green. Applications for 45,000 shares were received in all out of which application for 26,000 were marked.

Determine the liability of Green.

Solution:

Gross liability of Green being 60% of 50,000 shares,

i.e., 60% of 50,000 = 30,000 shares

Less: Marked applications = 26,000 shares

Net liability of Green = 4,000 shares

Notes:

(1) If the marked applications were for 30,000 shares or more, Green would have had no liability at all.
(2) If the applications received by the company were for all the 50,000 shares, Green would have no liability at all even though the marked applications were for 26,000 shares.

Sometimes, the information as to the marked applications and unmarked applications is not given in the problem. In such a case, total applications received by the company are divided between the company and the underwriter in the ratio of shares underwritten.

Illustration 3

ABC Ltd. Issued 50000 shares. 80% of the issue was underwritten by Azad. Applications were received for 30000 shares. Calculate the liability of Azad.

Statement of liability of underwriter

Particulars	Azad	Company	Total
Gross liability (No. of shares underwritten)	40,000	10,000	50,000
Less shares applied divided in the ratio of 80:20	24,000	6,000	30,000
Net Liability	16,000	4,000	20,000

Azad's liability is to take up 16000 shares.

FIRM UNDERWRITING

In the case of firm underwriting, the underwriters take up the agreed number of shares or debentures firm underwritten in addition to unsubscribed shares or debentures, if any. While computing the individual liability of the underwriters, the firm underwriting can be dealt with in the following manner:

WHEN FIRM UNDERWRITING SHARES ARE INCLUDED IN MARKED APPLICATIONS

In such a case, the statement of liability of underwriters will be as under:

Gross Liability (agreed ratio)	xxxxxxxxx.
Less: Marked applications including firm underwriting	xxxxxxxxx.
Balance left	
Less: Unmarked application (ratio of gross liability)	xxxxxxxxx.

Net liability	
Add: Firm underwriting	xxxxxxxxx
Total Liability	xxxxxxxxx.

Illustration 4

ABC Ltd. issued 40,000 shares which were underwritten as:

Red: 20,000 shares, White: 12,000 shares, and Blue: 8,000 shares. The underwriters made applications for firm underwriting as under:

Red: 4000 shares; White: 2000 shares; and Blue: 2,000 shares. The total subscriptions were 36,000 shares. The marked applications (including firm underwriting) were - Red: 14,000 shares; White: 5600 shares; and Blue: 6400 shares. Prepare a statement showing the net liability of underwriters.

Solution:

Statement of liability of underwriters

Particulars	Red	White	Blue
Gross liability (No. of shares underwritten)	20000	12000	8000
Less marked applications	14000	5600	6400
	6000	6400	1600
Less unmarked applications 36000-26000 (divided in the ratio of 20:12:8	5000	3000	2000
	1000	3400	-400
Surplus of Blue divided in the ratio of 20:12 between Red and White	250	150	+400
	750	3250	Nil
Add Firm underwriting	4000	2000	2000
Net Liability	4750	5250	2000

WHEN FIRM UNDERWRITING IS EXCLUDED FROM MARKED APPLICATIONS

In this case firm underwriting shares will also be deducted from gross liability.

ABC Ltd. issued 50,000 shares which were underwritten as:

Red: 30,000 shares, White: 15,000 shares, and Blue: 5,000 shares. Firm underwriting was as under:

Red: 5000 shares; White: 2000 shares; and Blue: 1,000 shares. The total subscriptions were 37,000 shares. The marked applications (excluding firm underwriting) were - Red: 16,000 shares; White: 10,000 shares; and Blue: 4000 shares. Prepare a statement showing the net liability of underwriters.

Solution:

Statement of liability of underwriters

Particulars	Red	White	Blue
Gross liability (No. of shares underwritten)	30000	15000	5000
Less firm underwriting	5000	2000	1000
Less marked applications	16000	10000	4000
	9000	3000	nil
Less unmarked applications 37000-30000 (divided in the ratio of 30:15:5)	4200	2100	700
	4800	900	(-)700
Surplus of Blue divided in the ratio of 30:15 between Red and White	+467	+233	+ 700
	4333	667	Nil
Add Firm underwriting	5000	2000	1000
Net Liability	9333	2667	1000

ACCOUNTING TREATMENT FOR UNDERWRITING OF SHARES OR DEBENTURES

(a) When the shares or debentures are allotted to the underwriters in respect of their liability:

Underwriters A/c Dr. (With the value of the shares or debentures taken up)

To Share Capital A/c

To Debentures A/c

(b) When commission becomes payable to the underwriters:

Underwriting Commission A/c Dr. (With the amount of commission due on the total issue)

To Underwriters A/c

(c) When the net amount due from the underwriters on the shares or debentures taken up by them is received:

Bank Dr. (With the net amount due)

To Underwriters A/c

Note: Underwriting commission is not generally paid in cash. Instead the same is adjusted against the money due on shares or debentures taken up by the underwriters and only the net amount (i.e., total amount due on shares or debentures taken up by the underwriters minus the underwriting commission) is received from the underwriters.

6.4 SUMMARY

Underwriting is a contract entered into by the company with individuals, firms, or financial institutions, called underwriters, who guarantee the subscription of shares or debentures offered to the public. Underwriter undertakes to take up the portion of such of the offered shares or debentures as may not be subscribed for by the public For this undertaking or guarantee, they receive a consideration called underwriting commission.

An underwriting contract may be ‘pure underwriting’, or ‘firm underwriting’ contract. Pure underwriting refers to a contract whereby the underwriter guarantees the subscription of shares or debentures upto a specified limit. If the subscription is not received from the public upto that limit, the underwriter takes up the shares unsubscribed. In case full subscription is received, the liability of the underwriter is nil. Pure underwriting can be complete underwriting or partial underwriting. If **whole of the issue** of shares or debentures of a company is underwritten, it is said to be complete underwriting. If **only a part of the issue** of shares or debentures of a company is underwritten, it is said to be partial underwriting. In case of Firm underwriting, the underwriters are committed to take up the agreed number of shares or debentures even if the issue is over-subscribed. The liability of the underwriters is determined on the basis of marked and unmarked applications.

6.5 SUGGESTED READINGS

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

6.6 ANSWER THE FOLLOWING QUESTIONS

1. What do you mean by ‘underwriting’? Describe various types of underwriting contract.
2. How the liability of underwriters determined?
3. Explain the following:
   (i) Marked and unmarked applications.
   (ii) Pure underwriting and firm underwriting.
4. **What are the legal provisions relating to the payment of underwriting commission.?.**

LESSON 7

ACQUISITION OF BUSINESS AND PROFITS PRIOR TO INCORPORATION

STRUCTURE

7.0 OBJECTIVES

After reading this lesson, you should be able to:

- ✓ Understand the meaning of acquisition of business
- ✓ Know accounting treatment of acquisition of business
- ✓ Understand the meaning and determination of profit prior to incorporation

7.1 MEANING OF ACQUISITION OF BUSINESS

Acquisition of business, generally, refers to the purchase of a non-corporate business like sole-proprietorship or partnership form of business by a company. This does not necessarily mean that a limited company cannot acquire the business of a corporate body, i.e., another limited company. But strictly speaking, the acquisition of business of a limited company by another limited company comes under the purview of 'Amalgamation, Absorption and Reconstruction of Companies'.

Such an acquisition of business by a limited company may take any of the following two forms:

a) **An existing company** may purchase an existing business of a sole-proprietor or a partnership firm, or

b) **A new company may be formed** to take over an existing business of a sole proprietor or a partnership firm, i.e., the existing business unit may be converted into a limited company. If the object is to retain the control of the sole-proprietor or the partners in the company, a private limited company may be formed. On the other hand, if the object of conversion is to supplement the resources for carrying out various expansion programmes, a public limited company may be formed for the purpose.

IMPORTANT POINTS TO BE NOTED IN CONNECTION WITH ACQUISITION OF A BUSINESS

***7.2* PURCHASE CONSIDERATION:** Purchase Consideration refers to the price payable by the company for the business acquired. Generally, an agreement is made between the company and the vendor containing the terms and conditions of the acquisition of business, the basis for determining the consideration and the mode of payment of the consideration. Consideration is usually, determined by taking into consideration the following facts:

a) the present value of the tangible assets acquired acquired by the company;

b) the amount payable, if any, for goodwill of the business acquired; and

c) the liabilities to be taken over by the purchasing company.

METHODS OF CALCULATING PURCHASE CONSIDERATION

The method to be adopted for the calculation of purchase consideration depends upon the information given in the question, which are explained as below :

1. LUMP-SUM PAYMENT:

The purchase consideration may be stated as a lump sum amount in the question. No calculations are required in this case. For example, it may be provided that X Ltd. takes over the business for

` 5 lakh. The sum of ` 5 lakh is purchase consideration.

2. NET ASSETS OR NET WORTH METHOD:

Under this method, purchase consideration is calculated by adding the agreed value of only those assets which have been taken over by the company and deducting there from the agreed value of only those liabilities which have been taken over by the company. For example, if X Ltd. takes over the following assets and liabilities of Sham & Sons :–

Assets/Liabilities	**Book value** `	**Agreed value** `
Fixed assets	6,00,000	6,50,000
Current assets	2,00,000	1,40,000
Current Liabilities	1,00,000	1,00,000

The amount of purchase consideration will be calculated as under:–

Assets taken over : Agreed Amount `

Fixed assets		6,50,000
Current assets		1,40,000
		7,90,000
Less : Liabilities taken over :		
Current liabilities	1,00,000	1,00,000
Purchase consideration		6,90,000

Note: If some assets are not taken over by the purchasing company, the same shall not be included in the calculation of purchase consideration.

The difference between the consideration to be paid and the value of net tangible assets will be the goodwill. On the other hand, if the value of net tangible assets exceeds the consideration the difference will be treated as "Capital Reserve".

MODE OF PAYMENT OF THE CONSIDERATION BY THE COMPANY

After the consideration is determined, the next question that arises is how to satisfy the consideration. The consideration may be satisfied by the company in any of the following ways:

a) the entire consideration may be paid in cash;

b) the entire consideration may be paid by the issue of shares of the company;

c) the entire consideration may be paid by the issue of debentures of the company; or

d) the consideration may be paid partly in cash and partly by the issue of shares and/or debentures of the company.

Generally the last method is adopted by a company to satisfy the consideration.

It is important to note here that the shares or debentures may be issued to the vendors either at par or at a premium or at a discount.

INTEREST PAYABLE TO VENDORS ON THE PURCHASE CONSIDERATION: If the payment of consideration to the vendors is unnecessarily delayed, the question of payment of interest to vendors for the period of the delay, naturally, arises. In such a case, the vendors can legitimately claim interest on the amount due to them for the period of delay, i.e., from the date of purchase to the date of payment. Hence, the agreement must mention about the payment of interest to vendors specifying the rate of interest.

REALISATION EXPENSES OF THE VENDOR BORNE BY THE PURCHASING COMPANY

Sometimes, as per the agreement, the purchasing company may agree to bear the cost of realization of assets of the vendor. Such expenses are to be treated as capital expenditure of the company and should be debited to Goodwill Account.

COLLECTION OF DEBTORS AND PAYMENT TO CREDITORS OF THE VENDOR

Sometimes, the debtors and the creditors of the vendor are not taken over by the purchasing company. In such a case, the purchasing company may agree to collect the debtors of the vendor and to pay the creditors of the vendor as agent of the vendor in exchange of certain commission at fixed rate.

7.3 ACCOUNTING TREATMENT IN THE BOOKS OF THE PURCHASING COMPANY ON ACQUISITION OF BUSINESS

1. WHEN THE BUSINESS IS ACQUIRED:

Business Purchase A/c Dr. with the amount of purchase consideration

To Vendors

2. WHEN THE ASSETS AND LIABILITIES TAKEN OVER BY THE COMPANY ARE RECORDED:

Sundry Assets A/c Dr. Revalued figures if given, otherwise, at book value

To Sundry Liabilities A/c with the values at which they are taken over

To Business Purchase A/c with the purchase consideration

Alternatively, instead of passing the above two entries the following entry may also serve the purpose, when the business is acquired -

Sundry Assets A/c (Individually) Dr. Revalued figures if given, otherwise, at book value

To Sundry Liabilities (Individually) with the values at which they are taken over

To Vendors with the consideration

Notes:

(i) If the credit total is greater than the debit total, the difference should be debited to Goodwill Account.

(ii) If the debit total is greater than the credit total, the difference has to be treated as capital gain and as such, Capital Reserve Account should be credited.

Students must note that Goodwill or Capital Reserve should be ascertained only as indicated above - the amount appearing in the vendor's balance sheet is not relevant.

3. WHEN THE PAYMENT IS MADE TO VENDORS:

Vendors Dr. With the amount due

To Share Capital A/c With the value of shares allotted, if any

To Debentures A/c with the value of debentures allotted, if any

To Cash or Bank A/c with the amount of cash paid, if any

Notes:

(i) Shares capital or Debentures should be credited only with their nominal value.
(ii) If the shares or debentures are issued at a premium, Securities Premium Account should be credited with the amount of the premium.
(iii) Similarly, if the shares or debentures are issued at a discount, Discount on Issue of Shares Account or Discount on Issue of Debentures Account should be debited with the discount.

4. If interest is payable to vendors on the purchase consideration for delayed payment:

Interest A/C Dr. With the amount of interest payable

To Vendors

Note: This entry would be made before the payment is made to vendors and the amount of interest would be included in the payment.

