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(DSC)

FOUR YEAR BACHELOR'S DEGREE COURSE
(CBCS in Accordance with NEP 2020)

SEMESTER-IV

CORPORATE ACCOUNTING

COMMERCE

Maniram Dewan School of Management
KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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SEMESTER 5
ADVANCED CORPORATE ACCOUNTING
COMMERCE

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COURSE INTRODUCTION

The course **"Advanced Corporate Accounting"** will help the learners in understanding the accounting procedure of companies. The companies issue shares to raise funds which are utilized for business activities. It covers various aspects like purchasing of the shares by the investors, any failure on the part of the investors to pay the required money, preparation of final accounts etc. All these require maintenance of proper books of accounts. A company is created under the Companies Act and all its activities are guided by this Act. In maintaining the accounts the company has to follow the provisions of the Act. In this course the learners will come to know the practical aspects in maintaining the accounts. The provisions of the Companies Act have also been stated in this course, whenever necessary.

While going through a unit, you will notice that some along-side boxes, which have been included to help you know some of the difficult, unseen terms. Some ''ACTIVITY'' (s) has been included to help you to apply your own thoughts. Again, we have included some relevant concepts in ''LET US KNOW'' along with the text. At the end of sections, you will get ''CHECK YOUR PROGRESS'' questions. These have been designed to self-check your progress of study. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with ''ANSWERS TO CHECK YOUR PROGRESS'' given at the end of each unit.

UNIT 1 : ISSUE AND SUBSCRIPTION OF SHARES

UNIT STRUCTURE

1.1 Learning Objectives

1.2 Introduction

1.3 Meaning of Share and Share Capital

1.4 Kinds of Shares and Share Capital

1.5 Sub-division of Share Capital

1.6 Issue of shares

- 1.6.1 Steps involved in Issue of shares
- 1.6.2 Accounting Treatment for Issue of Shares

1.7 Subscription of Shares

- 1.7.1 Full Subscription of Shares
- 1.7.2 Under-Subscription of Shares
- 1.7.3 Over-Subscription of Shares
- 1.7.4 SEBI Guidelines on Over-Subscription of Shares
- 1.7.5 Accounting Treatment on Over-Subscription of Shares

1.8 Let Us Sum Up

1.9 Further Reading

1.10 Answers To Check Your Progress

1.11 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- define the meaning of share and share capital
- explain the different types of shares
- explain different kinds of share capital of a company,
- elaborate the various methods and steps of issue of shares
- illustrate the accounting treatment for issue of shares
- explain the meaning of subscription of shares
- describe the SEBI Guidelines on over-subscription
- illustrate the accounting treatment for over- Subscription of shares.

1.2 INTRODUCTION

You are aware that finance is said to be the life blood of business. Finance is required for the commencement, running and growth of business for providing fixed and working capital. Business enterprises cannot move a step forward without finance. The availability of other factors of production also depends upon the availability of finance. When you plan for a business you must plan for required finance. After estimating its financial requirements, you will try to find out the sources from which these requirements will be met. In case of a company, finance is accumulated primarily by issuing shares. You have come across that a company is an incorporated association which is an artificial person created by law havin0g a common seal and perpetual succession. Lord Justice Lindley, defines a company as an "An association of many persons who contribute money or money's worth to a common stock , and employ it in some common trade or business (i.e. for a common purpose) and who share the profit or loss(as the case may be) arising there from. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute are the members. The proportion of capital to which each member is entitled is his share. Shares are always transferable, although the right to transfer them is often more or less restricted".

In this unit we will confine ourselves to explain the meaning of Share and Share capital, to illustrate the methods and steps of issue of different kinds of Shares and accounting treatment of Issue of Shares. We also discuss subscription of shares in this unit.

1.3 MEANING OF SHARE AND SHARE CAPITAL

In Partnership Account you have found the term 'share' while dealing with sharing of profits by the partners. General meaning of 'share' is a part of the whole. The profit earned during a period is distributed among the partners, or in other words, partners get a share of the total profits. You also know that without money business can not be started. The term 'capital' implies a specific amount of money required for starting a business. In the

context of company form of business, capital means share capital and the meaning of share is meant in relation to the total share capital. According to Section 2 (84) of the Companies Act, 2013 a share is defined as 'a share in the share capital of the company and includes stock except where a distinction between stock and shares is expressed or implied'.

