GOVERNMENT ARTS AND SCIENCE COLLEGE

NAGERCOIL

DEPARTMENT OF COMMERCE

III B.Com

CORPORATE ACCOUNTING

SMCO51

Dr.ANGELINE SHEBA ALBERT

III B. COM (V SEMESTER) – UNDER CBCS
PART III – MAJOR CORE -13
CORPORATE ACCOUNTING I

Objectives

1. To study the issue, allotment and forfeiture of shares of companies.
2. To prepare final accounts according to Companies Act, 2013.
3. To know how to value the goodwill and shares.

Unit I: Issue of shares- Issue at par, Premium and discount- Forfeiture and Re-issue of shares – Pro rata allotment- Redemption of preference shares. Issue of debentures (Excluding reduction of debentures).

Unit II: Final Accounts of Companies-as per Schedule II of Companies Act 2013 – excluding managerial remuneration.

Unit III: Amalgamation, Absorption and External Reconstruction - Methods of Purchase consideration. (Simple Problems only)

Unit IV: Profit Prior to Incorporation- Under Writing of shares or debentures.

Unit V: Valuation of Goodwill and Shares- Various methods of valuation of goodwill and shares.

Text Books

1. S.P.Jain & K.L.Narang, Advanced Accountancy, Kalyani Publishers, New Delhi.
2. T.S.Reddy & A.Murthy,Corporate Accounting, Margham Publications, Chennai.

Reference Books

1. R.L.Gupta and M.Radhaswamy, Advanced Accountancy, Sultan Chand &Sons, New Delhi.
2. M.C.Shukla and T.S.Grewal, Advanced Accountancy, Sultan Chand &Co., New Delhi.
3. Dr.M.A.Arulanandam&K.S.Raman, Advanced Accountancy, Himalaya Publishing House, Mumbai.
4. P.C.Tulsian, Corporate Accounting, Tata McGraw Hill Companies.

1.1 ACCOUNTING FOR SHARE CAPITAL

A company organisation grew out of the limitations and drawbacks of earlier forms of organisations – Individual proprietorship, Partnership, etc. A company represents the third state in the evolution of business organisations. The increased need of modern industry and commerce could not be fulfilled by the earlier organisations. Thus most of the large scale industries or business establishments are organised as Joint Stock Company.

DEFINITION

A company is a voluntary and autonomous association of certain persons with capital divided in to numerous transferable shares formed to carry out a particular purpose in common. It is created by following a process of law. It is an artificial person; it is invisible and intangible. According to Section 3(1) (i) of the companies Act 1956 defines a company as "company formed and registered under this act or an existing company".

CHARACTERISTICS OF A COMPANY

a. **Separate legal entity –** It is a distinct legal person existing independent of its members.
b. **Limited Liability –** Liability of the members is limited to the extent of the face value of shares held by them.
c. **Separation of ownership and management –** Though a company is an artificial person yet it acts through human beings who are called directors of the company. There is a divorce between ownership and management.
d. **Capital Contribution –** Capital is contributed by persons called shareholders in the name of shares and the share capital can be increased or reduced only in accordance with the provisions of the Indian Companies Act.
e. **Distribution of Profit –** Profit is distributed according to the provisions of the articles by the directors.
f. **Transferability of shares –** The shares of a company are freely transferrable except in case of a private limited company. Transferability of shares has given perpetual succession to a company.
g. **Common seal –** A company being artificial personality, it acts through natural persons, called directors and its distinct existence is evidenced by a common seal.

KINDS OF COMPANIES

ON THE BASIS OF INCORPORATION

a. **Chartered company**- Companies which are incorporated under a special charter by Royal Charter which lays down objectives, rights, duties etc. Of the companies are known as Chartered companies. For example, East India Company
b. **Statutory company** - Companies which are brought into existence and governed by special Acts of the legislature are known as statutory companies. For example, RBI, LIC, UTI etc.
c. **Registered company** - Companies which are formed and registered under the Companies Act 1956 or registered under the previous companies Act.

ON THE BASIS OF LIABILITY

a. **Limited company**- A company in which the liability of each member is limited to the extent of face value of shares held by him such company is called companies limited by shares.
b. **Guarantee company**- Where the liability of the members of a company is limited by Memorandum to a fixed amount which the members undertake to contribute to the assets of the company in case of its winding up, the company is called Guarantee Company.
c. **Unlimited company**- Unlimited companies are companies not having any limit on the liability of its members. In the event of winding up, the members are liable to the full extent of their fortunes to meet the obligations of the company.

ON THE BAIS OF PUBLIC INVESTMENT

a. **Private company**- A private company means a company which by its articles a) Restricts the transfer of its shares b) Number of members to two hundred c) Prohibits any invitation to the public for any shares d) Prohibits acceptance of deposits from the persons.
b. **Public company**- Public companies are those companies which are not private companies. All the above four restrictions are not imposed on such companies.

COMPANIES DEEMED TO BE PUBLIC

A private company will be deemed to be a public company in the circumstances given below:-

1. If 25% or more of its paid-up capital is held by one or more bodies corporate, or
2. If it holds 25% of the paid up capital of a public company, or
3. If its average annual turnover is not less than rupees ten crores subject to change in ceiling, or
4. If it invites deposits from the public or renews deposits from the public other than its members, directors or their relatives.

SHARE CAPITAL OF THE COMPANY

Capital is essential for a trading concern. A company collects capital by inviting the public to buy its shares through a document known as prospectus. The capital is usually divided into different units with definite value called shares. Section 2(46) of the companies act defines a share as "a share in the share capital of the company and includes stock except where a distinction between stock and share is expressed or implied". A share is not a sum of money but is an interest measured by a sum of money, and made up of various rights contained in the contract. A share is a fractional part of the share capital which forms the basis of ownership in a company.

Share capital refers to the amount of capital raised or to be raised by a company by the issue of shares. The main divisions of share capital are as follows:-

1. **Authorised capital** - The amount of capital with which the company intends to be registered is called Nominal or Registered or Authorised capital. It is the maximum amount which the company is authorised to raise by way of public subscription.
2. **Issued capital** – The part of the authorised capital which is offered to the public for subscription is called issued capital.
3. **Subscribed capital –** It is that part of the issued share capital which is actually taken up by the public. If the whole issued share capital is not subscribed for by the public, the balance of the issued share capital is called unsubscribed share capital.
4. **Called up capital –** It is that portion of the subscribed capital which has been called up by the company. The difference between subscribed capital and called up capital is known as uncalled capital
5. **Paid up capital –** It represents the amount received against the calls made on the shares. The unpaid balance of the called up capital is known as calls in arrears.
6. **Reserve capital –** Under Sec 99, Reserve capital is the amount of uncalled capital which the company has, by special resolution, decided not to call up except in the event of winding up of the company; reserve capital is available only to the creditors at the time of winding up of the company. Whereas Capital reserve is the capital profit earned by the business, not by the normal trading concerns. Capital reserve cannot be distributed as dividend to share holders. Eg. Share premium, profit prior to incorporation, forfeited shares a/c.etc.

TYPES OF SHARES

The shares which can be issued by a company are of two types - Preference shares and Equity shares.

1. PREFERNCE SHARES

The preference shares are those which have some preferential rights over the other types of shares. A share to be preference share must have two preferential rights:

a. They have a preferential right to be paid dividend during the life time of the company.
b. They have a preferential right to the return of capital when the Company goes in to liquidation.

The preference shares are of the following types:-

1. **Cumulative and Non - cumulative Preference shares –** Cumulative preference shares are those its dividend accumulated until it is paid off. The arrears of one year are carried forward to next year. If dividend not to accumulate and carried forward to next year are called non-cumulative preference shares. Preference shares are always cumulative unless otherwise stated.
2. **Convertible and Non-Convertible Preference shares** - The holders of the shares have a right to get their preference shares converted into equity shares within a certain period is called Convertible preference shares. If the preference shares cannot be converted in to equity shares then it is said to be Non- convertible preference shares.
3. **Participating and Non-participating preference shares** - In addition to the fixed dividend, balance of profit (after meeting equity dividend) shared by some preference shares. Such shares are participating preference shares. The holders of the preference shares are entitled to a fixed dividend and not in the surplus profits; they are called Non-participating preference shares.
4. **Redeemable and Irredeemable preference shares –** If preference shares are returned after a specified period of time to share holders are called redeemable preference shares. If preference shares are not redeemed (it is continue till the winding up) known as irredeemable preference shares.

2. EQUITY SHARES

Equity shares, with reference to any company limited by shares, are those which are not preference shares [(Sec. 85(2)]. Equity shares are also known as Ordinary shares. Equity share holders will get dividend and repayment of capital after meeting the claims of preference share holders. There will be no fixed rate of dividend to be paid to the equity shareholders and its rate may vary from year to year. The rate of dividend is determined by the directors of the company.

SWEAT EQUITY SHARE

Sweat equity share means the equity shares issued by a company at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights.

STOCK

As per Section 94(1) (c) of the Companies Act, 1956, when all the shares of a company have been fully paid up, they may be converted in to stock if so authorised by the articles of association. It is another type of unit of share capital of a company. Share capital of a company cannot be offered directly in the form of stock. Stock is a consolidation of fully paid shares. It is a set of shares put together in a bundle and stock has no definite value.

Difference between shares and stock

Shares	Stock
Shares may be fully or partly paid up.	For the purpose of conversion into stock, shares must be fully paid up.
It is not possible to transfer fractions of a share.	Stock may be split up into fractional parts and transferred as such.
Shares are distinctively numbered.	Stock bears no such number.
It is originally issued by a company.	Stock cannot be issued originally.
It may be always registered.	It may or may not registered.
Shares are individual units of the capital of a company.	Stocks are aggregate of fully paid up shares.

ISSUE OF SHARES

When a public limited company gets the certificate of incorporation, it issues a prospectus or a statement in lieu of prospectus inviting public to subscribe to the share capital of the company. That is the invitation is made through a document called *prospectus*. The prospectus is simply an invitation to an offer but is not an offer. If one is interested, application, which is prescribed and printed by the company, is filled, signed and sent to the company along with the prescribed application amount. These applications are considered by the Board of directors who take decision as to their acceptance or rejection, within a reasonable time. If the share applications are accepted by the company then shares are allotted and thereby, there arises a contract between the company and the applicant. That is, allotment results in a binding contract between the company and the prospective shareholders. The allotment must be communicated to the person making the application so that it is legally complete. From the accounting point of view, the following may be noted:

1. Every prospectus must mention the number of shares issued i.e. offered to the public.
   The excess applications received over the issued shares are to be rejected;
2. Prospectus must mention *the minimum subscription*. No allotment shall be made unless the amount stated in the prospectus as minimum subscription has been subscribed and the sum payable on application for the amount so stated has been paid in cash and received by the company. The minimum amount of share capital is determined to cover 1) the purchase price of any property purchased or to be purchased, 2) preliminary expenses, 3) money borrowed for the foregoing matters and 4) working. If this minimum capital is not applied for, share cannot be allotted. As per the SEBI's guidelines the minimum application money to be paid shall not be less than 25% of the issue price. Statutory minimum application money as per Section 69(3) of the Companies Act is 5% of the nominal value of shares. Hence, 25% of the issue price cannot be less than 5% of the nominal value of shares.
3. Each application for shares must be accompanied by the prescribed application money. The application money must not be less than *5% of the nominal value of each share*.
4. All application money must be kept intact in a scheduled bank and should not be used unless a certificate of commencement of business from the registrar has been obtained.
5. If the allotment takes place, a *letter of allotment* is sent to the allottees. If no allotment of share is made, *a letter of regret* together with application money is sent to the applicants.
6. The directors make the allotment of shares on the basis of the application. The directors reserve the right to allot less number of shares applied for or to reject an application at their discretion. On allotment, the allottee has to pay a part of the amount of the face value of the shares called allotment money. After the receipt of the allotment money, the company issues *Share Certificate*.
7. The balance due on shares may be called by the company in instalments. Each such instalment is called a *Call* and the amount payable is known as *call money*, between two calls there must be a gap of one month.
8. Share capital Suspense Account – Application money received on shares is transferred to share capital account on allotment of shares. But if the Balance sheet of the company is to be prepared

after receipt of the application money but before allotment of shares, it will not be proper to show the application money as share capital because shares have not yet been allotted. In such a case, the application money received may be shown as share capital suspense account under the head share capital till the shares is allotted.

BOOK BUILDING

Book building is a process of fixing price for an issue of securities on a feedback from potential investors based upon their perception about a company. It involves selling an issue step-wise to investors at an acceptable price with the help of a few intermediaries/merchant bankers who are called book runners. Under book building process, the issue price is not determined in advance, it is determined by the offer of potential investors.

EMPLOYEES STOCK OPTION

Employees stock option means the option given to the whole time directors, officers or employees of a company, which gives such directors , officers, or employees the benefit or right to purchase or subscribe at a future date , the securities offered by the company at a pre-determined price.

ISSUE OF SHARES AT DIFFERENT VALUES

Shares may be issued at a price which is termed as: (i) at par; (ii) at a premium; and (iii) at a discount

(i) At par – if the price required to be paid to the company for the share is equal to the nominal value of that share, it is called issue at par, e.g., a Rs. 10 equity share issued at a price of Rs.10

(ii) At a premium – if the price required to be paid to the company for the share is more than the nominal value of that share, it is called at a premium , e.g., a Rs. 10 equity share issued at a price of Rs.15

(iii) At a discount – if the price required to be paid to the company for the share is less than the nominal value of that share, it is called at a discount, e.g., a Rs.10 equity share issued at a price of Rs.8

Accounting Treatment of Issue of Shares

Specimen Journal Entries

1. On receipt of application money:
   Bank A/c Dr
   To Share Application A/c
2. On transferring of application money to capital account
   Share application A/c Dr
   To Share Capital A/c
3. On allotment money due:
   Share allotment A/c Dr
   To Share capital A/c
4. On receipt of allotment money:
   Bank A/c Dr
   To Share allotment A/c
5. On making first call due:
   Share first call A/c Dr
   To Share capital A/c
6. On receipt of first call money:
   Bank A/c Dr
   To Share first call A/c
7. On making second call due:
   Share second call A/c Dr
   To Share capital A/c
8. On receipt of second call money:
   Bank A/c Dr
   To Share second call A/c

9. On making final call due:
Share final call A/c Dr
To Share capital A/c

10. On receipt of final call money:
Bank A/c Dr
To Share final call A/c

Illustration - 1

The authorised capital of a limited company is Rs. 2,00,000 divided in to 20,000 equity shares of Rs.10 each. Out of these, 15,000 shares have been issued to the public, payable Rs. 2 on application, Rs. 4 on allotment, Rs. 2 on first call and Rs. 2 on second and final call. Pass necessary journal entries and prepare Balance sheet. All amounts have been duly received.

Solution

Journal entries

Bank A/c Dr To Equity Share Application A/c (Receipt of Application money on 15000 shares @ Rs. 2/ share)		30,000	30,000
Equity Share application A/c Dr To Equity Share Capital A/c (Transfer of application money to share capital)		30,000	30,000
Equity Share allotment A/c Dr To Equity Share capital A/c (Allotment money due on 15,000 shares @ Rs.4 per share)		60,000	60,000
Bank A/c Dr To Equity Share allotment A/c (Allotment money received)		60000	60,000
Equity Share first call A/c Dr To Equity Share capital A/c (First call money due on 15,000 shares @ Rs.2 per share)		30,000	30,000
Bank A/c Dr To Equity Share first call A/c (First call money received)		30,000	30,000
Equity Share final call A/c Dr To Equity Share capital A/c (Final call money due on 15,000 shares @ Rs.2 per share)		30,000	30,000
Bank A/c Dr To Share final call A/c (Final call money received)		30,000	30,000

Liabilities		Assets	
Authorised Capital		Cash at Bank	1,50,000
20,000 Equity shares of Rs. 10 each	2,00,000		
Issued, Subscribed, called up and paid up capital	1,50,000		
15,000 Equity shares of Rs. 10	1,50,000		1,50,000

Calls in Arrears

It often happens that some share holders fails to pay the allotment / call money due by them to the company. The total of such unpaid amount is known as calls in arrears. Though it is an outstanding asset, it is not shown on the asset side of the balance sheet; instead it is shown as a deduction from called up capital on the liability side of the balance sheet. Where a company maintains calls in arrears account, the journal entry is as follows:

Calls in Arrears A/c Dr
To Share allotment /Particular Call A/c

On calls in arrears, if there is a provision in the articles of the company, directors may charge interest @ 5% for the period between the day fixed for payment of allotment or call money and the date of actual payment.

Calls in Advance

Some of the shareholders may pay the balance amount on their shares along with allotment money or call money though not demanded by the company. Such amounts received in advance by the company from its shareholders are known as Calls in advance.

Accounting entries

1. When calls in advance is to be credited to calls in advance account –
   Bank A/c Dr
   To Calls in Advance
2. When Call money becomes due, the amount of calls in advance will be adjusted against the amount due
   Calls in Advance A/c Dr
   To Particular Call A/c

A call in advance is a liability to the company. According to the provisions of articles of the company, interest not exceeding 6% per annum is paid to shareholders for the period from the date of receipt of calls in advance up to the date when calls is due for payment.

Issue of shares for purchase of Assets

If the shares have been allotted to any person or firm from whom the company has purchased any asset, the following entry will be passed:

Asset A/c Dr
To Share capital A/c

This fact should also be disclosed in the Balance sheet while showing the issued, subscribed and paid up capital.

Issue of shares to promoters

Promoters are persons firms or companies who promote a company. They are paid remuneration for their services. If the remuneration is paid in the form of shares, the following journal entry will be passed:

Goodwill A/c Dr
To Share capital A/c

Goodwill account is debited and should be shown on the asset side of the Balance sheet.

Under Subscription, Over Subscription and Pro-rata Allotment

The company does not receive application equal to the number of shares offered for subscription, there may be two situations:

(i) Under subscription
(ii) Over subscription

(i) Under Subscription

The issue is said to have been under subscribed when the company receives applications for less number of shares than offered to the public for subscription. In this case company is not to face any problem regarding allotment since every applicant will be allotted all the shares applied for. But the company can proceed with allotment provided the subscription for shares is at least equal to the minimum required number of shares termed as minimum subscription.

(ii) Over Subscription

When shares are issued by well managed and financially strong companies to the public, they often receive more number of application than that they offer through prospectus and intend to allot. This is known as over subscription. In this situation, it becomes necessary to refuse allotment to some applicants. For this the directors make a decision about allotment of shares on a proportionate or an equitable basis to the applicants. It is called pro-rata allotment. In this case no application is fully accepted or fully rejected. Each applicant gets allotment for certain number of shares on the basis of number of shares applied for, number of shares that the company intends to allot and total number of applications received. In case of over subscription, company has the following options:

Option I

(i) Rejection of Excess Applications and Money Returned

The company may reject the applications for shares in excess of the shares offered for issue and a letter of rejection is sent to such applicants. In this case the application money received from these applicants is refunded to them in full. The journal entry made is as follows:

Share Application A/c Dr
To Bank A/c
(Application money on … shares refunded to the applicants)

(ii) Excess application money adjusted towards sums due on allotment.

Journal entry made is:

Shares Application A/c Dr
To Share Allotment A/c
(Excess application money adjusted towards sums due on allotment)

If the application money received on partially accepted applications is more than the amount required for adjustment towards allotment money, the excess money is refunded. However, if the Articles of the company so authorise, the directors may retain the excess money as calls in advance to be adjusted against the call/calls falling due later on and the following entry is made:

Share Application A/c Dr
To Call-in-advance A/c

(The adjustment of excess share application money retained as call-in- advance in respect of ... shares).

Option II

Partial acceptance of Applications.

In some cases the company accepts the applications for subscription partially. It means that the company does not allot the full number of shares applied for. For example if an applicant has applied for 5000 shares and is allotted only 2000 shares, then the applications is said to have been partially accepted. The company may evolve some formula of accepting applications partially or making proportionate allotment/ the Prorata allotment which means that the applicants are allotted shares proportionately. In such a case the company adjusts the excess share money received on application towards share allotment money due on partially accepted applications. The journal entry recording the adjustment of application money towards share allotment money is as under:

Share Application A/c Dr
To Share Allotment A/c
(Share application money transferred to Share Allotment Account in respect of ... shares).

Illustration - 2

The Full Health Care Ltd has offered to public for subscription 20000 shares of Rs 100 each payable as Rs 30 per share on application, Rs 30 per share on allotment and the balance on call. Applications were received for 30000 shares. Applications for 5000 shares were rejected all together and application money was returned. Remaining applicants were allotted the offered shares. Their excess application money was adjusted towards some due on allotment. Calls were made and duly received. Make journal entries in the books of the company.

Solution

Journal entries Full Health Care Ltd

Bank A/c	Dr		900000	
To Share Application A/c				900000
(Application money received for 30000 shares @ Rs 30 per share)				
Share Application A/c	Dr		900000	
To Share Capital A/c				600000
To Bank A/c				150000
To Share Allotment A/c				150000
(Application money of 20000 shares transferred to share capital A/c on their allotment. That of 5000 shares returned and of 5000 shares adjusted towards sum due on allotment.				
Share Allotment A/c	Dr		600000	
To Share Capital A/c...				600000
(Allotment money due)				

Bank A/c Dr To Share Allotment A/c. (Allotment money received)			450000	450000
Share First and Final call A/c. Dr To Share Capital A/c (Call money due)			800000	800000
Bank A/c Dr To Share First and Final call A/c. (Call money received)			800000	800000

Issue of Shares at Premium

If a company issues its shares at a price more than its face value, the shares are said to have been issued at Premium. The difference between the issue price and face value or nominal value is called 'Premium'. If a share of Rs 10 is issued at Rs 12, it is said to have been issued at a premium of Rs 2 per share. The money received as premium is transferred to Securities Premium A/c. A company issues its shares at premium only when its financial position is very sound. It is a capital gain to the company. The Premium money may be demanded by the company with application, allotment or with calls The Companies Act has laid down certain restrictions on the utilisation of the amount of premium.

According to Section 78 of this Act, the amount of premium can be utilised for:

(i) Issuing fully-paid bonus shares;
(ii) Writing off preliminary expenses, discount on issue of shares, underwriting commission or expenses on issue;
(iii) Paying premium on redemption of Preference shares or Debentures.

Accounting treatment of Premium on issue of shares:

(a) Securities premium collected with share Application money :

If the Securities premium is collected on application and the company has taken decision about the allotment of shares, the following journal entry is made :

Share Application A/c. Dr

To Securities Premium A/c

(The amount of Securities premium received on application of the allotted shares is transferred to Securities Premium A/c)

(b) Premium collected with Allotment money or Calls.

If the company decides to demand the premium with share Allotment or/and share call money, the journal entry made is:

Share Allotment A/c Dr
Or/and
Share Call A/c Dr
To Securities Premium A/c
(Adjustment of share premium due on……shares @Rs…….per share.)

Illustration 3

Luxuary Cars Ltd. issued 100000 shares of Rs 10 each at a premium of Rs 5 per share, payable as: On application Rs. 4 (including Rs 2 premium) per share On allotment Rs 8 (including Rs 3 premium) per share On call Rs. 3 per share. Applications were received for 100000 shares and allotment was made to all. Make journal entries.

Solution

Journal entries

Books of Luxury Cars Ltd.

Bank A/c Dr. To Share Application A/c (Amount received for 1,00,000 shares)		400000	 400000
Share Application A/c Dr To Share Capital A/c To Securities Premium A/c (Share application money transferred to share capital A/c and securities Premium A/c)		400000	 200000 200000
Bank A/c Dr To Share Allotment A/c (Share allotment money is received on 1,00,000 shares @ Rs 8 per share)		800000	 800000
Share Allotment A/c Dr To Share Capital A/c To Securities Premium A/c (Share allotment money made Due)		800000	 500000 300000
Share First and Final Call A/c Dr To Share Capital A/c (Share call money made due on 1,00,000 shares @ Rs 3 per share.)		300000	 300000
Bank A/c Dr To Share First and Final Call A/c (Share call money received on 1,00,000 shares @ Rs 3 per share.)		300000	 300000

Issue of Shares at discount

When the issue price of share is less than the face value, shares are said to have been issued at discount. For example if a company issues its shares of Rs 100 each at Rs. 90 each, the shares are said to be issued at discount. The amount of discount is Rs 10 per share (i.e. Rs 100 – Rs 90). Discount on shares is a loss to the company. The Companies Act, permits issue of shares at a discount subject to the following conditions. (sec. 79) –

(a) The issue must be of a class of shares already issued.

(b) Not less than 1 year has at the date of issue elapsed since the date on which the company became entitled to commence business.

(c) The issue at a discount is authorized by a resolution passed by the company in the general meeting & sanctioned by the company law board.

(d) The maximum rate of discount must not exceed 10% or such rate as the company law board may permit.

(e) The shares to be issued at a discount must be issued within two months of the sanction by the company law board or within such extended time as the company law board may allow.

Accounting Treatment of Shares Issued at Discount

The amount of discount is generally adjusted towards share allotment money and the following journal entry is made:

Share Allotment A/c Dr
Discount on issue of shares A/c Dr
To Share Capital A/c

Allotment money due on….shares @Rs ……per share after allowing discount @Rs ….per share.

Illustraion 4

Sri Krishna Agro Chemical Ltd. was registered with a capital of Rs 5000000 divided into 50000 shares of Rs 100 each. It issued 10000 shares at discount of Rs 10 per share, payable as : Rs 40 per share on application Rs 30 per share on allotment Rs 20 per share on call. Company received applications for 15000 shares. Applicants for 12000 shares were allotted 10000 shares and applications for the remaining shares were sent letters of regret and their application money was returned. Call was made. Allotment and call money was duly received. Make journal entries in the books of the company.