5. If the realisation expenses of the vendor are borne by the company and acquisition expenses are incurred by the company, the same has to be treated as capital loss and the entry for this will be as follows:

Goodwill A/c Dr. with the amount of expenditure

To Cash/Bank A/c

6. If any item of expenses or losses can be adjusted against Securities Premium Account, the same should be adjusted to the extent possible and for this the entry will be as follows:

Securities Premium A/c Dr. with the amount of adjustment

Or To Discount on Issue of Shares A/c

Or To Discount on Issue of Debentures A/c

Illustration 1

ABC Ltd., was registered with an authorised capital of 1,00,000 Equity Shares of Rs.10 each and it acquired the business of Rama BROS. at an agreed price of 2,50,000. The Balance Sheet of Rama BROS. at the date of acquisition was as follows:

Liabilities		Assets		
Capital	2,00,000	Freehold Premises		1,00,000
Reserve	20,000	Plant and Machinery		80,000
Sundry Creditors	50,000	Stock		20,000
Bills Payable	30,000	Debtors	27,500	

		Less: Provisions 2,500 25,000	
		Cash at Bank	75,000
	3,00,000		3,00,000

The consideration was to be discharged by the issue of 20,000 equity shares of 10 each as fully paid-up and the balance in cash. You are asked to journalize the transactions in the books of ABC Ltd.

Solution:

JOURNAL ENTRIES

Date	**Particulars**		Debit Amount	**Credit Amount**
			`	`
	Business Purchase Account	Dr.	2,50,000	
	To Rama BROS.			2,50,000
	(Being purchase consideration due)			
	Freehold premises	Dr.	1,00,000	
	Plant & Machinery Account	Dr.	80,0000	
	Stock Account	Dr.	20,000	
	Debtors Account	Dr.	27,500	
	Bank Account	Dr.	75.000	
	Goodwill (Balancing figure)	Dr.	30,000	
	To Creditors Account			50,000
	To Bills Payable			30,000
	To Reserve for Doubtful Debts Account			2500
	To Business Purchases Account			2,50,000
	(Being assets & liabilities taken over & differences of purchase consideration & net assets being profit has been transferred to Goodwill)			
	Rama BROS.	Dr.	250000	
	To Equity Share Capital Account			2,00,000
	To Bank			50,000
	(Being payment in the form of shares and cash)			

7.4 PROFIT OR LOSS PRIOR TO INCORPORATION

A company comes into existence only after its registeration or incorporation. Sometimes, a new company is formed to take over the business of an existing business unit as a going concern on date prior to the date of incorporation of the company. For example, a business unit is taken over as on 1st January, 2014 but the company got incorporated on 31st March, 2014. In such case, the profit or loss of the business, thus acquired, for the period from the date of purchase till the date of incorporation is called **Profit or Loss Prior to Incorporation.** Unless the agreement with the vendors provides otherwise, such a profit or loss belongs to the company. But profit or loss prior to incorporation should not be regarded as trading profit or loss of the company since the company cannot earn profit or incur loss before it comes into existence. Thus, profit or loss prior to incorporation is of capital nature and as such it is necessary to ascertain such profit or loss as accurately as possible.

The profit or loss prior to incorporation should be treated in the books of accounts in the following manner:

(i) PROFIT PRIOR TO INCORPORATION: Such a profit, being of capital nature, cannot be credited to the Profit and Loss Account and thus it cannot ordinarily be used for the purpose of payment of dividend. Hence, such a profit should be credited to Capital Reserve Account which can be utilised in writing off capital losses like preliminary expenses, discount on issue of shares or debentures or in writing down the value of fixed assets including goodwill. Until it is fully utilized, Capital Reserve Account has to be shown in the liabilities side of the Balance Sheet under the heading “Reserves and Surplus’.

(ii) LOSS PRIOR TO INCORPORATION: Such a loss, being of capital nature, should be debited to either a separate account called ‘Loss Prior to Incorporation Account’ which can be written off against other capital profits of the company, or it can be debited to ‘Goodwill Account’.

*** Students must remember that it is the date of incorporation and not the date of commencement of business which is considered to calculate profit or loss prior to incorporation.**

METHODS TO ASCERTAIN PROFIT OR LOSS PRIOR TO INCORPORATION

Profit or loss prior to incorporation can be ascertained in any of the following methods:

METHOD I : PREPARATION OF TRADING AND PROFIT AND LOSS ACCOUNT FOR THE PERIOD UP TO THE DATE OF INCORPORATION

Under this method, a trial balance has to be prepared as on the date of incorporation of the company by balancing off of the books and the value of stock has to be ascertained as on that date. Then, a Trading and Profit and Loss Account has to be prepared for the period which will disclose the profit or loss prior to incorporation. Profit or Loss prior to incorporation can be ascertained accurately under this method. All transactions thereafter would naturally relate exclusively to the post-incorporation period and thus give post-incorporation profit or loss.

But stock-taking and the balancing off of the books in the intervening period is often very inconvenient as the same will adversely affect the normal functioning of the business. In view of this difficulty, this method is not generally adopted in actual practice.

METHOD II: PREPARATION OF PROFIT AND LOSS ACCOUNT BY APPORTIONMENT INTO PRE-INCORPORATION AND POST-INCORPORATION PERIODS

Under this method, profit or loss for the pre and post incorporation period is ascertained by apportioning items of income and expenses between the two periods, i.e., the pre-incorporation and the post-incorporation periods on some rational basis. Thus under this method, profit or loss for the two periods cannot be ascertained as accurately as under the first method. This method can only give an estimate of the profit or loss of the two periods. As the first method involves a lot of inconvenience, there is no other alternative than to depend on this method.

BASIS OF APPORTIONMENT

The apportionment of profit or loss, in such a case, between the pre-incorporation and post-incorporation periods can be done on any one of the following basis: Time Basis, or Turnover Basis

TIME BASIS/ TIME RATIO

The profit or loss for the whole accounting period is apportioned between the periods prior to and after incorporation on the basis of time i.e., in proportion of the time of the respective periods. For example, if the time of the pre-incorporation and post-incorporation period be 3 months and 9 months respectively, the profit or loss for the whole period would be apportioned between the two periods in the ratio 3 : 9, i.e. 1 : 3. Thus, 1/4th of the profit would be treated as pre-incorporation profit while 3/4th of the profit would be treated as post-incorporation profit.

This principle is based on the assumption that profits are earned by the business evenly throughout the year. But in reality since no business can be expected to earn its profits evenly throughout the year, apportionment of profit or loss solely on the basis of time is not at all satisfactory.

TURNOVER BASIS/SALES RATIO

The profit or loss for the whole accounting period is apportioned between the periods prior to and after incorporation on the basis of turnover, i.e., in proportion of the turnover of the respective periods. For example, if the turnover of the pre-incorporation and post- incorporation periods be 1, 00,000 and 4, 00,000 respectively, the profit or loss for the whole period would be apportioned between the two periods in ratio of 1 : 4. Thus, 1/5th of the profit would be treated as pre-incorporation profit while 4/5th of the profit would be treated as post-incorporation profit.

This principle is also based on the assumption that turnover is spread evenly throughout the year. But in reality, this may not be always true. Besides, all the expenses of business need not necessarily depend on the turnover. As such, apportionment of profit or loss solely on the basis of turnover is also not satisfactory.

EQUITABLE BASIS

The manner of apportionment of profit or loss between the pre-incorporation and the post-incorporation periods actually depends upon the nature of each particular item. The most equitable method is normally to apportion the **gross profit or gross loss of the whole accounting period on the basis of the turnover** and the **expenses on their respective nature**, those varying with turnover being apportioned on that basis and those which do not vary with the turnover being apportioned on the basis of time.

What is actually to be done in this case is to prepare a Trading Account for the whole period and to find out the gross profit or gross loss in the usual way. Then The Profit and Loss Account is split up into the two periods (i.e., pre-incorporation and post-incorporation periods) and all the items of Profit and Loss

Account are then apportioned on the basis of their respective nature. For this, following principles are generally followed:

1. **Gross Profit or Gross Loss:** On the basis of sales ratio

OR

In the absence of turnover in the respective periods, on the basis of expenses which are directly related to turnover in the respective periods.

OR

In the absence of any such information, on the basis of time in the respective periods

2. F**ixed or standing charges:** such as rent, rates, taxes, insurance, general expenses, salaries, printing and stationery, telephone, postage, and telegrams, depreciation, audit fees, etc.

On the basis of time ratio

3. V**ariable expenses directly varying with the turnover:** such as commission, discount, brokerage, salesmen‘s salaries, advertisement carriage outwards, etc.

On the basis of sales ratio.

4. **Expenses wholly applicable to the period prior to incorporation:** like vendors‘ salary, interest on vendors‘ capital, interest on purchase consideration upto the date of incorporation, etc.

Exclusively to be shown in the pre-incorporation period.

5. **Expenses wholly applicable to the post-incorporation period:** like, directors'fees, debenture interest, discount on issue of debentures, preliminary expenses or formation expenses, etc.

Exclusively to be shown in the post-incorporation period.

Illustration 2

ABC Ltd. was incorporated on 1st August, 2010 with an authorised capital of 5,00,000 equity shares of 10 each to acquire the business of Raj Kumar with effect from 1st April, 2010. The purchase consideration was agreed at Rs. 7, 00,000 to be satisfied by the issue of 40,000 equity shares of Rs.10 each as fully paid-up and 3,000, 9% debentures of 100 each as fully paid-up. The entries relating to the transfer were not made in the books which were carried on without a break until 31st March, 2011. On 31st March, 2011 the trial balance extracted from the books showed the following:

Sales	10, 43,700
Purchases	7,76,580
Advertising	37,800
Postage and Telegram	8,820
Rent and Rates	18,420
Packing Expenses	16,800
Office Expenses	12,540
Opening Stock as on 1.4.2010	1,05,220
Directors' fees	20,000
Debenture Interest	18,000
Land and Buildings	3,00,000
Plant and Machinery	1,80,000
Furniture and Fixture	20,000
Sundry Debtors	1,39,500
Cash at Bank	40,000
Cash-in-hand	4,900
Bills Payable	30,000
Sundry Creditors	53,240
Preliminary Expenses	7,360
Capital Account	5, 89,000
Drawings Account	10,000

You are also given the following additional information:

(i) Stock on 31st March, 2011 amounted to 98,920.

(ii) The average monthly sales for April, May and June were one half of those for the remaining months of the year and the gross profit margin was constant throughout the year.

You are required to prepare the Trading and Profit and Loss Account for the year ended 31st March, 2011.

Solution:

Trading Account for the year ended 31st March, 2011

Dr. Cr.

	Particulars			Particulars	
To	Opening Stock	1,05,220	By	Sales	10,43,700
To	Purchases	7,76,580	By	Closing Stock	98,920
To	Gross Profit c/d	2,60,820			
		11,42,620			11,42,620

Profit and Loss Account for the year ended 31st March, 2011

Particulars	**Pre-incor-poration period**	**Post-incor-poration period,**	**Particulars**	**Pre-incor-Porationpe riod**	**Post-incor-poration period,**
	1.4.2010 to 31.7.2010	1.8.2010 to 31.3.2011		1.4.2010 to 31.7.2010	1.8.2010 to 31.3.2011

To Advertising (5: 16)	9,000	28,800	By Gross Profit b/d (5 : 16)	62,100	1,98,720
To Postage and Telegram (1 : 2)	2,940	5,880			
To Rent and Rates (1 : 2)	6,140	12,280			
To Packing Expenses (5 : 16)	4,000	12,800			
To Office Expenses (1 : 2)	4,180	8,360			
To Directors' fees		20,000			
To Debenture Interest		18,000			
To Preliminary Expenses		7,360			
To Pre-Incorporation Profit	35,840				
To Net Profit c/d		85,240			
Total	62,100	1,98,720	**Total**	62,100	1,98,720

Working Notes:

1. Ratio of Time between pre-incorporation period and post-incorporation period = 4 months: 8 months = 1: 2

2. Ratio of turnover between pre-incorporation period and post-incorporation period -

Let the turnover for the months of April, May and June be 1, turnover for the remaining months will be 2.

Now, turnover for the pre-incorporation period (i.e. 1.4.2010 to 31.7.2010) = 1+1+1+2 = 5 and turnover for the post-incorporation period (i.e., 1.8.2010 to 31.3.2010) = 8 x 2 = 16

Ratio of turnover between the two periods = 5 : 16

3. As the amount of preliminary expenses is negligible, it has been assumed that the same has to be written off against the revenue. .

7.5 SUMMARY

Acquisition of business, generally, refers to the purchase of a non-corporate business like sole-proprietorship or partnership form of business by a company. Such an acquisition of business by a limited company may take any of the following two forms: i) An existing company may purchase an existing business of a sole-proprietor or a partnership firm, or ii) the existing business unit may be converted into a limited company.

Sometimes, a new company is formed to take over the business of an existing business unit as a going concern on date prior to the date of incorporation of the company. In such case, the profit or loss of the business, thus acquired, for the period from the date of purchase till the date of incorporation is called **Profit or Loss Prior to Incorporation.** Thus, profit or loss prior to incorporation is of capital nature and as such it is necessary to ascertain such profit or loss as accurately as possible. Profit prior to incorporation should be credited to Capital Reserve Account which can be utilised in writing off capital losses like preliminary expenses, discount on issue of shares or debentures or in writing down the value of fixed assets including goodwill.

7.6 SUGGESTED READINGS

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

7.7 ANSWER THE FOLLOWING QUESTIONS

1. What do you mean by 'Acquisition of business? Describe accounting treatment for acquiring the business by a limited company?.
2. What is purchase consideration? How is it calculated?
3. Explain the following:
   (i) Time ratio
   (ii) Sales ratio
4. **What are profits prior to incorporation? How will you calculate profits prior to incorporation?**

LESSON 8

VALUATION OF GOODWILL

STRUCTURE

8.0 Objectives

8.0 OBJECTIVES

After reading this lesson, you should be able to:

- ✓ Understand the meaning and types of goodwill
- ✓ Know the factors determining goodwill
- ✓ Learn about the need for valuation of goodwill
- ✓ Understand the methods of valuation of goodwill

8.1 MEANING OF GOODWILL

Goodwill is the advantage of the good name or reputation of a business. It is those forces which attracts customers and thereby increase sales and profits. Goodwill is an intangible and invisible asset. Its value keeps on increasing and decreasing depending upon various factors such as sales, profitability, tangible assets employed by the business, business connections etc.