According to Justice Farwel, *"A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place and of interest in the second, but also consisting of mutual covenants entered into by all the shareholders in terms of the Act and the Articles".*

Share capital is the amount of 'investment in shares of a company' made by the promoters and members of that company. A **share** is a unit of account for various financial instruments, and more particularly for the total share capital. In simple words, a **share is a small part of the total share capital of a company**. The capital of a company is divided into a large number of equal parts/units of small denomination. Each part or unit is called a share. For example, a company has total capital Rs. 20,00,000 divided into 2, 00,000 equal parts/units of the denomination of Rs. 10. Each unit/ part will be known as a share of Rs. 10 each.

As the total capital of the company is divided into shares, the capital of the company is termed as share capital. In ordinary parlance, share capital means the capital raised by the company by the issue of shares.

A company collects its capital by issuing shares. When share is issued and allotted to a person by a company, it also issued a document by which the person is entitled to be one of the owners of the company. The person to whom shares are alloted is called shareholder. A share is issued by a company or can be purchased from the stock market.



CHECK YOUR PROGRESS

Q 1: Give the meaning of Share and Share Capital?

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1.4 KINDS OF SHARES AND SHARE CAPITAL

Generally, there are two types of shares: Equity Share and Preference Share.

Equity share is also called ordinary share or nominal share or common share. The holders of these shares are the real owners, risk-takers and care-takers of the company and they have a control over the affairs of the company and enjoy the right of voting.

Preference share is that share which has certain preferential rights over the equity share. These preferential rights are given in two respects, (a) as regards the payment of dividend either as a fixed amount or at a fixed rate; and (b) to the payment of the paid up capital.

In this regard the provision of Companies Act, 2013, is noteworthy. According to Section 43 of the Companies Act, 2013, the new issue of share capital of a company limited by shares shall be of two kinds only, namely:

(a) Equity share capital –

(i) with voting rights; or

(ii) with differential rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed.

(b) Preference share capital.

However, the provision of this section does not apply to a private limited company which is not a subsidiary of a Public Company.

This means that a private company may have other kinds of shares such as deferred shares or founder shares in addition to Preference and Equity Shares.



Companies limited by Shares: The liability of the shareholders of such a company is limited to the value of the shares.



***Deferred shares*:** The shares which have no rights on the assets of the company in the event of liquidation until other shareholders are paid.



LET US KNOW

While studying the shares, you may come across the term "stock". Stock is a set of fully paid-up shares. A company limited by shares can convert the fully paid-up shares into stocks. The differences between share and stock are –

- The share has nominal value, whereas stock has no nominal value.
- A share may not be fully paid-up but a stock is always fully paid-up.

- Shares can be directly issued to the public but stocks cannot be directly issued to the public.
- The shares bear distinct numbers but stocks are the consolidated value of the share capital.

1.5 SUB-DIVISION OF SHARE CAPITAL

The term 'capital' means a specific amount of money required for starting a business. In the context of company form of business, capital means share capital. As per Schedule III to the Companies Act, 2013 the share capital of a company is divided into the following categories:

(i) Authorised or nominal or registered capital;
(ii) Issued capital;
(iii) Subscribed capital;
(iv) Called-up capital;
(v) Paid-up capital;
(vi) Reserve capital;
(vii) Calls-in-arrear;
(viii) Calls-in-advance.

They are explained below:

(i) ***Authorised or nominal or registered capital:*** Authorised capital is the capital with which a company is registered. This amount is clearly mentioned in the capital clause of the **Memorandum of Association**. Therefore, the amount of capital which is mentioned in the Memorandum of Association of the company is the authorised capital. Authorised share capital is the maximum amount of share capital which the company is empowered to issue. For example H Ltd. is registered with a capital of Rs. 8, 00,000 divided into shares of Rs. 10 each. Here the authorised, nominal or registered capital of the company is Rs. 8, 00,000. A company cannot issue shares more than the nominal or authorised capital. But the company may change this limit by observing the required statutory provisions.