Solution **Journal entries**

Sri Krishna Agro Chemicals

1	Bank A/c Dr. To Share Application A/c (Application money received for 15000 shares @ Rs 40 per Share)			6,00,000	6,00,000
2.	Share Application A/c Dr To Share Capital A/c (Application money of 10000 shares transferred to share Capital A/c on their allotment)			4,00,000	4,00,000
3.	Share Application A/c Dr To Share Allotment A/c To Bank A/c (Application money of 3000 shares returned and of 2000 shares adjusted towards sum due on allotment)			2,00,000	80,000 1,20,000

4.	Shares Allotment A/c Dr Share discount A/c Dr To Share Capital A/c. (Allotment money due)		3,00,000 1,00,000	4,00,000
5.	Bank A/c Dr To Share Allotment A/c (Allotment money received)		2,20,000	2,20,000
6.	Share First & Final Call A/c Dr To Share Capital A/c Amount due on call		2,00,000	2,00,000
7.	Bank A/c Dr To Share First & Final Call A/c (Call money received)		2,00,000	2,00,000

Forfeiture of Shares

When shares are allotted to an applicant, it becomes a contract between the shareholder & the company. The shareholder is bound to contribute to the capital and the premium if any of the company to the extent of the shares he has agreed to take. as & when the Directors make the calls. If he fails to pay the calls then his shares may be forfeiture by the directors if authorised by the Articles of Association of the company.

The Forfeiture can be only for non-payment of calls on shares and not for any other reasons. When the directors forfeiture the shares the person loses his membership in the company as well as the amount already paid by him towards the share capital and premium. His name is removed from the register of members. The directors must observe strictly all the legal formalities required by the Articles of Association before forfeiting the shares.

Share Capital A/c Dr (no of forfeited shares * amount called up per shares)
Security Premium A/c Dr (to the extent premium not received)
To Calls in Arrears A/c
To Share Forfeiture A/c (amount received towards share received)

Note: Once the security premium is collected it cannot be cancelled later on. Therefore if he Forfeited shares were issued at a premium and the premium money is already received on those Forfeited shares, security premium A/c will not be cancelled or debited.

Conditions for forfeiture of shares

The authority to forfeit shares is given to the Board of Directors in Articles of Association of the company. The Board of Directors has to give at least fourteen days notice to the defaulting members calling upon them to pay outstanding amount with or without interest as the case may be before the specified date. The notice must also state that if the shareholders fail to remit the amount mentioned therein within the stipulated period, their shares will be forfeited. If they still fail to pay the amount within the specified period of time, the Board of Directors of the company may decide to forfeit such shares by passing a resolution. The decision regarding the forfeiture of shares should be communicated to the concerned allottees and should be asked to return the allotment letters and share certificates of the forfeited shares to the company.

Accounting treatment for forfeiture of shares

When shares issued at par are forfeited the accounting treatment will be as follows:

(i) Debit Share Capital Account with amount called up (whether received or not) per share up to the time of forfeiture.

(ii) Credit Share Forfeited A/c. with the amount received up to the time of forfeiture.

(iii) Credit 'Unpaid Calls A/c' with the amount due on forfeited shares. This cancels the effect of debit to such calls which take place when the amount is made due.

The journal entry is :

Share capital A/c	Dr	(Amount called up)
To share forfeited A/c		(Amount paid)
To unpaid calls A/c		(Amount called but not paid)

Note : (i) Amount called up = No. of shares × called up per share

(ii) Amount paid = No. of shares × Amount paid per share

(iii) Amount called but not paid = No. of shares × Amount called but not paid per share

Illustration 4

X, a shareholder, holding 100 shares of Rs 10 each has paid application money of Rs 2 per share and allotment money of Rs 3 per share, but has failed to pay the first call of Rs 2 per share and second call of Rs 3 per share. His shares were forfeited. Make the journal entry to record the forfeiture of shares.

Solution **Journal entries**

	Share Capital A/c (100 × Rs 10) Dr		1000	
	To Share forfeited A/c (100 × Rs 5)			500
	To Share First Call A/c (100 × Rs 2)			200
	To Share Second and Final Call A/c (100 × Rs 3)			300
	(forfeiture of 100 shares)			

Illustration 5

Alpha Ltd. issued 10000 shares of Rs 100 each payable as: Rs 25 on application. Rs 25 on allotment Rs 20 on First call and Rs 30 on second and final call. 9000 shares were applied for and allotted. All the payments were received with the exception of allotment money, first call and second and final call money on 300 shares allotted to Ganesh. The Board of Directors decided to forfeit these shares. Make journal entry to record transaction relating to forfeiture of shares.

Solution **Journal entries**

Share Capital A/c (300 × Rs 100) Dr	30000	
To Share forfeited A/c (300 × Rs 25)		7500
To Share allotment A/c (300 × Rs 25)		7500
To Share first call A/c (300 × Rs 20)		6000
To Share second call A/c (300 × Rs 30)		9000
(300 shares of Rs 100 each forfeited due to non payment of allotment money and calls money)		

Forfeiture of shares issued at premium

In case shares are issued at premium and thereafter forfeited there can be two situations :

1. Premium on shares has been received prior to the forfeiture.
2. Amount of premium on shares has not been received and it still stands credited to the Securities Premium A/c.

1. Premium money has been received prior to the forfeiture

If the amount of premium on shares forfeited has been received by the company prior to the forfeiture, securities Premium A/c will not get affected. In this case the journal entry of forfeiture of shares will be similar to the entry made as if the shares had been issued at par.

The journal entry will be :

Share Capital A/c	Dr		
To Share forfeited A/c			
To Unpaid Calls A/c./Calls in arrears A/c			
(Forfeiture of share issued at premium)			

Illustration 6

ABC Software Ltd. issued Rs 500000 capital divided into equity shares of Rs 10 each. The shares were issued at a premium of Rs 4 per share and were payable as : Rs 3 per share on application, Rs 7 (including premium) per share on allotment and the balance on call. All the shares applied for and were duly allotted. All the money was duly received except on 500 shares on which the call money was not received. Company decided to forfeit these shares. Make journal entry to record the forfeiture of 500 shares.

Solution

Journal entries

Share Capital A/c	Dr.	5000	
To Share Forfeited A/c			3000
To Share First & Final Call A/c			2000
(Forfeiture of 500 shares of Rs 10 each due to on non payment of call money of Rs 4 per share)			

2. Premium on shares has not been received and stands credited to Securities Premium A/c as due but not paid.

When a share is forfeited on which the amount of premium has been made due but has not been received, either wholly or partially, the Securities Premium A/c will be cancelled. At the time of making due, Securities Premium A/c will be credited. The journal entry will be as follows:

Share Capital A/c	Dr
Securities Premium A/c	Dr
To Share Forfeited A/c	
To Unpaid call A/c.	
(Forfeiture of shares originally issued at premium due to non payment of dues).	

Illustration 7

The L & T Company Ltd. offered to public for subscription of 50,000 shares of Rs. 20 each at a premium of Rs. 5 per share. The amount was payable as under:

On application	Rs. 5 per share
On allotment	Rs. 12 per share (Including premium of Rs 5 per share)
On first call	Rs. 4 per share
On Second and Final call	Rs. 4 per share

Applications were received for all the shares. Allotment was made to all the applicants in full. Mr.A failed to pay allotment and call money on 200 shares held by him. Mr.B was allotted 300 shares. He did not pay the call money. Their shares were forfeited. Make necessary journal entry for the forfeiture only.

Solution **Journal entries**

	Share Capital A/c (200 × 20) Dr.		4000	
	Securities Premium A/c (200 × 5) Dr.		1000	
	To Share Forfeited A/c (200 × 5)			1000
	To Share Allotment A/c (200 × 12)			2400
	To Share First Call A/c (200 × 4)			800
	To Share Second and Final call A/c (200 × 4)			800
	(Forfeiture of 200 shares held by Mr.A who did not pay allotment and call money).			
	Share Capital A/c (200 × 20) Dr.		6000	
	To Shares forfeited A/c			3600
	To Share First Call A/c			1200
	To Share Second Call A/c			1200
	(Forfeiture of 300 shares held by Mr.B)			

Forfeiture of shares issued at discount

Discount on issue of shares is a loss to the company. When shares issued at a discount are forfeited for non payment of dues, the discount allowed on such shares is written back. At the time of issue of shares, Discount on issue of Shares A/c is debited and when forfeited, this account is credited to cancel the discount allowed on such shares. In this case the following journal entry is made :

Share Capital A/c Dr.

To Share Forfeited A/c

To Discount on Issue of Shares A/c

To Unpaid call A/c

(Forfeiture of shares originally issued at discount for non payment of dues).

Illustration 8

The Snow white Ltd. invited applications for 200 shares of Rs. 50 each at a discount of 10% payable as follows: On application Rs. 10 per share On allotment Rs. 20 per share On call Rs. 15 per share Whole of the issue was subscribed and paid for except the calls money on 200 shares which were forfeited by the company. Make journal entry for forfeiture of shares.

Solution **Journal entries**

Share Capital A/c (200 × 50)	Dr.	10000	
To Shares forfeited A/c (200 × 30)			6000
To Discount on Issue of Shares A/c (200 × 5)			1000
To Share First and Final call A/c (200 × 15)			3000

(Forfeiture of 200 shares of Rs 50 each issued at discount of 10% on non payment of call money)

Reissue of Forfeited shares

Shares are forfeited because only a part of the due amount of such shares is received and the balance remains unpaid. On forfeiture the membership of the original allottee is cancelled. He/she cannot be asked to make payment of the remaining amount. Such shares become the property of the company. Therefore company may sell these shares. Such sale of shares is called 'reissue of shares'. Thus reissue of shares means issue of forfeited shares. The Directors may reissue the Forfeited shares at par, at premium or at a reissued at a discount; the maximum discount is restricted to the amount Forfeited on these shares + the original discount.

The maximum permissible discount at the time of reissue of forfeited shares is ascertained in different situations in the following manner:

(i) Shares originally issued at par: When the shares are originally issued at par, the maximum permissible discount for reissue of shares is equal to the amount forfeited on such shares

(ii) Shares originally issued at premium: In case of shares originally issued at premium, there can be two situations: (a) premium has not been received on the forfeited shares, and (b) premium has been received on such shares. The amount forfeited is the amount that has been received including the amount of premium if it has been received and the maximum discount that can be allowed on reissue of such shares is the amount so forfeited.

(iii) Shares originally issued at discount: In this case the actual amount received becomes the forfeited amount. But the maximum permissible discount on reissue of shares will be equal to the amount forfeited plus the amount of discount initially allowed on these shares at the time of their original issue.

Reissue of forfeited shares at a discount: When the shares forfeited are reissued at discount, Bank account is debited by the amount received and Share capital account is credited by the paid up amount. The amount of discount allowed is debited to Share Forfeited Account. This is for adjusting the amount of discount so allowed from the amount forfeited at the time of forfeiture.

Bank A/c (the amount received on reissue) Dr.
Share Forfeited A/c (the amount allowed as discount) Dr.
To Share Capital A/c (paid up amount)

The amount of discount is less than the amount forfeited; the remaining forfeited amount will be profit for the company. This profit is a capital gain to the company and is transferred to Capital Reserve account. Journal entry of the same will be as follows:

Share forfeited A/c Dr
To Capital Reserve A/c

In case, only a part of the forfeited shares are reissued and others remain cancelled, the amount forfeited on forfeited shares not reissued will remain in the Shares Forfeited Account. For adjustment of forfeited amount on share reissued will be calculated as:

$$\text{Amount to be adjusted} = \text{Total forfeited amount} * \frac{\text{No. of shares reissued}}{\text{Total No. of shares forfeited}}$$

Illustration 9

Jai Company Ltd. forfeited 200 shares of Rs 10 each, fully called up on which Rs. 7 have been received and final call of Rs. 3 per share remains unpaid. These shares were later on reissued for Rs. 8 per share fully paid up. Make journal entry for recording the forfeiture and reissue of shares.

Solution **Journal entries**

	Share Capital A/c To Shares Forfeited A/c To Shares Final call A/c (Forfeiture of 200 shares of Rs. 10 each due to non payment of final call of Rs 3 per share)	Dr	2000	1400 600
	Bank A/c Shares Forfeited A/c To Share capital A/c (Reissue of 200 forfeited shares of Rs 10 each for Rs. 8 per share as fully paid up)	Dr Dr	1600 400	2000
	Shares forfeited A/c To Capital Reserve A/c (The Balance amount in Share Forfeited A/c transferred to Capital Reserve A/c)	Dr	1000	1000

Illustration 10

India infrastructure Ltd. has issued its shares of Rs. 20 each at a discount of Rs 2 per share. Mahima holding 100 shares did not pay final call of Rs 5 per share. Her shares were forfeited. Later on the company reissued 100 shares of these forfeited shares at (I) Rs. 15 per share (II) Rs. 20 per share, and (III) Rs. 25 per share Make journal entries for the forfeiture and reissue of the shares in the books of company.

Solution **Journal entries**

Share Capital A/c	Dr	2000	
To Shares Forfeited A/c			1300
To Discount on Issue of Shares A/c			200
To Shares Final Call A/c			500

(Forfeiture of 200 shares issued at discount for non payment of final call)

Reissue of shares: Reissued at Rs 15 per share

I.	(i) Bank A/c	Dr	1500	
	Discount on Issue of Shares A/c	Dr	200	
	Shares Forfeited A/c	Dr	300	
	To Share Capital A/c			2000
	(100 shares reissued at Rs 15 per share)			
	(ii) Shares Forfeited A/c	Dr	1000	
	To Capital Reserve A/c			1000
	(Balance in share Forfeited A/c of 100 shares reissued transferred to Capital Reserve A/c)			
II.	Bank A/c	Dr	2000	
	To Share Capital A/c			2000
	(100 shares reissued at Rs 20 per share)			
	Shares Forfeited A/c	Dr	1300	
	To Capital Reserve A/c			1300
	(Balance in shares forfeited A/c transferred to Capital Reserve A/c)			

III. Reissued at Rs. 25 per share

Bank A/c	Dr	2500	
Discount on issue of share A/c	Dr	200	
To Share Capital A/c			2000
To Securities Premium A/c			700
(Reissue of discounted shares at Rs 25 per share)			
Shares Forfeited A/c	Dr	1300	
To Capital Reserve			1300
(Balance in shares forfeited A/c transferred to capital Reserve A/c)			

Illustration 11

A Company issued for public subscription 40,000 equity shares of Rs. 10 each at a premium of Rs. 2 per share payable as under:

On application	Rs. 2 per share
On Allotment	Rs. 5 per share (including premium)
On first call	Rs. 2 per share
On final call	Rs. 3 per share

Applications were received for 70,000 Shares. Allotment was made pro-rata to the applicants for 50,000 shares, the remaining applications being refused. Money overpaid on applications was applied towards sum due on allotment. A, to whom, 1,500 shares were allotted, failed to pay the allotment and call money. B, to whom 2,000 shares were allotted, failed to pay the two calls. The shares of A and B were subsequently forfeited after the second call was made. 3,000 of the forfeited shares were reissued @ Rs. 8 per share fully paid. The reissued shares included all of A's shares. Pass journal entries in the books of the company to record the above transactions.

Solution

Working Notes :

40,000 shares were issued to applicants for 50,000 shares

Ratio of allotment is 4:5

A was allotted 1,500 shares so he applied for =1500×5	= 1875 shares
A paid on application 1875 × 2	= 3,750
A was allotted 1,500 shares and was to pay on application	= 3,000
Surplus transferred to Share Allotment	= 750
Total Amount due on allotment = 40,000 × 5	= 2,00,000
Less: Surplus adjusted from Share Application	= 20,000
Balance amount due	= 1,80,000
Less: Arrears from A (Due Rs. 7,500 Less: Surplus Application amount Rs 750)	= 6,750
Amount received on allotment	= 1,73,250
Amount due on share First Call = 40,000 × 2	= 80,000
Less: Arrears from A & B [(1,500+2,000) × 2]	= 7,000
Hence amount received	= 73,000
_Amount due on Second and Final Call = 40,000 × 3	= 1,20,000
Less: Arrears from A & B [(1,500+2,000) × 3]	= 10,500
Amount Received	= 1,09,50
Amount Forfeited A & B	= 13,750
From A = 3,750	
From B (2,000×5 = 10,000	
Amount forfeited on 3,000 shares [From A Rs. 3,750	
And From B (10,000 ÷ 2,000) × 1,500]	= 3,750
	+ 7,500
	= 11,250
Less: Discount allowed on re-issue	= 6,000
Balance transferred to Capital Reserve	= 5,250

Journal entries

	Bank A/c To Share Application A/c (Being share application money received on 70,000 shares @ Rs. 2 per share)		1,40,000	1,40,000
	Share Application A/c To Share Capital A/c To Share Allotment A/c To Bank A/c (Being share application money transferred to Share Capital account, Share Allotment account and balance refunded)		1,40,000	80,000 20,000 40,000
	Share Allotment A/c To Share Capital A/c To Securities Premium A/c (Being share allotment money due on 40,000 share@ Rs. 5 per shares, including premium of Rs. 2 per share)		2,00,000	1,20,000 80,000
	Bank A/c Calls in Arrears A/c To Share Allotment A/c (Being the amount received on share allotment)		1,73,250 6,750,	1,80,000
	Share First Call A/c To Share Capital A/c (Being share first call money due on 40,000 shares @ Rs. 2 per share)		80,000	80,000
	Bank A/c Calls in Arrears A/c To Share First Call A/c (Being share first call money due on 36,500 shares @ Rs. 2 per share)		73,000 7,000	80,000
	Share Second and Final Call A/c To Share Capital A/c (Being share second and final call money due on 40,000 shares @ Rs. 3 per share)		1,20,000	1,20,000
	Bank A/c Call in Arrears A/c To Share Second and Final Call A/c (Being amount received on 36,500 shares @ Rs. 3 per share)		1,09,500 10,500	1,20,000
	Share Capital A/c Securities Premium A/c To Calls in Arrears A/c To Share Forfeited A/c (Being 3,500 shares forfeited for non-payment of call in arrears)		35,000 3,000	24,250 13,750
	Bank A/c Share Forfeited A/c To Share Capital A/c (Being reissue of 3,000 shares @ Rs. 8 per share as fully paid)		24,000 6,000	30,000
	Share Forfeited A/c To Capital Reserve A/c (Being the surplus of amount forfeited in respect of shares reissued transferred to Capital Reserve)		5,250	5,250

Surrender of Shares

A shareholder who is not able to pay the call money may surrender his shares to the company. The company cancels such surrender shares. Surrender is a voluntary act on the part of the shareholder, whereas Forfeiture is a compulsory act on part of the company. The effect of both surrender & Forfeiture is the same, i.e. cancellation of the shares. The company can accept surrender of shares if permitted by its Articles of Association. The accounting treatment in respect of surrender of shares is same as that of Forfeiture of Shares.

Lien on Shares

Lien on shares is an equitable charge on shares to secure any debt which may be recoverable from the shareholder of the company. Right of lien can be exercised on dividends payable and final amounts to be settled on dissolution of the company.

Right Issue or Pre-emptive Right

According to Section 81(1) when a company proposes to issue further share capital , the new shares shall first be offered to existing share holders in proportion of their existing shareholding. Such right is called Pre-emptive right or right issue.

Advantages

a. Control of the company is retained in hands of the existing share holders.
b. Existing shareholders get right issue at a price lower than the market price of share.
c. The expenses of issue are lower than the fresh issue of shares.
d. When the right issues are made from time to time, the image of the company improves and the existing shareholders remain satisfied.
e. There is more certainty of getting capital in the case of right issue than the public issue.

Valuation of right issue

a. Calculate the market value of shares already held by a shareholder.
b. Add to the above price paid for the fresh shares.
c. Find out the average price of existing shares and fresh shares using following formula:-

$$\frac{\text{Market price of existing shares + Issue price of right shares}}{\text{No. of existing shares + No. of Right shares}}$$

d. The average price of the share should be deducted from market price, that amount is the value of right.

(Value of right = Market price of shares – Average price of shares)

1.2 REDEMPTION OF PREFERENCE SHARES

Under section 100 of the Companies Act, a company is not allowed to return to its shareholders the share money without the permission of the court. But permission of the court is not necessary, if the refund is to be made to the preference shareholders.

When the capital is raised by issuing redeemable preference shares, it is to be paid back by the company to such shareholders after the expiry of stipulated period whether the company is to be wound up or not. Preference shares which are repayable after the expiry of a stipulated period are called redeemable preference shares. As per the latest amendment, all preference shares are to be redeemed within ten years.

The following are the important provisions regarding the redemption of preference shares which are given under Section 80 of the Companies Act:

1. The shares shall be redeemable only if they are fully paid up. If the shares to be redeemed are partly paid up, they should be made fully paid up before they are redeemed.
2. Shares shall be redeemed either out of profits of the company available for dividends or out of proceeds of fresh issue of shares made for the purpose of redemption.
3. Premium if any, payable on redemption, should be provided out of the profits or out of the share premium account of the company.
4. Where any such shares are redeemed out of profits, an amount equal to face value of shares redeemed must be transferred to capital redemption reserve account.
5. The Capital Redemption Reserve Account can be utilised for issuing fully paid bonus shares to the shareholders.

The redemption of preference shares should not be regarded as a reduction of the authorised capital of the company and as such the reduced shares should remain as part of the authorised capital and must be shown in the balance sheet.

Capital Redemption Reserve (CRR)

If the preference shares are redeemed out of accumulated profit, it will be necessary to transfer an amount equal to the amount repaid on the redemption to Capital Redemption Reserve Account. If the company issues any fresh shares for redemption purpose, the transferred amount will be the difference between nominal value of shares redeemed and the nominal value of shares issued (i.e. amount transferred to CRR = Nominal value of shares redeemed – Nominal value of shares issued). The capital redemption reserve account can be used for issuing fully paid bonus shares.

The importance of creation of capital redemption reserve account is to a) protect the interest of creditors and b) maintain working capital. Redemption of preference shares involves repayment of capital before paying creditors of the company. It may affect the interest of creditors. In addition to that the working capital of the company will be depleted as a result of outflow of cash due to redemption. The amount is capitalized by creating the capital redemption reserve account. As a result this amount will not be available for distribution of dividend. It helps to protect the interest of creditors and on the other hand it replenishes working capital.

Accounting Entries

The redeemable preference shares can be redeemed by a) the proceeds of a fresh issue of equity shares/ preference shares, b) the capitalization of undistributed profit i.e. creating capital redemption reserve account, or c) a combination of both (a) and (b). Let us see the accounting entries required for redemption of preference shares.

i) When new shares are issued at par:

Bank A/c ....Dr.
To Share Capital A/c.

ii) When new shares are issued at premium:

Bank A/c ....Dr.
To Share Capital A/c
To Securities Premium A/c

iii) When new shares are issued at a discount:

Bank A/c ....Dr.
Discount on Issue of Share Capital...........Dr.
To Share Capital A/c.

iv) Conversion of partly paid shares into fully paid shares:

a) Share Call A/c ....Dr.
To Share Capital A/c
b) Bank A/c ....Dr.
To Share Call A/c.

v) When preference shares are redeemed at par:

Redeemable Preference Share Capital A/c ....Dr.
To Preference shareholders A/c.

vi) When preference shares are redeemed at a premium:

Redeemable Preference Share Capital A/c ....Dr
Premium of Redemption Preference Share Capital A/c....Dr.
To Preference shareholders A/c.

vii) Adjustment of premium on redemption:

Profit and Loss A/c....................Dr.
Securities Premium A/c ....Dr.
To Premium of Redemption Preference Share Capital A/c

viii) Transferring the amount to Capital Redemption Reserve Account:

General Reserve A/c ....Dr.
Profit and Loss A/c ....Dr.
To Capital Redemption Reserve A/c

ix) Expenses on issue of shares:

Expenses on Issue of shares A/c…………….Dr.

To Bank A/c.

x) When payment is made to preference shareholders:

Preference Shareholders A/c ……………Dr.

To Bank A/c.

xi) When the fully paid bonus shares are issued:

Capital Redemption Reserve A/c ……………. Dr.

General Reserve A/c …………………………..Dr.

Securities Premium A/c ……………………………Dr.

Profit & Loss A/c …………………………….. Dr.

To Bonus to Shareholders A/c

xii) Capitalization of profit:

Bonus to Shareholders A/c ………………Dr.

To Equity share capital A/c

Illustration - 12

ABC Co. Ltd. had part of its share capital in 2000 preference shares of Rs.10 each fully paid up and these have become due for redemption. The preference share capital was to be redeemed out of a fresh issue of equity shares at par made particularly for this purpose and the general reserve of the company stood at Rs.25,000. Show the journal entries for the above transactions.

Solution

Journal entries

Date	Particulars	LF	Dr.(Rs.)	Cr.(Rs.)
2010 April 1	Preference share capital A/c Dr. To Preference shareholders A/c (Being amount payable on redemption of 2000 preference shares)		20,000	20,000
2010 April 1	Bank A/c Dr. To Equity Share Capital A/c (Being the amount received on issue of 2000 equity shares of Rs.10 each made for the purpose of redemption of preference shares as per Board's Resolution dated).		20,000	20,000
2010 April 1	Preference shareholders A/c Dr. To Bank (Being the amount due to preference shareholders paid)		20,000	20,000

Illustration – 13

X Co. Ltd. Issued 50,000 Equity shares of Rs.10 each and 3000, 10% Preference shares of Rs.100 each, all shares being fully paid. On 31.3.08, Profit and Loss Account showed an undistributed profit of Rs..50,000 and General Reserve Account stood at Rs.1,20,000. On 2.4.08, the directors decided to issue 1500, 6% Preference shares of Rs.100 each for cash and to redeem the existing preference shares at Rs.105 utilizing as much as would be required for the purpose. Show the journal entries to record the transactions.