Zoological Classification of Goodwill

Types of goodwill can be determined by the type of business and the type of customer which such a business is likely to attract. In **Whiteman Smith Motor Company vs. Chaplin Case,** the goodwill is classified zoologically into cats, dogs, rats & rabbits on the basis of nature of these animals.

(a) CAT GOODWILL: Cat prefers the old home although the person who has kept the home leaves. Therefore cat goodwill represents the customer who goes to the old shop whosoever keeps it. **It provides the local goodwill** and is the most valuable.

(b) DOG GOODWILL: Faithful **dog** is attached to the person rather than the place. He will follow the outgoing owner if he does not go too far. Certain customers are attached to the owner of the business due to his exceptional skill, personality, honesty etc. This applies specifically to professional persons like chartered accountants, sweet shop owners, doctors, lawyers etc. Dog goodwill is difficult to be transferred and is thus less valuable.

(c) RAT GOODWILL: The **rat** has no attachments and is purely casual. Certain fugitive customers are neither faithful to the business nor to the owner. They may be here today and gone tomorrow. Therefore business which has such customers carry little goodwill.

(d) RABBIT GOODWILL: The **rabbit** is attracted by mere propinquity (nearness in time, place relationship). Some customers come to a business or shop because they happen to live close by and find it convenient to to go there. Thus, locational advantage causes goodwill for such type of business.

8.2 FACTORS AFFECTING THE VALUE OF GOODWILL

The value of goodwill depends upon the earning capacity of the business. Therefore, the factors which affect the profitability of the concern will also affect its goodwill. The important factors are listed below :

(i) AMOUNT OF CAPITAL EMPLOYED : A business which earns more profits with smaller amount of capital and with this smaller base of capital enjoys higher goodwill as compared to that business which has higher amount of capital invested in it, but earning smaller quantum of profits. Hence the amount of capital will have a bearing on the value of goodwill.

(ii) LOCATION OF BUSINESS: If a business house is located at a place easily approachable by the customers then it is likely to earn more profits and it will have more goodwill. So locational advantage is an important determinant of goodwilll.

(iii) NAME OF BUSINESS: Value of goodwill depends upon the name of the business also. For example names like Tata, Birla, Reliance do signify some amount of good impression in the minds of the customers. Good name depends upon the past service provided by the business to its customers.

(iv) NATURE OF BUSINESS: A business which involves less risk, has monopolistic advantage etc. possesses high value of goodwill.

(v) PAST PROFITS: The business earning good profits in the past years will have more goodwill. Good profits earned by the business in the past help to maintain investors confidence in the business. Thus, it enhances the value of goodwill of a firm because the indication of the high profits in the past assures the investors that their money will be put to good use.

(vi) EXPERIENCE OF THE BUSINESS: Old and established business houses have commercial reputation as compared to new business houses. This helps the old firms to earn higher profits as compared to new firms although both have same locational advantages.

(vii) EFFICIENCY OF MANAGEMENT: Good management practices eliminate wastage in the business which result in better business operations. Good planning, decision making and controlling of the affairs of the firm help to increase productivity of the firm. This results in the improvement of the overall efficiency of the business. Increased efficiency affects the value of the goodwill of the firm.

(viii) POSSESSION OF PATENTS OR TRADE MARKS: A firm having ownership of valuable patents and trade marks will enjoy higher amounts of profits, therefore goodwill will be higher.

(ix) PERSONAL SKILLS: Personal skills refer to the abilities of the persons managing the business. A firm, having professionals like solicitors, management consultants, chartered accountants enjoy higher amount of goodwill, because the skills of these experts affect the profitability of the business. Further, the goodwill of the business, is built up gradually, by the managerial skills of these businessmen.

(x) CONTINUOUS SUPPLIES: A firm with continuous supply of raw materials, even in the times of shortage enjoys higher amount of goodwill. Thus continuous supply is derived in the form of import quotas, monopolistic agreements etc.

(xi) EMPLOYER EMPLOYEE RELATIONS: Good and harmonious employer-employee relations in the past create good impression in the minds of persons dealing with the business, hence such organizations enjoy high goodwill.

(xii) POLITICAL CONNECTIONS: Political connections of the owners of the business, render security to the business in case of solution of some of the business problems. Such organisations enjoy more goodwill as compared to ordinary business houses.

(xiv) RISKS IN BUSINESS : If the risk involved in the business is more, then the goodwill will be less. On the contrary, less risky ventures enjoy more amount of goodwill.

(xv) ADVANTAGEOUS CONTRACTS: If a business is having some special contracts in hand, which are giving exceptional profits then goodwill be on the higher side.

8.3 NEED FOR VALUATION OF GOODWILL

Generally, the necessity for valuing the goodwill arises only when the business is to be sold. But in partnership and company forms of business organisation, the need for valuation of goodwill may arise during the continuation of the business. In the case of partnership and company, the valuation of goodwill is needed in following circumstances:

(1) When there is change in the constitution of the concern *i.e.*

(a) on admission of a new partner

(b) on retirement or death of a partner

(c) on change in profit sharing ratio

(2) On sale of business or conversion of a firm into a company.

(3) In case of amalgamation of two or more firms or companies.

(4) On dissolution of a going concern.

(5) Upon the taking over of the business of a company by another company.

(6) Upon the desire to acquire controlling interest in another company.

(7) Upon the Government taking over the business.

(8) Upon the valuation of the shares of unlisted companies.

(9) Even in case of listed companies, sometimes market value of the shares may not reflect the true value of the shares.

8.4 METHODS OF VALUATION OF GOODWILL

There are a number of methods of valuation of goodwill. The important methods are :-

1. Arbitrary valuation

2. Average profits method

3. Super profits method

4. Capitalization method
5. Annuity method
6. Hidden or implied goodwill

These methods have been explained as follows:-

1. ARBITRARY VALUATION

Value of goodwill, in this case is fixed by mutual agreement between the parties. In some cases, the value may be fixed by an independent person known as Arbitrator. This method can be used only where earning capacity of the firm is exactly known.

2. AVERAGE PROFITS METHOD

As the value of goodwill is directly dependent upon its profitability, therefore, average profits method is the most widely used method of valuation of goodwill. Under this method, goodwill is calculated on the basis of certain number of year's purchase of average profits of past few years.

Following steps are involved in this method.

(i) Calculate **average maintainable profit** of given number of past few years.

$$\text{Average future maintainable profits} = \frac{\text{Total Adjusted Profit}}{\text{No. of years}}$$

(ii) Value of goodwill :

Goodwill = Average adjusted profits ×Number of year's purchase.

LESSON-1 How to calculate Average Future Maintainable Profits

Goodwill is the price paid by the buyer for earning profits from the business in future. For this purpose, certain adjustments are made in the past profits, discussed below:

(a) Abnormal losses and expenses not likely to occur in the future are added back to the past profit.

(b) Any item of income earned in the past but not likely to be received in future is deducted from profits.

(c) Any item of income not earned in the past but likely to be received in future is added to past profits.

(e) Any loss and expenses likely to occur in the future is deducted from the past profit.

(f) The past average profits should be calculated after deducting tax at current rates.

Illustration 1

X Ltd. decided to purchase business of Y Ltd. The profits disclosed by Y Ltd. were:

2011 ` 2,10,000 (including abnormal gains ` 30,000)

2012 ` 1,80,000 (including abnormal loss ` 22,000)

2013 ` 1,90,000

2014 ` 2,70,000 (excluding abnormal loss ` 25,000)

Now, alternate management shall be required for which ` 20,500 p.a. shall have to be spent.

X Ltd. want to insure the property now for which annual insurance premium will be ` 20,000.

Find the value of goodwill on the basis of three year's purchase of average profits of last four years.

Solution.

Valuation of Goodwill

Adjusted Profits

2011		`
Profit given	` 2,10,000	
Less : Abnormal gain	30,000	1,80,000
2012		
Profit given	` 1,80,000	
Add : Abnormal loss	22,000	2,02,000
2013		
Profit given		1,90,000
2014		
Profit given		2,70,000
Total Profits		8,42,000
Average profits = $\frac{\text{` } 8,42,000}{4}$		` 2,10,500
Less : Managerial remuneration		` 20,500
		` 1,90,000
Less : Insurance premium of property		` 20,000
Average Adjusted Profits		` 1,70,000

Value of goodwill = Average Adjusted Profits × No. of years purchase

= ` 1,70,000 × 3 = ` 5,10,000

WEIGHTED AVERAGE PROFIT METHOD

Average profit method has an important limitation that it gives same weightage to the profits of all year. In averaging past profits, **trend of profits** earned must be taken into account. Where the past profits are widely fluctuating from year to year, an average fails to help future trend. Further, in some companies, profits may record a noticeable rising or falling trend from year to year. In such case, **weighted average profit** is more appropriate method to calculate goodwill.

The value of goodwill is calculated by using the following formula :

Goodwill = Weighted Average Profit ×Number of Year's purchase.

The following steps are used to calculate the value of goodwill :

(a) Calculate adjusted profit of each year by making past and future adjustments.

(b) Multiply the adjusted profits of different years with their respective weights to get the product

The highest weight should be given to the most recent past year and the smallest weight for the remotest or earlier year.

Product = Adjusted Profit ×Respective Weight

(c) Take the total of product

(d) Calculate the weighted average profit by dividing the product by sum of weights by using the following formula :

$$\text{Weighted Average Profit} = \frac{\text{Total of Product}}{\text{Total of Weights}}$$

(*d*) Now multiply weighted average profits by the number of years, purchase.

Illustration 2

A Ltd. proposed to purchase the business carried on by B &Co. Goodwill for this purpose is agreed to be valued at three year's purchase of the weighted average profits of the past four years. The appropriate weights and profits for the last four year are as under :

Year	Weight	Profit (`)
2010-11	1	1,01,000
2011-12	2	1,24,000
2012-13	3	1,00,000
2013-14	4	1,40,000

On a scrutiny of the accounts the following matters are revealed :

(i) On 1, December, 2012 a major repair was made in respect of the plant incurring ` 30,000 which was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balance method.

(ii) The closing stock for the year 2011-12 was over-valued by ` 12,000.

(iii) To cover management cost, an annual charge of ` 24,000 should be made for the purpose of valuation of goodwill.

Solution.

(i) Calculation of Adjusted Profits

	`
Profit for 2010-11	1,01,000
Less : Management Expenses	24,000
Adjusted Profits for 2000-01	77,000
Profit for 2011-12	1,24,000
Less : Management Expenses	24,000
	1,00,000
Less : Overvaluation of Closing Stock	12,000
Adjusted profit for 2011-12	88,000
Profit for 2012-13	1,00,000
Less : Management Expenses	24,000
	76,000
Add : Overvaluation of Opening Stock	12,000
	88,000
Add : Major repairs to the plant to be treated as capital expenditure	30,000
	1,18,000
Less : Depreciation on plant @ 10% for 4 Months on ` 30,000	1,000
Adjusted Profits for 2012-13	1,17,000
Profits for 2013-14	1,40,000
Less : Management Expenses	24,000
	1,16,000
Less : Depreciation for one year on ` 29,000 (` 30,000 – ` 1,000) @ 10%	2,900
Adjusted Profit for 2003-04	1,13,100

(ii) Calculation of Weighted Average Profits

YEAR	ADJUSTED PROFITS `	WEIGHT	Product `
2011-11	77,000	1	77,000
2011-12	88,000	2	1,76,000
2012-13	1,17,000	3	3,51,000

2013-14	1,13,100	4	4,52,400
	Total	10	10,56,400

Weighted Average Profits = $\frac{\text{Total of Product}}{\text{Total of Weights}} = \frac{`\ 10,56,400}{10}$ = ` 1,05,640

Goodwill = Weighted average Profits × No. of Year's purchases = ` 1,05,640 ×3 = ` 3,16,920

3. SUPER PROFIT METHOD

A business which is has been earning super profits will obviously expect higher goodwill. Super profit is the excess of additional earnings over the normal earnings. The excess of average profit over the normal profit is technically called super profit. Goodwill under super profits method can be calculated by

A) Number of years' purchase of super profits

B) Capitalization of super profits

A) NUMBER OF YEARS PURCHASE OF SUPER PROFITS

Value of goodwill =Super profits ×number of year's purchase.

Following steps are required for the calculation of goodwill in this method :

(i) Calculate **average profits** (explained in average profits method)

(ii) Calculate **normal profits**.

Normal profits = Capital employed ×Normal rate of returnt ÷100

(iii) Calculate **super profits** :

Super profits = Average profits – normal profit

(iv) Value of goodwill :

Super profits ×number of year's purchase.

CAPITAL EMPLOYED

The term "capital employed" has wide variety of meaning. But for the purpose of valuation of goodwill, it is usually taken to be the value of net tangible assets employed by the business.

Net Tangible assets= Total tangible assets - liabilities

NORMAL RATE OF RETURN

This is the rate of profit or return which the investor would expect on their investment in a particular type of industry. The normal rate of return is not uniform in all types of industries and therefore differs from industry to industry.

Normal rate of return= Pure rate of return+ Risk Rate of return

.

Illustration 3

Mr. X has assets worth ` 7, 00,000 and liabilities amounting to ` 3, 50,000. His annual profits are ` 80,000 including a sum of ` 22,000 received as compensation relating to business premises. He can engage himself in another business from which he expects 8% rate of return. In addition, he could also engage himself in part-time employment at an annual salary of ` 16,000. Considering 2% risk involved in the business, calculate value of goodwill at 5 year's purchase of super profits.

Solution.