***Memorandum of Association*:** An essential document required for the registration of the company containing various information about the company.

(ii) ***Issued capital:*** Issued capital is that portion of authorised share capital which is issued for subscription. In other words, it is the nominal value

of shares which have been offered for public subscription. That portion of authorised share capital for which offers have not been invited for subscription is called un-issued share capital. For example, H Ltd. has Rs. 8, 00,000 authorised capital of Rs. 10 each out of which it invited applications for the issue of 50,000 shares of Rs. 10 each. In this case the issued capital will be Rs. 5,00,000 (50, 000 X 10). The remaining 30, 000 shares are un- issued share capital. Issued capital also includes any share or shares issued for consideration other than cash. **The issued capital can never exceed its authorised capital**.

(iii) ***Subscribed capital:*** Subscribed capital represents that part of the issued share capital which has actually been subscribed and allotted to the public. For example, out of the above 50,000 shares of Rs. 10 each, 48,000 shares are applied for and allotted by the company, the subscribed capital will be Rs. 4,80,000. Again, if whole of the 50,000 shares are applied for and allotted by the company, the subscribed capital will be Rs. 5, 00,000. It must be noted that the **subscribed capital can be equal to or less than the issued capital but it cannot be more than the issued capital**.

(iv) ***Called-up capital:*** Called-up capital is that part of the subscribed share capital which the company actually demanded from the shareholders. The amount of subscribed capital and called up capital may vary in case the amount due on a share is collected in instalments and all the instalments have not been demanded by the company. For example, for a share of Rs. 10, the company called Rs. 8 on 50,000 shares, the called-up capital shall be Rs. 4, 00,000 and if the whole amount has been called, the called-up capital would be Rs. 5, 00,000. The called-up capital of the company cannot exceed the subscribed capital**. The portion of the capital which has not been called is known as uncalled capital**.

(v) ***Paid-up capital:*** Paid-up share capital is that part of the subscribed share capital which has been actually paid by the shareholders. Sometimes some of the subscribers of the shares may fail to pay the

amount due from them on account of a call. The paid up capital may be either equal to or less than the called up capital. The amount of call money which has not been paid by the shareholders is termed as **calls-in-arrear**.

(vi) ***Reserve capital:*** Reserve capital is the special portion of the subscribed capital which is not called up under ordinary situation. A company by special resolution may resolve that a certain portion of the subscribed capital can be called up only in the event of the company being wound up. This capital cannot be called for payment from the shareholders except in the case of winding-up.

(vii) ***Calls-in-Arrear:*** It is the amount which has been called for by the company but has not been paid by the shareholders. In other words, it is the amount remaining unpaid on allotted shares, although it has been called up.

(viii) ***Calls-in-Advance:*** Sometimes some shareholders may pay a part or whole of the amount due on a share before the amount is called up. Such amount paid in advance is known as 'Calls-in-Advance'.

Disclosure of Share Capital in Company's Balance Sheet

As per Schedule III of Companies Act, 2013, only the paid-up capital i.e., the portion of the issued capital subscribed by shareholders which is taken into account while totalling the liabilities side of the balance sheet. The details of authorised, issued and subscribed capital are given in the Notes to Accounts but are not counted.

In the books of .....

Balance Sheet as at 31st March.....

Particulars	Notes No.	Rs.
EQUITY AND LIABILITIES		
Shareholder's Funds		
Share Capital	1	xxxxxxxxx
Total		

Notes of Accounts

Particulars	Amount (Rs.)	Amount (Rs.)
1. Share Capital		
Authorised share capital		
..... equity shares of Rs. 10 each		xxxxxxxxxxx
Issued capital		
..... equity shares of Rs. 100 each		xxxxxxxxxxx
Subscribed share capital		
..... equity shares of Rs. 100 each		xxxxxxxxxxx
Called up and Paid up share capital		
..... equity shares of Rs. 100 each.....called up	xxxxxxxxxx	
Less: Calls unpaid on ..... shares @ Rs. .... per share	(xxxxxxxxx)	
	xxxxxxxxxx	
Add: Share forfeiture A/c (..... shares × Rs. .....)	xxxxxxxxxx	xxxxxxxxx
		xxxxxxxxx



CHECK YOUR PROGRESS

Q 2: Show the classification of share capital shown in the balance sheet of a public limited company.