Solution **Journal entries**

Date	Particulars	LF	Dr.(Rs.)	Cr.(Rs.)
2008 April 2	10% Preference share capital A/c Dr. Premium on Redemption of Preference shares capital A/c Dr. To Preference shareholders A/c (Being amount payable on redemption of 3000 preference shares, with premium of 5%).		3,00,000 15,000	3,15,000
"	Bank A/c Dr. To 6% Preference Share Capital A/c (Being the amount received on issue of 1500, 6% Preference shares of Rs.100 each made for the purpose of redemption of preference shares as per Board's Resolution dated…………).		150,000	150,000
"	General Reserve A/c Dr. To Premium on Redemption of Preference shares capital A/c (Being the amount written off against general reserve)		15,000	15,000
"	General Reserve A/c Dr. Profit & Loss A/c Dr. To Capital Redemption Reserve A/c (Being amount transferred equal to the difference between the nominal value of shares redeemed and proceeds of new issue).		105,000 45,000	150,000
"	Preference shareholders A/c Dr. To Bank (Being the amount due to preference shareholders paid).		315,000	315,000

Illustration – 13

X Co. Ltd. Issued 50,000 Equity shares of Rs.10 each and 3000, 10% Preference shares of Rs.100 each, all shares being fully paid. On 31.3.08, Profit and Loss Account showed an undistributed profit of Rs..50,000 and General Reserve Account stood at Rs.1,20,000. On 2.4.08, the directors decided to issue 1500, 6% Preference shares of Rs.100 each for cash and to redeem the existing preference shares at Rs.105 utilizing as much as would be required for the purpose. Show the journal entries to record the transactions.

Solution **Journal entries**

Date	Particulars	LF	Dr.(Rs.)	Cr.(Rs.)
2008 April 2	10% Preference share capital A/c Dr. Premium on Redemption of Preference shares capital A/c Dr. To Preference shareholders A/c (Being amount payable on redemption of 3000 preference shares, with premium of 5%).		3,00,000 15,000	 3,15,000
"	Bank A/c Dr. To 6% Preference Share Capital A/c (Being the amount received on issue of 1500, 6% Preference shares of Rs.100 each made for the purpose of redemption of preference shares as per Board's Resolution dated…………).		150,000	 150,000
"	General Reserve A/c Dr. To Premium on Redemption of Preference shares capital A/c (Being the amount written off against general reserve)		15,000	 15,000
"	General Reserve A/c Dr. Profit & Loss A/c Dr. To Capital Redemption Reserve A/c (Being amount transferred equal to the difference between the nominal value of shares redeemed and proceeds of new issue).		105,000 45,000	 1,50,000
"	Preference shareholders A/c Dr. To Bank (Being the amount due to preference shareholders paid).		315,000	 3,15,000

Illustration – 14

The Producers Ltd.'s Balance sheet shows the following balance s on 31-3-08. 30,000 equity shares of Rs.10 each fully paid; 18,000 10% Redeemable Preference shares of Rs.10 each fully paid; 4000, 15% Redeemable Preference shares of Rs.10 each, Rs.8 paid up. General Reserve Rs.12,000; Securities Premium Rs.15,000; Profit Loss Account Rs.80,000 and capital Reserve Rs.20,000. Preference shares are redeemed on 1-4-08 at a premium of Rs.2 per share. For redemption, 4000 equity shares of Rs.10 each are issued at 10% premium. A bonus issue of equity share was made at par, two shares being issued for every five held on that date. Show the journal entries to record the above transactions

Date	Particulars	LF	Dr.(Rs.)	Cr.(Rs.)
2008 April 1	10% Preference share capital A/c Dr. Premium on Redemption of Preference shares capital A/c Dr. To Preference shareholders A/c (Being amount payable on redemption of 18000 preference shares, with premium of 2%).		180,000 36,000	 216,000
"	Bank A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being the amount received on issue of 4000, Equity shares of Rs.10 each made with premium of 10% for the purpose of redemption of preference shares as per Board's Resolution dated...........).		44,000	 40,000 4,000
"	Securities Premium A/c Dr. Profit And Loss A/c Dr. To Premium on Redemption of Preference shares capital A/c (Being the amount written off against general reserve)		19,000 17,000	 36,000
"	General Reserve A/c Dr. Profit & Loss A/c Dr. To Capital Redemption Reserve A/c (Being amount transferred equal to the difference between the nominal value of shares redeemed and proceeds of new issue).	"	120,000 20,000	 140,000

"	Preference shareholders A/c Dr. To Bank (Being the amount due to preference shareholders paid).	"	216,000	216,000
"	Capital Redemption Reserve A/c Dr. To Bonus to Shareholders A/c Being the amount utilised for issue of bonus shares in 5:2 ratio as per shareholders Resolution No. Dated…) 30,000x2/5xRs.10	"	120,000	120,000
"	Bonus to Shareholders A/c Dr. To Equity Share capital A/c (Being the amount capitalised by issue of bonus shares)		120,000	120,000

Illustration - 15

The preference shares were redeemed on April 1, 2008 at a premium of Rs.5.00 per share, the whereabouts of the holders of 1500 such shares not being known. At the same time, a bonus issue of equity share was made at par, one share being issued for every four equity shares held. Show the journal entries to record the above transactions and the Balance sheet as it would appear after the redemption. The following is the balance sheet of Black & White Co. Ltd. as at 31st March, 2008.

Liabilities	Amount(Rs.)	Assets	Amount(Rs.)
Issued & Subscribed Capital: 40,000 Equity shares of Rs.10 each fully paid 18,000, 8% Preference shares of Rs.10 each fully paid **Reserves & Surplus:** Profit & Loss Account **Current Liabilities:** Sundry Creditors	4,00,000 1,80,000 4,80,000 40,000	Fixed Assets Current Assets	7,00,000 4,00,000
	11,00,000		11,00,000

Solution

Journal Entries

Date	Particulars	LF	Dr.(Rs.)	Cr.(Rs.)
2008 April 1	8% Preference share capital A/c Dr. Premium on Redemption of Preference shares capital A/c Dr. To Preference shareholders A/c (Being amount payable on redemption of 18000 preference shares, with premium of Rs.5 each).		1,80,000 90,000	270,000
"	Profit And Loss A/c Dr. To Premium on Redemption of Preference shares capital A/c (Being the amount written off against Profit And Loss A/c)		90,000	90,000
"	Profit & Loss A/c Dr. To Capital Redemption Reserve A/c (Being amount transferred equal to the nominal value of shares redeemed and proceeds of new issue).	"	1,80,000	1,80,000
'	Capital Redemption Reserve A/c Dr. To Bonus to Shareholders A/c (Being issue of 1 bonus share to every 4 equity shares held as per shareholders Resolution No. Dated…) 40,000x1/4xRs.10		1,00,000	1,00,000
"	Bonus to Shareholders A/c Dr. To Equity Share capital A/c (Being the amount capitalised by issue of bonus shares)		1,00,000	1,00,000
"	Preference shareholders A/c Dr. To Bank (Being the amount due to preference shareholders paid except 1500 share holders).		2,47,000	2,47,000

Balance Sheet

Liabilities	Amount(Rs.)	Assets	Amount(Rs.)
Issued & Subscribed Capital: 50,000 Equity shares of Rs.10 each fully paid (of the above shares, 10,000 shares have been allotted as fully paid bonus shars) **Reserves & Surplus:** Capital Redemption Reserve Account (Rs.180000-100000) Profit & Loss Account (Rs.480000-90000-180000) **Current Liabilities:** Sundry Creditors Outstanding claim (Pref. Shareholders)	5,00,000 80,000 2,10,000 40,000 22,500	Fixed Assets Current Assets (Rs.400000-247500)	7,00,000 1,52,500
	8,52,500		8,52,5000

1.3 BUY BACK OF SHARES

Buyback of shares means that any company may purchase their own shares or other specified securities. According to section 77A (1) of the companies Act 1999, a company may purchase its own shares or other securities out of:

(i) Its free reserves or
(ii) The securities premium account or
(iii) The proceeds of any shares or other specified securities.

Specified securities include employee's stock option or other securities as may be notified by the Central Government from time to time. Buyback of shares of any kind is not allowed out of fresh issue of shares of the same kind. In other words, if equity shares are to be bought back, preference shares or debentures may be issued for buyback of equity shares. Companies are allowed to buy back their own shares if they fulfil certain conditions as given in section 77A (2) of the companies Act 1999.

No company shall purchase its own shares or other specified securities unless:

(a) The buyback is authorised by its articles.
(b) A Special resolution has been passed in general meeting of the company authorising the buyback.
(c) The buyback is for less than 25% of the total paid up capital and free reserves of the company.
(d) It also provides that buyback shall not be exceeding 25% of total paid up capital.
(e) The debt equity ratio should not be more than 2:1 after such buyback.
(f) All the shares or other specified securities for buyback are fully paid up.
(g) The buyback of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.
(h) The buyback in respect of shares or other specified securities other those specified in clause
(i) The buyback should be completed within 12 months from the date of passing the special resolution.

1. Entry for Assets sold for Buyback:

Bank A/c Dr.
Profit & Loss A/c Dr. (In Case of Loss)
To Assets A/c
To Capital Reserve A/c (In case of Profit)

2. Entry for issue of debentures or other securities for the purpose of buyback

Bank A/c Dr
Discount on issue Dr.
To Debentures A/c
To Other securities A/c
To Securities Premium A/c

3. Entry for the cancellation of shares bought back :

Equity Share Capital A/c Dr.
Free Reserves or Securities Premium A/c Dr.
To Shareholders A/c

4. Entry for transfer of nominal value of shares bought back to CRR

General Reserves A/c Dr. Or
Profit & Loss A/c Dr. Or
Any other reserve A/c Dr.
To Capital Redemption Reserve

5 Entry for making the payment of buyback shares:

Shareholders A/c Dr.
To Bank A/c

6 Entry for expenses incurred in buyback of shares:

Buyback Expenses A/c Dr.
To Bank A/c

7 Entry for transfer of buyback of expenses to P & L A/c

Profit & Loss A/c Dr.
To Expenses A/c

Advantages of Buy Back of Shares:

1. The buyback facility enables the companies to manage their cash effectively. Many co's in this country are faced with a problem of surplus cash without having any idea of where to invest them. It would be better for them to return surplus cash to shareholders rather than to go on spending simply for want to alternative.
2. Companies having large amount of free reserves are free is use funds to acquire shares and other specified securities under the buyback process.
3. Buyback shares in helpful co. to reduce its share capital.
4. Buyback of shares is helpful to improvement in the values of shares.
5. Avoid high financial risk and ensure maximum return to the shareholders.
6. Buyback of shares helps the promoters to formulate an effective defence's strategy against hostile takeover bids.

Disadvantages of buy back of shares:

1. All the control of buy back of shares in the hands of promoters, so results of co.'s which the position of minority shareholders in weak.
2. The promoters before the buy back, may understand the earnings by manipulating accounting policies and highlight other unfavourable factors affecting the earnings.
3. High buy back of share may lead to artificial manipulation of stock price in the stock exchange. Confusion is much more.

Escrow account

Under the scheme of buyback of shares, the company in order to perform its obligations, is required to open an Escrow Account i.e., cash deposited in a commercial bank. Or bank guarantee or deposit of acceptable securities or a combination the three.

Illustration - 16

The Balance sheet of ABC Ltd is given below:

Liabilities		Assets	
Paid up Capital		Fixed assets	80,00,000
8,00,000 Equity shares of Rs. 10 each	80,00,000	Stock	48,00,000
		Debtors	40,00,000
		Bank	72,00,000
Securities premium	8,00,000		
General Reserve	72,00,000		
13% Debentures	40,00,000		
Current liabilities	40,00,000		
	2,40,00,000		2,40,00,000

It was decided at the meeting of shareholders;

1. to buyback 20% of equity shares @ Rs.12 per share
2. to utilise general reserve for buyback of shares
3. to utilise securities premium for premium payable on buyback of shares

Pass journal entries

Solution

Journal entries

Mar 31	General Reserve A/c Dr		16,00,000	
	To Capital Redemption Reserve			16,00,000
	(Being nominal value of Rs.16,00,000 bought back out of general reserve)			
,,	Equtiy share capital A/c Dr		16,00,000	
	Securities premium A/c Dr		3,20,000	
	To Shareholders A/c			19,20,000
	(Being amount due on buy back of 1,60,000 shares)			
,,	Shareholders A/c Dr		19,20,000	
	To Bank A/c			19,20,000
	(Being amount paid for buyback of 1,60,000 shares @ Rs.10 each @ Rs. 12 per share)			

Illustration – 17

Following figures have been extracted from the books of Metals product Ltd. as on 31-03-2012.

Paid up capital – 9,00,000 e. Shares of Rs. 10 each	90,00,000
General Reserve	15,00,000
P/L A/c	5,00,000
Securities premium	3,00,000
14% Debentures	10,00,000
Bank balance	20,00,000

The company decided to buy back 25% of the paid up equity shares at face value. It was also decided to issue further 14% debentures of Rs. 10,00,000 at par for the purpose of buy back of shares. Journalise the above transactions relating to buyback of shares.

Solution

Journal entries

Mar 31	Bank A/c Dr To 14% Debenture (Being the issue of debentures of Rs.10,00,000 at par for the purpose of buyback)		10,00,000	10,00,000
,,	Equtiy share capital A/c Dr To Shareholders A/c (Being the cancellation of 25% of the paid up capital on account of 25% shares bought back)		22,50,000	22,50,000
,,	General Reserve A/c Dr To Capital Redemption Reserve A/c (Being amount paid for buyback of 1,60,000 shares @ Rs.10 each @ Rs. 12 per share)		12,50,000	12,50,000
,,	Shareholders A/c Dr To Bank A/c (Being payment made t for shares bought back)		22,50,000	22,50,000

1.4 ISSUE AND REDEMPTION OF DEBENTURES

A Debenture is a unit of loan amount. When a company intends to raise the loan amount from the public it issues debentures. A person holding debenture or debentures is called a debenture holder. A debenture is a document issued under the seal of the company. It is an acknowledgment of the loan received by the company equal to the nominal value of the debenture. It bears the date of redemption and rate and mode of payment of interest. A debenture holder is the creditor of the company. As per section 2(12) of Companies Act 1956, "Debenture includes debenture stock, bond and any other securities of the company whether constituting a charge on the company's assets or not".

Types of Debentures

Debenture can be classified as under:

1. From Security point of view

(i) **Secured or Mortgage Debentures:** These are the debentures that are secured by a charge on the assets of the company. These are also called mortgage debentures. The holders of secured debentures have the right to recover their principal amount with the unpaid amount of interest on such debentures out of the assets mortgaged by the company. In India, debentures must be secured. Secured debentures can be of two types:

(a) First mortgage debentures: The holders of such debentures have a first claim on the assets charged.

(b) Second mortgage debentures: The holders of such debentures have a second claim on the assets charged.

(ii) **Unsecured Debentures:** Debentures which do not carry any security with regard to the principal amount or unpaid interest are called unsecured debentures. These are called simple debentures.

2. On the basis of Redemption

(i) **Redeemable Debentures :** These are the debentures which are issued for a fixed period. The principal amount of such debentures is paid off to the debenture holders on the expiry of such period. These can be redeemed by annual drawings or by purchasing from the open market.

(ii) **Non-redeemable Debentures :** These are the debentures which are not redeemed in the life time of the company. Such debentures are paid back only when the company goes into liquidation.

3. On the basis of Records

(i) **Registered Debentures:** These are the debentures that are registered with the company. The amount of such debentures is payable only to those debenture holders whose name appears in the register of the company.

(ii) **Bearer Debentures:** These are the debentures which are not recorded in a register of the company. Such debentures are transferrable merely by delivery. Holder of these debentures is entitled to get the interest.

4. On the basis of Convertibility

(i) **Convertible Debentures:** These are the debentures that can be converted into shares of the company on the expiry of pre decided period. The term and conditions of conversion are generally announced at the time of issue of debentures.

(ii) **Non-convertible Debentures :** The debenture holders of such debentures cannot convert their debentures into shares of the company.

5. On the basis of Priority

(i) First Debentures: These debentures are redeemed before other debentures.

(ii) Second Debentures : These debentures are redeemed after the redemption of first debentures

The procedure of issue of debentures by a company is similar to that of the issue of shares. A Prospectus is issued, applications are invited, and letters of allotment are issued. On rejection of applications, application money is refunded. In case of partial allotment, excess application money may be adjusted towards subsequent calls.

Difference between Shares and Debentures.

Shares	Debentures
1. Amount collected through shares Constitute capital of the company.	1. Amount collected through debentures Constitute borrowed fund of the company.
2. A shareholder is a member of the company.	2. A debenture holder is only a creditor.
3. A shareholder gets a share in the profits called dividend.	3. A debenture holder receives interest at a fixed rate.
4. A shareholder is entitled to vote at meetings.	4. A debenture holder is not entitled to vote.

Issue of Debenture takes various forms which are as under:

1. Debentures issued for cash

2. Debentures issued for consideration other than cash

3. Debentures issued as collateral security. Further, debentures may be issued
(i) At par, (ii) At premium, and (iii) At discount

Accounting treatment of issue of debentures ***for cash***

1. Debentures issued for cash at par: Following journal entries will be made: **(i) Application money is received**

Bank A/c Dr

To Debentures Application A/c

(Application money received for Debentures)

(ii) Transfer of debentures application money to debentures account on their allotment

Debentures Application A/c Dr

To Debentures A/c

(Application money transferred to debenture account on allotment)

(iii) Money due on allotment

Debentures Allotment A/c Dr

To Debentures A/c
(Allotment money made due)

(iv) Money due on allotment is received

Bank A/c Dr

To Debentures Allotment A/c

(Receipt of Debenture allotment money)

(v) First and final call is made

Debentures First and Final call A/c Dr

To Debentures A/c

(First and Final call money made due on .... debentures)

(vi) Debentures First and Final call money is received

Bank A/c Dr
To Debentures First and Final call A/c
(Receipt of Amount due on call)

Note: Two calls i.e. first call and second call may be made
Journal entries will be made on the lines made for first and final call.

Illustration 18

Star India Ltd. issued 5000 8% Debentures of Rs 100 each payable as follows
Rs 20 on Application
Rs 30 on Allotment
Rs. 50 on First and Final call
All the debentures were applied for and allotted. All the calls were duly received. Make necessary journal entries in the books of the company.

Bank A/c ... Dr To Debentures Application A/c (Application money received for		100000	100000
Debentures Application A/c Dr To 8% Debentures A/c (Application money transferred to		100000	100000
Debentures Allotment a/c Dr To 8% Debentures A/c (Allotment money due on 5000 debentures @ Rs 30 per		150000	150000
Bank A/c Dr To Debentures Allotment A/c (Allotment money received)		150000	150000
Debentures First and Final call A/c Dr To 8% Debentures A/c (Debentures first and final call money made due @ Rs 50 per		250000	250000
Bank A/c Dr To Debentures First and Final call A/c (Receipt of Debentures first and		250000	250000

Issue of Debentures at Premium and Discount

Debentures are said to be issued at premium when these are issued at a value which is more than their nominal value. For example, a debenture of Rs 100 is issued at Rs 110. This excess amount of Rs 10 is the amount of premium. The premium on the issue of debentures is credited to the Securities Premium A/c as per section 78 of the Companies Act, 1956.

Journal entry will be as follows:

Debentures Allotment A/c Dr
To Debentures Account
To Securities Premium A/c
(Amount due on allotment along with premium of Rs ....)

Illustration 19

A company has issued 5000 10% Debentures of Rs 100 each at a premium of 20% payable as Rs 60 on application Rs 60 on allotment (including premium) All the debentures were subscribed for and money was duly received. Make journal entries.

Solution

Journal entries

1.	Bank A/c Dr To Debentures Application A/c (Application money received)		300000	300000
2.	Debentures Application A/c Dr To 10% Debentures A/c (Application money transferred to Debenture A/c)		300000	300000
3.	Debentures Allotment A/c Dr To 10% Debentures A/c To Securities Premium A/c (Amount due on allotment along with premium)		300000	200000 100000
4.	Bank A/c Dr To Debentures Allotment A/c (Allotment money received)		300000	300000

When debentures are issued at less than their nominal value they are said to be issued at discount. For example, debenture of Rs 100 each is issued at Rs 90 per debenture. Companies Act, 1956 has not laid down any conditions for the issue of debentures at a discount as have been laid down in case of issue of shares at discount. However, there should be provision for issue of such debentures in the Articles of Association of the Company.

Journal entry for issue of debentures at discount (at the time of allotment) Debentures
Allotment A/c Dr
Discount on issue of debentures A/c Dr

To Debentures A/c
(Allotment money due. The amount of discount is @ Rs.... per debenture)

Illustration 20

A company has issued 2000 9% debentures of Rs 100 each at a discount of 10% payable as Rs 40 on application, Rs 50 on allotment Make necessary journal entries.

	Bank A/c Dr To Debentures Application A/c (Application money received		80000	80000
	Debentures Application A/c Dr To 9% Debentures A/c (Application money transferred to debenture A/c)		80000	80000
	Debentures Allotment A/c Dr Debentures Discount A/c Dr To 9% Debenture A/c (Amount due on allotment, along with discount amount Rs 10 per debenture)		100000 20000	120000
	Bank A/c Dr To Debentures Allotment (Receipt of allotment money)		100000	100000

Issue of Debentures for consideration other than cash

When a company purchases some assets and issues debentures as a payment for the purchase, to the vendors it is known as issue of debentures for consideration other than cash. Debentures can be issued to vendors at par, at premium and at discount

Accounting Treatment:

1. Purchase of Assets

   Sundry Assets A/c Dr
   (Individually)
   To Vendors A/c

   (Purchase of assets)

2. Allotment of debentures

   (i) **At par**

   Vendors' A/c Dr
   To Debentures A/c
   (Issue of debentures at par to vendors)

   (ii) **At discount**

   Vendors' A/c Dr
   Debentures Discount A/c Dr
   To Debentures A/c
   (Issue of debentures to vendors at a discount of Rs... per debenture)

Illustration 21

VG. Electronics Ltd. purchased machinery for Rs 198000 and issued 9% debentures of Rs 100 each to the vendors. Make journal entries if the debentures were issued

(a) at par
(b) at a premium of Rs 10
(c) at a discount of Rs 10

Solution **Journal entries**

	Machinery A/c Dr To Vendors A/c (Machine purchased)	198000	198000
	Vendors A/c Dr To 9% Debentures A/c (1980 debentures of Rs 100 each issued to vendors)	198000	1980000
	Vendors A/c Dr To 9% Debentures A/c To Securities Premium A/c (1800 debentures issued at a premium of Rs 10 per debenture)	198000	180000 18000

Issue of Debentures with conditions Stipulated to their Redemption
(Journal entry)

(i) Issued at par redeemable at par

Bank A/c Dr
To Debentures Account
(Issue of debentures of Rs .... at par)

(ii) Issued at discount and redeemable at par

Bank A/c Dr
Discount on issue of Debentures A/c Dr
To Debentures A/c
(Issue of debentures of Rs ... at a discount of Rs ....)

(iii) Issued at premium redeemable at par

Bank A/c Dr
To Debentures A/c
To Securities Premium A/c

(Issue of ... debentures of Rs .... at a premium of Rs ....)

(iv) Issued at par, redeemable at premium

Bank A/c Dr
Loss on Issue of Debentures A/c Dr
To Debentures A/c
To Premium on Redemption of Debenture A/c
(Issue of ... debentures of Rs ... a redeemable at a premium of Rs ...)

(v) Issued at discount and redeemable at premium

Bank A/c Dr
Discount on Issue of Debentures A/c Dr
Loss on Issue of Debentures A/c Dr
To Debentures A/c
To Premium on Redemption of Debenture A/c
(Issue of ... debentures of Rs ... at a discount of Rs ... redeemable at a premium of Rs ....)

Illustration – 22

Make journal entries if 200 debentures of Rs 500 each have been issued as:

(i) Issued at Rs 500, redeemable at Rs 500
(ii) Issue at Rs 450; redeemable at Rs 500
(iii) Issued at Rs 550; redeemable at Rs 500
(iv) Issued at Rs 500; redeemable at Rs 550
(v) Issued at Rs 450; redeemable at Rs 550

	Bank A/c Dr To Debentures A/c (Issue of 200 debentures @ Rs. 500 each	100000	100000
	Bank A/c. Dr. Discount on issue of Debentures A/c Dr. To Debentures A/c. (Issue of 200 debentures @ Rs.50 each at Rs. 450)	90000 10000	 100000
	Bank A/c Dr. To Debentures A/c To Securities Premium A/c. (Issue of 200 debentures of 500 each at Rs.550)	110000	 100000 10000
	Bank A/c Dr Loss on Issue of Debentures A/c Dr. To Debentures A/c. To redemption of debentures A/c (Issue of 200 debentures of 500 each at Rs.550)	100000 10000	 100000 10000
	Bank A/c Dr Loss on Issue of Debentures A/c Dr. Discount on issue of Debentures A/c. Dr. To Debentures A/c. To Premium on Redemption of debentures A/c (Issue of 200 debentures of 500 each at Rs.45 repayable at Rs.550)	90000 10000 10000	 100000 10000

Discount on issue of Debentures and loss on issue of debentures

In case company issues debentures on discount the total amount of discount is not charged to profit and Loss Account of the company in the accounting

The amount of debenture discount can be written off in two ways:

1. All debentures are to be redeemed after a fixed period.

When the debentures are to be redeemed after a fixed period, the amount of discount will be distributed equally within the number of years spread between the issue of debentures and their redemption. The amount of discount on issue of debentures to be written off each year is calculated as

$$\textbf{Amount of discount written off} = \frac{\textbf{Total amount of Discount}}{\textbf{No. of years}}$$

CHAPTER - 2

FINAL ACCOUNTS OF LIMITED LABILITY COMPANIES

Every company registered under the Act shall prepare its Balance Sheet, Statement of Profit and Loss and notes thereto in accordance with the manner prescribed in Schedule VI to the Companies Act, 1956. To harmonise the disclosure requirements with the Accounting Standards and to converge with the new reforms, the Ministry of Corporate Affairs vide Notification No. S.O. 447(E), dated 28th February 2011 replaced the existing Schedule VI of the Companies Act, 1956 with the revised one.