		`
Annual Profit		80,000
Less : Compensation received (abnormal gain)	22,000	
Alternate salary	16,000	38,000
Average maintainable profits		42,000
Capital employed		
Assets		7,00,000
Less : liabilities		3,50,000
Net assets or capital employed		3,50,000

Normal Profits $= \text{`}\ 3{,}50{,}000 \times \frac{10}{100}(8\% + 2\%)$

= ` 35,000

Super Profit = ` 42,000 – ` 35,000 = ` 7,000

(i) Goodwill = Super Profit ×No. of Years Purchases

= ` 7,000 ×5 = ` 35,000

B) CAPITALIZATION OF SUPER PROFITS METHOD

Goodwill can also be calculated by capitalization of super profits. In other words, this method attempts to determine the amount of capital needed for earning super profit.

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

Illustration 4

The net profits of a firm, after providing for taxation for the past five years are ` 4,20,000, ` 4,70,000, ` 4,30,000, ` 4,10,000 and ` 4,70,000. Capital employed in the business is ` 40,00,000 on which a reasonable rate of return 10% is expected. Calculate the goodwill under Capitalisation of super profits method.

Solution :

	`
Profits of the year	

1st	4,20,000
2nd	4,70,000
3rd	4,30,000
4th	4,10,000
5th	4,70,000
	22,00,000

Average profits = $\frac{\text{Rs. } 22{,}00{,}000}{5}$ = ` 4,40,000

		`
Average profits		4,40,000
Less : Normal profit	$\left(40{,}00{,}000 \times \frac{10}{100}\right)$ 4,00,000	
Super profit		40,000

Capitalisation of super profits at 10% = 40,000 × $\frac{100}{10}$ = ` 4,00,000

Goodwill = Capitalised Value of Super Profit = ` 4,00,000.

4. CAPITALISATION METHOD

Under this method, goodwill is taken to be the excess of capitalised value of business over the net assets employed in the business.

Under this method, the business unit's goodwill is valued by the following steps :

(i) Calculate the total value of the firm by capitalising average profits.

Capitalised Value of Business = Average Profit × $\frac{100}{\text{Normal Rate of Return}}$

(ii) Calculate the value of net tangible assets:

Net Tangible Assets = Total Tangible Assets – All Liabilities

(iii) Value of Goodwill is determined as follows:

Goodwill = Capitalised Value of Average Profit – Value of Net Tangible Assets

Illustration 5.

Average profits of the company for the past five years are ` 22,000 and assets and liabilities are ` 2,75,000 and ` 75,000 respectively. The fair rate of return is 10%. Calculate the value of goodwill by :

(i) Capitalising average profits

(ii) Capitalising super profits

Solution.

(i) Capitalising average profits method

Average profits = ` 22,000

Capitalised value of the business = $\frac{₹\ 22,000 \times 100}{10} = ₹\ 2,20,000$

Net tangible assets = Assets – liabilities = 2,75,000 – 75,000

= ₹ 2,00,000

Value of goodwill = ₹ 2,20,000 – ₹ 2,00,000 = ₹ 20,000

(ii) Average profit = ₹ 22,000

Less : Normal profit = 2,00,000 × $\frac{10}{100}$ = ₹ 20,000

Super Profit = ₹ 2,000

Value of goodwill on capitalisation at super profits at 10% = ₹ 2,000 × $\frac{100}{10}$ = ₹ 20,000

5. ANNUITY METHOD

An annuity means a series of equal periodic payments made at equal interval of time. The goodwill under this method is equal to the present value of future extra profits (super profits) expected to be earned which is discounted at normal rate of return. Thus, the goodwill is valued at by using the following formula:

Goodwill = Super Profit ×Reference to Annuity Table

Illustration 12.

Average annual profits after tax are ₹ 1,50,000. Normal rate of return is 12% p.a Present value of annuity of ₹ 1 for the five years is 3. 60477. Capital employed in the business is ₹ 7,50,000. Find out the value of goodwill by annuity method :

Solution.

Annual profits = ₹ 1,50,000

Normal profits = 7,50,000 × $\frac{12}{100}$ = ₹ 90,000

Super profit = ₹ 1,50,000 – ₹ 90,000 = ₹ 60,000

Value of goodwill = ₹ 60,000 ×3.60477 = ₹ 2,16,286 approx.

6. HIDDEN GOODWILL

Sometimes, no particular method of valuation of goodwill or information is provided in the question. In such a case, goodwill is calculated on the basis of capitals contributed by the partners and their respective share in the firm. Following steps are required:

(*ii*) Find out full capital of the firm

Full capital = New partner's capital ×Reverse of new partner's share (*ii*) Deduct from the full capital, the combined capital of all the partners and balance is the value of goodwill.

Illustration 6.

A and B are partners with capital ` 2, 00,000 and ` 1,50,000. They admit C for $\frac{1}{5}$th share who brings ` 1,00,000 as capital. Find out the value of goodwill.

Solution.

`

Full Capital = ` 1,00,000 $\times \frac{5}{1}$ = 5,00,000

Less : Combined Capital :

A	` 2,00,000	
B	` 1,50,000	
C	` 1,00,000	4,50,000
Value of hidden goodwill		50,000

8.5 SUGGESTED READINGS

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

8.6 ANSWER THE FOLLOWING QUESTIONS

1. What do you know about the nature of goodwill? When is it valued?

2. Explain, with suitable examples, the different methods of valuation of goodwill.

3. Explain the factors on which the value of goodwill depends.

4. What is super profit? What are the steps to be followed for calculating super profit for the valuation of goodwill?

5. How would you determine future maintainable profit?

6. Define Goodwill. What is its zoological classification?

LESSON 9

Valuation of Shares

VALUATION OF SHARES

When shares of company change hands, the value of such shares has to be ascertained.

The value of shares of unlisted companies is not available as those shares are not quoted on the stock exchange. The value of shares of listed companies is available on the stock exchanges. But the market price quoted in the stock exchange may not reflect the true value of the shares because market value is a function of many factors. Sometimes it gets unduly affected by the market sentiments. So even when shares of listed companies are transferred, their value has to be ascertained.

FACTORS AFFECTING VALUATION OF SHARES:

The principal factors which have to be taken into consideration for valuing the shares of a Joint Stock Company are enumerated below:

1. The present and expected earnings of the company affect the value of shares. The investors are willing to pay a higher price for the shares of a company which has bright future..

2. The yield or return expected from similar type of companies in the same industry also affects the value of shares of a company in which the investors are actually interested. The prevailing bank rate and risks involved have also a bearing on the market yield.

3. The investors take a negative view of a company whose dividend rates fluctuate or which sets aside either too small or too big a share of divisible profits.

4. A company with in-appropriate financial ratios such as debt-equity ratio, current ratio and various long term financial position ratios would not be favoured by the investors.

5. Financial position as reflected by the balance sheet of the company also affects the value of shares.

6. The amount of capital employed in relation to expected profits also affects the valuation of shares.

7. The shares of reputed companies with efficient and progressive managements command ready acceptance and good price.

8. The Government may offer special incentives for the growth of a particular type of business e.g., tax holidays for companies in backward regions. And if the company in question falls within the framework of those incentives, the value of its shares would go up due to growth prospects.

9. Political, social and economic conditions inside and outside the country have their impact on the value of shares in the stock market.

OCCASIONS WHEN SHARES ARE VALUED

Need for valuation of shares arises in following cases:–

(i) For formulation of schemes of amalgamation, absorption etc.

(ii) For assessment of excise duty, wealth tax, gift tax etc.

(iii) For acquiring the interest of the dissenting shareholders in case of reconstruction.

(iv) For conversion of one class of shares into another class.

(v) For advancing loans on security of shares.

(vi) For compensation of shareholders in case their shares are acquired by the Government under some scheme of nationalisation.

(vii) For purchase or sale of block of shares involving acquisition of controlling interest by the holding company.

METHODS OF VALUATION OF SHARES

Following are the important methods of valuation of shares :

1. Net assets method

2. Yield method or Earnings method

3. Fair Value Method

4. Earning Per Share Method

1. NET ASSETS METHOD

This method is also known as **intrinsic value method** or **break-up value method or assets backing method**. This method attempts to ascertain the amount of assets of the business enterprise against each share.

This method takes into account the realisable value of assets as reduced by the claims of creditors, debenture holders and other debts. If preference shares have priority over equity shares, preference shares are also deducted form the realisable value of assets. The net assets above are divided by the number of equity shares to give value per share. The procedure has been explained as under :-

(i) CALCULATION OF NET ASSETS

Realisable value of assets :–		`
Goodwill		X X X
Land		X X X
Building		X X X
Plant		X X X
Furniture		X X X
Debtors		X X X
Bills Receivable		X X X
Closing Stock		X X X
Cash and bank balance, etc.		X X X
Total Assets		X X X
Less : Payment for :–		
Debentureholders	X X X	
Creditors	X X X	

Other debt	X X X	X X X
		X X X
Less : Preference share capital (if have priority over equity shares)		X X X
Balance assets available for equity shareholders		X X X

(ii) Value per equity share = $\frac{\text{Assets available for Equity Shareholders}}{\text{Number of Equity `Shares}}$

Notes :

(i) A proper calculation of goodwill must be made.

(ii) Fictitious assets such as preliminary expense, debit balance of profit and loss, discount or commission on shares or debentures etc. should be excluded from the assets.

(iii) Other assets should be taken at current realisable value.

(iv) Only outside liabilities should be deducted from assets

(v) General reserve/fund, Profit and Loss Account balance, dividend equalisation fund, contingency reserve, debenture redemption fund etc. should not be deducted.

Alternatively, the value of assets available to equity shareholders can also be calculated as follows :

		`
Equity Share Capital		X X X
Add : Reserves & Surplus		X X X
Profit on Revaluation of Assets (if asset is revised upward)		X X X
		X X X
Less:		
Loss on Revaluation of Assets	X X X	X X X
Value of Net Equity		X X X

Value per Equity Share = $\frac{\text{Value of Net Equity}}{\text{Number of Equity Shares}}$

Advantage of Net Asset Method

This method enjoys some peculiar advantages as enumerated below :

(a) This method of valuation of shares is very useful when the firm is being liquidated since the very foundation of this method is to use net realisable value of assets to value shares.

(b) This method takes into consideration both types of assets tangible as well as intangible. Thus, goodwill, value of patent rights etc. is also included in calculating the value of shares.

(c) This method creates no problem in calculating the value of different types of equity shares.

Limitations of Net Asset Method

This method suffers from the following limitations :

(a) It is difficult task to estimate the realisable value of assets. There is a considerable scope for personal bias.

(b) As the company is treated as going concern and where there is no possibility of its liquidation in the near future, this method of share valuation is most hypothetical.

Illustration 1

The following is the summarised Balance Sheet of a company as at December 31st, 2014.

Liabilities	`	Assets	`
Share Capital		**Fixed Assets**	38,00,000
10,000 5% preference shares of `100 each fully paid	10,00,000	**Investments**	10,25,000
		Current Assets	
2,00,000 Equity Shares of ` 10 each fully paid	20,00,000	Stock in Trade	5,72,000
		Sundry Debtors less Provisions	12,78,000
Reserve and Surplus :		Cash and Bank Balances	2,25,000
General Reserve	15,00,000		
Profit & Loss Account (Cr.)	12,00,000		
Secured Loan			
6% Debentures	8,00,000		
Current Liabilities			
Sundry Creditors	2,75,000		
Liabilities for expenses	1,25,000		
	69,00,000		69,00,000

For purposes of valuation of shares, Fixed assets are to be depreciated by 10 per cent. Investments are to be taken at ` 10,80,000 and Sundry debtors are to be further reduced by 5 per cent.

Interest on Debentures is accrued due for 9 months and preference dividend for 2014 is also due; neither of these has been provided for in the Balance Sheet.

Calculate the value of each Equity Share.

Solution.

	`
Net Assets :	
Fixed Assets (` 38,00,000 – ` 3,80,000)	34,20,000
Investment	10,80,000
Stock	5,72,000
Debtors (` 12,78,000 – 5%)	12,14,100
Cash at Bank	2,25,000
	65,11,100

Less : Liabilities :–		
6% Debentures	8,00,000	
Interest on Debenture for 9 months	36,000	
Creditors	2,75,000	
Outstanding Expenses.	1,25,000	12,36,000
		52,75,100
Less : Preference share capital	10,00,00	
Preference dividend due	50,000	10,50,000
Assets available for Equity Shareholders		42,25,100

$$\text{Value per share} = \frac{\text{Assets available for Equity Shareholders}}{\text{Number of Equity Shares}}$$

$$= \frac{\text{` } 42{,}25{,}100}{2{,}00{,}000 \text{ Shares}} = \text{` } 21.13$$

VALUATION OF SHARES HAVING DIFFERENT PAID-UP VALUES

There is no problem if the company has issued one type of equity share-fully paid or partly paid since the amount of net assets (Assets-Liabilities) has to be divided among them equally. However, if there are different types of equity shares having different paid-up values then the value of shares can be worked out by adding the unpaid and uncalled amount of shares (or making the notional call for making the capital fully paid-up). Such a value when divided by total number of shares (fully paid) would give up the value of each fully paid share. To get the intrinsic value of such shares the unpaid amount (which is added earlier) should be further deducted.

Illustration 2

The following particulars relate to a company :

Total assets	18,50,000
External liabilities :	2,50,000
Share Capital :	
14% Preference shares of ` 10 each, fully paid	5,00,000
40,000 Equity shares of ` 10 each, fully paid	4,00,000
60,000 Equity shares of ` 10 each , ` 7·50 paid	4,50,000

Calculate the value of each category of equity shares of the company based on a deemed liquidation.

Solution.