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1.6 ISSUE OF SHARES

As discussed earlier the capital of a public limited company is raised from issue of shares to the public. Issue of shares means the process through which the capital, required for carrying the objects of the company, is collected or raised. The share capital of a public company is raised by issue of either (i) equity shares; or (ii) both equity and preference shares.

Securities and Exchange Board of India (SEBI) has defined 'issue' under clause 3(da) as "issue" means an offer of sale or purchase of securities by any body corporate or by any other person or group of persons on his or its or their behalf, as the case may be, to or from the public, or the holders of securities of such body corporate or person or group of persons;"

There are various methods for the issue of shares. These may be discussed from two different view points.

(a) ***From the point of view of Price; and***

(b) ***From the point of view of Consideration.***

(a) ***From the point of view of Price of Issue:*** From this point of view shares may be issued: at par, at a premium and at a discount.

(i) ***At par:*** Issue of shares at par means issue of shares at face value. In other words, when the shareholders are required to pay an amount equal to the nominal or face value of the shares, it is called issue of shares at par. For example, if the face value of a share is Rs.10 and the same is issued at Rs.10, it means that the shares have been issued at par.

(ii) ***At a premium:*** Issue of shares at a premium means issue of shares at a price higher than its face value. For example, if the face value of a share is Rs.10 and the same is issued at Rs.11, it means that the shares have been issued at a premium. The amount of premium is Re.1.00. Thus, in a premium issue, a subscriber of share is required to pay an amount which is equal to the nominal value of shares plus the amount of premium.

(iii) ***At a discount:*** Issue of shares at a discount means issue of shares at a price lower than its face value. For example, if the face value of a share is Rs.10 and the same is issued at Rs. 9, it means that the shares have been issued at a discount. The amount of discount being Re. 1.00 which is the difference between the face value and issue price. It may be mentioned here that there are legal restrictions imposed on the company under Section 53 of the Companies Act, 2013 for issue of shares at a discount. As per section 53 of the companies Act, 2013 a company cannot issue shares at discount except for in case of sweat equity shares and therefore any issue on discount by the company will be void with company being punishable with fine.

(b) ***From the point of view of Consideration:*** From the point of view of consideration, the shares may be issued: ***(i) For cash and (ii) For consideration other than cash***

(i) ***For cash:*** Issue of shares for cash means collection of cash

either in lump sum or in instalments against the issue of shares.

(ii) ***For consideration other than cash:*** Sometimes shares may be issued for consideration other than cash. This means that the company has received some benefit in kind or services and shares have been issued against that benefit. For example, a company purchased some assets from vendor and instead of making payment to the vendor in cash, the company may allot shares in discharge of purchase consideration. The issue of shares to vendors is known as issue of shares for consideration other than cash. Issue of bonus shares by a company to its existing shareholders is another example of this kind.



CHECK YOUR PROGRESS

Q 3: What are these: Shares issued at par, issued at premium and issued at discount?

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1.6.1 Steps Involved in Issue of Shares

The procedure of issue of shares consists of the following steps:

(i) Permission from SEBI for the Issue of share

(ii) Selection of Merchant Banker for the issue;

(iii) Issue of a Prospectus;

(iv) Receipt of applications for shares by the company;

(v) Allotment of shares to applicants; and

(vi) Issue of share certificates.

(i) Permission from SEBI for the Issue of share

The Securities and Exchange Board of India (SEBI) has framed some rules and guidelines for the public issue of shares. The companies issuing securities offered through an offer document shall satisfy certain conditions at the time of filing the draft offer document with SEBI (unless specified otherwise in the Chapter) and also at the time of filing the final offer document with the Registrar

of Companies/ Designated Stock Exchange:) No issuer company shall make any public issue of securities, unless a draft Prospectus has been filed with the Board through a Merchant Banker, at least 30 days prior to the filing of the Prospectus with the Registrar of Companies.