Government vide Notification No. S.O. 653(E) dated 30th March 2011 made applicable the revised Schedule VI for the Balance Sheet and Profit and Loss Account to be prepared for the financial year commencing on or after 01st April 2011. The requirements of the Revised Schedule VI however, do not apply to companies as referred to in the proviso to Section 211 (1) and Section 211 (2) of the Act, i.e., 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 Balance Sheet and Profit and Loss account has been specified in or under any other Act governing such class of company.

Key Features of Revised Schedule VI

- The revised schedule contains General Instructions, Part I – Form of Balance Sheet; General Instructions for Preparation of Balance Sheet, Part II – Form of Statement of Profit and Loss; General Instructions for Preparation of Statement of Profit and Loss.
- The Revised Schedule VI has eliminated the concept of 'schedule' and such information is now to be furnished in the notes to accounts.
- The revised schedule gives prominence to Accounting Standards (AS) i.e. in case of any conflict between the AS and the Schedule, AS shall prevail.
- The revised schedule prescribes a vertical format for presentation of balance sheet therefore, no option is there to prepare the financial statement in horizontal format. It ensures application of uniform format.

Balance Sheet

- All Assets and liabilities classified into current and non-current and presented separately on the face of the Balance Sheet.
- Number of shares held by each shareholder holding more than 5% shares now needs to be disclosed.
  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.
- 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.
- 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."

- 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.

- 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 VI requires separate disclosure of "trade receivables outstanding for a period exceeding six months from the date the bill/invoice is due for payment."

- "Capital advances" are specifically required to be presented separately under the head "Loans & advances" rather than including elsewhere.

- Tangible assets under lease are required to be separately specified under each class of asset. In the absence of any further clarification, the term "under lease" should be taken to mean assets given on operating lease in the case of lessor and assets held under finance lease in the case of lessee.

- In the Old Schedule VI, details of only capital commitments were required to be disclosed. Under the Revised Schedule VI, other commitments also need to be disclosed.

Statement of Profit and Loss

- The name has been changed to "Statement of Profit and Loss" as against 'Profit and Loss Account' as contained in the Old Schedule VI.

- Unlike the Old Schedule VI, the Revised Schedule VI lays down a format for the presentation of Statement of Profit and Loss. This format of Statement of Profit and Loss does not mention any appropriation item on its face. Further, the Revised Schedule VI format prescribes such 'below the line' adjustments to be presented under "Reserves and Surplus" in the Balance Sheet.

- As per revised schedule VI, any item of income or expense which exceeds one per cent of the revenue from operations or `100,000 (earlier 1 % of total revenue or `5,000), whichever is higher, needs to be disclosed separately.

- In respect of companies other than finance companies, revenue from operations need to be disclosed separately as revenue from (a) sale of products, (b) sale of services and (c) other operating revenues.

- Net exchange gain/loss on foreign currency borrowings to the extent considered as an adjustment to interest cost needs to be disclosed separately as finance cost.

- Break-up in terms of quantitative disclosures for significant items of Statement of Profit and Loss, such as raw material consumption, stocks, purchases and sales have been simplified and replaced with the disclosure of "broad heads" only. The broad heads need to be decided based on materiality and presentation of true and fair view of the financial statements.

COMPARITIVE ANALYSIS BETWEEN OLD SCHEDULE VI AND REVISED SCHEDULE VI

Particulars	Old Schedule VI	Revised Schedule VI
Parts	Part I (Balance Sheet), Part II (Profit and Loss Account), Part III (Interpretation) and Part IV (Balance sheet Abstract of company's general business profile)	Only two parts - Part I (Balance Sheet) and Part II (Statement of Profit and Loss) Part III (Interpretation) and Part IV (Balance sheet Abstract of company's general business profile) omitted.
Format of Balance Sheet	Horizontal and Vertical formats are prescribed.	Only vertical format is prescribed.
Rounding off (R/off) of Figures appearing in financial statement	(a) Turnover of less than ` 100 Crs - R/off to the nearest Hundreds, thousands or decimal thereof (b) Turnover of ` 100 Crs or more but less than ` 500 Crs - R/off to the nearest Hundreds, thousands, lakhs or millions or decimal thereof (c) Turnover of `500 Crs or more - R/off to the nearest Hundreds, thousands, lakhs, millions or crores, or decimal thereof.	(a) Turnover of less than ` 100 Crs- R/off to the nearest Hundreds, thousands, lakhs or millions or decimal thereof (b) Turnover of ` 100 Crs or more- R/off to the nearest lakhs, millions or crores, or decimal thereof
Net Working Capital	Current Assets & Liabilities are shown together under application of funds. The net working capital appears on balance sheet.	Assets & Liabilities are to be bifurcated into current & Non- current and to be shown separately. Hence, net working capital will not be appearing on Balance sheet.
Fixed Assets	There was nobifurcation	Fixed assets to be shown under non-
	required into tangible & intangible assets.	current assets and it has to be bifurcated into Tangible & intangible assets.
Borrowings	Short term & long term borrowings are grouped together under the head Loan funds sub- head Secured / Unsecured.	Long term borrowings to be shown under non - current liabilities and short term borrowings to be shown under current liabilities with separate disclosure of secured / unsecured loans. Period and amount of continuing default as on the balance sheet date in repayment of loans and interest to be separately specified.
Finance lease obligation	Finance lease obligations are included in current liabilities.	Finance lease obligations are to be grouped under the head non- current liabilities.
Deposits	Lease deposits are part of loans & advances.	Lease deposits to be disclosed as long term loans & advances under the head non-current assets.
Investments	Both current & non - current investments to be disclosed under the head investments.	Current and non - current investments are to be disclosed separately under current assets & non-current assets respectively.

Loans & Advances	Loans & Advance are disclosed along with current assets.	Loans & Advances to be broken up in long term & short term and to be disclosed under non-current & current assets respectively.
Deferred Tax Assets / Liabilities	Deferred Tax assets / liabilities to be disclosed separately.	Deferred Tax assets / liabilities to be disclosed under non-current assets/ liabilities as the case may be.
Cash & Bank Balances	Bank balance to be bifurcated in scheduled banks & others.	Bank balances in relation to earmarked balances, held as margin money against borrowings, deposits with more than 12 months maturity, each of these to be shown separately.
Profit & Loss (Dr Balance)	P & L debit balance to be shown under the head.	Debit balance of Profit and Loss Account to be shown as negative.
	Miscellaneous expenditure & losses.	figure under the head Surplus. Therefore, reserve & surplus balance can be negative.
Sundry Creditors	Creditors to be broken up in to micro & small suppliers and other creditors.	It is named as Trade payables and there is no mention of micro & small enterprise disclosure.
Other current liabilities	No specific mention for separate disclosure of Current maturities of long term debt. No specific mention for separate disclosure of Current maturities of finance lease obligation.	Current maturities of long term debt to be disclosed under other current liabilities. Current maturities of finance lease obligation to be disclosed.
Separate line item Disclosure criteria	Any item under which expense exceeds one per cent of the total revenue of the company or `5,000 whichever is higher ; shall be disclosed separately.	Any item of income / expense which exceeds one per cent of the revenue from operations or `1,00,000, whichever is higher; to be disclosed separately.
Expense classification	Function wise & nature wise.	Expenses in Statement of Profit and Loss to be classified based on nature of expenses.
Finance Cost	Finance cost to be classified in fixed loans & other loans.	Finance cost shall be c classified as interest expense, other borrowing costs & Gain / Loss on foreign currency transaction & translation.

FORMAT OF REVISED SCHEDULE VI

The Ministry of Corporate Affairs specified the format of Schedule VI vide Notification No. S.O. 447(E), dated 28th February 2011 as follows:

- General Instructions for preparation of Balance Sheet and Statement of Profit and Loss of a company
- Part I – Form of Balance Sheet
- General Instructions for Preparation of Balance Sheet
- Part II – Form of Statement of Profit and Loss
- General Instructions for Preparation of Statement of Profit and Loss

Part II

Form of Statement of Profit And Loss

Name of the Company ....

Balance Sheet as at .... (Rupees in ....)

Particulars	Note No.	Figures as at the end of current eporting period	Figures as at the end of previous reporting period
(1)	(2)	(3)	(4)
I Revenue from operations			
II Other income			
III **Total revenue (I+II)**			
IV **Expenses**			
(a) Cost of materials consumed			
(b) Purchases of stock-in-trade			
(c) Changes in inventories of finished g oods, work-in-progress and stock-in-trade			
(d) Employee benefits expense			
(e) Finance costs			
(f) Depreciation and amortisation expense			
(g) Other expenses			
Total expenses			
V Profit / (Loss) before exceptional and extraordinary items and tax (III - IV)			
VI Exceptional items			
VII Profit / (Loss) before extraordinary items and tax (V – VI)			
VIII Extraordinary items			
IX Profit / (Loss) before tax (VII – III)			
X Tax expense:			
(1) Current tax			
(2) Deferred tax			
XI Profit / (Loss) for the period from continuing operations (IX - X- XIV)			
XII Profit / (Loss) from discontinuing operations			
XIII Tax expense of discontinuing operations			
XIV Profit / (Loss) from discontinuing operations (after tax) (XII - XIII)			
XV Profit / (Loss) for the year (XI + XIV)			
XVI Earnings per equity share:			
(1) Basic			
(2) Diluted			

(a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of –

I. Raw materials;

II. Components and spare parts; III. Capital goods.

(b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings in foreign exchange classified under the following heads, namely:- I. Export of goods calculated on F.O.B. basis;
2. Royalty, know-how, professional and consultation fees;
3. Interest and dividend;
4. Other income, indicating the nature thereof.

Illustration 1

From the following particulars of Ronald Ltd. , prepare its Balance Sheet as at 31st March, 2013 (as per Revised Schedule VI of the Companies Act, 1956) along with Notes to Accounts.

Authorised Equity Share Capital (10,000 shares @Rs10)	1,00,000
Authorised 6% Preference Share Capital (1,000 shares @Rs100)	1,00,000
Issued Equity Share Capital (7,000 shares @Rs10)	70,000
Issued 6% Preference Share Capital (1,000 shares @Rs100)	1,00,000
Subscribed Equity Share Capital (5,000 shares,` 8 called up, Calls in arrear` 3 on 100 shares)	
Subscribed 6% Preference Share Capital (1,000 shares @Rs100)	1,00,000
500, 5% Debentures of` 1000 each	5,00,000
Short term loan from bank	10,000
Debtors	5,000
Provision for Doubtful Debts	200
Provision for Taxation	1,000
General Reserve	4,000
Statement of P/L (Dr)	6,000
Marketable Securities	500

Solution:

Balance Sheet of Ronald Ltd. as at 31st March, 2013

Particulars	Note No.	31.03.2013	31.03.2012
I. EQUITY AND LIABILITIES			
Shareholders Funds			
(a) Share Capital	1	1,39,700	
(b) Reserves and Surplus	2	(2,000)	
Non- Current Liabilities			
Long- term borrowings	3	5,00,000	
Current Liabilities			
(a) Short term borrowings	4	10,000	
(b) Short term provisions	5	1,200	
TOTAL			
II. ASSETS			
Current Assets			
(a) Current Investments	6	500	
(b) Trade Receivables	7	5,000	
TOTAL			

Particulars		Amount (Rs)
1. Share Capital		
Authorised Capital		
10,000 equity shares of ` 10 each		1,00,000
1000 6% Preference shares of ` 100 each		1,00,000
		2,00,000
Issued Capital		
7,000 shares of ` 10 each		70,000
1000 6% Preference shares of ` 100 each		1,00,000
		1,70,000
Subscribed Capital		
Subscribed and fully paid up		1,00,000
1000 6% Preference shares of ` 100 each		
Subscribed but not fully paid up		
5000 equity shares of ` 10 each, `8 called up	40,000	
Less calls-in-arrear	(300)	39,700
		1,39,700
2. Reserves and Surplus		
General Reserve	4,000	
Statement of P/L	(6,000)	(2000)
3. Non-current Liabilities		
500, 5% Debentures of ` 1000 each		5,00,000
4. Current Liabilities Short term borrowings Short term loan from bank		10,000
5. Current Liabilities		
Short term provision		
Provision for Tax	1,000	
Provision for Doubtful Debts	200	1,200
6. Current Assets		
Current Investments		
Marketable Securities		500
7. Current Assets		
Trade Receivables		
Debtors		5000

Illustration 2

From the following ledger balances of Sunshine Co. Ltd., prepare a Balance Sheet of the company as on 31st March 2014 as per Schedule VI of the Companies Act.

Particulars	Rs.	Particulars	Rs.
Equity Share Capital	2600000	Advances to employees	150000
General Reserves	30000	Discount on issue of debentures(unwritten off)	12500
12% Debenture	400000	Tools and equipment	375000
Land & Buildings	1554970	Gratuity Fund	300000
Goodwill	1000000	Debtors	138520
Bank Overdraft	245100	Cash at Bank	157160
Proposed Dividend	82000	Stores & Spares	177800
Prepaid insurance	25000	Profit & Loss A/c	21490
Mutual Fund	168000	Bills Receivable	44600
Interest payable	32400	Sundry Creditors	92560

Solution: Notes to the Financial Statement:

1. Reserve and Surplus

General Reserve	30000
Profit & Loss A/c (Cr. Bal.)	21490
Total	51490

2. Tangible Fixed Assets

Land & Buildings	1554970
Tools & Equipment	375000
Total	1929970

3. Trade Receivables

Sundry Debtors	138520
Bills Receivable	44600
Total	183120

Balance Sheet of Sunshine Company Limited as on 31st March 2014

`Particulars	Note No.	Amount (Rs.)
I.EQUITY AND LIABILITIES		
1 Shareholders' funds:		
(a) Share capital		2600000
(b) Reserves and surplus	1	51490
2 Share application money pending allotment:		Nil
3 Non-current liabilities:		
(a) Long-term borrowings		400000
(b) Long-term provisions		300000
4 Current liabilities:		
(a) Short-term borrowings		245100
(b) Trade payables	2	92560
(c) Other current liabilities		32400
(d) Short-term provisions		82000
TOTAL		3803550

II.ASSETS		
1Non-current assets:		
(a)Fixed assets		
(i) Tangible assets	3	1929970
(ii) Intangible assets		1000000
(b) Other non-current assets		12500
2 Current assets:		
(a) Current investments		168000
(b) Inventories		177800
(c) Trade receivables		183120
(d) Cash and cash equivalents		157160
(e) Short-term loans and advances		150000
(f) Other current assets		25000
TOTAL		3803550

Illusration 3

From the following Ledger balances of TISCO CO. LTD., prepare a Balance Sheet of the company as on 31st March 2014 as per Schedule VI of the Companies Act.

Particulars	Rs.	Particulars	Rs.
Plant & machinery	300000	Premises	500000
6% Debenture	400000	Fixed Deposits	250000
Provision for workmen, compensation	65000	Provision for taxation	90000
General Reserves	40000	Loan from Bank of India	250000
Cash in hand	17000	Discount on issue of Debentures(unwritten off)	55000
Equity Share capital	600000	Bills Receivable	120000
Sundry creditors	58000	Bank overdraft	75000
Advance salary to staff	35000	Security deposits	62000
Shares of Reliance Co. Ltd	99000	Goodwill	90000
Commission Receivable	50000		

Solution: Notes to the Financial Statement:

1 .Long Term borrowings

6% Debentures	400000
Loan from Bank of India	250000
TOTAL	650000

2. Tangible Assets

Plant & Machinery	300000
Premises	500000
TOTAL	800000

3Cash & Cash equivalent

Cash in hand	17000
Fixed Deposit	250000
TOTAL	267000

Balance Sheet of TISCO CO. LTD. as on 31st March 2014

Parti	Note No.	Amount (Rs.)
I.EQUITY AND LIABILITIES		
1 Shareholders' funds:		
(a) Share capital		600000
(b) Reserves and surplus		40000
2 Share application money pending allotment:		Nil
3 Non-current liabilities:		
(a) Long-term borrowings	1	650000
(d) Long-term provisions		65000
4 Current liabilities:		
(a) Short-term borrowings		75000
(b) Trade payables	2	58000
(d) Short-term provisions		90000
TOTAL		1578000
II.ASSETS		
1Non-current assets:		
(a) Fixed assets		
(i) Tangible assets	3	800000
(ii) Intangible assets		90000
(b) Long-term loans & advances		62000
(e) Other non-current assets		55000
2 Current assets:		
(a) Current investments		99000
(c) Trade receivables		120000
(d) Cash and cash equivalents		267000
(e) Short-term loans and advances		35000
(f) Other current assets		50000
TOTAL		1578000

Illustration 4

From the following ledger balances of Reality Limited as on 31st March 2014. You are required to prepare the Balance Sheet as on 31st March 2014 as per Revised schedule VI of the Indian Companies Act, 1956.

Particulars	Rs	Particulars	Rs
Furniture and Fixtures	4,85,600	General Reserve	4,20,000
8% Govt. Bonds	2,50,000	Sundry Creditors	1,73,500
Securities Premium	80,000		
Plant and machinery	18,50,000		
Copyrights	88,250	Bank Overdraft	3,15,000
Sundry Debtors	1,95,000	Public Deposit	5,60,000
Underwriting Commission writtenoff	35,000	Rent payable	41,000
Cash at Hand	1,05,200	Provision for Pension fund	90,000
Prepaid insurance	56,000	Equity Share Capital	15,50,000
Loan to director	28,000	Provision for Taxation	31,550
Stock in trade	1,68,000		

Solution: Notes to the Financial Statement:

1. Reserve and Surplus

General Reserve	4,20,000
Securities Premium	80,000
Total	5,00,000

2. Trade payables

Sundry Creditors	1,73,500
Rent payable	41,000
Total	2,14,500

3. Tangible Fixed Assets

Furniture and Fixtures	4,85,600
Plant and machinery	18,50,000
Total	23,35,600

Balance Sheet of Reality Limited as on 31st March 2014

Particulars	Note No.	Amount (Rs.)
I.EQUITY AND LIABILITIES		
1 Shareholders' funds:		
(a) Share capital		15,50,000
(b) Reserves and surplus	1	5,00,000
2 Share application money pending allotment:		Nil
3 Non-current liabilities:		
(a) Long-term borrowings		5,60,000
(d) Long-term provisions		90,000
4 Current liabilities:		
(a) Short-term borrowings		3,15,000
(b) Trade payables	2	2,14,500
(d) Short-term provisions		31,550
TOTAL		32,61,050
II.ASSETS		
1Non-current assets:		
(a)Fixed assets		
(i) Tangible assets	3	23,35,600
(ii) Intangible assets		88,250
(e) Other non-current assets		35,000
2 Current assets:		
(a) Current investments		2,50,000
(b) Inventories		1,68,000
(c) Trade receivables		1,95,000
(d) Cash and cash equivalents		1,05,200
(e) Short-term loans and advances		28,000
(f) Other current assets		56,000
TOTAL		32,61,050

Illustration 5

From the following particulars, prepare Statement of profit and loss for the year ending March 2013, as per the revised Schedule VI:]

Balances	Rs.	Rs.
Plant and Machinery	1,60,000	
Land	6,74,000	
Depreciation on Plant and Machinery	16,000	
Purchases (Adjusted)	4,00,000	
Closing stock	1,50,000	
Wages	1,20,000	
Sales (Net)		
Salaries	80,000	10,00,000
Bank overdraft		
10% debentures (issued on 1st April, 2012)		2,00,000
Equity share capital– shares of Rs. 100 each (fully		1,00,000
paid) Preference share capital– 1,000; 6% shares of		2,00,000
Rs. 100 each (fully paid)		1,00,000
	16,00,000	16,00,000

Additional information

(i) Equity dividend @ 10% declared on paid up capital.

(ii) Dividend on the preference share capital paid in full.

(iii) Rs. 2,00,000 transferred to general reserve.

Solution

Statement of Profit and Loss for the year ending 31st March, 2013

Particulars	Note No.	Amount (Rs.)
I. Income		
Revenue from operations (Sales)		10,00,000
Total		10,00,000
II. Expenses		
Cost of materials consumed (Adjusted purchase)		4,00,000
Employees benefit expenses		2,00,000
Finance cost	1	10,000
Depreciation and amortisation		16,000
Total		6,26,000
Profit before tax (I-II)		3,74,000

Notes to Accounts

Particulars	Amount Rs.	Amount Rs.
Employee Benefit Expenses		
(i) Wages	1,20,000	
(ii) Salary	80,000	2,00,000

Illustration 6

Given is the Trial Balance of Marathon Limited as on 31st March, 2012. You are require to prepare the Profit and loss Account and Balance Sheet on 31st March, 2012

	Dr.	Cr.
Authorised Share capital divided into 8,000, 6% preference shares of ` 100 each and 20,000 equity shares of ` 100 each		28,00,000
Subscribed Capital		
5,000 6% preference shares of ` 100 each		5,00,000
Equity Share Capital		8,00,000
Capital Reserve		5,000
Purchases - Coco, Tea, Coffee	58,800	
- Bakery products	36,200	
Wages and Salary	15,300	
Rent, Rates and Taxes	8,900	
Laundry	750	
Sales - Coco, Tea and Coffee		82,000
- Bakery products		44,000
Coal and Firewood	3,290	
Carriage	810	
Sundry Expenses	5,840	
Advertising	8,360	
Repair	4,250	
Rent of Rooms		48,000
Receipt from Billiards		5,700
Miscellaneous Receipts		2,800
Discount Received		3,300
Transfer Fee		700
Freehold Land and Building	8,50,000	
Furniture and Fittings	86,300	
Stock on hand, 1st April, 2011		
Coco, Tea, Coffee	12,800	
Bakery products	5,260	
Cash in Hand	2,200	
Cash with Bank	76,380	

Preliminary and Formation Expenses	8,000	
2000, 8% debentures of ` 100 each		2,00,000
Profit and Loss Account		41,500
Sundry Creditors		42,000
Sundry Debtors	19,260	
Investment	2,72,300	
Goodwill at Cost	5,00,000	
General Reserve		2,00,000
	19,75,000	**19,75,000**

Additional Information:

— Wages and Salaries outstanding 4,280

— Stock as on 31st march, 2012

— Coco, Tea, Coffee 22,500

— Bakery Products 16,400

— Provide 5% depreciation on Furniture and Fittings and 2% on Land and Building. The equity capital on 1st April, 2011 stood at `7, 20,000, that is 6,000 shares fully paid and 2,000 shares of `60 paid. The directors made a call of ` 40 per share on 1st October, 2011. A shareholder could not pay the call on 100 shares and his shares were then forfeited and reissued at `90 per share as fully paid. The director proposes a dividend of 8% on equity shares, transferring any amount that may be required from general reserve. Ignore taxation.