Calculation of Net Assets available to Equity Shareholders

	`
Total assets	18,50,000

Less : External liabilities	2,50,000
Net assets	16,00,000
Less : Preference shares capital	5,00,000
Net assets for equity shareholder	11,00,000
Add : Notional call on 60,000 equity shares @ ` 2.50 per share	1,50,000
Net Assets available for equity shareholders after notional call	12,50,000

No. of equity shares = 40,000 + 60,000 = 1,00,000

$$\text{Value of fully paid equity share} = \frac{\text{Net Assets available for equity shareholders}}{\text{Number of Equity shares}}$$

$$= \text{` } 12{,}50{,}000/1{,}00{,}000 = \text{` } 12.50$$

Value of partly paid equity share = ` 12.50 – ` 2.50 = ` 10

2. YIELD METHOD OR EARNING METHOD

This method takes prospective earnings of the company as the basis for share valuation. Shares are valued assuming company as a going concern.

For the valuation of a share under this method, the following two bases are considered:

(a) Valuation based on rate of dividend

(b) Valuation based on rate of earning

(A) VALUATION BASED ON RATE OF DIVIDEND:

This method of valuation of share is based on expected dividend on the shares. **This method is suitable for shareholders having small blocks of shares because these shareholders are usually interested in dividends.**

The value of a share according to this method is ascertained as follows:

Value of Equity Share

$$= \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid– up value of a share}$$

Find the expected rate of dividend as under :–

$$= \frac{\text{Profits available for dividend}}{\text{Paid up equity share capital}} \times 100$$

Note : While calculating profits available for dividend, following procedure should be followed :–

	`
Earning before interest and tax (EBIT)	××××
Less : Interest on debt	××××
Profit before tax	××××

Less : Income tax	××××
Profit after tax	××××
Less : Preference dividend	××××
Profit after preference dividend	××××
Less : Transfer to General reserve (if any)	××××
Profit available as dividend for equity shareholders	××××

ADVANTAGES OF EARNING/YIELD METHOD

This method enjoys the following superiority as compared to Net Assets Method :

(a) The investors while making investment decision would be more directly influenced by the apparent earning power than what he can obtain in the event of company's liquidation.

(b) The value of share is primarily based on what the investor will earn.

(c) Risk factor plays an important role in any investment decision. Risk factor is suitably taken into account while calculating the normal rate of return.

LIMITATIONS OF EARNING/YIELD METHOD

This method suffers from following limitations :

(a) It is difficult to predict the future maintainable profit on account of risky and uncertain future.

(b) It is difficult to select a normal rate of return representing the element of risk involved in a particular business.

(c) In case the company has been incurring losses for number of years then this method is not suitable for valuation of shares.

Illustration 3

You have been given the following information:

Share Capital of X Ltd. is ` 8,00,000. X Ltd. distributes 60% of its profits as dividend while

Annual profit of X Ltd. is ` 2,00,000. Find out value of shares of X Ltd. Normal rate of return is 10% p.a. The share of the company is of ` 100 paid-up value.

Solution

Calculation of Expected Rate of Dividend

Annual Profit = ` 2,00,000

Profit available for Dividend = ` 2,00,000 ×60%

= ` 1,20,000

$$\text{Expected Rate of Dividend} = \frac{\text{Profit Available for Dividend}}{\text{Paid - up Equity Share Capital}} \times 100$$

$$\text{Expected Rate of Dividend} = \frac{\text{` 1,20,000}}{\text{` 8,00,000}} \times 100$$

$$= 15\%$$

Valuation of Share

$$\text{Value of Share} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid - up value of a share}$$

$$= \frac{15}{10} \times \text{` } 100 = \text{` } 150$$

Illustration 4

From the following information, compute the value of equity share :

	`
50,000 equity shares of ` 10 each ` 8 paid up	4,00,000
2,000 9% preference shares of ` 100 each	2,00,000
Estimated profits before tax	2,18,000
Rate of tax	50%

Transfer to reserve fund is required at 20% of profits. Normal rate of earnings 15%

Solution:

Calculation of Expected Rate of Dividend

Annual Profit before tax=		` 2,18,000
Less: Tax = ` 2,18,000 ×50%	=	` 1,09,000
Less: Transfer to reserve fund ` 1,09,000x20%		` 21800
Less: Preference dividend		` 18000
Profit available for dividend		69, 200

$$\text{Expected Rate of Dividend} = \frac{\text{Profit Available for Dividend}}{\text{Paid - up Equity Share Capital}} \times 100$$

$$\text{Expected Rate of Dividend} = \frac{\text{` 69200}}{\text{` 4,00,000}} \times 100$$

$$= 17.3\%$$

Valuation of Share

$$\text{Value of Share} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid - up value of a share}$$

$$= \frac{17.3}{15} \times ` 8 = ` 9.23$$

b) VALUATION BASED ON RATE OF EARNING

This method of valuation of shares is particularly **suitable in case of big investors** because they are more interested in company's earnings rather than what the company distributes in the form of dividends. Value of share in this method is calculated by using the following formula :

Value of Equity Share = $\frac{\text{Expected Rate of Earning}}{\text{Normal Rate of Earning}} \times$Paid-up value of a share

Where, Expected Rate of Earning = $\frac{\text{Earnings available for equity shareholders}}{\text{Equity Share Capital or Capital Employed}} \times 100$

While calculating expected rate of return, students must observe whether earnings show a specific increasing or decreasing trend or not. In case trend is observed, it is advisable to calculate weighted rate of return.

Illustration 5

From the following figures, calculate the value of the share of ` 100 on (*i*) Yield on Capital employed, and the market expectation being 12%.

Year	Capital Employed	Profit	Dividend
	`	`	(%)
2011	5,50,000	88,000	12
2012	8,00,000	1,60,000	15
2013	10,00,000	2,20,000	18
2014	15,00,000	3,75,000	20

Solution.

(i) Valuation of Share on the basis of Yield on Capital Employed

Since the capital employed & profit shows an increasing trend over years, hence weighted average return on capital employed is calculated as follows :

Year	Capital Employed	Profit	Return On Capital Employed (%)	Weight	Product
	(`)	(`)			
2011	5,50,000	88,000	$\frac{88,000}{5,50,000} \times 100$ = 16	1	16
2012	8,00,000	1,60,000	$\frac{1,60,000}{8,00,000} \times 100$ = 20	2	40
2013	10,00,000	2,20,000	$\frac{2,20,000}{10,00,000} \times 100$ = 22	3	66

2014	15,00,000	3,75,000	$\frac{3,75,000}{15,00,000} \times 100 = 25$	4	100
Total				10	222

$$\text{Weighted Average Rate of Return On Capital Employed} = \frac{\text{Total of Product}}{\text{Total of Weight}}$$

$$= \frac{222}{10} = 22.2\%$$

$$\text{Value of Share} = \frac{\text{Weighted Average Rate of Return on Capital Employed}}{\text{Normal Rate of Return}} \times \text{Paid-up Value per share}$$

$$= \frac{22.2}{12} \times 100 = \text{`}\ 185$$

3. FAIR VALUE METHOD

From the analysis of two methods *i.e.,* Net Assets Method and Earning /Yield Method, it is clear that both the methods have different considerations and as a consequence the value of share differs under the two methods. Many accountants are of the view that neither the net assets method nor the earning method considered independently is correct method of valuation of shares. They suggested that valuation of shares should be done by combining the said two methods. Popularly known as **fair value method or dual method** of valuation of shares which is a composite of intrinsic value and yield value. This method provides a better insight about the value of shares as compared to asset backing method and yield method.

Fair value of a share can be calculated by using the following formula :

$$\text{Fair value} = \frac{\text{Intrinsic Value} + \text{Yield Value}}{2}$$

Illustration 5.

From the following particulars, calculate the fair value of an equity share assuming that out of the total assets, those amounting to ` 41,00,000 are fictitious :

(i) Share Capital :

5,50,000 10% Preference Shares of ` 100 each fully paid up.

55,00,000 Equity Shares of ` 10 each fully paid up.

(ii) Liability to outsiders : ` 75,00,000.

(iii) Reserves & Surplus: ` 45,00,000.

(iv) The average normal profit after taxation earned every year by the company during last five years ` 85,05,000.

(v) The normal profit earned on the market value of fully paid equity shares of similar companies is 12%.

Solution:

VALUATION OF SHARES

(a) Intrinsic Value Method

Calculation of Net Assets available to Equity Shareholders

	`
Equity Share Capital	5,50,00,000
Reserves & Surplus	45,00,000
	5,95,00,000
Less : Fictitious Assets	41,00,000
Net Assets available to Equity shareholders	5,54,00,000
Number of equity shares	55,00,000
Intrinsic value of a share	$\frac{5,54,00,000}{55,00,000}$
	= ` 10.07

(b) Yield Value Method

	`
Average Profit after tax (Given)	85,05,000
Less : Preference Dividend (` 5,50,00, 000 × 10%)	55,00,000
Net Profit available to Equity Shareholders	30,05,000
Equity share capital	5,50,00,000

Expected Rate of Return $= \frac{\text{Net Profit Available to Equity Shareholder}}{\text{Equity Share Capital}} \times 100$

$= \frac{30,05,000}{5,50,00,000} \times 100$

= 5.46%

Value of an Equity Share $= \text{Paid up value of a share} \times \frac{\text{Expected Rate of Return}}{\text{Normal Rate of Return}}$

$$= ` 10 \times \frac{5.46}{12}$$

$$= ` 4.55$$

(c) Fair Value of A Share

$$\text{Fair Value} = \frac{\text{Intrinsic Value of Share + Yield Value of Share}}{2}$$

$$= \frac{` 10.07 + ` 4.55}{2}$$

$$= ` 7.31$$

4. EARNING PER SHARE METHOD

Earning per share method of valuation of shares has become a very significant & popular method now a days. In this method, earning per share (EPS) of the company whose shares are to be valued is calculated. By comparing the earning per share of the company with that of normal earning per share of similar companies or industry, the value of share of a company is determined. Thus, value of share under this method is calculated as follows :

$$\text{Value of Share} = \frac{\text{EPS of Company}}{\text{Normal EPS}} \times \text{Paid-up Value per Share}$$

Where, $$\text{EPS of Company} = \frac{\text{Profit Available to Equity Shareholders}}{\text{Number of Equity Shares}}$$

$$\text{Normal EPS} = \text{Paid-up value per share} \times \text{Normal Rate of Earning}$$

Illustration 28.

From the following balance sheet of Dabur India Ltd., find out the value per share under EPS method.

Balance Sheet
As on 31st March 2014

Liabilities	Amount	Assets	Amount
	`		`
Share Capital :		**Fixed Assets**	2,50,000
3,400 Equity Share of ` 100 each	3,40,000		
5% Preference Shares of ` 100 each	50,000	**Current Assets**	2,20,000
Current Liabilities	80,000		
	4,70,000		4,70,000

Average net profit after tax of the company is ` 1,48,700. Expected normal return is 20% in case of similar companies.

Solution.

Calculations of Earning Per Share

	`
Net Profit after Tax	1,48,700
Less : Preference Dividend (` 50,000 ×5%)	2,500
Profit available to equity shareholders	1,46,200
Number of Equity Shares	3,400

Earning Per Share (EPS) $= \dfrac{\text{Profit available to equity shareholder}}{\text{Number of Equity Shares}} = \text{`}\ \dfrac{1,46,200}{3,400} = \text{`}\ 43$

Normal EPS = Paid-up value per share ×Normal rate of return

= ` 100 ×20% = ` 20

Value of a Share $= \dfrac{\text{EPS of the company}}{\text{Normal EPS}} \times$ Paid-up Value per Share

$= \dfrac{43}{20} \times 100 = \text{`}\ 215$

SUMMARY

When shares of company change hands, the value of such shares has to be ascertained.The value of shares of unlisted companies is not available as those shares are not quoted on the stock exchange. The value of shares of listed companies is available on the stock exchanges. But the market price quoted in the stock exchange may not reflect the true value of the shares because market value is a function of many factors. Sometimes it gets unduly affected by the market sentiments. So even when shares of listed companies are transferred, their value has to be ascertained. The principal factors which have to be taken into consideration for valuing the shares of a Joint Stock Company are the present and expected earnings of the company affect the value of shares, the yield or return expected from similar type of companies in the same industry, financial position as reflected by the balance sheet of the company etc. Important methods of valuation of shares are i) Net assets method, ii) Yield method or Earnings method, iii) Fair Value Method.

SUGGESTED READINGS

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

ANSWER THE FOLLOWING QUESTIONS

1. Explain the steps involved in the valuation of shares under Yield method.

2. What do you understand by valuation of shares ? Explain the important methods of valuation of shares. Illustrate your answer with examples.
3. What factors influence the valuation of shares.
4. What is the need for valuation of shares? State the factors affecting valuation of shares.
5. What is the difference between "Asset Backing Method" & "Yield Valuation Method" for valuing the shares.

6. What are the circumstances in which there may be a need for valuation of shares of a joint stock company ? How will you determine the intrinsic value of one equity share of a joint stock company ? Explain with the help of an illustration.

LESSON 10

LESSON-2 FINAL ACCOUNTS OF COMPANIES -I

STRUCTURE

10.0 OBJECTIVES

After reading this lesson, you should be able to:

- ✓ Understand the meaning and types of financial statements of accompany
- ✓ Know about form and contents of Statement of Profit and Loss
- ✓ Understand the form and contents of balance sheet

10.1 Financial statements of A company

Financial statements are the basic and formal annual reports through which the corporate management communicates financial information to its owners and various other external parties such as stock exchanges, investors, tax authorities, government, employees etc. These normally refer to: (a) the balance sheet (position statement) as at the end of accounting period, and (b) the statement of profit and loss of a company. Now-a-days, the cash flow statement is also taken as an integral component of the financial statements of a company.

Section 129 of Companies Act, 2013 makes it compulsory for a joint stock company to prepare its **Statement of Profit and Loss and Balance Sheet.** In case the company has not been carrying on business for profit, an **Income and Expenditure Account** shall be laid before the company at its annual general meeting. The companies are required to prepare their financial statements for the "financial year".

Section 2(41) of the Companies Act, 2013 defines **"financial year",** in relation to any company as the period starting on Ist April of and ending on 31st March of the following year.