(ii) Selection of Merchant Banker:

Next step of the issuing company is to select a Merchant Banker to manage its issue. A merchant banker is a financial institution engaged in rendering financial services relating to advising on and arranging for the share issues. The Merchant Banker may also be the Lead Manager of the issue.

(iii) Issue of a Prospectus:

Generally a part of share capital of a public limited company is contributed by the promoter directors and financial institutions. But a large amount of share capital is raised from the public. This is done by inviting offers for purchase or subscription of shares from the general public through the issue of the prospectus. Before its issue to the public, it must be : (1) dated : (2) signed by every director or proposed director or his authorised agent; and (3) filed with the Registrar of Companies. A prospectus incorporates necessary information about the company to the prospective investors and to encourage them to purchase its shares. The prospectus provides details as to the nature of share capital in terms of kinds of shares and the exact terms on which the shares are to be issued to the applicants, the opening and closing dates of subscription lists, the amount payable on application and allotment of shares respectively and whether other instalments, if any, are payable on stated dates or when called upon by the directors.

(iv) Receipt of Applications for Shares by the company:

The fourth step is to receive application for shares from the public. After the publication of a prospectus, a prospective shareholder is required to collect a copy of the prospectus which contains a printed application form. Properly filled-in application forms

must be forwarded to the company or to the bankers to the issue along with necessary application money. The application is required to be submitted before the closing of the subscription. After the last date of receiving applications, the collecting banker sends all applications to the company along with a draft for the application money collected by the bank. The company deposits all the drafts in a separate bank account opened for the purpose in a scheduled bank. As per section 39 of the companies Act, 2013, application money must be at least 5% of the nominal value of shares. A company cannot proceed to allot shares unless miniumn subscription is received by the company.

(v) Allotment of Shares to applicants:

The allotment of shares means acceptance by the company of the offer made by the applicants to take up the shares applied for. Until the allotment is done, the company cannot use the application money for its day-to-day activities. The company categorizes the applications received into different groups according to the number of shares applied for. After all the conditions and formalities are fulfilled, the Board of Directors can proceed to allot shares as per SEBI guidelines after obtaining permission from the stock exchange. In this way, a contract is entered into between the company and the applicants.

'Letter of Regret' is sent to those applicants to whom no shares have been allotted and the application money paid by them is refunded along with the 'Letters of Regret'.

(vi) Issue of Share Certificates:

Share Certificate is a document that provides evidence of ownership of shares in a limited company. The certificate bears the name of the shareholder and the number and the class of shares owned by the shareholder. It is serially numbered, stamped by the common seal of the company and signed by the authorised signatory. The authorised signatory is at least one director of the company and the company secretary. It is not a negotiable

instrument. On allotment of shares, share certificates are issued to the successful applicants.



CHECK YOUR PROGRESS

Q 4: What do you mean by 'letter of allotment' and 'letter of regret'?

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.....

1.6.2 Accounting Treatment for Issue of Shares

Generally shares are issued for cash. There may be two situations in this case.

(i) Where full consideration in cash is payable on application; and

(ii) Where full consideration in cash is payable in instalments.

Again the shares may be issued at par and at premium.Hence the issue of shares may be tabulated in the following manner from the accounting point of view:

	Issue of Shares	
(i) Where full consideration in cash is payable on application	(a) at par	(b) at a premium
(ii) Where full consideration in cash is payable in instalments	(a) at par	(b) at a premium

The accounting entries in each case are shown below:

(i) (a) Where full consideration in cash is payable on application and shares are issued at par:

In this case the following accounting procedure is followed:

On receipt of application money

Particulars	Debit	Credit
Bank A/c Dr.	money received on application	
To .....Share Application and Allotment A/c		money received on application

On allotment of shares

Particulars	Debit	Credit
Share Application and Allotment A/c Dr.	money received on the number of shares allotted	
To ……. Share Capital A/c		money received on the number of shares allotted

Note: *(i) If the company issues Equity Shares, the word share will be prefixed by the word 'Equity' and if the company issues Preference Shares, the word share will be prefixed by the word 'Preference'.*

(ii) If nothing is stated about the class of shares, it should be taken as 'Equity Shares'. In such a case the word share will be prefixed by the word 'Equity'.