	Particulars	Notes	Amount (`)
I	Revenue from Operations	10	1,79,700
II	Other Receipts	11	6,800
III	**Total Revenue (I + II)**		**1,86,500**
IV	**Expenses**		
	Purchase of Stock in Trade	12	95,000
	Change in Inventories of Finished Goods	13	(20,840)
	Employee Benefit Expenses	14	19,580
	Other Operating Expenses	15	23,840
	Selling and Administrative Expenses	16	8,360
	Finance Costs	17	16,000
	Depreciation and Amortization Expenses	18	21,315
	Total expenses		1,63,255

V	**Profit(Loss) for the period (III-IV)**	**23,245**
	Balance from Previous Years	41,500
	Transfer from General Reserve	29,255
	Less: Proposed Dividend	
	- Preference Share Capital @6%	30,000
	- Equity Share Capital @ 8%	64,000
	Profit (Loss) carried to Balance Sheet	**0**

Balance Sheet of Marathon Limited as on 31st March, 2012

Particulars	Notes	Amount (`
I Equity and Liabilities		
1. Shareholders' Fund		
(a) Share Capital	1	13,00,000
(b) Reserve and Surplus	2	1,75,745
2. Non-current liabilities		
(a) Long term liabilities	3	2,00,000
3. Current liabilities		
(a) Trade Payables	4	46,280
(b) Short Term Provisions	5	1,10,000
TOTAL		**18,32,025**
II Assets		
1. Non-Current Assets		
(a) Fixed assets		
(i) Tangible Fixed Assets	6	9,14,985
(ii) Intangible Assets (Goodwill)		5,00,000
(b) Non – Current Investments		2,72,300
2. Current Assets		
(a) Inventories	7	38,900
(b) Trade Receivables		19,260
(c) Cash and Cash Equivalents	8	78,580
(d) Other Current Assets	9	8,000
TOTAL		**18,32,025**

Notes to the Financial Statements

1. Share Capital	
Equity Share Capital	
- Authorised Equity Share Capital : 20,000 Equity Shares of ` 100 each	20,00,000
- Issued and Subscribed 8,000 Equity Shares of ` 100 each	8,00,000
Preference share capital	
Authorised Preference Share Capital	
- 8,000, 6% Preference Shares of ` 100 each	8,00,000
- Issued and Subscribed 5,000 6% Preference Shares of ` 100 each	5,00,000
	13,00,000

2.	**Reserve and Surplus**		
	- Capital Reserve	5,000	
	- General Reserve	2,00,000	
	Less : Amount used to pay dividend on Equity and Preference Share Capital	29,255	1,70,745
			1,75,745
3.	**Long Term Borrowings**		
	- 2000, 8% Debentures of ` 100 each		2,00,000
4.	**Trade Payables**		
	- Sundry Creditors		42,000
	- Wages and Salaries Outstanding		4,280
			46,280
5.	**Short term Provisions**		
	- Interest on Debentures		16,000
	- Proposed Preference Dividend		30,000
	- Proposed Equity Dividend		64,000
			1,10,000
6.	**Tangible Assets**		
	- Freehold Land and Building	8,50,000	
	Less : Depreciation @2%	17,000	8,33,000
	- Furniture and Fitting	86,300	
	Less : Depreciation @5%	4,315	81,985
			9,14,985
7.	**Inventories**		
	- Coco, Tea, Coffee		22,500
	- Bakery Products		16,400
			38,900
8.	**Cash and Cash Equivalents**		
	- Cash at Bank		76,380
	- Cash in Hand		2,200
			78,580
9.	**Other Current Assets**		
	- Preliminary and Formation Expenses		8,000
10.	**Revenue from Operations**		
	Sale of products		
	- Coco, Tea and Coffee	82,000	
	- Bakery Products	44,000	1,26,000
	Sale of services		

- Rent of Rooms	48,000	
- Receipt from Billiards	5,700	53,700
		1,79,700

11. Other Receipts

- Miscellaneous Receipts	2,800
- Discount Received	3,300
- Transfer Fee	700
	6,800

12. Purchases of Stock in Trade

- Coco, Tea and Coffee	58,800
- Bakery Products	36,200
	95,000

13. Change in Inventories of Finished Goods

- Coco, Tea, Coffee		
Opening Stock	12,800	
Less: Closing Stock	22,500	(9,700)
- Bakery Products		
Opening Stock	5,260	
Less : Closing Stock	16,400	(11,140)
		(20,840)

14. Employee Benefit Expenses

Wages and Salaries	15,300
Add: Outstanding Wages and Salaries	4,280
	19,580

15. Other Operating Expenses

- Rent Rates and Taxes	8,900
- Coal and Firewood	3,290
- Laundry	750
- Carriage	810
- Repair	4,250
- Sundry Expenses	5,840
	23,840

16. Selling and Distribution Expenses

- Advertising	8,360

17. Finance Cost

- Interest on Debentures	16,000

18. Depreciation and Amortization Expenses

- Land and Building	17,000
- Furniture and Fittings	4,315
	21,315

Illustration 7

You are required to prepare financial statements from the following trial balance of Mehul Company Ltd. for the year ended 31st March, 2012

Mehul Company Ltd.
Trial Balance as at 31st March, 2012

Particulars	`	Particulars	`
Stock	68,000	Equity Shares Capital (Shares of ` 10 each)	2,50,000
Furniture & Fixtures	50,000	11% Debentures	50,000
Discount	4,000	Bank Loans	64,500
Loan to Directors	8,000	Bills Payable	12,500
Advertisement	2,000	Creditors	15,600
Bad Debts	3,500	Sales	4,26,800
Commission	12,000	Rent Received	4,600
Purchases	231,900	Transfer Fees	1,000
Plant and Machinery	86,000	Profit & Loss Appropriation Account	13,900
Rentals	2,500	Provision for Depreciation on Plant & Machinery	14,600
Current Account	4,500		
Cash	800		
Interest on Bank Loan	11,600		
Preliminary Expenses	1,000		
Wages	90,000		
Consumables	8,400		
Freehold Land	1,54,600		
Tools and Equipments	24,500		
Goodwill	26,500		
Debtors	28,700		
Bills Receivables	15,300		
Dealer Aids	2,100		
Transit Insurance	3,000		
Trade Expenses	7,200		
Distribution Freight	5,400		
Debentures Interest	2,000		
	8,53,500		**8,53,500**

Additional Information :

- Closing stock as on 31st march, 2012, `82,300
- Depreciation on furniture & fixtures @5%, Freehold land @2% and Tools and Equipments @5% to be provided.

Solution

Profit and Loss Account of Mehul Company Ltd. for the year ended on 31st March, 2012

	Particulars	Notes	Amount (`)
I	Revenue from Operations		4,26,800
II	Other Receipts	8	5,600
III	**Total Revenue (I + II)**		**4,32,400**
IV	**Expenses**		
	Purchase of Stock in Trade	9	2,31,900
	Change in Inventories of Finished Goods	10	(14,300)
	Employee Benefit Expenses	11	90,000
	Other Operating Expenses	12	48,100
	Selling and Administrative Expenses	13	2,000
	Finance Costs	14	13,600
	Depreciation and Amortization Expenses	15	6,817
	Total Expenses		3,78,117
V	**Profit (Loss) for the Period (III-IV)**		**54,283**
	Balance from Previous Years		13,900
	Profit (Loss) carried to Balance Sheet		**68,183**

Balance Sheet of Mehul Company Ltd. as on 31st March, 2012

	Particulars	Notes	Amount (`)
I	**Equity and Liabilities**		
	1. Shareholders' Fund		
	(a) Share Capital	1	2,50,000
	(b) Reserve and Surplus	2	68,183
	2. Non-Current Liabilities		
	(a) Long Term Liabilities	3	1,14,500
	3. Current liabilities		
	(a) Trade Payables	4	28,100
	TOTAL		**4,60,783**

II Assets		
1. Non-Current Assets		
(a) Fixed Assets		
(i) Tangible Fixed Assets	5	2,93,683
(ii) Intangible Assets (Goodwill)		26,500
Current Assets		
(a) Inventories		82,300
(b) Trade Receivables		28,700
(c) Cash and Cash Equivalents	6	5,300
(d) Short Term Loan and Advances	7	23,300
(e) Other Current Assets		1,000
TOTAL		**4,60,783**

Notes to the Financial Statements

1. Share Capital

- Equity Share Capital	
Authorised Share Capital	
25,000 equity shares of ` 10 each	2,50,000
Issued and Subscribed	
25,000 equity shares of ` 10 each	2,50,000
	2,50,000

2. Reserve and Surplus

- Balance as per last Balance Sheet	13,900
Add : Balance in Current Year Profit	54,283
	68,183

3. Long Term Borrowings

11% Debentures of ` 100 each	50,000
Bank Loan	64,500
	1,14,500

4. Trade Payables

Sundry Creditors	15,600
Bills Payables	12,500
	28,100

5. Tangible Assets

	Book value	Depreciation	Net value
Freehold Land and Building	1,54,600	3,092	1,51,508
Furniture and Fixtures	50,000	2,500	47,500
Plant and Machinery	86,000	14,600	71,400
Tools and Equipments	24,500	1,225	23,275
Total	3,15,100	14,600	2,93,683

Cash and Cash Equivalents	
Cash at Bank	4,500
Cash in Hand	800
	5,300
7. Short Term Loans and Advances	
Loan to Directors	8,000
Bills Receivables	15,300
	23,300
8. Other Income	
Rent Received	4,600
Transfer Fee	1,000
	5,600
9. Purchase of Stock in Trade	
Purchases	2,31,900
10. Change in Inventories of Finished Goods	
Closing Stock	82,300
Less : Opening Stock	68,000
	14,300
11. Employee Benefit Expenses	
Wages	90,000
12. Other Operating Expenses	
Consumables	8,400
Bad Debts	3,500
Discount	4,000
Rentals	2,500
Commissions	12,000
Dealer's Aid	2,100
Transit Insurance	3,000
Trade Expenses	7,200
Distribution Freight	5,400
	48,100
13. Selling and Administrative Expenses	
Advertisements	2,000
14. Finance Costs	
Interest on Bank Charges	11,600
Debenture Interest	2,000
	13,600
15. Depreciation and Amortization Expenses	
Freehold Land and Building	3,092
Furniture and Fixtures	2,500
Tools and Equipments	1,225
	6,817

CHAPTER 3

AMALGAMATION, ABSORPTION AND EXTERNAL RECONSTRUCTION

Amalgamation :

When two or more companies go into liquidation and a new company is formed to take over the business of the above two or more companies, this process is known as **amalgamation.**

Amalgamation refers to two or more companies merging to form a new company. Example : A Ltd and B Ltd went into liquidation formed a new company (AB Ltd) to take over the business of A Ltd and B Ltd.

In amalgamation, existing two companies are liquidated and a new company is formed.

To avoid competition and to fix the price of an article, amalgamation takes place.

Absorption :

When one or more existing companies go into liquidation and some existing company takes over the business, it is said to be absorption. That is, the business of a small company is absorbed by the big company. Absorption refers to the acquisition of business by an existing company.

Example:

A Ltd (existing company) absorbs the business of B Ltd (existing Company). In absorption, no new company is formed.

Reconstruction :

Reconstruction refers to the reconstruction of a company's financial structure. It may take place with or without the liquidation of the company. If a company goes into liquidation for reconstruction, then it is known as **external reconstruction.**

When one existing company goes into liquidation and a new company is formed inorder to buy its business, it is said to be external reconstruction. When a new company is formed with the same name in order to take over the business of an existing company, it is called **external reconstruction.**

Example : A Ltd goes into liquidation and a new company B Ltd is formed to take over the business A Ltd.

Internal Reconstruction:

Internal Reconstruction is a scheme of arrangement made among the parties in the company for any one or more of the following purposes:

i) Reduction of share capital

ii) Vary the rights of different types of shareholders, debentureholders and creditors

iii) To write off the accumulated losses of the company.

iv) To reduce the over valuation of assets of the company.

Internal reconstruction is also known as capital reduction. In internal reconstruction, no new company is formed. In internal reconstruction, reorganisation of capital structure of a company takes place.

Example :

A company incurred heavy losses. It made a scheme of reconstruction to set off losses. Parties involved in the company (shareholders, debentureholders and creditors) may sacrifice certain amounts to the company to adjust the accumulated losses.

Differences between amalgamation, absorption and Reconstruction:

1) Under amalgamation, two or more companies go into liquidation. In case of absorption, one or more companies go into liquidation. But under external reconstruction only one company goes into liquidation.

2) Under amalgamation, the shareholders of amalgamated company are the shareholders of amalgamating company. In case of absorption, the shareholders of purchasing company become the shareholders of new company. But in reconstruction, the shareholders of the new company are the shareholders of the old company.

3) Under amalgamation, a new company is formed. But in case of absorption, no new company is formed. Existing company takes over the business of another company. In case of reconstruction new company is formed to take over the business of liquidated company.

3

Differences between external reconstruction and Internal reconstruction :

	External Reconstruction	*Internal Reconstruction*
i)	One company goes into liquidation.	One company does not go into liquidation.
ii)	New company is formed.	No new company is formed.
iii)	New company is formed.Therefore, there is no question of capital reduction.	Capital is reduced.

iv)	Accumulated losses of vendor company are transferred to equity shareholder's account.	Accumulated losses are written off through capital reduction.
v)	Court's sanction is not necessary	Court's sanction is necessary
vi)	It involves the liquidation of an old company and formation of a new company.	It involves reorganisation of existing company.
vii)	It is governed by the provisions of Sec 394 of the Companies Act.	It is governed by the provisions of Sec.100 of the Companies Act.

B

Purchase Consideration:

Accounting Standard - 14 defines the term consideration as follows. "Consideration for amalgamation means the aggregate of the shares and other securities issued and payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company". **Payment made to debentureholders should not be considered as part of purchase consideration.** Purchase consideration should not include the amount of liabilities taken over by the transferee company.

Amount of purchase consideration (amalgamation under merger) can be computed under any one of the following four methods.

1) Lumpsum method　　2) Net payment method
3) Net assets method　　4) Instrinsic value method

i) Lumpsum method:

Under this method, the transferee company agrees to pay a fixed sum to the transferror company. The purchase price to be paid to shareholders may be stated in the agreement directly.

Example:

If A Ltd purchase the business of B Ltd for a price of Rs. 5,00,000. This Rs. 5,00,000 is the purchase consideration in lumpsum.

ii) Net assets method:

According to this method, the purchase consideration is calculated on the basis of net assets taken over by the transferee company.

Net assets to be taken by the purchasing company is considered to be the purchase consideration.

As per AS -14, purchase consideration has the following implications.

i) Purchase consideration refers to the total amount payable to the shareholders of the selling company only.

ii) Purchase consideration does not include the amount payable to creditors and debentureholders.

iii) Liquidation expenses of selling company paid by the purchasing company are added to the purchase consideration.

AS 14 refers to consideration payable both to the prefrence and equity shareholders of the transferor company.

In some circumstances, liquidation expenses are paid by the selling company and the same amount is reimbursed by the purchasing company. 4

Calculation of purchase consideration under Net Asset Method :

Assets and Liabilities taken by the purchasing company at an agreed value:

			Rs.
	Land and Buildings		xxx
	Plant and Machinery		xxx
	Debtors		xxx
	Stock in trade		xx
	Furniture		xx
			xxx
Less :	Creditors	xx	
	Other Liabilities	xx	xxx
	Net Assets		xxx

While calculating net assets, following points are to be considered

i) While calculating net assets, items such as preliminary expenses, debit balance of profit and Loss a/c, discount on issue of shares and debentures etc are to be excluded.

ii) When a company takes over another company or the business of another company, it means that both assets and liabilities to third parties are taken over.

iii) The term trade liabilities implies trade creditors and Bills payables. It excludes bank overdraft, debentures, outstanding expenses, Tax payable etc.

iv) When a company takes over the assets of another company, it implies that purchase consideration includes cash and bank balances. But accumulated losses if any should be excluded.

v) The term liabilities include all amount due to third parties excluding amount payable to shareholders.

vi) While calculating purchase consideration, liabilities which are not taken by the purchasing company are to be excluded.

vii) Assets which are not taken by the purchasing company should not be considered while calculating purchase consideration.

Example:

Total assets to be taken by the purchasing company is Rs. 5,00,000 and its liability amounted to Rs. 50,000. Therefore, purchase consideration is Rs. 5,00,000 – 50,000 = Rs. 4,50,000.

Problem : 1

The company B takes over the business of company A. The value agreed for various assets is goodwill Rs. 32,000, Land and Buildings Rs. 25,000. Plant and Machinery Rs.34,000. Stock Rs. 13,000. Debtors Rs. 8,000. B Company does not take over cash but agrees to assume the liabilities of sundry creditors at Rs. 25,000. Calculate purchase consideration.

Answer :

	Rs.
Agreed value of assets:	
Goodwill	32,000
Land and buildings	25,000
Plant and Machinery	34,000
Stock	13,000
Debtors	8,000
Total assets	1,12,000
Less : Agreed value of liabilities - creditors	25,000
Purchase consideration	87,000

Problem : 2

The balance sheet of A Ltd and B Ltd as on 31st March 2005 were

Liabilities	A Ltd	B Ltd	Assets	A Ltd	B Ltd
Share capital			Goodwill	5,000	2,000
(Rs. 50 each)	50,000	40,000	Buildings	17,000	10,000
General reserve	20,000	-	Machinery	24,000	16,000
P / L a/c	3,000	-	Vehicles	5,000	7,500
Creditors	4,000	8,000	Stock	10,000	7,500
Bank Overdraft	4,000	8,000	Debtors	12,000	7,000
			Cash	8,000	300
			P / L a/c	-	5,700
	81,000	56,000		81,000	56,000

The above two companies wanted to amalgamate and the following scheme of valuation is proposed.

A Ltd
1. Provide 5% on debtors
2. Write off Rs. 400 from stock and 33 1/3 from machinery.

B Ltd 1. Eliminate its goodwill and P/L a/c
2. Write off Rs. 1,000 on debtors as bad and provide 5% on debtors.
3. Write off 10% of machinery and Rs. 1,400 from stock.
Compute purchase consideration.

(M.S.University, November 2005)

Answer : Calculation of purchase consideration

A Ltd : Agreed value of assets:

		Rs.
Goodwill		5,000
Buildings		17,000
Machinery (24,000 - 8,000) 1/3 on 24,000		16,000
Vehicles		5,000
Stock (10,000 - 400)		9,600
Debtors (12,000 - 600)		11,400
Cash		8,000
		72,000
Less : Agreed value of third party liabilities		
Creditors	4,000	
Bank overdraft	4,000	8,000
Purchase consideration		64,000

B Ltd : Agreed value of assets

Buildings		10,000
Machinery (16,000 - 1,600)		14,400
Vehicles		7,500
Stock (7,500 - 1,400)		6,100
Debtors (7,000 - 1,000 = 6,000) - 300 (i.e 5/100 × 6,000)		5,700
Cash		300
Total assets		44,000
Less : Agreed value of third party Liabilities		
Creditors	8,000	
Bank	8,000	16,000
Purchase consideration		28,000

(iii) Net payment method:

Under this method, purchase consideration is calculated by adding the various payments in the form of shares, securities, cash etc made by the transferee company. No amount of liabilities is deducted even if these are assumed by the purchasing company.

The total of payments (in the form of cash or shares or debentures) represents the net payment made by the purchasing company as purchase price for the concern.

Example :

A Ltd agrees to purchase the business of X Ltd, on the following terms.

i) For each of the 10000 shares of Rs. 10 each in X Ltd. 3 shares in A Ltd of Rs. 10 each will be issued at an agreed value of Rs. 12 per share. In addition, Rs. 5 per share cash will be paid.

ii) 10% Debentures worth Rs. 1,00,000 will be issued to settle the Rs. 75,000 9% debentures in X Ltd.

iii) Rs. 20,000 will be paid towards expenses of winding up.

Calculate purchase consideration when the amalgamation is in the nature of merger.

Answer:

	Rs.
Shares issued to shareholder of X Ltd	
10,000 × 3 × 12	3,60,000
Cash paid to shareholders of X Ltd	
(10,000 × 5)	50,000
Purchase consideration	4,10,000

In this the net payment is 3,60,000 + 50,000 = Rs. 4,10,000

Note:

i) Payment to debentureholders should not be included in the purchase consideration.

ii) Payment of expenses of winding up by the purchasing company may be debited to General Reserve in the books of purchasing company.

iii) If any liabilities are taken by purchasing company, such amount should not be considered while calculating purchase consideration.

iv) When the liquidation expenses of selling company are paid by the purchasing company then that expenses should not be considered.

Problem : 3

Calculate purchase consideration.

i) A cash payment equivalent to Rs. 3 for every Rs. 10 share in G Ltd. (No.of shares 1,20,000)

ii) The issue of 90,000 shares of Rs. 10 fully paid in W Ltd having an agreed value of Rs. 12 per share.

iii) The issue of 5% debentures of W Ltd for 6% debentures of the G Ltd (Rs.

1,00,000) at a premium of 20%. (M.S.University, April 2014)

Answer:

Payment of cash @ Rs.3 for every Rs. 10 share =1,20,000 × 3=	3,60,000
90,000 shares of Rs.10 fully paid @ Rs. 12 = 90,000 × 12	= 10,80,000
Purchase consideration	= 14,40,000

iv) Intrinsic value method or shares exchange method:

Under stock exchange method, the purchase consideration is ascertained on the basis of the ratio in which the shares of purchasing company are exchanged for the shares of selling company. Under this method, purchase consideration is required to be calculated on the basis of the ratio in which the shares of the purchasing company are exchanged with those of the selling company. The exchange ratio is calculated on the basis of intrinsic values of the respective companies' shares.

The intrinsic value of a share is calculated by dividing the value of net assets available to equity shareholders by the number of equity shares of the company.

The ratio of exchange may be decided on the basis of the intrinsic or market value of the shares concerned.

$$\text{Intrinsic value} = \frac{\text{Assets available to equity shareholders}}{\text{Number of equity shares}}$$

Example:

X Ltd and Y Ltd are two companies carrying on business in the same line of business. Their capital is Rs. 4,00,000 and Rs. 2,00,000 respectively (face value of each share Rs. 10). The two companies decided to amalgamate in XY Ltd. The two companies shares are valued at Rs. 20 and Rs. 25 respectively for the purpose of amalgamation. Calculate purchase consideration of each company.

Answer:

	X Ltd	Y Ltd
40,000 shares of Rs. 20 each	8,00,000	-
20,000 shares of Rs. 25 each	-	5,00,000

Example :

Arun Ltd was taken over by Rajan Ltd. The following position was mutually agreed upon.

	Arun Ltd.	Rajan Ltd.
No. of shares	60,000	60,000
Face value of share (Rs.)	100	10
Net asset (Rs.)	3,60,00,000	90,00,000

Calculate intrinsic values of the shares, ratio of the shares, ratio of exchange of shares and No.of shares to be issued.

Answer:

	Arun Ltd.	Rajan Ltd.
Net asset (Rs.)	3,60,00,000	90,00,000
No of shares	60,000	60,000
Intrinsic value of shares (Rs.)	600	150
Ratio	1	4

Number of shares issued = 1 share of Arun Ltd is equal to 4 shares of Rajan Ltd.
Hence, number of shares to be issued = 60,000 × 4 = 2,40,000 shares

Problem : 4

B Ltd agreed to absorb A Ltd upon the following terms.

Shares of A Ltd are to be considered worth Rs. 12 each (of which shareholders are to be paid one quarter in cash and the balance in Rs. 100 shares of B Ltd which are to be issued at 25% premium. Total shares were : 10,000 in B Ltd and 20,000 in A Ltd. Ascertain the number of shares to be issued by B Ltd. ***(M.S.University, Nov.2014)***

Answer : Calculation of purchase consideration

Payment of cash	$20{,}000 \times 12 \times \frac{1}{4}$	60,000
Payment of shares	$20{,}000 \times 12 \times \frac{3}{4}$	1,80,000
Purchase consideration		2,40,000

No.of equity shares to be issued by B Ltd to A Ltd = $\frac{1{,}80{,}000}{125}$ = 1,440

Issue price of one equity share of B Ltd = 100 + 25 = Rs. 125 per share.

Problem : 5

A purchasing company agrees to issue three shares of Rs. 10 each paid up at market value of Rs. 15 per share for every 5 shares in the vendor company. Find out the number and amount of shares to be issued by the purchasing company if the vendor company has 1,00,000 shares of Rs.10 each Rs. 5 paid up. ***(M.S.University, April 2013)***

Answer :

For every 5 shares of vendor company, shares issue by vendor company = 3
For 1,00,000 shares of vendor company, shares of purchasing company
= 3/5 × 1,00,000 = 60,000

Calculation of purchase consideration :

Amount of shares issued (capital) 60,000 × 10	= 6,00,000
Securities premium = 60,000 × 5	= 3,00,000

Purchase consideration = 9,00,000

Net Asset Method:

Problem : 6

The company B takes over the business of company A. The value agreed for various assets is goodwill Rs.22,000 ; Land and Buildings Rs.25,000 ; Plant & Machinery Rs. 24,000 ; Stock Rs.13,000 ; Debtors Rs. 8,000. B company does not take over cash but agrees to assume the liability of sundry creditors at Rs. 5,000. Calculate purchase considered.

(M.S.University, Nov: 2017)

Answer : Calculation of purchase consideration

	Rs.
Goodwill	22,000
Land and Buildings	25,000
Plant & Machinery	24,000
Stock	13,000
Debtors	8,000
Total assets taken over	92,000
Less : Liabilities taken over	
Sundry creditors	5,000
Purchase consideration	87,000

Problem : 7

The capital of A, B and C partnership firm at the date of purchase by the limited company were Rs.10,000; Rs.6,000 ; Rs. 5,000. The partnership firm was converted into a limited company and assets and liabilities were sold to the company agreed to pay Rs.8,000 more than the book value and machinery which was taken at the Rs.1,000 less than the book value.

Calculate total purchase consideration.

(M.S.University, April 2011, Nov.2011, November 2013)

Answer :

Net Assets = Assets - Liabilities = Capital employed

Purchase consideration = Total capital of A, B & C

Calculation of purchase consideration		Rs.
A' Capital		10,000
B's Capital		6,000
C's Capital		5,000
		21,000
Less : Increase in value of liabilities	8,000	
Decrease in value of Assets	1,000	9,000

Purchase consideration 12,000

Accounting for Amalgamation - Accounting Standard 14 (AS - 14) :

The concept amalgamation has been modified by the Accounting Standard 14. This standard is applicable in respect of accounting periods commencing on or after 1st April 1995 and is madatory in nature.

Transferor company is one which is amagamated into another company.

Transferee company means the company into which a transferor company is amalgamated.

Types of Amalgamation :

There are two types of amalgamation.

1. Amalgamation in the nature of merger.
2. Amalgamation in the nature of purchase.

1. Amalgamation in the nature of Merger :

It is also known as pooling interests method of amalgamation. Amalgamation in the nature of merger occurs when the following conditions are satisfied.

i) All the assets, liabilities and reserves of the transferror company should be recorded at their existing amount in the books of the transferee company. No adjustments is intended to be made to the book values of the assets and liabilities of the tranferor company.

ii) Shareholders holding not less than 90% of the face value of equity shares of the tranferor company become equity shareholders of the transferee company after amalgamation.

iii) The consideration for amalgamation shall be discharged by the transferee company.

iv) The business of the transferor company is intended to be carried on after, the amalgamation by the transferee company.

v) Any excess amount paid as purchase consideration shall be adjusted in reserves.

vi) The balance of the profit and loss account of the transferor company should be aggregated with the corresponding balance of the transferee company.

Pooling interest method has no specific effect on the book value of the transferor company.

2. Amalgamation in the nature of purchase:

It is also known as purchase method. Under this method when any one or more of the conditions specified for amalgamation in the nature of merger is not satisfied.