Legal provisions relating to financial statements of a company

1. Form and Contents of Financial Statements

Section 129(1) of Companies Act, 2013 provides that every financial statement of a company shall give a true and fair view of the state of affairs of the company, comply with the accounting standards notified by the Central Government under Section 133 of the said Act, shall be in the form or forms as may be provided for different class or classes of companies in Schedule III. It shall also include any notes annexed to or forming part of such financial statements.

2. Exemption from the applicability of Schedule III of the Companies Act, 2013

Schedule III of the Companies Act, 2013 is not applicable to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

3. Modification of the Format of the financial statements in order to comply with the requirement of the Accounting Standards

The General Instructions to the Schedule III provide that where requirements of Accounting Standards as applicable to the companies require any change in treatment or disclosure of any item, or in the head or sub-head in the financial statements, same shall be made and the requirements of this Schedule shall stand modified accordingly.

4. Notes to Accounts

Narrative descriptions or details of items presented in financial statements shall be made in **Notes to accounts** attached to those statements**.**

5. Requirement to provide comparable figures for the previous reporting figures

Companies are required to give the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements.

6. Laying of annual accounts and balance sheet before annual general meeting

Section 129(2) of the Companies Act, 2013 casts an obligation upon the Board of directors of a company to lay down financial statements before each and every annual general meeting.

7. Compliance with Accounting Standards

Every financial statements of the company shall comply with the accounting standards. Section 129(5) of the Companies Act, 2013 provides that where the financial statements of the company do not comply with the accounting standards, such companies shall disclose in the financial statement, the following, namely :-

(a) the deviation from the accounting standards;

(b) the reasons for such deviation; and

(c) the financial effect, if any, arising due to such deviation

10.2 Form of Statement of Profit & Loss (COMPANIES ACT, 2013)

Form of Statement of Profit And Loss
(as per schedule-III part-II of companies act, 2013)

STATEMENT OF NAME OF COMPANY……………				
Profit and Loss for the year ended…………				
	Particulars	**Note No.**	**Figures as at the end of current reporting period**	**Figures as at the end of previous reporting period**
			`	`
I.	**Revenue from Operations (gross)** **Less** Excise duty **Revenue from operations (Net)**			
II.	**OTHER INCOME**			
III.	**Total Revenue (I + II)**			
IV.	**Expenses :**			
	Cost of materials consumed			
	Purchases of stock-in-trade			
	Changes in inventories of finished goods, work-in- progress and stock-in-trade			
	Employee benefits expense			
	Finance costs			
	Depreciation and amortization expense			
	Other expenses			
V.	**TOTAL EXPENSES**			
VI.	**Profit/(Loss) before exceptional and extraordinary items and tax (III -V)**			
VII.	**Exceptional items**			
VIII.	**Profit / (Loss) before extraordinary items and tax (VI$\pm$ VII)**			

IX.	**Extraordinary items**			
X.	**Profit / (Loss) before tax (VIII $\pm$ IX)**			
XI.	**Tax expense:**			
	(1) Current tax			
	(2) Deferred tax			
XII.	**Profit (Loss) from continuing operations (X – XI)**			
XII.	Profit/(Loss) from discontinuing operations (before tax)			
XIII.	Tax expense of discontinuing operations			
XIV.	Profit (Loss) from discontinuing operations (after tax) (XII-XIII)			
XV.	Profit / (Loss) for the period (XII + XIV)			
XVI.	Earnings per equity share:			
	(1) Basic			
	(2) Diluted			

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GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. This form also applies to the income and expenditure account which is prepared by non-profit organizations.
2. Revenue from operations shall disclose separately in the notes revenue from –
   (a) sale of products ;
   (b) sale of services ;
   (c) other operating revenues ;
   Less :
   (d) Excise duty.
   In respect of a finance company, revenue from operations shall include revenue from
   (a) Interest; and
   (b) Other financial services
3. **Finance Costs:** Finance costs shall be classified as:
   (a) Interest expense;
   (b) Other borrowing costs;
   (c) Applicable net gain/loss on foreign currency transactions and translation.
4. **Other income:** Other income shall be classified as:
   (a) Interest Income (in case of a company other than a finance company);
   (b) Dividend Income;
   (c) Net gain/loss on sale of investments
   (d) Other non-operating income (net of expenses directly attributable to such income).

5. **Additional Information:** A Company shall disclose **by way of notes** additional information regarding aggregate expenditure and income on the following items:-

   (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

   (b) Depreciation and amortization expense;

   (c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or Rs.1,00,000, whichever is higher;

   (d) Interest Income;

   (e) Interest Expense;

   (f) Dividend Income;

   (g) Net gain/ loss on sale of investments;

   (h) Adjustments to the carrying amount of investments;

   (i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

   (j) Payments to the auditor as (a) auditor,(b) for taxation matters, (c) for company law matters, (d) for management services, (e) for other services, and (f) for reimbursement of expenses;

   (k) In case of Companies covered under Section 135, amount of expenditure on corporate social responsibility activities;

   (l) Details of items of exceptional and extraordinary nature;

   (m) Prior period items;

(n) Expenditure incurred on each of the following items, separately for each item:-

(*a*) Consumption of stores and spare parts;

b) Power and fuel;

(c) Rent;

(d) Repairs to buildings;

(e) Repairs to machinery;

(f) Insurance;

(g) Rates and taxes, excluding, taxes on income ;

(h) Miscellaneous expenses,

10.3 Balance Sheet– Forms and Contents

Form of Balance Sheet (AS PER SCHEDULE III - PART-I OF COMPANIES ACT, 2013)

NAME OF THE COMPANY	
Balance Sheet as at	**(Rupees in ....)**

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
I	EQUITY AND LIABILITIES			
(1)	**Shareholders' funds**			
	(*a*) Share capital			
	(*b*) Reserves and surplus			
	(*c*) Money received against share warrants			
(2)	**Share application money pending allotment**			
(3)	**Non-current liabilities**			
	(*a*) Long-term borrowings			
	(*b*) Deferred tax liabilities (net)			
	(*c*) Other long-term liabilities			
	(*d*) Long-term provisions			
(4)	**Current liabilities**			
	(*a*) Short-term borrowings			
	(*b*) Trade payables			
	(*c*) Other current liabilities			
	(*d*) Short-term provisions			
	TOTAL			
II	**ASSETS**			
	Non-current assets			
(1)	(*a*) Fixed assets			
	(*i*) Tangible assets			
	(*ii*) Intangible assets			
	(*iii*) Capital work-in-progress			
	(*iv*) Intangible assets under development			
	(*b*) Non-current investments			
	(*c*) Deferred tax assets (net)			
	(*d*) Long-term loans and advances			
	(*e*) Other non-current assets			

(2)	**Current assets**			
	(*a*) Current investments			
	(*b*) Inventories			
	(*c*) Trade receivables			
	(*d*) Cash and cash equivalents			
	(*e*) Short-term loans and advances			
	(*f*) Other current assets			
	Total			

NOTES: GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:
   (a) it is expected to be realised in, or is intended for sale or consumption in, the company's normal operating cycle;
   (b) it is held primarily for the purpose of being traded;
   (c) it is expected to be realised within twelve months after the reporting date; or
   (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

   All other assets shall be classified as non-current.
2. An operating cycle is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have duration of 12 months.
3. A liability shall be classified as current when it satisfies any of the following criteria:
   (a) It is expected to be settled in the company's normal operating cycle;
   (b) It is held primarily for the purpose of being traded;
   (c) It is due to be settled within twelve months after the reporting date; or

   All other liabilities shall be classified as non-current.
4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

DISCLOSURES IN NOTES TO ACCOUNTS

A. Share Capital

For each class of share capital (different classes of preference shares to be treated separately):

(a) The number and amount of shares authorized;

(b) The number of shares issued, subscribed and fully paid, and subscribed but not fully paid ;

(c) Par value per share;

(d) A reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

(e) The rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) Shares held by holding company in its subsidiaries or associates;

(g) Shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held

(h) Shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts

(i) (A) Aggregate number and class of shares allotted as fully paid up issued for consideration other than cash.

(B) Aggregate number and class of shares allotted as fully paid up by way of bonus shares.

(C) Aggregate number and class of shares bought back.

Shares issued under (A), (B), and (C) above are to be shown in the balance sheet for the period of five years only.

(*j*) Terms of any securities convertible into equity/preference shares issued.

(k) Calls unpaid (showing aggregate value of calls unpaid by directors and officers)

(l) Forfeited shares (amount originally paid-up).

B. Reserves and Surplus

(i) Reserve and surplus shall be classified as follows

(a) Capital Reserves

(b) Capital Redemption Reserve

(c) Securities Premium Reserve

(d) Debenture Redemption Reserve

(e) Revaluation Reserve

(*f*) Share Options Outstanding Account

(g) Other Reserves (specify the nature and purpose of reserve and the amount in respect thereof)

(h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc (Additions and deductions since the last Balance Sheet to be shown under each of the specified head)

(ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-term Borrowings

(i) Long-term borrowings shall be classified as:

(a) Bonds/debentures;

(b) Term loans;

- from banks;
- from other parties;

(c) Deferred payment liabilities;

(d) Deposits;

(e) Loans and advances from related parties;

(*f*) Long term maturities of finance lease obligations;

(*g*) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated.

(v) Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

D. Other Long-term Liabilities

Other Long Term Liabilities should be classified into:

(a) Trade payables for long period; and

(b) Others.

E. Long-Term Provisions

This amount should be classified as:

(a) Provision for employee benefits and

(b) Others (specifying the nature).

F. Short-term Borrowings

Short-term borrowings shall be classified as:

(i) (*a*) Loans repayable on demand

(A) from banks;

(B) from other parties.

(b) Loans and advances from related parties;

(c) Deposits;

(d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

G. Other Current Liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends;

(g) Application money received for allotment of securities and due for refund and interest accrued thereon;

(h) Unpaid matured deposits and interest accrued thereon;

(i) Unpaid matured debentures and interest accrued thereon;

(j) Other payables (specify nature).

H. Short-term Provisions

The amounts shall be classified as:

(a) Provision for employee benefits;

(b) Others (specify nature).

I. Tangible Assets

(i) Classification shall be given as:

(a) Land.

(b) Buildings.

(c) Plant and Equipment.

(d) Furniture and Fixtures.

(e) Vehicles.

(f) Office equipment.

(g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

(iii) Additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

J. Intangible Assets

(i) Classification shall be given as:

(a) Goodwill.

(b) Brands /trademarks.

(c) Computer software.

(d) Mastheads and publishing titles.

(e) Mining rights.

(f) Copyrights, and patents and other intellectual property rights, services and operating rights.

(g) Recipes, formulae, models, designs and prototypes.

(h) Licenses and franchise.

(i) Others (specify nature).

(ii) Additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

K. Non-current Investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(*a*) Investment property;

(*b*) Investments in Equity Instruments;

(*c*) Investments in preference shares

(*d*) Investments in Government or trust securities;

(*e*) Investments in debentures or bonds;

(*f*) Investments in Mutual Funds;

(*g*) Investments in partnership firms

(*h*) Other non-current investments (specify nature)

(*ii*) Investments carried at other than at cost should be separately stated specifying the

basis for valuation thereof.

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments

L. Long-term Loans and Advances

(i) Long-term loans and advances shall be classified as:

(a) Capital Advances;

(b) Security Deposits;

(c) Loans and advances to related parties (giving details thereof);

(d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good ;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other Non-current Assets

Other non-current assets shall be classified as:

(i) Long Term Trade Receivables

(ii) Others (specify nature)

(iii) Long term Trade Receivables, shall be sub-classified as:

- (A) Secured, considered good ;
- (B) Unsecured considered good;
- (C) Doubtful
  - (a) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
  - (b) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

(i) Current investments shall be classified as:

- (a) Investments in Equity Instruments;
- (b) Investment in Preference Shares
- (c) Investments in government or trust securities;
- (d) Investments in debentures or bonds;
- (e) Investments in Mutual Funds;
- (f) Investments in partnership firms

(g) Other investments (specify nature).

(ii) In respect of investments, The following disclosures are also required:

- (a) The basis of valuation of individual investments
- (b) Aggregate amount of quoted investments and market value thereof;
- (c) Aggregate amount of unquoted investments;
- (d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

- (a) Raw materials;
- (b) Work-in-progress;
- (c) Finished goods;
- (d) Stock-in-trade (in respect of goods acquired for trading) ;
- (e) Stores and spares;
- (f) Loose tools;
- (g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories. Mode of valuation shall be stated.

P. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

(a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and Cash Equivalents

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature).

(ii) Bank deposits with more than 12 months maturity shall be disclosed separately.

R. Short-Term Loans and Advances

(i) Short-term loans and advances shall be classified as:

(a) Loans and advances to related parties (giving details thereof);

(b) Others (specify nature).

(ii) The above shall also be sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other Current Assets (Specify Nature)

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent Liabilities and Commitments (to the extent not provided for)

(i) Contingent liabilities shall be classified as:

(a) Claims against the company not acknowledged as debt;

(b) Guarantees;

(c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:

(a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

(b) Uncalled liability on shares and other investments partly paid;

(c) Other commitments (specify nature).

10.4 MAIN DIFFERENCES BETWEEN FINANCIAL STATEMENTS AS PER SCHEDULE VI AND FINANCIAL STATEMENTS AS PER REVISED SCHEDULE III

(a) The revised schedule gives prominence to Accounting Standards (AS) i.e. in case of any conflict in the treatment of any item or its disclosure between the AS and the Schedule, AS shall prevail.

(b) The name of 'Profit and Loss Account' as contained in the Old Schedule VI, has been changed to "Statement of Profit and Loss".

(c) There was no format of Profit and loss in the Old Schedule VI, the Revised Schedule lays down a format for the presentation of Statement of Profit and Loss.

(d) The format of Statement of Profit and Loss does not mention any appropriation item on its face. It prescribes appropriations to be presented under "Reserves and Surplus" in the Balance Sheet.

(e) In Schedule VI, the detailed information in respect of items of profit and loss account and balance sheet were given in 'Schedules'. The Schedule III has eliminated the concept of 'Schedule' and such information is now to be furnished in the notes to accounts.

(f) The revised schedule has prescribed a vertical format for presentation of financial statements, therefore, no option to prepare the financial statement in horizontal format.

(g) The revised schedule has classified all assets and liabilities into current and non-current and presented separately on the face of the Balance Sheet.

(h) Number of shares held by each shareholder holding more than 5% shares now needs to be disclosed.

(i) Details pertaining to aggregate number and class of shares allotted for consideration other than cash, bonus shares and shares bought back will need to be disclosed only for a period of five years immediately preceding the Balance Sheet date.

(j) Any debit balance in the Statement of Profit and Loss will be disclosed under the head "Reserves and surplus." Earlier, any debit balance in Profit and Loss Account carried forward after deduction from uncommitted reserves was required to be shown as the last item on the asset side of the Balance Sheet.

(k) Specific disclosures are prescribed for Share Application money. The application money not exceeding the capital offered for issuance and to the extent not refundable will be shown separately on the face of the Balance Sheet. The amount in excess of subscription or if the

requirements of minimum subscription are not met will be shown under “Other current liabilities.”

(l) The term “sundry debtors” has been replaced with the term “trade receivables.” ‘Trade receivables’ are defined as dues arising only from goods sold or services rendered in the normal course of business. Hence, amounts due on account of other contractual obligations can no longer be included in the trade receivables.

(m) The Old Schedule VI required separate presentation of debtors outstanding for a period exceeding six months based on date on which the bill/invoice was raised whereas, the Revised Schedule III requires separate disclosure of “trade receivables outstanding for a period exceeding six months from the date the bill/invoice is due for payment.”

(n) Tangible assets under lease are required to be separately specified under each class of asset.

(o) In the Old Schedule VI, details of only capital commitments were required to be disclosed. Under the Revised Schedule III, other commitments also need to be disclosed.

10.5 SUMMARY

Financial statements are the basic and formal annual reports through which the corporate management communicates financial information to its owners and various other external parties such as stock exchanges, investors, tax authorities, government, employees etc. These normally refer to: (a) the balance sheet (position statement) as at the end of accounting period, and (b) the statement of profit and loss of a company. Now-a-days, the cash flow statement is also taken as an integral component of the financial statements of a company.

Section 129 of Companies Act, 2013 makes it compulsory for a joint stock company to prepare its **Statement of Profit and Loss as per part II of Schedule III and and Balance Sheet as per Part I of Schedule III .** In case the company has not been carrying on business for profit, an **Income and Expenditure Account** shall be laid before the company at its annual general meeting. The companies are required to prepare their financial statements for the “financial year”. **Section 2(41) of the Companies Act, 2013** defines **“financial year”,** in relation to any company as the period starting on Ist April of and ending on 31st March of the following year.

10.6 SUGGESTED READINGS

- R. L. Gupta and Radhaswamy, Advanced Accountancy, Volume II, Sultan Chand and Sons, New Delhi.
- Maheshwari and Maheshwari, Advanced Accountancy, Volume II, Vikas Publishing House, New Delhi
- Shukla, Grewal and Gupta, Advanced Accounts, Volume II, S Chand and Company, New Delhi
- Tulsian, P.C., Corporate Accounting, Tata McGraw Hill Education Pvt. Ltd., New Delhi

10.7 ANSWER THE FOLLOWING QUESTIONS

1. DRAW UP A PROFORMA OF BALANCE SHEET AS PER REQUIREMENTS OF sCHEDULE III OF THE cOMPANIES ACT, 2013.

2. Give a brief description of statutory contents of assets side of a company's Balance Sheet?
3. Prepare in a summarised form, the Balance Sheet of a company as per Companies Act, 2013 taking imaginary figures.
4. Draw up the performa of 'Statement of Profit and Loss' of accompany as per Schedule III of Companies Act, 2013.

LESSON 11

LESSON-3 FINAL ACCOUNTS OF COMPANIES-II

STRUCTURE

11.0 OBJECTIVES

After reading this lesson, you should be able to:

- ✓ Understand the accounting treatment of special items in financial statements of accompany
- ✓ Learn to prepare the Statement of Profit and Loss as per schedule III
- ✓ Learn to prepare the Balance Sheet of companies as per Schedule III

11.1 TREATMENT OF SPECIAL ITEMS WHILE PREPARING FINAL ACCOUNTS

Although, the general principles for preparing the final accounts of a company are the same as partnership firms and the sole proprietorship concerns, some special points relating to the items particular to a company are worth noting. These special points are :

1. **Calls in Arrear:** Calls in arrears, which appears in the trial balance, represents the amount not paid by the shareholders when the call is made on them by the company. This is shown in the balance sheet on the liability side by deducting the amount from called up capital under the heading **"share capital"**.
2. **Calls-in-Advance:** If Articles of the company permits, a company may accept calls-in-advance. That is, the shareholders may pay the amount on instalments not yet called by the company. Calls-in-advance is a debt on the company and hence must be shown on the liability side of the balance sheet. But the prescribed form of the balance sheet does not contain this item. In the light of the nature of calls-in-advance, it is suggested that it ought to be treated as a current liability and hence shown as **"Other Current Liabilities"** under the heading **Current Liabilities.**

3. **Share Forfeited Account:** Share forfeited account represents amount forfeited from the shareholders on their default to pay the calls. This account appears on the credit side of trial balance and is shown on the liability side of the balance sheet by adding to the paid-up-capital under the heading **"Share Capital"**.

4. **Securities Premium Account :** This account is shown on the liability side of the balance sheet under the heading "Reserves & surplus".

5. **Interest on Debentures:** Interest on debenture account appears on the debit side of trial balance and is treated as a charge against the profit. Hence this account is shown on **"Statement of Profit & Loss"** under the head **"Finance Cost"**

6. **Preference Dividend :** Preference dividend is paid to preference shareholders at a fixed rate in preference to payment of dividend to equity shareholders. If preference dividend account appears in the trial balance, then it is shown as an appropriation from Profit & Loss Balance under the heading "**Reserves and Surplus"** in the Balance Sheet. However, if this account is given under adjustments then it will be firstly shown as appropriation from Profit and Loss under the heading **"Reserves and Surplus"** and secondly shown as **"Short Term Provisions"** under the heading **"Current Liabilities".**

7. **Equity Dividend:** Dividend paid to equity shareholders after the payment of preference dividend is known as equity dividend. Equity dividend is of following two types :

   (a) Interim Dividend: Interim dividend represents dividend paid by the company between two annual general meetings in anticipation of profit. This account always appears in the trial balance. This is an appropriation of profit and hence is shown as an appropriation from Profit & Loss Balance under the heading "**Reserves and Surplus"** in the Balance Sheet".

   (b) Final Dividend: Final dividend is dividend declared by the company after finalisation of accounts. It will be firstly shown as appropriation from Profit and Loss under the heading **"Reserves and Surplus"** and secondly will be shown as **"Short Term Provisions"** under the heading **"Current Liabilities".**

8. **Corporate Dividend Tax :** When a domestic company declares, distributes or pays dividends (interim or final), it also has to pay tax on such dividend which is known as corporate dividend tax. Rate of corporate dividend tax keeps on varying from year to year. Presently it is 16.995% of dividends distributed by the company. This rate includes surcharge and education cess.

   The treatment of corporate dividend tax in financial statements of a company is two-fold. Firstly, it is shown as appropriation from Profit and Loss under the heading **"Reserves and Surplus"** and secondly is shown as **"Short Term Provisions"** under the heading **"Current Liabilities".**

9. **Unclaimed Dividend:** Unclaimed dividend represents dividend not collected by the shareholders. This account is shown as **"Other Current Liabilities"** under the heading **"Current liabilities"**.

10. **Miscellaneous expenditure :** Schedule III is silent on treatment of Miscellaneous Expenditure like **preliminary expenses, discount on issue of shares or debentures, underwriting commission and brokerage on issue** of shares and debentures. It is prudent to write off

some amount from these accounts every year. The amount written off is shown on the **"Statement of Profit & Loss"** under the heading "**other expenses"** and the unwritten off portion appears in the balance sheet under the heading **"Other Non Current Assets/Other Current Assets"** depending on whether the amount will be amortized in the next 12 months or thereafter.

11. **Provision for Taxation:** According to Income Tax Act, 1961, a company is liable to pay tax on profits following the year in which such profits are earned. Since, the taxable profits are not the same as accounting profits, hence it is not possible to determine the actual amount of tax payable at the time the final accounts are prepared. As such, the liability for tax is estimated and provided for while preparing the final accounts. It is firstly shown under the heading **"Tax Expense"** in **Statement of Profit and Loss** and secondly shown as **"Short Term Provisions"** under the heading **"Current Liabilities"** in the Balance Sheet.

11.3 Numerical problems to prepare Balance Sheet as per Schedule III of Companies Act, 2013

Illustration 1

How will you treat the following items while preparing Statement of Profit and Loss as per Revised Schedule III of Companies Act, 2013

(i) Excise Duty
(ii) Staff Welfare Expenses
(iii) Interest on Debentures
(iv) Carriage Inwards
(v) Goodwill Written off
(vi) Stock of Finished Goods and Work in Progress

Solution.

	Items	**Treatment**
(*i*)	Excise Duty	It will be shown as deduction from sales while calculating **"Revenue from Operations".**
(*ii*)	Staff Welfare Expenses	It will be shown as an expense under the heading **"Employee Benefits Expense".**
(iii)	Interest on Debentures	It will be shown as an expense under the heading **"Finance Cost"**.
(i*v*)	Carriage Inwards	Added in material cost while calculating "**Cost of Materials Consumed".**
(*v*)	Goodwill Written Off	It will be shown as an expense under the **heading "Depreciation and Amortization Expense"**.
(*vi*)	Stock of Finished Goods and Work in Progress	It will be shown under the heading **"Changes in Inventories of Finished Goods, Work in Progress and Stock in Trade"** as follows. Balance of Stock at the end: Work in Progress x x x Finished Goods x x x xxxxx Balance of Stock at the beginning: Work in Progress x x x Finished Goods x x x x x x

		Changes in Inventories	x x x

Illustration 2

The following is the Trial Balance of Sat Kartar Ltd. as on 31st March, 2014. You are required to prepare a Statement of Profit and Loss for the year ending 31st March 2014

		`		`
Land & Buildings		1,25,000	Authorized Capital : 20,000 Equiity	
Plant and Machinery		30,000	shares of ` 10 each	
Goodwill		17,000	(12,000 Equity shares issued and paid-up)	1,20,000
Stock on 1-4-2013 :			General Reserve	25,000
Raw Materials	20,000		8 % Debentures	30,000
Stock in Process	10,000		Sales	1,81,300
Finished Goods	16,000	46,000	Creditors	1,01,490
Purchases of Raw Materials		87,000	Profit & Loss A/c balance on 1-4-2013	27,630
Discounts		1,000		
Manufacturing Wages		42,000		
Salaries		8,000		
Plant Repairs		2,500		
General Charges		1,500		
Directors Fees		1,200		
Debenture Interest (upto 30-9-2013)		1,200		
Cash at Bank		64,000		
Debtors		53,000		
Bad Debts		1,020		
Interim Dividend paid		5,000		
		4,85,42		4,85,420

0	

Additional Information

(i) Depreciate Plant and Machinery by 10%.

(ii) Create Reserve for Doubtful Debts @ $2\frac{1}{2}\%$.

(iii) Closing Stock: Raw materials ` 15,000; Stock in process ` 9,000; Finished Goods ` 14,380.

Solution :

STATEMENT OF PROFIT AND LOSS
FOR THE YEAR ENDED 31 MARCH, 2014

PARTICULARS	Note No.	Amount `
INCOME		
Revenue from Operations (Gross)	1	1,81,300
Less : Excise Duty		NIL
Revenue from Operations (Net)		1,81,300
Other Income		----
Total Revenue		1,81,300
EXPENSES		
Cost of Materials Consumed	2	92,000
Change in Inventories of Finished Goods, Work-in Progress and Stock-in-trade	3	2,620*
Employee Benefits Expenses	4	50,000
Finance Costs	5	2,400
Depreciation and Amortization Expenses	6	3,000
Other Expenses	7	8,545
Total Expenses		1,58,565
Profit of the year		22,735

Notes on Statement of Profit & Loss :

	`
1. Revenue from Operations	
Sales	1,81,300

2.	**Cost of Materials Consumed**		
	Opening Stock of Raw Material		20,000
	Add : Purchases of Raw Material		87,000
			1,07,000
	Less : Closing Stock of Raw Material		15,000
			92,000
3.	**Changes in Inventories of Finished Goods and Work in Progress**		
	Inventories at the close :		
	Finished Goods		14,380
	Stock in Process		9,000
			23,380
	Inventories at the beginning :		
	Finished Goods	16,000	
	Stock in Process	10,000	26,000
			2,620
4.	**Employee Benefits Expenses**		
	Manufacturing Wages		42,000
	Salaries		8,000
			50,000
5.	**Finance Costs**		
	Interest on Debentures		1,200
	Add : Outstanding for 6 months		1,200
			2,400
6.	**Depreciation and Amortization Expenses**		
	Depreciation on plant and Machinery		3,000
7.	**Other Expenses**		
	Discount		1,000
	Plant Repairs		2,500
	General Charges		1,500
	Director Fees		1,200
	Provision for Bad Debts :		
	New Provision	1,325	
	(2.5% of 53,000)		
	Add : bad Debts	1,020	2,345
			8,545

***Students should note that if closing balance of stock in trade and work in process is higher than opening balance, then it will appear as negative balance.**

Illustration 3

Under which main heading and sub-heading of Equity and Liabilities will you classify the following items in a Company's Balance Sheet as per Schedule III :

(*i*) Debentures, (*ii*) Public Deposits (*iii*) Securities Premium Reserve (*iv*) Capital Reserve (*v*) Forfeited Shares Account (*vi*) Interest Accrued and due on Debentures (*vii*) Acceptances (Bills Payable), (viii) Advances Received from Customers (*ix*) Sundry Creditors, (*x*) Unclaimed Dividend (*xi*) Calls in Arrears (*xii*) Calls in Advance (*xiii*) Arrears of Fixed Cummulative Preference Dividends.