Differences between pooling interest method and purchase method:

Pooling Interest Method	Purchase Method
i) It is the amalgamation in the nature of merger.	It is the amalgamation in the nature of purchase.
ii) All the assets and liabilities are transferred at their book values.	All the assets and liabilities are transferred at market value or shown at any value.
iii) All the reserves of the transferor company are recorded in the same form in the transferee company.	The reserves of the transferor company are not transferred to the transferee company.
iv) Any excess amount paid as purchase consideration shall be adjusted in reserves.	Any excess amount paid as purchase consideration is treated as goodwill or shown as capital reserve.
v) Any excess amount paid as purchase consideration shall be adjusted in reserves. So there is no question of treatment of goodwill.	Any excess amount paid as purchase consideration shall be shown as goodwill or capital reserves. In such a case, goodwill is to be written off within 5 years.
vi) Liquidation expenses paid by purchasing company is debited to General Reserve of the purchasing company. Sometimes it may be added to purchase consideration.	Liquidation expenses paid by the purchasing company is debited to Goodwill account.

Journal entries in the books of vendor company or Transferor company:

The books of transferror company being wound up will be closed in the same way as the books of a partnership firm being dissolved.

Journal entries:

Particulars		Debit	Credit
i) To Transfer assets:			
Realisation a/c	Dr	xx	
To Assets a/c			xx
ii) To Transfer liabilities:			
Creditors a/c	Dr	xx	
B/P a/c	Dr	xx	
Other liabilities a/c	Dr	xx	

To Realisation a/c			xx
iii) Purchase consideration:			
Purchasing company a/c	Dr	xx	
To Realisation a/c			xx
iv) To receive purchase consideration:			
Shares a/c	Dr	xx	
Cash a/c	Dr	xx	
Debentures a/c	Dr	xx	
To Purchasing company a/c			xx
v) Assets not taken by purchasing company sold out			
Cash a/c	Dr	xx	
To Realisation a/c			xx
vi) Liabilities not paid by purchasing company:			
Realisation a/c	Dr	xx	
To cash a/c			xx
vii) Realisation expenses paid:			
Realisation a/c	Dr	xx	
To cash a/c			xx
viii) Realisation expenses paid by purchasing company:			
a) Cash a/c	Dr	xx	
To Purchasing company a/c			xx
b) Purchasing company a/c	Dr	xx	
To cash a/c			xx
ix) Realisation profit:			
Realisation a/c	Dr	xx	
To Shareholders a/c			xx
(If there is any realisation loss-reverse entry is to be followed.)			
x) To transfer loss:			
Shareholders a/c	Dr	xx	
To P & L a/c			xx
xi) To transfer Reserves & Surplus:			
Reserve fund a/c	Dr	xx	
P & L a/c	Dr	xx	
General Reserve a/c	Dr	xx	
To Shareholders a/c			xx
xii) To transfer debenture:			
Debenture a/c	Dr	xx	
Realisation a/c	Dr (premium)	xx	
To debentureholders a/c			xx

xiii) To pay the amount to the debentureholders:			
Debentureholders a/c	Dr	xx	
To Bank a/c			xx
xiv) Shareholders a/c	Dr	xx	
To Cash a/c			xx
To Shares a/c			xx
(Being account Settled)			

Note : As per AS14, while calculating purchase consideration, amount payable to Debentureholders need not be taken into account. It may be settled by the purchasing company individually.

Problem : 8

The balance sheet of X Ltd and Y Ltd as on 31.3.1917 are given below.

Liabilities	A Ltd	B Ltd	Assets	A Ltd	B Ltd
Equity capital Rs.100 each	4,00,000	3,60,000	Premises	1,20,000	-
			Goodwill	-	1,20,000
General Reserve	75,000	-	Debtors	80,000	1,60,000
			Stock	3,00,000	90,000
P & L a/c	38,000	-	Bank	85,000	75,000
Creditors	72,000	1,20,000	P & L a/c	-	35,000
	5,85,000	4,80,000		5,85,000	4,80,000

A new company, XY Ltd was formed to take over the two businesses in entirely on the following terms :

i) X Ltd. Premises to be revalued at Rs. 1,50,000. Debtors to be taken over at 90% and stock at Rs. 3,15,000.

ii) Y Ltd. Goodwill to be taken over at Rs. 16,000. Debtors to be taken over at Rs.1,50,000 and stock at 75,000.

It was decided that the purchase consideration of both X and Y Ltd was discharged by the equity shares of Rs.10 of XY Ltd. Calculate Purchase consideration and Prepare the Balance Sheet of XY Ltd.

(M.S.University, April 2000)

Answer : Calculation of Purchase consideration

Particulars	X Ltd Rs.	Y Ltd Rs.
Premises	1,50,000	-
Debtors	72,000	1,50,000
Stock	3,15,000	75,000
Bank	85,000	75,000
Goodwill	-	16,000

	6,22,000	3,16,000
Less : Third Parties Liabilities :		
Creditors	72,000	1,20,000
Purchase consideration	5,50,000	1,96,000
No. of share to be received	55,000	19,600

Balance sheet of XY Ltd as on 31.3.1997

	Note No.	Amount
I Equity & Liabilities		
i) Share holder's funds		
Share capital	1	7,46,000
Reserves & Surplus		-
ii) Non-current liabilities :		
Long term borrowing		-
iii) Current Liabilities		
Trade payables	2	1,92,000
Total of (i) (ii) and (iii)		9,38,000
II Assets :		
i) Non-current assets :		
Fixed assets		
Tangible	3	1,50,000
Intangible		16,000
ii) Current Assets :		
Inventories	4	3,90,000
Trade receivables	5	2,22,000
Cash and Cash equivalents	6	1,60,000
		9,38,000

Notes forming part of Balance Sheet :	**Rs.**
1) Share capital :	
74,600 shares of Rs.10 each	7,46,000
2) Trade payables:	
Creditors of X	72,000
Creditors of Y	1,20,000
	1,92,000
3) Tangible assets :	
Premises	1,50,000
4) Inventories	
Stock of X	3,00,000
Stock of Y	90,000
	3,90,000
5) Trade Receivables :	

Debtor of X 90% of 80,000	72,000
Debtors of Y	1,50,000
	2,22,000

6) Cash and Cash equivalents :

Bank Balance of X	85,000
Bank Balance of Y	75,000
	1,60,000

Problem : 9 Given below are the balance sheets as on March 31, 2005 of A Ltd and B Ltd. which are amalgamated to form a new company Gama Ltd.

Liabilities	A Ltd Rs.	B Ltd Rs.	Assets	A Ltd Rs.	B Ltd Rs.
Share capital of Rs. 100 eac fully paid	1,00,000	2,00,000	Fixed Assets		
			Good will	-	40,000
			Building	30,000	25,000
Capital reserve	50,000	10,000	Plant	60,000	80,000
General reserv	10,000	-	Furniture	5,000	10,000
P & L a/c	40,000	-	Current assets		
Loans	80,000	60,000	Stock	1,00,000	1,40,000
Other Liabilitie	20,000	80,000	Debtors	1,04,000	13,000
			Cash at Bank	1,000	2,000
			P & L a/c	-	40,000
	3,00,000	3,50,000		3,00,000	3,50,000

The shareholders in the amalgamating companies are to be allotted fully paid equity shares in Gama Ltd for the amount of purchase consideration for which purpose all assets and liabilities are to be taken at book values except Goodwill of B Ltd.

Show the opening balance sheet of the New company.

(M.S.University, April 2014, April 2015)

Answer : Calculation of purchase consideration

	A Ltd Rs.	B Ltd Rs.
Goodwill	-	
Buildings	30,000	25,000
Plant	60,000	80,000
Furniture	5,000	10,000
Debtors	1,04,000	13,000

Stock		1,00,000		1,40,000
Cash at Bank		1,000		2,000
Agreed value of assets		3,00,000		2,70,000
Less : Liability				
Loans	80,000		60,000	
Other Liabilities	20,000	1,00,000	80,000	1,40,000
Purchase consideration		2,00,000		1,30,000

In the Books of Gama Ltd :

Journal entries :

	Particulars		Debit	Credit
i)	Business purchases a/c	Dr	3,30,000	
	To Liquidator of A Ltd			2,00,000
	To Liquidator of B Ltd			1,30,000
	(Being business purchased)			
ii)	Building a/c	Dr	55,000	
	Plant a/c	Dr	1,40,000	
	Furniture a/c	Dr	15,000	
	Stock a/c	Dr	2,40,000	
	Sundry Debtors a/c	Dr	1,17,000	
	Cash at Bank a/c	Dr	3,000	
	To Loans			1,40,000
	To Other liabilities			1,00,000
	To Business purchases a/c			3,30,000
	(Being assets and liabilities incorporated)			
iii)	Liquidator of A Ltd a/c	Dr	2,00,000	
	Liquidator of B Ltd a/c	Dr	1,30,000	
	To Share Capital a/c			3,30,000
	(Being shares issued to liquidators of A Ltd and B Ltd)			

In the Books of Gama Ltd:

Opening Balance Sheet as on 31.3.2005

I Equity & Liabilities	Note No.	Amount
i) Shareholder's funds		
Share capital	1	3,30,000
ii) Non-current Liabilities		-
iii) Current Liabilities		
Short term borrowings	2	1,40,000
Other liabilities	3	1,00,000
Total		5,70,000

II Assets :

i) Non - current Assets :		
Fixed Assets		
Tangible Assets	4	2,10,000
ii) Current Assets :		
Inventories	5	2,40,000
Trade Receivables	6	1,17,000
Cash and Cash equivalents	7	3,000
Total		5,70,000

Notes forming part of Balance Sheet :

1) Share capital :

3,300 shares of Rs. 100 each	3,30,000

2) Short term borrowings :

Loans - A Ltd	80,000
Loans - B Ltd	60,000
	1,40,000

3) Other Liabilities :

A Ltd	20,000
B Ltd	80,000
	1,00,000

4) Tangible Assets :

Building -	30,000 + 25,000	55,000
Plant -	60,000 + 80,000	1,40,000
Furniture -	5,000 + 10,000	15,000
		2,10,000

5) Inventories :

Stock of A Ltd	1,00,000
Stock of B Ltd	1,40,000
	2,40,000

6) Trade Receivables

Debtors of A Ltd	1,04,000
Debtors of B Ltd	13,000
	1,17,000

7) Cash and Cash equivalents :

A Ltd	1,000
B Ltd	2,000
	3,000

Liabilities	Amount Rs.	Assets	Amount Rs.
Share capital	1,20,000	Land and buildings	90,000
Sundry Creditors	30,000	Plant and Machnery	50,000
Bank overdraft	28,000	Stock	17,000
		Debtors	20,000
		P & L a/c	1,000
	1,78,000		1,78,000

The company went into volundary liquidation and the assets were sold to Y Co. Ltd., for Rs. 1,50,000 payable as to Rs.60,000 in cash and for Rs. 90,000 equity shares. The cash payment Rs. 60,000 is sufficient to discharge creditors. Bank Payables Rs. 2,000 liquidation expenses. Prepare realization a/c.

(M.S.University, April 2014)

Answer :

Purchase consideration - Rs. 1,50,000
Cash - Rs. 60,000
Shares - Rs. 90,000

Realisation a/c

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*
To Land & Buildings	90,000	By Y & Co Ltd. a/c	1,50,000
To Plant & Machinery	50,000	By Share holders	29,000
To Stock	17,000		
To Debtors	20,000		
To Cash (Expenses)	2,000		
	1,79,000		1,79,000

Problem : 2

Following is the balance sheet of X company Ltd., as on June 30, 2006.

Balance Sheet

Liabilities	Amount Rs.	Assets	Amount Rs.
12,000 equity shares of Rs. 500 each	60,00,000	Land & Building	27,20,000
2,600 debentures @ Rs. 500 each	13,00,000	Plant and Machinery	30,00,000
P & L a/c	20,000	Furniture & Fittings	1,00,000
Sundry Creditors	5,00,000	Patents and Trade marks	4,00,000

Workman's Savings bank	4,00,000	Stock	20,00,000
Insurance fund	1,30,000	Debtors	6,00,000
General Reserve	6,50,000	Cash at Bank	1,80,000
	90,00,000		90,00,000

Y Company Ltd., agreed to take over X Ltd on the following basis.

i) Payment of cash at Rs.90 for every share in X Ltd.

ii) Payment of cash at Rs.5.50 for every debentureholder in full discharge of debentures.

iii) Exchange of 4 shares of Y Company Ltd., of Rs. 75 each (quoted in the market at Rs.140 each) for every share in X Company Ltd.,

Show necessary ledger accounts in X Ltd.

(M.S.University, April 2010 ,April 2011,Nov.2011,Nov.2012 , April 2013)

Answer : Calculation of purchase consideration:

Payment to equity shareholders

Cash (12,000 × 90)	10,80,000
Shares 4/1 × 12,000 × 75	36,00,000
	46,80,000

In the Book of X Ltd - Ledger accounts

Realisation account

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*
To Land & Buildings	27,20,000	By Debentures	13,00,000
To Plant & Machinery	30,00,000	By Workmen savings bank	4,00,000
To Furniture & Fittings	1,00,000	By Creditors	5,00,000
To Patent & trademark	4,00,000	By Y Company Ltd	46,80,000
To Stock	20,00,000	By Equity shareholders	21,20,000
To Debtors	6,00,000		
To Cash at Bank	1,80,000		
	90,00,000		90,00,000

Equity shareholders' a/c

To Realisation a/c	21,20,000	By Share capital	60,00,000
To Bank	10,80,000	By P & L a/c	20,000
To shares	36,00,000	By Insurance fund	1,30,000
		By General reserve	6,50,000
	68,00,000		68,00,000

Y Company Ltd

To Realisation a/c	46,80,000	By Bank	10,80,000
		By Shares in Y Ltd	36,00,000
	46,80,000		46,80,000

Bank a/c

To Y Company Ltd	10,80,000	By Equity share holder	10,80,000
	10,80,000		10,80,000

Problem : 17

On January 1, 1987 the Balance Sheet of Karpagam Ltd was:

Issued Capital :	Rs.		Rs.
15,000 equity shares of Rs. 10 each	1,50,000	Goodwill	40,000
5,000 6% preference shares of Rs. 10 each	50,000	Patents	15,000
6% Debentures	30,000	Sundry assets	1,64,500
Creditors	20,000	Cash	500
Preference dividends in four years	-	P & L a/c	28,000
		Preliminary expenses	2,000
	2,50,000		2,50,000

A Scheme of reconstruction was agreed upon as follows:

a) A new Company to be formed called Krishnan company with an authorised capital of Rs. 3,25,000 all in ordinary shares of Rs. 10 each.

b) One ordinary share Rs. 5 paid, in the new company to be issued for each ordinary share in the old company.

c) Two ordinary shares, Rs. 5 paid, in the new company to be issued for each preference share in the old company.

d) Arrears to be cancelled.

e) DebentureshoIders to receive 3,000 ordinary shares in the new company credited as fully paid.

f) Creditors to be taken over by the new company.

g) The remaining unissued shares to be taken up and paid for in full by the directors.

h) The new company to take over the old company's assets, except patents, subject to writing down 'Sundry assets' by Rs. 35,000.

i) Patents were realised by Karpagam company for Rs. 1,000.

ii) The expenses of Karpagam company were Rs. 1,000. Close the books of Karpagam company, and open the books of Krishnan company by means of Journal entries and give balance sheet of Krishnan Company.

(M.S.University, April 1995, April 2010)

Answer : Calculation of purchase consideration

Preference share holders	10,000 × 5 -	50,000 shares
Equity share holders	15,000 × 5 -	75,000 shares
Purchase consideration		1,25,000

Ledger accounts in the books of Karpagam Limited

Realisation a/c

Particulars	Amount Rs.	Particulars	Amount Rs.
To Goodwill	40,000	By Debentures	30,000
To Sundry Assets	1,64,500	By Creditors	20,000
To cash	- 15,000	By Krishnan company	1,25,000
To cash	1,000	By Cash	1,000
To cash	500	By Equity shareholders	45,000
	2,21,000		2,21,000

Equity shareholder's a/c

To Realisation	45,000	By Equity capital	1,50,000
To Profit and Loss a/c	28,000		
To Preliminary exp.	2,000		
To Shares in new company	75,000		
	1,50,000		1,50,000

Krishnan Company a/c

To Realisation	1,25,000	By Equity shares Rs. 5 paid up	1,25,000
	1,25,000		1,25,000

In the books of Krishnan Company - Purchasing Company :

	Particulars		Debit	Credit
i)	Business purchases a/c	Dr	1,25,000	
	To Liquidator of Karpagam Ltd			1,25,000
	(Being business purchased)			
ii)	Sundry Assets a/c	Dr	1,29,500	
	Cash a/c	Dr	500	
	Goodwill a/c	Dr	45,000	
	To Creditors a/c			20,000
	To Debentures a/c			30,000
	To Business purchases			1,25,000
	(Being assets & Liabilities recorded)			

iii)	Liquidator of Karpagam Ltd a/c	Dr	1,25,000	
	To Share capital a/c			1,25,000
	(Being share issued)			
iv)	Debentures a/c	Dr	30,000	
	To Fully paid equity shares capital a/c			30,000
	(Being shares issued to debentures)			
v)	Bank a/c	Dr	45,000	
	To Share capital a/c			45,000
	(Being unissued shares issued)			

In the Books of Krishnan company

Balance Sheet as on 1.1.1997

	Note No.	Amount
I Equity & Liabilities		
i) Share holder's funds		
Share capital	1	2,00,000
ii) Non-current Liabilities		-
iii) Current Liabilities	2	
Trade payables		20,000
Total of (i) (ii) (iii)		2,20,000
II Assets		
i) Non - current Assets :		
Fixed Assets		
Tangible assets	3	1,29,500
Intangible assets	4	45,000
ii) Current assets :		
Cash and Cash equivalents	5	45,500
Total of (i) and (ii)		2,20,000

Notes forming part of Balance Sheet :

	Rs.
1. Share capital	
Issued to equity shareholders	1,25,000
Issued to Debentureholders	30,000
Issued for Cash	45,000
	2,00,000
2. Trade payables	
Sundry Creditors	20,000
3. Tangible assets :	
Sundry assets	1,29,500
4. Intangible assets - Goodwill	45,000

INTERNAL RECONSTRUCTION

Internal Reconstruction:

Internal reconstruction means the reduction of capital to cancel any paid up share capital which is lost or unrepresented by available assets. This is resorted to write off the past accumuated losses of the company. Internal Reconstruction is a scheme of arrangement made among the parties in the company for any one or more of the following purposes:

i) Reduction of share capital.

ii) Vary the rights of different types of shareholders, debenture holders and creditors.

iii) To write off the accumulated losses of the company.

iv) To reduce the over valuation of assets of the company.

Internal reconstruction and reduction of share capital means the same.

Different methods of capital reduction:

There are three methods of capital reduction.

i) Reducing or extinguishing the uncalled liability of members.

ii) Reducing by returning the excess capital.

iii) Reducing the paid up capital.

Provisions relating to capital reduction :

A company can reduce the share capital as per Sec.100 of the Companies Act 1956.

i) Articles of Association of the company must permit the reduction.

ii) A special resolution must be passed at the shareholder's meeting

iii) The reduction must be approved by the Court

iv) If the reduction leads to reduction in the authorised capital of the company, then capital clause of the Memorandum of Association must be altered.

v) Permission from the Registrar of companies must be obtained to alter the capital clause.

vi) After the reduction, the word **and reduced** must be used to its name.

The following reduction does not amount to capital reduction.

i) Forfeiture of shares for non payment of any calls.

ii) Surrender of shares

iii) Omission to issue the unissued share capital.

iv) Redemption of preference shares

v) Payment of interest out of capital

Reduction of share capital means cancellation of any paid up share capital which is lost or unrepresented by available assets.

Journal entries:

	Particulars		Debit Rs.	Credit Rs.
i)	Old equity Capital a/c	Dr	xx	
	To New equity capital a/c			xx
	To Capital Reduction a/c			xx
	(Being value of equity shares reduced)			
ii)	Old preference share capital a/c	Dr	xx	
	To New preference share capital a/c			xx
	To Capital reduction a/c			xx
	(Being value of preference shares reduced)			
iii)	Old Debentures a/c	Dr	xx	
	To New Debentures a/c			xx
	To Capital Reduction a/c			xx
iv)	Asset a/c	Dr	xx	
	To Capital Reduction a/c			xx
	(Being value of asset appreciated)			
v)	Capital Reduction a/c	Dr	xx	
	To Liabilities a/c			xx
	(Being value of liabilities increased)			
vi)	Capital reduction a/c	Dr	xx	
	To P&L a/c			xx
	To Goodwill a/c			xx
	To Patents a/c			xx
	To Trade mark a/c			xx
	To Asset a/c			xx
	(Being loss, ficitious assets written off and assets depreciated)			

Capital Reduction account:

Under a scheme of internal reconstruction, if any amount available to write off losses, intangible assets and tangible assets transferred to an account, known as **Capital Reduction** account. Any amount which is left in this account is known as capital reserve.

Problems

1. The following scheme of reconstruction was approved by Royal Ltd. The shareholders to receive in lieu of their present holding of 50,000 shares of Rs.10 each the following;

i) Fully paid ordinary shares equal to 2/5 of their holdings.

ii) 5% preference shares to the extent of 1/5 of the above ordinary shares.

iii) Rs.60,000, 6% debentures

iv) The Goodwill which stood at Rs.3,00,000 was written down to Rs.1,50,000

v) Plant and machinery were written down by Rs.20,000 and Rs.30,000 respectively. Pass journal entries.

(M.S. University Nov.2006, April 2011)

Answer : Journal entries

Particulars		**Debit Rs.**	**Credit Rs.**
) Equity share capital a/c	Dr	5,00,000	
To New equity share capital			2,00,000
To 5% Pre.share capital			40,000
To 6% Debentures a/c			60,000
To Capital reduction a/c			2,00,000
(Being share capital reduced)			
i) Capital reduction a/c	Dr	2,00,000	
To Good will a/c			1,50,000
To Plant a/c			20,000
To Building a/c			30,000
(Being assets written off)			

2. The following scheme of reconstruction approved by A Ltd.

(i) The shareholder to receive in lieu of their present holding of 1,00,000 shares of Rs.10 each the following:

(1) Fully paid ordinary shares equal to 2/5 of their holdings.

(2) 5% Preference shares to the extent of 1/5 the above ordinary shares.

(3) Rs.1,20,000, 6% Debentures.

(ii) The Goodwill which stood at Rs.6,00,000 was written down to Rs.3,00,000.

(iii) Plant and machinery were written down by Rs.40,000 and Rs.60,000 respectively.

Pass journal entries.

(M.S.University April 2012, Nov. 2013, Nov.2017)

Answer : Journal entries

Particulars		Debit Rs.	Credit Rs.
i) Old Equity share capital a/c	Dr	10,00,000	
To New share capital a/c			4,00,000
To 5% Pref.share capital a/c			80,000
To 6% Debentures			1,20,000
To Capital Reduction a/c			4,00,000
(Being old share capital reduced)			
ii) Capital reduction a/c	Dr	4,00,000	
To Goodwill a/c			3,00,000
To Plant			40,000
To Machinery			60,000
(Being value of assets reduced)			

3. The share capital of Z Ltd., considered of the following;

(a) 10,000 6% preference shares at Rs.100 each and

(b) 50,000 Equity shares of Rs.10 each. The shares were fully paid. The company had accumulated losses totaling Rs.3,50,000, besides preliminary expenses Rs.20,000. It was also ascertained that the fixed assets which stood in the books at Rs.14,00,000 were overvalued to the extent of Rs.4,00,000.

(i) 6% Preference shares to be converted into 7% Preference shares at Rs.60 each.

(ii) Equity shares were to be reduced to Rs.2 each journalise.

(Madras University, Nov 2015)

Answer : Journal entries

Particulars		Debit Rs.	Credit Rs.
i) 6% Pre.share capital a/c	Dr	10,00,000	
To 7% Pre.share capital a/c			6,00,000
To Capital reduction a/c			4,00,000
(Being preference share capital reduced)			
ii) Old equity share capital a/c	Dr	5,00,000	
To New equity share capital a/c			1,00,000
To Capital reduction a/c			4,00,000
(Being equity share capital reduced)			
iii) Capital reduction a/c	Dr	8,00,000	
To Profit and loss a/c			3,50,000

To Preliminery expense		20,000
To Fixed asset a/c		4,00,000
To Capital reserve		30,000
(Being capital reduction account written off)		

4. The following is the Balance sheet of VPM Ltd. as on 31.12.2005.

Liabilities	Rs.	Assets	Rs.
10,000 equity shares of Rs. 10 each	10,00,000	Fixed Assets	10,50,000
1,00,000 7% preference shares of Rs. 10 each	10,00,000	Good will	1,50,000
Creditors	2,00,000	Investments	2,00,000
		Debtors	2,50,000
		Profit and Loss A/c	5,50,000
	22,00,000		22,00,000

The Board of directors passed the following resolutions.

i) Equity Share Capital would be reduced by Rs. 4.

ii) Preference Shares reduced by Rs.3.

It was further resolved that the amount so available would be used for writing off goodwill and debit balance of P & L a/c. Pass Journal entries and the revised balance sheet.

(M.S.University, April 2008)

Answer : Journal entries

	Particulars		Debit Rs.	Credit Rs.
i)	Old share capital a/c	Dr	10,00,000	
	To New share capital a/c			6,00,000
	To Capital Reduction a/c			4,00,000
	(Being equity share capital reduced)			
ii)	Old preference share capital a/c	Dr	10,00,000	
	To New Pre.share capital a/c			7,00,000
	To Capital reduction a/c			3,00,000
	(Being preference share capital reduced)			
iii)	Capital Reduction a/c	Dr	7,00,000	
	To Profit and Loss a/c			5,50,000
	To Goodwill a/c			1,50,000
	(Being capital reduction account written off)			

Revised Balance sheet of VPM Ltd as on 31.12.2005

	Note No.	Rs.
I. Equity & Liabilities		
i) Shareholders' funds:		
Share capital	1	13,00,000
ii) Non current liabilities :		
iii) Current liabilities :		
Trade payables	2	2,00,000
Total of equity and liabilities		15,00,000
II. Assets :		
i) Non - current assets :		
Tangible Assets	3	10,50,000
Intangible assets		
ii) Current Assets :		
Investments	4	2,00,000
Debtors	5	2,50,000
Total		15,00,000

Notes to theBalance Sheet:

	Rs.
1. Share capital	
1,00,000 equity shares of Rs.6 each	6,00,000
1,00,000 preference shares of Rs. 7 each	7,00,000
	13,00,000
2. Trade Payables:	
Creditors	2,00,000
3. Tangible assets:	
Fixed assets	10,50,000
4. Investments	2,00,000
5. Trade Receivables	
Debtors	2,50,000

5. The following is the balance sheet of Bharat Ltd on 31.12.1985.

Liabilities	Rs.	Assets	Rs.
Authorised Capital:		Patent at cost	8,50,000
10,000 pref. shares of		Leasehold premises	1,30,800
Rs. 100 each	10,00,000	Plant & Machinery	42,200
10,000 equity shares		Sundry Debtors	76,500
of Rs. 100 each	10,00,000	Stock	55,000
Subscribed Capital:		Discount on issue of shares	18,000
7,500 Pref. shares of		Preliminary expenses	12,000

Rs. 100 each	7,50,000	Profit & Loss a/c	1,15,000
5,000 equity shares of		Cash in hand	500
Rs. 100 each	5,00,000		
Sundry Creditors	30,000		
Bank overdraft	20,000		
	13,00,000		13,00,000

The company suffered losses. The following schemes of capital reduction was adopted:

a) The preference shares to be reduced to an equal number of fully paid shares of Rs. 50 each.

b) The equity shares to be reduced to an equal number of fully paid shares of Rs. 25 each.

c) The amount available to be used to write off Rs. 30,800 off the leasehold premises, Rs. 15,000 stocks, 20% off plant and machinery and sundry debtors and the balance available (after writing off discount on issue of shares, preliminary expenses and P & L a/c completely) patents.

Journalise the transactions and prepare the Balance Sheet after the above Capital reduction.

(M.K.University, April 1987, M.S.University, April 2008, Nov.2012, April 2014)

Answer : Journal entries

Particulars	Debit	Credit
i) Old Preference share capital a/c Dr	7,50,000	
To New preferences share capital a/c		3,75,000
To Captal reduction a/c		3,75,000
(Being pre.share capital reduced)		
ii) Old equity share capital a/c Dr	5,00,000	
To new equity share capital a/c		1,25,000
To capital reduction a/c		3,75,000
(Being equity capital reduced)		
iii) Capital reduction a/c Dr	7,50,000	
To Leasehold property a/c		30,800
To Stock a/c		15,000
To Machinery a/c		8,440
To Debtors a/c		15,300
To Discount on issue of shares a/c		18,000
To Preliminary expenses a/c		12,000
To Profit and Loss a/c		1,15,000
To Patents		5,35,460
(Being accumulated losses and assets written off)		

Balance sheet of Bharat Ltd., as on 31.12.1985 (reduced).

	Note No.	Rs.
I. Equity & Liabilities		
i) Shareholders' funds:		
Share capital	1	5,00,000
ii) Non current liabilities :		
iii) Current liabilities :		
Trade payables	2	30,000
Short term borrowings	3	20,000
Total of equity and liabilities		5,50,000
II. Assets :		
i) Non - current assets :		
Tangible Assets	4	1,33,760
Intangible assets	5	3,14,540
ii) Current Assets :		
Stock	6	40,000
Trade Receivables	7	61,200
Cash in hand	8	500
Total		5,50,000

Notes to the Balance Sheet:

1. Share capital:

5,000 equity shares of Rs.50 each	1,25,000
7,500 preference shares of Rs. 50 each	3,75,000
	5,00,000

2. Trade Payables:

Sundry creditors	30,000

3. Short term borrowings

Bank overdraft	20,000

4. Tangible assets:

Fixed assets	
Leasehold premises	1,00,000
Plant & Machinery	33,760
	1,33,760

5. Intangible assets

Patents	3,14,540

6. Stock 40,000

7. Trade Receivables

Debtors	61,200

8.Cash in hand 500

6. A company's balance sheet as on 31st March 2007 is given below.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital	1,00,000	Fixed Assets	80,000
Creditors	50,000	Current Assets	40,000
		P & Loss a/c	25,000
		Goodwill	5,000
	1,50,000		1,50,000

Reduce Rs. 3 per share and write off losses Journalise.

(M.S.University, Nov. 2012)

Answer : Journal entries

Particulars		Debit Rs.	Credit Rs.
i) Old equity share capital a/c	Dr	1,00,000	
To New equity share capital a/c			70,000
To Capital reduction a/c			30,000
(Being old capital reduced)			
ii) Capital reduction a/c	Dr	30,000	
To Profit and Loss a/c			25,000
To Goodwill a/c			5,000
(Being capital reduction a/c written off)			

Note : It is assumed that value per equity share is Rs. 10

Balance sheet of of a company as on 31.03.2007 (and reduced).

	Note No.	Rs.
I. Equity and Liabilities :		
i) Shareholders' funds		
Share capital		70,000
ii) Non current liabilities		Nil
iii) Current liabilities		
Trade payables	1	50,000
Total		1,20,000
II. Assets :		
i) Non current Assets :		
Tangible Assets		80,000
ii) Current Assets		40,000
		1,20,000

CHAPTER 4
PROFITS PRIOR TO INCORPORATION

Profits Prior to Incorporation:

Amount of profit which is earned by a company prior to incorporation is known as **profits prior to incorporation.** Such profit cannot be said to have been earned by the company as it is not available for distribution as dividend to its shareholders. Incorporation certificate is the birth certificate of a company. In order to get an incorporation certificate, a company has to fulfil certain legal formalities. Fulfillment of legal formalities take three or four months. During this period of three or four months, the business will earn some profit. The amount of profit, which is earned by a company from the date of its acquisition to the date of incorporation, is known as profits prior to incorporation. When a company acquires the running business of a sole trader or a partnership firm, it is termed as acquisition of business. The acquiring company may be an existing company or a newly started company.

Accounting Treatment:

i) Profits prior to incorporation is a capital profit. Therefore, it should be transferred to the capital reserve of a company.

ii) It should not be used for payment of dividend to the shareholders.

iii) Profit prior to incorporation should be credited to capital reserve account. This profit may be utilised to

a) Write off capital losses

b) Write off expenses like 'preliminary expenses' underwriting commission, discount on issue of debentures, etc.

iv) Balance amount (if any) is transferred to capital Reserve account. It will appear on the liability side of the Balance sheet under the heading 'reserves and Surplus'.

Journal entry:

Profit and Loss a/c	Dr	xx	
To Capital Reserve a/c			xx

Loss prior to incorporation:

i) If a company incurs a loss, from the date of its acquisition to date of its incorporation, it is known as loss prior to incorporation. It is a capital loss. Therefore, it should be debited to Goodwill account.

ii) It may be debited to a separate account called 'Loss prior to incorporation account'. This loss may be adjusted by utilising the capital profits of the company.

iii) It is a capita loss. So, it will appear on the asset side of the Balance sheet under the heading 'Miscellaneous expenditure'. It is to be written off during the few years out of the profits of the company.

iv) It may be treated as goodwill and debited to goowill account.

v) Sometimes, it may also be treated as 'deferred revenue expenditure' and may be written out of the profits of the company over several years.

Journal entry:

Goodwill a/c	Dr	xx	
To Profit and Loss a/c			xx

Statement of profit or loss is prepared as per the new format.

Statement of Profit and Loss for the year ended - xxxx

	Note no.	Rs.
Revenue from operations	1	xx
Other income	2	xx
Total Revenue (A)		xx
Expenses :		
Cost of materials consumed	3	xx
Purchase of Stock in trade		xx
Changes in inventories of finished stock /WIP		xx
Employees benefits expenses	4	xx
Finance costs	5	xx
Depreciation and amortisation expenses	6	xx
Other expenses	7	xx
Total expenses (B)		xx
Profit before extra ordinary items & tax (A - B)		xx
Less : Extra ordinary items		xx
Tax		xx
Profit or Loss for the period		xx

Calculation of Profit prior to incorporation:

Methods available to calculate profit or loss prior to incorporation:

- Three methods are available:

1) Preparation of Trading, Profit and loss account for the period up to the date of incorporation.

2) Preparation of Trading and Profit and loss account for the whole accounting period and apportionment of the resulting profit or loss between pre and

post incorporation periods.

3) Preparation of common Trading account and Profit and loss account in columnar form. But as per the new format no trading account is prepared.

Apportionment of Expenses:

	Expenses / Items	Basis of apportionment
1.	Gross profit / Gross loss	Sales ratio
2.	All fixed expenses such as salary, rent, printing, audit fees depreciation, insurance, postage etc.	Time ratio
3.	All variable expenses which are directly related to sales such as commission, discount, salesmen's remuneration, advertisement, bad debts, carriage outwards, etc.	Sales ratio
4.	All expenses which are related to period before incorporation such as vendor's salary, interest for purchase consideration.	Allocated to the pre-incorporation period.
5.	All expenses which are related to period after incorporation such as directors' fees, debenture interest, discount on issue of debentures, preliminary expenses, formation expenses, etc.	Allocated to the post incorporation period.

The following procedure may be followed to calculate profit prior to incorporation.

i) Sales ratio and Time ratio are to be calculated. The ratio between the period prior to incorporation and the period after incorporation is considered to be the Time ratio. Like this, ratio between the sales prior to incorporation and the sales after incorporation is known as the sales ratio.

ii) Profit and Loss account is to be prepared. The following steps are to be followed:

a) Items which are to be included in the trading account are to be included under the heading revenue from operations and cost of material consumed and purchase of stock in trade.

b) Items such as Gross profit, Salesmen's commission, Advertisement, Bad debts, Selling expenses etc. depend upon the sales volume. Therefore, these items are to be allocated on the basis of sales ratio.

c) Expenses such as salaries, rent, depreciation, general expenses, printing and stationery etc. are to be allocated on the basis of time ratio between the period prior to incorporation and after incorporation.

c) Expenses such as director's fees, interest on debentures, formation expenses etc. are to be allocated directly to the period after incorporation.

d) Expenses such as partner's salary, interest on capital etc., are to be allocated directly to the period before incorporation.

After allocating the expenses in the above said manner, profit is calculated.

Profit which is earned after incorporation is a revenue profit. Therefore, it is treated as Net profit of the company. It is termed as surplus. Profit which is earned before incorporation is a capital profit and it is to be transferred to capital reserve.

Example 1:

A Limited company was incorporated on 31st July 2017 to purchase the business of Mr. A as on 1st April 2017. The company obtained certificated to commence business on 31st October 2017. The accounts of the company were closed on 31st March every year.

Sales for the year ended on 31st March 2018 amounted to Rs. 3,00,000. Sales upto 31st July 2017 amounted to Rs. 1,20,000. Sales upto 31st October 2017 amounted to Rs. 1,60,000. Calculate Time Ratio and Sales Ratio.

Calculation of Time Ratio:

Date of purchase of business	- 1-4-2017
Date of incorporation	- 31-7-2017
Date on which accounts are closed	- 31-3-2018
Period before incorporation (from 1-4-2017 to 31-7-2017)	- 4 months
Period after incorporation	- 8 months
Time ratio	= 4 : 8 = 1 : 2

Calculation of Sales Ratio:

Sales before incorporation	= Rs. 1,20,000
Sales after incorporation	= Rs. 3,00,000 – 1,20,000 = 1,80,000
Sales ratio	= 1,20,000 : 1,80,000 = 2 : 3

Example 2:

Raj Ltd was incorporated on 1st May 2017 to purchase the business of Bala & Co with effect from 1-1-2017. While preparing final accounts on 31-12-2017, it was found that,

1) Total sales for the year were Rs. 1,00,000.
2) Sales in the second half of the year were double to those in the

first half, on a monthly average basis.

You are required to find out the sales ratio and time ratio.

Answer:

Calculation of Time ratio:

Period before incorporation = 4 months
(from 1-1-2017 to 1-5-2017)
Period after incorporation = 8 months
Time ratio = 4 : 8 = 1 : 2

Calculation of Sales ratio:

Let the sales per month be Rs. x
Sales before incorporation = 4 × x = 4x
Let the sales per month in the second half of the year be = Rs. 2×x = Rs. 2x
Sales after incorporation = 6×2x = 12x
Sales ratio = 4x : 12x = 1 : 3

If a concern is purchased for a price which is less than net value, how will you deal with the difference?

The difference is known as capital profit and therefore it is transferred to capital reserve account.

On the other hand if the purchase price is more than the net value, then the difference is treated as a capital loss and therefore, it is transferred to Goodwill account.

Capital Reserve :

Capital Reserve is the amount which is created out of the capital profits of the company. At the time of acquisition of business, if the net asset of the business is more than the purchase consideration, then the purchasing company will earn profit. This profit is a non recurring profit and it is transferred to a Reserve known as **capital reserve.**

Example: A Ltd. purchases a business for a purchase consideration of Rs. 1,00,000 and the net asset of the business is Rs. 1,20,000. In this example, the company earns a profit of Rs. 20,000. This profit is transferred to capital Reserve.

Journal entry:

Asset a/c	Dr	1,20,000	
To Purchase consideration a/c			1,00,000
To Capital Reserve a/c			20,000

3. A Ltd. was formed on 1-7- 2017 to acquire the business of A& Co. with effect from 1-1-2017. When the company's first accounts were prepared on 31-12 2017, the following were noticed:

i) Sales for the year 2017 Rs.6,00,000

ii) Sales in January, February, April and May were only 50% of the annual average. Sales of August, September and December were twice the annual average.

Calculate time and sales ratio.

Answer:

Time ratio - 6: 6 = 1:1.

Average sales = 6,00,000/12 = Rs.50,000.

Sales for January, February, April and May = 4 x 50,000 x 50% = Rs.1,00,000

Sales for August, September and December= 3 x 50,000 x 2 = Rs.3,00,000

Sales for the remaining 5 months = 6,00,000 - 4,00,000 = Rs.2,00,000.

Average sales for the remaining 5 months = 2,00,000/5= Rs.40,000.

Sales before incoporation = 1,00,000 + 2 x 40,000 = Rs.1,80,000

Sales after incorporation = 3,00,000 + 3 x 40,000 = Rs.4,20,000

Sales ratio = 1,80,000 : 4,20,000 = 3 :7.

4. A public limited company was formed to take over a running business with effect from 1st April 2017. The company was incorporated on 1st August 2017, and the certificate of commencement of business was received on 1st October 2017. Total sales for the year ended on 31st March 2018 Rs. 9,60,000 arose evenly up to 1st October 2017 and thereafter spurted to record an increase of two-thirds during the rest of the year.

Answer: Calculation of Time Ratio:

Period before incorporation = 4 months
(1.4.2017 to 31.7.2017)

Period after incorporation = 8 months
(1.8.2017 to 31.3.2018)

Time Ratio = 4 : 8 = 1 : 2

Calculation of Sales ratio:

Let sales for one month be = Rs.x

Sales up to 1st October 2017 will be = 6 x x = 6x

Sales after 1st October 2017 will be = 6 x 5/3x = 10x

$6x + 10x = \text{Rs. } 9,60,000$

$16x = \text{Rs. } 9,60,000 : \quad x = \frac{9,60,000}{16} = \text{Rs. } 60,000$

Sales before incorporation = 4 x 60,000 = Rs. 2,40,000.

Sales after incorporation = 9,60,000 - 2,40,000 = Rs. 7,20,000.

Sales ratio = 2,40,000 : 7,20,000 = 1 : 3.

5. A company, incorporated on 1st April 2017, took over a running business from 1st January 2017. The company prepared its final accounts on 31st December 2017. From the following information, you are required to calculate Time Ratio and Sales Ratio.

i) Sales for the year 2017 - Rs. 6,00,000.

ii) Sales for the month of January twice the average sales

For the month of February - equal to average sale:

Sales for four months from May to August - 1/4 th of the average sale of each month and sales for October and November three times the average sale.

Answer:

Period before incorporation = 3 months

(1.1.2017 to 1.4.2017)

Period after incorporation = 9 months.

(1.4.2017 to 31.12.2017)

Time Ratio = 3 : 9 = 1 : 3.

Calculation of sales ratio:

$$\text{Average Sales per month} = \frac{6,00,000}{12} = \text{Rs. } 50,000$$

Calculation of sales for each month:

		Rs.
January	2 x 50,000	1,00,000
February	1 x 50,000	50,000
May	1/4 x 50,000	12,500
June	1/4 x 50,000	12,500
July	1/4 x 50,000	12,500
August	1/4 x 50,000	12,500
October	3 x 50,000	1,50,000
November	3 x 50,000	1,50,000
Sales for 8 months		5,00,000

Sales for the remaining 4 months = Rs. 1,00,000

Average sales per month = $\frac{1,00,000}{4}$ = Rs. 25,000

Sales prior to incorporation = 1,00,000 + 50,000 + 25,000 = Rs. 1,75,000
Sales after incorporation = Rs. 4,25,000
Sales ratio = 1,75,000 : 4,25,000 = 7 : 17.

6. You are required to calculate time ratio and also divide the total wages into pre and post incorporation period.

Date of incorporation	-	1.4.2004
Period of financial account	-	Jan. to Dec.2004
Date of business purchase	-	1.1.2004

Total wages Rs. 4,800.

(M.S.University, Nov. 2012, April 2018)

Answer:

Date of purchase of business	-	1.1.2004
Date of incorporation	-	1.4.2004
Date of account closing	-	31.12.2004
Period before incorporation	-	3 months

Period after incorporation to the date of account closing - 9 months
Time ratio = 3 : 9 = 1 : 3
Amount of wages = Rs. 4,800
Wages before incorporation = 4,800 × ¼ = 1,200
Wages after incorporation = 4,800 × ¾ = 3,600

7. Raja Ltd was incorporated on 1.7.2014 which took over a running concern with effect from 1.1.2014. The sales for the period upto 1.7.2014 was Rs.2,70,000 and the sales from 1.7.2014 to 31.12.2014 amounted to Rs. 3,30,000. The expenses debited to profit and loss account included.

	Rs.
i) Director's fee	15,000
ii) Bad debts	1,800
iii) Advertisement	6,000
iv) Salaries and general expenses	32,000
v) Preliminary expenses written off	3,000
Gross profit (1.1.2014 to 31.12.14)	2,40,000

Ascertain the profit prior to incorporation.

(M.S.University, Nov. 2016, Madras University, Nov. 1995)

Answer :

Period before incorporation - 6 months

Period from incorporation to account closing : 6 months

Time Ratio = 6 : 6 = 1 : 1

Sales upto incorporation - Rs. 2,70,000

Sales after incorporation - Rs. 3,30,000

Sales ratio = 2,70,000 : 3,30,000 = 9 : 11

Statement showing Profit and Loss for the year ended 31-12-2014.

Particulars	**Working Notes**	**Total**	**Pre incor poration**	**Post incor poration**
Revenue from operations (A)	1	2,40,000	1,08,000	1,32,000
Less : Expenses				
Employee Benefit exp.	2	32,000	16,000	16,000
Depreciation ans amortisation	3	3,000	-	3,000
Other expenses	4	22,800	3,510	19,290
Total expenses (B)		57,800	19,510	38,290
Profit (A - B)		182,200	88,490	93,710

Notes forming part of Profit and Loss account :

1. Revenue from operations :
   Gross profit is to be divided on the basis of
   sales ratio (9 : 11) = 1,08,000 1,32,000
2. Employee benefit expenses :
   Salary - Time ratio (1 : 1) - 16,000 16,000
3. Depreciation and amortisation : - 3,000
4. Other expenses :

	Total	**Pre incor-poration**	**Post incorporation**
Directors' fees	15,000	-	15,000
Bad debts (9:11)	1,800	810	990
Advertisement (9 :11)	6,000	2,700	3,300
Total	22,800	3,510	19,290

12. P Ltd was incorporated on 1.7.1997 to take over the business carried by R as a going concern with effect from 1.4.1997. The following is the profit and loss account for the year ended 31.3.1998 of P Ltd.

Particulars	**Rs.**	**Particulars**	**Rs.**
To Administration expenses	18,000	By Gross Profit	75,000
To Directors fees	3,000		
To Selling expenses	36,000		
To Audit fees	1,000		
To Preliminary expenses	3,000		
To Net profit	14,000		
	75,000		75,000

Sales Rs. 3,00,000 (sales upto 30.6.1997 Rs. 1,00,000). You are required to prepare a statement showing the profit earned prior to and after incorporation.

(Madras University, Nov. 2013) (M.S.University, Nov. 2006)

Answer:

Date of purchase of business		1.4.1997
Date of incorporation		1.7.1997
Date of account closing		31.3.1998
Time ratio		3 : 9 = 1 : 3
Sales before incorporation	=	Rs. 1,00,000
Sales after incorporation	=	Rs. 2,00,000
Sales ratio		= 1 : 2

Statement showing profit before and after incorporation.

Particulars	**Working notes**	**Total**	**Pre incorporation**	**Post incorporation**
Revenue from operations (A)	1	75,000	25,000	50,000
Less : Expenses				
Depreciation & amortisation	2	3,000	-	3,000
Other expenses	3	58,000	16,750	41,250
Total expenses (B)		61,000	16,750	44,250
Profit (A - B)		14,000	8,250	5,750

Working Notes :

1.	Revenue from operations (1 : 2)	75,000	25,000	50,000
2.	Depreciation & Amortisation	3,000	-	3,000
3.	Other expenses:			
	Administration expenses (1 : 3)	18,000	4,500	13,500
	Directors fees	3,000	-	3,000
	Selling expenses (1 : 2)	36,000	12,000	24,000
	Audit fees (1 : 3)	1,000	250	750
		58,000	16,750	41,250

13 B Ltd. was incorporated on 1.8.1994. It acquired the business of a partnership firm from 1.4.1994 from the following particulars. Find out the profit prior to incorporation and after incorporation.

a. Sales for the year ended 31.3.1995 is Rs. 6,00,000. This includes a sale of Rs. 2,50,000 upto 1.8.1994.

b. Gross profit for the year was Rs. 1,80,000

c. The expenses debited to the Profit and Loss account were:

	Rs.		Rs.
Rent	9,000	Salaries	15,000
Director's fees	4,800	Interest on debentures	5,000
Audit fees	1,500	Discount on sales	3,600
Depreciation	24,000	General expenses	4,800
Advertising	18,000	Stationery	3,600
Commission on sales	6,000	Bad debts (Rs. 500 related to prior to incorporation)	1,500
Interest paid to vendors on purchase consideration (Upto 1.10.'94)	3,000		

(M.S.University, April 1996)

Answer:

Date of incorporation 1.8.'94

Date of Purchase 1.4.'94

Date of a/c closing 31.3.'95

Period before incorporation : 4 months

Time Ratio = 4 : 8 = 1 : 2

Period after incorporation : 8 months

Calculation of sales ratio:

Sales before incorporation - Rs. 2,50,000.

Sales after incorporation - 6,00,000 - 2,50,000 = Rs. 3,50,000

Sales ratio - 2,50,000 : 3,50,000 = 5 : 7.

Statement showing profit before and after incorporation for the year ended 31.3.1995.

Particulars	Working Note	Total	Pre incorporation	Post incorporation
Revenue from operations (A)	1	1,80,000	75,000	1,05,000
Less : Expenses				
Employees benefit cost	2	15,000	5,000	10,000
Finance costs	3	8,000	2,000	6,000
Depreciation & amortisation	4	24,000	8,000	16,000
Other expenses	5	52,800	18,300	34,500
Total expenses (B)		99,800	33,300	66,500
Profit (A - B)		80,200	41,700	38,500

Notes forming part of Profit and Loss account :

	Total	Pre	Post
1. Revenue from operations	1,80,000	75,000	1,05,000
2. Employees benefit expenses :			
Salaries (1 : 2)	15,000	5,000	10,000
3. Finance cost			
Interest to vendors (2:1)	3,000	2,000	1,000
Interest on debentures	5,000	-	5,000
	8,000	2,000	6,000
4. Depreciation (1:2)	24,000	8,000	16,000
5. Other expenses (Rent (1:2)	9,000	3,000	6,000
Director's fees	4,800	-	4,800
Audit fees (1 : 2)	1,500	500	1,000
Advertising (5:7)	18,000	7,500	10,500
Commission on sales (5 : 7)	6,000	2,500	3,500
Discount on sales (5 : 7)	3,600	1,500	2,100
General expenses (1 : 2)	4,800	1,600	3,200
Stationery (1 : 2)	3,600	1,200	2,400
Bad debts (Given)	1,500	500	1,000
	52,800	18,300	34,500

Calculation of interest paid to vendors (Prior & after):

Total interest paid for 6 months (1.4.'94 to 1.10.'94) : Rs. 3,000.