Solution.

S No.	ITEM	Main Heading	Sub-heading
(*i*)	Debentures	Non-Current Liabilities	Long-term Borrowings
(*ii*)	Public Deposits	Non-Current Liabilities	Long-term Borrowings
(*iii*)	Securities Premium Reserve	Shareholders' Funds	Reserves and Surplus
(*iv*)	Capital Reserve	Shareholders' Funds	Reserves and Surplus
(*v*)	Forfeited Shares Account	Shareholders' Funds	Addition to Subscribed & Paid-up Capital)
(*vi*)	Interest Accrued and due on Debentures	Current Liabilities	Other Current Liabilities
(*vii*)	Acceptances (B/P)	Current Liabilities	Trade Payables
(*viii*)	Advances Received from Customers	Current Liabilities	Other Current Liabilities
(*ix*)	Sundry Creditors	Current Liabilities	Trade Payables
(*x*)	Unclaimed Dividend	Current Liabilities	Other Current Liabilities
(*xi*)	Calls-in-Arrear	Shareholders Funds	Deduction from Subscribed Capital
(*xii*)	Calls-in-Advances	Current Liabilities	Other Current Liabilities
(*xiii*)	Arrears of Fixed Cumulative Preference Dividends	Contingent liability as a footnote by way of a	–

Illustration 4

How will you treat the following items while preparing balance sheet of a company ?

(i) Advances from Customers
(ii) Proposed Dividend
(iii) Corporate Dividend Tax
(iv) Unclaimed Dividend
(v) Security Deposits
(vi) Creditors for goods and services

(vii) Trade Investments
(viii) Loan to Employees
(ix) Fixed Deposits with Banks
(x) Provision for Tax
(xi) Interest due on Debentures
(xii) Advance to Sundry Creditors
(xiii) Interest Receivable on Fixed Deposits with Banks
(xiv) Interest accrued but not due

Solution.

	Items	Treatment in Balance Sheet
(i)	Advances from Customers	**"Other Current Liabilities"** under the heading **"Current Liabilities".**
(ii)	Proposed Dividend	Shown as appropriation from Profit and Loss under the heading **"Reserves and Surplus"** and secondly shown as **"Short Term Provisions"** under the heading **"Current Liabilities".**
(iii)	Corporate Dividend Tax	Shown as appropriation from Profit and Loss under the heading **"Reserves and Surplus"** and secondly shown as **"Short Term Provisions"** under the heading **"Current Liabilities".**
(iv)	Unclaimed Dividend	**"Other Current Liabilities"** under the heading **"Current Liabilities".**
(v)	Security Deposits	**"Long Term Loans and Advances"** under the heading **"Non-Current Assets".**
(vi)	Creditors for goods and services	**"Trade Payables"** under the heading **"Current Liabilities".**
(vii)	Trade Investments	**"Non Current Investments"** under the heading **"Non-Current Assets".**
(viii)	Loan to Employees	**"Long Term Loans and Advances"** under the heading **"Non Current Assets".**
(ix)	Fixed Deposits with Banks	**"Cash and Cash Equivalent"** under the heading **"Current Assets".**
(x)	Provision for Tax	**"Short Term Provision"** under the heading **"Current Liabilities".**
(xi)	Interest due on Debentures	**"Other Current Liabilities"** under the heading **"Current Liabilities".**
(xii)	Advance to Sundry Creditors	**"Short Term Loans and Advances"** under the heading **"Current Assets".**
(xiii)	Interest Receivable on Fixed Deposits with Banks	**"Other Current Assets"** under the heading **"Current Assets".**
(xiv)	Interest accrued but not due	**"Other Current Liabilities"** under the heading **"Current Liabilities".**

Illustration 5

From the following information, prepare the Balance sheet of B Limited in the prescribed form per Schedule III Part I as on March 31, 2014.

	`		`
Land	2,00,000	Underwriting commission	15,000
Cost of Building	4,00,000	Brokerage on issue of shares	8,000
Plant and Machinery	3,00,000	Cash-in-hand	15,000
Additions to Plant & Machinery	1,00,000	Cash at Bank	20,000
Investment in Govt. Securities	3,00,000	12% Debentures	4,68,000
Investment in Shares of the Company	1,50,000	Deposits from the public	3,00,000
Stock in Trade	40,000	Creditors for goods	40,000
Debtors Outstanding for more than		Creditors for expenses	10,000
6 months	20,000	Unpaid Dividend	2,000
Other Debts	60,000	Employees Provident Fund	20,000
Preliminary Expenses	13,000	Arrears of Preference Share Dividend	18,000
		Capital Reserve	10,000
		General Reserve	40,000
		Profit and Loss (Credit)	50,000
		Securities Premium	94,000

Authorized capital 10,000 equity shares of ` 100 each and 1,000, 12% Preference shares of ` 100 each. All the shares were issued. Out of these 4,500 equity shares were subscribed and paid-up except ` 1,000 as calls in arrears. Forfeited shares account shows a balance of ` 6,000. All the 1,000 Preference shares were fully paid up, ` 100 per share.

Additional information-Depreciate building by 5%, Depreciation on Plant and Machinery ` 30,000, provision for bad-debts @ $2\frac{1}{2}$%.

Solution:

Balance Sheet of B Ltd.
As at 31st March, 2014

	Particulars	Note No.	Amount `'000
A	***Equity and liabilities***		
1.	***SHAREHOLDERS' FUNDS***		
	(A) SHARE CAPITAL	1	555

	(b) Reserves and Surplus	2	194
2.	***NON-CURRENT LIABILITIES***		
	(a) Long-term Borrowings	3	768
	(b) Long-term Provisions	4	20
3.	**Current Liabilities**		
	(a) Trade Payables	5	40
	(b) Other Current Liabilities	6	12
	TOTAL		1,589
B	*Assets*		
1.	**Non-current Assets**		
	(a) Fixed Assets		
	(i) Tangible Assets	7	950
	(b) Non-current Investments	8	450
	© Other Non-current Assets	9	36
2.	**Current Assets**		
	(a) Inventories	10	40
	(b) Trade Receivables	11	78
	© Cash and Cash Equivalents	12	35
	TOTAL		1,589

Contingent Liabilities

Arrears of Preference Dividend	18,000

Notes on Balance Sheet :

		`'000
1.	**Share Capital**	
	10,000 Equity Shares of ` 100 each	1,000
	1,000, 12% Preference Shares of ` 100 each	100
		1,100
	Issued, Subscribed and Paid-up Capital	
	4,500 Equity Shares of ` 100 each	450
	Less : Calls in Arrears	1
		449

	Add : Share Forfeited		6
			455
	1,000, 12% Preference Shares of ` 100 each		100
			555
2.	**Reserves and Surpluses**		
	Capital Reserve		10
	General Reserve		40
	Securities Premium		94
	Profit and Loss Account		50
			194
3.	**Long Term Borrowings**		
	Secured :		
	12 % Debentures		468
	Unsecured :		
	Deposits from Public		300
			768
4.	**Long Term Provisions**		
	Provision for Employees Benefits (Provident Fund)		20
5.	**Trade Payable**		
	Creditors for Goods		40
6.	**Other Current Liabilities**		
	Creditors for Expenses		10
	Unpaid Dividend		2
			12
7.	**Tangible Assets**		
	Land		200
	Building	400	
	Less : Dep.	20	380
	Plant and Machinery	300	
	Add : Additions during the year	100	
		400	
	Less : Depreciation	30	370
			950

8.	**Non-current Investments**	
	Investment in Govt. Securities	300
	Investment in Shares of the company	150
		450
9.	**Other Non-Current Assets**	
	Preliminary Expenses	13
	Underwriting Commission	15
	Brokerage on issue of Shares	8
		36
10.	**Inventories**	
	Stock in trade	40
11.	**Trade Receivables**	
	Debtors :	
	Outstanding for more than 6 months	20
	Other Debts	60
		80
	Less : Provision for bad debts	2
		78
12.	**Cash and Cash Equivalents**	
	Cash in hand	15
	Cash at bank	20
		35

Illustration 6

The following is the Trial Balance of ABC Limited as on 31-3-2004. Prepare Final Accounts for the year ended 31-3-2004.

Trial balance

	`	`
Equity Share Capital		2,80,000
6% Debentures		75,000

Leasehold Premises	1,75,000	
Salaries	28,350	
Carriage Inwards	4,650	
Insurance	780	
Motor Lorry	16,500	
Bad Debts Reserves		2,100
Sales		6,36,850
Bills Payable		23,000
Discount		4,255
Sundry Creditors		30,180
Profit and Loss		1,980
Postage	3,165	
Machinery	1,20,000	
Rent	2,850	
Purchases	2,69,100	
Directors Fees	4,695	
Office Expenses	5,085	
Bad Debts	915	
Furniture	4,380	
Goodwill	45,000	
Opening Stock	2,52,500	
Wages	28,450	
Interest on Debentures	2,250	
Cash at Bank	61,195	
Debtors	28,500	
	10,53,365	10,53,365

Adjustments :

(a) Provide interest on debentures for half year.

(b) Write off further bad debts ` 500 and maintain bad debts reserve @ 5% on debtors.

(c) Unexpired insurance amounted to ` 500.

(d) Depreciate leasehold by 5%, machinery by 10% and motor lorry by 20%.

(e) Out of profits, transfer ` 25,000 to reserve fund and a dividend of 15% to be declared on equity share capital.

(*f*) The closing stock is valued at ` 55,905.

Sol.

STATEMENT OF PROFIT AND LOSS

FOR THE YEAR ENDING 31ST MARCH, 2004

	Note No.	`
(I) Revenue from Operations (Sales)		6,36,850
(II) Other Incomes (Discount)		4,255
(III) Total Revenue (I + II)		6,41,105
(IV) Expenses :		
Cost of Materials Consumed	1	4,65,695
Employees Benefit Expenses	2	56,800
Finance Expenses :	3	4,500
Depreciation and Amortisation Expenses	4	24,050
Other Expenses	5	21,440
		5,72,485
(v) Profit before tax the year (III-IV)		68,620

Balance Sheet of ABC Ltd.

As on 31st March 2004

PARTICULARS	Note No.	`
EQUITY AND LIABILITIES		
1. Shareholder's Fund		
(*a*) Share Capital	6	2,80,000
(*b*) Reserve and Surplus	7	28,600
2. Non-Current Liabilities		
(*a*) Long Term Borrowings	8	75,000
3. Current Liabilities :		
Trade Payable	9	53,180
Short Term Provisions	10	42,000
Other Current Liabilities	11	2,250

	Total		4,81,030
Assets			
1. Non-Current Assets			
(*a*) Fixed Assets :			
Tangible Assets		12	2,91,830
Intangible Assets		13	45,000
2. Current Assets			
(*a*) Inventories		14	55,905
(*b*) Trade Receivable		15	26,600
(*c*) Cash and Cash Equivalents		16	61,195
(*d*) Short term loans and Advances		17	500
	Total		4,81,030

ACCOMPANYING NOTES TO FINAL ACCOUNT

1.	**Cost of Materials Consumed :**	`
	Opening Stock	2,52,500
	Add : Purchases	2,69,100
		5,21,600
	Less : Closing Stock	55,905
		4,65,695
2.	**Employees Benefit Expenses :**	
	Wages	28,450
	Salaries	28,350
		56,800
3.	**Finance Expenses**	
	Interest on Debentures	2,250
	Add : Outstanding Interest	2,250
		4,500
4.	**Depreciation and Amortisation Expenses :**	
	Depreciation on Leasehold Premises	8,750
	Depreciation on Machinery	12,000
	Depreciation on Motor Lorry	3,300
		24,050
5.	**Other Expenses**	
	Director Fees	4,695

Carriage Inward				4,650
Insurance		780		
(–) Prepaid		500		280
Rent				2,850
Office Expenses				5,085
Provision for Bad Debts :				
New provision for Bad Debt		1400		
Add : Bad debts (915 + 500)		1415		
		2,815		
Less : Existing provision for bad debts		2,100		715
Postage				3,165
				21,440
6. Share Capital :				
Equity Share Capital				2,28,000
				2,28,000
7. Reserves and Surplus				
Reserve Fund				25,000
Profit and Loss Account :				
Balance as on 1st April 2003		1,980		
Add : Profit for the year		68,620		
			70,600	
Less : Transfer to Reserve Fund	25,000			
Proposed Dividend	42,000	67,000		3,600
				28,600
8. Long Term Borrowings				
6% Debentures				75,000
				75,000
9. Trade Payables				
Bills Payable				23,000
Sundry Creditors				30,180
				53,180
10. Short Term Provisions				

Proposed Dividend	42,000
	42,000
11. Other Current Liabilities	
Outstanding Interest on Debentures	2,250
	2,250
12. Fixed Assets-Tangible Assets	
Furniture	4,380
Leasehold Premises (1,75,000 – 8,750)	1,66,250
Motor Lorry (16,500 – 3,300)	13,200
Machinery (1,20,000 – 12,000)	1,08,000
	2,91,830
13. Intangible Assets	
Goodwill	45,000
14. Inventories	
Closing Stock	55,905
15. Trade Receivable	
Debtors	28,500
Less : Further Bad Debts	500
	28,000
Less : New Provision for doubtful debts	1,400
	26,600
16. Cash and Cash equivalents	
Cash at Bank	61,195
17. Short Term Loans and Advances	
Prepaid Insurance	500