Interest prior to incorporation: $\frac{3,000}{6} \times 4$ = Rs. 2,000

Interest after incorporation : $\frac{3,000}{6} \times 2$ = Rs. 1,000

14. From the following details calculate profit before and after incorporation.

a) Time ratio 3 : 4

b) Sales ratio 2 : 3

c) Gross profit Rs. 5,00,000

d) Expenses

Expenses	Rs.
Salary	96,000
Discount	40,000
Rent	15,000
General expenses	12,000
Advertisements	50,000
Directors fees	18,000

(Madras University, November 2015)

Answer :

Time ratio - 3 : 4

Sales ratio - 2 : 3

Statement showing profit or Loss for the year ended ------

Particulars	**Working Note**	**Total**	**Pre incor poration**	**Post incor poration**
Revenue from operations (A)	1	5,00,000	2,00,000	3,00,000
Less : Expenses				
Employees benefit expenses	2	96,000	41,143	54,857
Other Expenses	3	1,35,000	47,572	87,428
Total Expenses (B)		2,31,000	88,715	1,42,285
Profit / Loss		2,69,000	1,11,285	1,57,715

Notes forming part of Profit and Loss account :

1. Revenue from operation	2 : 3	5,00,000	2,00,000	3,00,000
2. Employees benefit expenses	3 : 4	96,000	41,143	54,857
3. Other expenses				
Discount	2 : 3	40,000	16,000	24,000
Rent	3 : 4	15,000	6,429	8,571
General expenses	3 : 4	12,000	5,143	6,857
Advertisements	2 : 3	50,000	20,000	30,000
Director's fees	-	18,000	-	18,000
		1,35,000	47,572	87,428

CHAPTER 5

Valuation of Goodwill and Shares

Definition of Goodwill

Goodwill refers to a measure of the capacity of a business to earn above normal profits. It represents the advantages a business has in connection with its customers, employees and outside parties with whom it comes in contact. It is the benefit and advantage of a good name, reputation and connection of a business. It is the attractive force which brings in customers. It is the one thing which distinguishes an old and established business from a new business at start. It is an intangible but a real asset.

Goodwill is defined as 'the present value of a firm's anticipated excess earnings.' When a man pays for goodwill, he pays for something which puts him in a position of being able to earn more than he would be able to do by his own unaided efforts (Prof. Dicksee). Goodwill is thus the extra saleable value attached to a prosperous business beyond the intrinsic value of net assets. In the words of Spicer and Pegler, "Goodwill may be said to be that element arising from the reputation, connection, or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by the net tangible assets employed in the business."

Valuation of Goodwill

There are various circumstances when it may be necessary to value goodwill. Some of the circumstances are:

(1) In the case of a partnership, when there is an admission, retirement, death or amalgamation, or a change in the profit sharing ratio take place, valuation of goodwill becomes necessary.

(2) In the case of a company, when two or more companies amalgamate, or one company absorbs another company, or one company wants to acquire controlling interest in another company or when the Government takes over the business, valuation of goodwill becomes necessary.

(3) In the case of a sole trader concern, goodwill is valued at the time of selling the business, to decide the purchase consideration.

(4) In the case of individuals, goodwill is valued for purposes of Estate Duty, Death Duty, etc. on the death of a person.

Factors determining the value of Goodwill

Since goodwill of a business represents its capacity to earn above normal profits, all factors which contribute to such profits influence the goodwill of the firm. Some of those factors may be:

(1) **Location factors.** Favourable location influences the earning capacity of the business and enhances its goodwill.

(2) **Time factor.** An older, more established, business enjoys better goodwill than a new business.

(3) **Nature of business.** The nature of goods dealt with, the risks attached, the competition involved, certain special privileges enjoyed by the firm such as special licences, franchise, etc., determine the value of goodwill.

(4) **Efficiency of management.** Planned production, distribution and highly successful marketing of a business leads to better profits and higher value of goodwill.

(5) **Other factors.** General economic conditions, political stability, Government policies, money market conditions, trade cycles, etc., are the other factors influencing the value of goodwill.

Factors determining the value of Goodwill

(1) Goodwill is always paid for the future. The buyer of a business is always interested in knowing whether the business will maintain its profits in the future also. If the advantage is not likely to come to the buyer, the buyer will not be ready to pay anything for goodwill. Therefore, when evaluating the amount of goodwill the buyer always keeps the future in mind and goodwill is the assurance of the future maintainable profits.

(2) The ability to earn future profits is measured by the profits made by the business in the recent past. Hence, analysis of the past profits becomes necessary to determine the average maintainable profits in the future. For the purpose of finding out the average profits likely to be earned in the future: (*a*) all actual expenses and losses not likely to occur in the future are added back to the profits, (*b*) all expenses and losses not incurred in the past, but likely to arise in the future are to be deducted, (*c*) all profits likely to be earned in the future only are to be added and (*d*) profits earned in the past, but not likely to be earned in the future are to be deducted.

After having adjusted profit in the light of the future possibilities, the average maintainable profit is ascertained which forms the basis for the valuation of goodwill.

(3) The future profits are likely to be reduced materially by taxation and hence it is also taken into account for determining the value of goodwill.

Methods of valuing goodwill

Basically there are two methods of valuing goodwill:

(1) Simple profit method and (2) Super-profit method.

(1) Simple Profit Method

There are two methods based on simple profit: (*a*) Purchase of Past Profit Method and (*b*) Capitalisation of Average Profit Method.

(a) Purchase of Past Profit Method. Under this method goodwill is expressed as a purchase of a certain number of years' profit based on the adjusted average profit of a given number of years. This method involves two steps:

(*i*) The profits for an agreed number of years preceding the valuation are averaged so as to arrive at the average annual profit earned during that period. This will have to be adjusted in the light of future possibilities and the average future maintainable profit determined.

If the profits have been fluctuating, a simple average is used. If profits show a steadily increasing or decreasing trend, appropriate weights are used giving greater weightage for profits of the later year.

(*ii*) The average future maintainable profit is multiplied by a certain number of years to find out the value of goodwill. The number of years selected for this purpose is based on the expectation of the number of years' benefit to be derived in the future from the past association. For example, if the average future maintainable profit is Rs. 25,000 and it is expected that this profit would be earned for at least another 3 years, then the goodwill will be:

Goodwill = Average profit $\times$ Number of years

$= 25{,}000 \times 3 = \text{Rs. } 75{,}000$

The number of years over which the profits are averaged and the number of years' purchase applied may vary considerably in practice but generally falls between one and five years. Estimating future profit beyond a period of say, 5 years would be quite difficult and unrealistic. The method suffers from two defects: (*a*) Difficulty of finding out the right number of years' purchase of profits as it depends on so many factors and (*b*) ignoring capital to be employed in the business.

(b) Capitalisation of Average Profit Method:

The following steps are to be taken in ascertaining the value of goodwill under this method:

(i) Ascertain the average future maintainable profit, as explained already.

(ii) Capitalise this average profit at the normal rate of return on investment on the type of business under consideration. This will give the net worth of the business.

(iii) Find out the value of net tangible assets (i.e., net assets other than goodwill) of the business.

(iv) Deduct the net tangible assets from the capitalised net worth of the business and the difference is goodwill.

Illustration 3

A company desirous of selling its business to another company has earned an average past profit of Rs. 1,60,000 per annum and the same amount of profit is likely to be earned in the future also, except that :

(1) Directors' fees of Rs. 12,000 per annum charged against such profits will not be payable by the purchasing company whose existing Board can manage the new business also.

(2) Rent at Rs. 28,000 pr annum which had been paid by the vendor company will not be incurred in the future since the purchasing company owns its own premises and the necessary accommodation can be provided.

The net assets, other than goodwill, were Rs. 18,00,000 and it was considered that a reasonable return on investment in this type of business would be 10%.

Solution:

			Rs.
	Average Net Profit		1,60,000
Add:	Expenses not likely to be incurred in the future:		
	Directors' fees	12,000	
	Rent	28,000	40,000
	Average future maintainable profit		2,00,000

$$\text{Capitalised net wealth} = \frac{2{,}00{,}000 \times 100}{10} = \text{Rs. } 20{,}00{,}000$$

Less: Net tangible assets other than Goodwill Rs. 18,00,000

Goodwill Rs. 2,00,000

(2) Super-Profit Method

Strictly speaking, goodwill can be attached only to a business which is earning above normal profits or super-profits. If there are no anticipated excess earnings over normal earnings, there can be no goodwill. Such excess profit is known as super-profit and it is the difference between the average profit earned by the business and the normal profit based on the normal rate of return. Hence for finding out the super-profits the following information will be required: (*a*) The estimated average future profits of the firm (ascertained as already explained), (*b*) The normal rate of return on investment and (*c*) The fair value of average capital employed in the business.

Normal rate of return: The normal rate of return refers to the rate of earnings which investor in general expect on their investments in a particular type of industry. It varies depending upon general factors like the bank rate, general economic conditions, political stability, etc., and specific factors like period of investment, risk attached to the investment, etc.

Illustration 4

X. Ltd., declared a dividend of 25% on its shares of Rs. 100 eacn, Rs. 80 paid-up. Its shares are quoted in the market at Rs. 200. Calculate the rate of return.

Solution:

On Rs. 100 the company pays a dividend of Rs. 25

On Rs. 80 the company pays a dividend of 25/100x80 = Rs. 20. Since the shares are quoted and demanded in the market at Rs. 200 the investor expects Rs. 20 for an investment of Rs. 200. In other words his expectation is a return of 10%.

Average Capital Employed: The average capital employed in the business may be ascertained in two ways, *i.e.*, either through the assets side or through the liabilities side.

Asset side approach:

		Rs.
	Assets (other than non-trading assets, goodwill and past expenses and losses) at market value, at the Balance Sheet date.	...
Less:	Liabilities to outsiders at revised values, if any	...
	Capital employed at the end of the year	...
Less:	Half of the profit earned during the year	...
	Average capital employed for the year.	...

Liabilities side approach :

			Rs.
Add:	Equity share capital		...
	Preference share capital		...
	Reserves and profits		...
	Profit on revaluation of assets and liabilities		...
Less:	Goodwill (Book-value)	...	
	Losses & past expenses not yet written off	...	
Less:	Loss on revaluation	...	...
	Capital employed at the end		...
Less:	$^1/_2$ of the profit		
	Average capital employed		...

Non-trading assets, that is assets acquired because of spare funds such as Government securities are excluded.

Normal profit and Super-profit

If the average capital employed and the normal rate of return are known, the normal profit can be ascertained. For example, if the average capital employed is Rs. 1,00,000 and the normal rate of return is 10%, the normal profit is

$$1{,}00{,}000 \times \frac{10}{100} = \text{Rs. } 10{,}000$$

Super-profit is the simple difference between the actual average profit earned and the normal profit. If in the above example, the average profit is Rs. 25,000, then the super-profit will be Rs. 25,000 – Rs. 10,000 = Rs. 15,0000.

Goodwill based on Super-Profit

There are four methods of calculating goodwill based on super-profit. They are: (1) Purchase of Super-profit Method, (2) Sliding-scale Valuation of Super-profit Method, (3) Annuity of Super-Profit Method and (4) Capitalisation of Super-Profit Method.

(1) Purchase of Super-profit Method:

Goodwill as per this method = Super-profit × Number of years. If, for example, the super-profit is Rs. 15,000 and goodwill is agreed to be 3 years purchase of super-profit, then the goodwill will be Rs. 45,000 (15,000 × 3).

(2) Sliding-scale Valuation of Super-profit Method:

This is only a variation of the first method. It is based on the logic that the greater the amount of super-profit, the more difficult it would be to maintain. Higher profit will naturally attract competition and soon the firm's ability to make super-profit is curtailed. Hence, instead of multiplying the whole super-profit by a certain number of years, a grading scale is adopted as shown below:

		Rs.
First	Rs. 5,000 at 3 years' purchase	15,000
Second	Rs. 5,000 at 2 years' purchase	10,000
Third	Rs. 5,000 at 1 year purchase	5,000
	Goodwill	Rs. 30,000

(3) Annuity of Super-Profit Method:

Under this method, goodwill is calculated by finding the present worth of an annuity paying the super-profit per year, over the estimated period discounted at the given rate of interest. The person worth of an annuity of Re. 1 for *n* years at *r*% is obtained by the formula:

$$Q = \frac{1 - \left(1 + \frac{r}{n}\right)^{n}}{\frac{r}{100}}$$

where Q = the present value of an annuity of Re. 1 for n years at r%
r = rate of interest per annum
n = the number of years.

Usually reference to the Annuity Table will give the present value of annuity for the given number of years and at the given rate of interest.

∴ Goodwill = super-profit × annuity.

For example, if the super-profit is Rs. 15,000 and the annuity of Re. 1 at 10% for 3 years is 2.48,685, then the goodwill is =Rs. 15,000 × 2.48,685 = Rs. 37,302.75.

This method takes into consideration the interest loss involved in paying a lump sum as goodwill in anticipation of future return of profit.

(4) Capitalisation of Super-Profit Method:

This is similar to the Capitalisation of average profit method as already explained. Under this method, the super-profit when capitalised at the normal rate of return will give the value of goodwill.

$$\text{Goodwill} = \frac{\text{Super profit}}{\text{Normal rate of return}} \times 100$$

$$= \frac{\text{Rs. } 15{,}000}{10} \times 100 = \text{Rs. } 1{,}50{,}000.$$

This method gives the maximum value for goodwill. Since the contention that super-profit will continue for long is unreasonable, this method is not safe for one to follow.

(VALUATION OF SHARES) 1

The valuation of shares by the company becomes necessary where there is no market price of the shares, as in the case of a private limited company or a proprietorship company, as the shares of such companies are not quoted in the market or where, for certain reasons, the market price does not reflect the true value of the shares. In addition, the need for the valuation of shares of a company arises in the following circumstances also:

(1) For formulating amalgamation or absorption schemes

(2) For purchase or sale of controlling shares

(3) For reconstruction schemes

(4) For Estate Duty purposes

(5) For pledging shares as a security against loan

(6) When shares are acquired by the Government.

Method of Valuation

There are 3 methods of valuation of shares : (1) Net Assets Method or Intrinsic Value Method, (2) Yield Method or Market Value Method and (3) Earning Capacity Valuation Method.

1. Net Assets Method or Intrinsic Value Method

This method aims at finding out the possible value of the shares in the event of the company going into liquidation. Investors are influenced by security and earnings. Security is indicated by the assets' cover of shares. Therefore, for finding out the real value or intrinsic value the assets' cover is considered. The assets and liabilities, including goodwill, should be revalued first and then the net asset is found out. Net asset is the difference between the realisable value of assets and the liabilities to outsiders. Non-trading assets, if any, should also be included at their market values. The available net asset less the paid-up value of preference shares represents net assets available for equity shareholders. This, divided by the number of equity shares, gives the intrinsic value of each equity share.

Where there are both fully paid equity shares and partly paid equity shares, the amount of uncalled amount on partly paid shares should be added to the funds available to equity shares, thus notionally converting all partly paid shares into fully paid shares. Then intrinsic value of equity shares

$$= \frac{\text{Total funds available for equity shareholders}}{\text{Number of equity shares (both fully paid and partly paid)}}$$

The value of each partly paid shares can be ascertained by deducting the uncalled amount from the value of each fully paid share.

2. Yield Method or Market Value Method

Small investors are generally interested in the income they earn from the company and hence the price they will be prepared to pay will depend upon the yield or the size of the dividends that can be expected.

The formula for calculating the market value, therefore, is:

$$(a)\ \text{Market value on yield basis} = \frac{\text{Dividend per share in rupees}}{\text{Normal rate of return}} \times 100$$

OR

$$(b)\ \text{Market value} = \frac{\text{Rate of dividend}}{\text{Normal rate of return}} \times \text{paid-up value per share}$$

For example, a company has issued shares of Rs. 100 each on which Rs. 80 has been paid up and the company declares a dividend of 25%. The amount of dividend per share comes to Rs.20. On the basis of a normal rate of return of 10%, the market value of the share will be

$20/10 \times 100 = 200$ (applying the (*a*) formula)

or $25/10 \times 80 =$ Rs. 200 (applying the (*b*) formula)

For the purpose of calculating the dividend per equity share, the average profit is calculated and the following are deducted therefrom: (*a*) taxes payable, (*b*) transfer to reserves, (*c*) transfer to various funds such as Debenture Redemption Funds, etc. and (*d*) preference dividend payable. The remainder, when divided by the number of equity shares, gives the dividend payable per share. If the dividend per share is knwon, the rate of dividend will be calculated as follows:

$$\text{Rate of dividend} = \frac{\text{Dividend per share}}{\text{Paid-up value per share}} \times 100$$

This method suffers from certain disadvantages:

(1) The market value, under this method, depends, upon the dividend declared by the company and not on its real earning capacity. The dividend declared in any year may be less than the rate of its earning or more than its earning, since dividend paid in a year may be paid out of the company's past earnings. Thus, the value may be misleading.

(2) If this method of valuation is adopted, the shares of a company which observes financial prudence by building up good reserves will be undervalued, whereas the shares of a company which distributes larger profits will be overvalued.

Advance corporate Accounting

Valuation of Goodwill and shares

Definition of Goodwill:

Good will is defined as the present value of firm is anticipated Excess earning.

Valuation of Goodwill:

Factors determining the value of Goodwill:

1. Location Factors
2. Time Factors
3. Nature of Business
4. Efficiency of management.
5. other Factors.

Methods of valuation of Good will:

There are two methods of valuing goodwill

i) simple profit method
ii) super profit method.

simple profit method:

i) purchase of past profit method
ii) capitalisation of average profit method.

super profit method:

i) purchase of super profit method
ii) sliding - scale valution of super profit method.
iii) Annuity of super profit method.
iv) capitalazation of super profit method.

Prob. 1 A trader started a Business on 01.03.1995 with Rs 25000 as capital. His profits for the first two years were Rs 7200 Rs 11700 but for the years ending April 30 1998. The incurred a loss of Rs 1575. He estimated salary of ~~xxxx~~ market rate of interest on investment was 10% and of the rate of risk return on capital was 3%. He estimated his salary from an alternative employment at Rs 1500 per year. compute the value of goodwill of the business of 3 years purchase of super profit. of the three years.

Ans: Good will = 3 x super profit

Super profit = Actual profit - normal profit

normal profit = capital employed x normal rate

normal profit = 25000 x 13/100 = 3250

Calculation of Adjusted profit

	I year profit		7200
	II year profit	11700	
(+)	Abnormal loss	1575	13275
			20475
(-)	Future expenses salary of the propriator		1500
			18975

Average profit $\frac{18975}{2} = 9487.5$

(-)	normal profit	3250.
	super profit	6237.50

Good will = 3x super profit
= 3 x 6237.50
= 18712.50

Prob. 2 The net profit of a Business after providing for taxation for the past 5 years are Rs 80000, 85000, 92000, 105000, 118000. The capital employed in the business is Rs 800000. The normal rate of return expected in this type of business is 10%. It is expected that the Good will be able to ~~mention~~ maintain is super profit for the next 5 year calculate the value of good will on the basis of

A) 5 year purchase of super profit method.

B) Annuity method taking the present value of annuity of Rs 1 for five year at 10% for five year at 10% as 3.78.

C) capitalisation of super profit method.

Ans

Profit for 5 years

80000 + 85000 + 92000 + 105000 + 118000 = 480000

Average profit 480000/5 = 96000

(-) normal profit 800000 × 10/100 = 80000

Super profit = 16000

a) Purchase of super profit method

Good will = super profit × 5 years

= 16000 × 5 = 80000

B) Annuity method

16000 × 3.78 = 60480

$$\frac{16000 \times 100}{10} = 160000$$

16000 x 5 = 80000

C) Capitalisation employment

800000 x 10/100 = 80000

Prob: 3 The following particular are available in respect of the business carried on by ~~[illegible]~~

A) Capital employed Rs 50000

B) Trading result 2009 profit 12200, 2010 profit 15000 2011 loss 2000 2012 profit 21000

C) market rate of Interest on Investment 8%.

D) Rate of Risk return on Capital Invested in business 2%.

E) Remuneration from alternative employment of the propriator if not engagged in business Rs 3600 per annum.

compute the value of good will on the basis of 3 year purchase of super profit of the business calculated on the average profit of the last four year.

Ans) Averege profit = $\frac{12200 + 15000 - 2000 + 21000}{4}$

$= \frac{46200}{4} = 11550$

Adjusted Averege profit = 11550 - 3600

= 7950

Normal profit = Capital employment x Normal rate of return

$= 50000 \times \frac{10}{100}$

= 5000

valuation of shares

Prob 7 On 31.03.1997 the Balence sheet of Join stock Company disclosed the following position

Liabilities		Assets	
Share capital		Good will	40000
40000 Equity share [Rs 10 each fully paid]	4,00000	other Fixed Asset	500000
General reserve	90000	current Asset	200000
profit & loss A/c	20000		
10% Debenture	100000		
current Liabilities	130000		
	740000		740000

on 31st march 1997 the good will of the company was valued at Rs 50000 while other fixed Assets were valued at Rs 350000. The net profit earned by the company amounted to Rs 51600 for 1994-95; Rs 52000 for 1995-96 and 51650 for 1996-1997. Every year an amount equal to 20% of profit earned was Transfered general reserve - this being considered reasonable in the industry in which the company is engaged. A return of 10% on the investment consitered fair in the Industry.

Compute the valuation of share yield method.

Ans

i) valuation of shares according to yield method

Profit	1994-1995	51600
	1995-1996	52000
	1996-1997	51650
		155250

Average profit = 155250/3 = 51750

(-) 20% Transfer to reserve 10350
20% on 51750

Average profit after Transfer to reserve 41400

ii) calculation of Expected Return

$$\text{Expected return} = \frac{\text{Expected profit}}{\text{Equity capital}} \times 100$$

$$= \frac{41400}{400000} \times 100$$

$$= 10.35\%$$

iii) Yield value of share

$$= \frac{\text{Expected Rate}}{\text{Normal Rate}} \times \text{paid up value of share}$$

$$= \frac{10.35}{10} \times Rs\ 10$$

$$= 10.35\ Rs$$

Prob: 8 Balence Sheet of Mook Ltd as on 31.03.1993

Liabillties		Assets	
Share capital		Sundry Assets	510000
10000 6% preference		Discount on Debenture	10000
share Rs 10 Each Full	100000	preliminary Exp	30000
30000 ordinary share		profit & loss A/c	60000
of Rs 10 Each Fully	300000		
Debenture Redemption			
Fund	30000		
7% debenture	50000		
Depreciation Fund	30000		
Sundry creditor	100000		
	610000		610000

The sundry Assets are worth Rs 525000 one year. Interest is owing on debentures and divident on preference shares are in arrears for two years. You are required to value of shares on the net Assets method if

A. preference shares have priority to value the shares of Dividend. In the event of Liquidation

B. preference shares have no priority as to capital or arrears of dividend

C. preference have to priority as to payment of capital only.

D. preference shares have priority as to the payment of arrear of dividend only.

Ans calculation of net Assets

Sundry Assets		525000
(-) Liabilities		
7% debenture	50000	
Interest on debenture	3500	
sundry creditor	100000	153500
Net Assets		371500

Calculation of value of share

a) When preference share have priority as to capital and divident

Net Asset		371500
(-) preference share capital	100000	
(-) Arrears of dividend	12000	112000
Net Assets to Eq. shares		259500

Intrisic value of one share = $\frac{259500}{30000} = 8.65$

B. When preference share have no priority as to all ~~dividend only~~

Net Assets 371500

Available to Equity and preference share $\} \frac{371500}{40000} = 9.29.$

c. When preference shares have priority as to capital only

Net Assets	371500
(-) preference capital	100000
Net Assets to eq share holder	271500

Intrinsic value of one share } $\frac{271500}{30000} = 9.05$

D) when preference share have priority as to dividend only

Net Assets	371500
(-) Arrears of preference dividend for 2 years	12000
Assets available to share holder	359500

Intrinsic value $= \frac{359500}{40000} = 8.99.$

prob. 9. The authorised and paid up capital of a company consists of 1000 5% preference shares of Rs 100 each and 20000 Equity Shares of 15 Each all fully paid up. A. person 300 preference share and 2000 Equity share. Find out value of Eq. shares held by assuming that the normal annual profit of the company Rs 40000 and the normal annual return on similar equity shares 8% perannum Assuming a company transfer 25% of the profit to General reserve and the profit give above the after tax

Net profit	40000
(-) General Reserve 25%	10000
	30000
(-) dividend for preference shares	
$1000 \times 100 = \frac{100000}{100}$	5000
	25000

(-)	preference share capital 50000		
	Arrears of Divident for 4 years		
	50000 x 10/100 x 4	20000	-70000
			195000
(+)	Notion call on partly paid shares		
	20000 x 3		60000
			255000

Net Assets For Equity share holders } net Assets / No. of shares.

= 255000

value of share
yield Method

Liabilities		Asset	
50000 share capital		Land & Building	220000
Rs 100 Each	500000	plant & mechinary	95000
profit & loss	103000	Stock	350000
Bank over draft	20000	Debtor	155000
Creditor	77000		
provition for Tax	45000		
propossed Dividend	75000		
	820000		820000

prop: 11

The profit of the 5 years

2015 - 85000 2019 - 95000

2016 - 96000

2017 - 90000

2018 - 100000

Normal rate of 10%. Calculate Value of Equity shares based on yield value.

Value of share = $\frac{\text{Expected rate}}{\text{Normal rate}} \times$ Paid up value

Expected rate = $\frac{\text{Profit Available for Eq shares}}{\text{Equity capital}} \times 100$

$= \frac{85000 + 96000 + 90000 + 100000 + 95000}{5}$

$= \frac{466000}{5} = 93200$

Average profit = 93200
(-) preference dividend -
profit for Eq shares 93200

Expected Rate $= \frac{93200}{500000} \times 100$

$= 18.64\%$

Value of share $= \frac{18.64}{10\%} \times 100$

$= 186.4$ Rs