Example 2

Hindustan Ltd. was registered with an authorised capital of Rs. 5, 00,000 divided into 50,000 equity shares of Rs.10 each. The company invited applications for the issue of 35,000 equity shares. The full nominal value is payable on application. All the shares were subscribed by the public. The shares were duly allotted.

Pass necessary Journal entries in the books of the company.

Solution:

In this case the following accounting procedure is followed:

On receipt of application money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
Last date for receipt of Application	Bank A/C Dr.	3,50,000	
	To Equity Share Application and Allotment A/c		3,50,000
(Being the share money received on 35,000 equity shares of Rs. 10 each @ Rs. 10 per share along with application.)			

On allotment of shares

Date	Particulars	Debit (Rs.)	Credit .(Rs.)
date of allotment	Equity Share Application and Allotment A/c Dr. To Equity Share Capital A/c	3,50,000	 3,50,000
(Being the transfer of share money on 35,000 shares of Rs. 10 each to share capital account on allotment as per Board's Resolution No..... dated....)			

(i) (b) Where full consideration in cash is payable on application and share are issued at premium:

On receipt of application money

Particulars	Debit	Credit
Bank A/c Dr. To .....Share Application and Allotment A/c To Securities Premium A/c	money received on application	 Face value of share Premium on share

On allotment of shares

Particulars	Debit	Credit
Share Application and Allotment A/c Dr. To ……. Share Capital A/c	Face value of share received on the number of shares allotted	 Face value of share received on the number of shares allotted



Example 3

Hindustan Ltd. was registered with an authorised capital of Rs. 5, 00,000 divided into 50,000 equity shares of Rs.10 each. The company invited applications for the issue of 35,000 equity shares at a premium of Rs. 10 each. The total amount is payable on application. All the shares were subscribed by the public. The shares were duly allotted.

Pass necessary Journal entries in the books of the company.

Solution:

In this case Total amount payable per share is =

(Nominal value per share Rs. 10 + Premium per share Rs. 10)

= Rs.20

The accounting entries are as below:

On receipt of application money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
Last date for receipt of Application	Bank A/c Dr. To Equity .Share Application and Allotment A/c	7,00,000	 7,00,000
(Being the share money received on 35,000 equity shares of Rs. 10 each @ Rs. 20 per share, Rs 10 being premium, along with application.)			

On allotment of shares

Date	Particulars	Debit (Rs.)	Credit (Rs.)
date of allotment	Share Application and Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium A/c	7,00,000	 3,50,000 3,50,000
(Being the transfer of share money on 35,000 shares of Rs. 10 each to share capital account and Rs. 10 each to Securities Premium A/c on allotment as per Board's Resolution No..... dated....)			

B: Where full consideration in cash is payable by instalments

Sometimes the amount payable on a share is payable by instalments. The number of such instalments may be two, three, four or five. In such a case the various instalments are named as under:

(a) First instalment money payable along with application is known as **Application Money.**

(b) Second instalment money is known as **Allotment money.**

(c) Third instalment money is known as **First Call money**. If the amount is payable in this instalment is the last one then it is called **First and Final Call money.**

(d) Fourth instalment money is known as **Second Call money**. If the amount is payable in this instalment is the last one then it is called **Second and Final Call money** and so on.

Accounting entries are shown below:

(ii) (a) Where full consideration in cash is payable in four instalments and shares are issued at par:

(1) On receipt of application money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	Amount received with application	
	To Equity Share Application A/c		Amount received with application

(2) Transfer application money to Share Capital Account

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Application A/c Dr.	Amount received with application	
	To Equity Share Capital A/c		Amount received with application

(3) Refund of Excess Application Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Application A/c Dr.	With excess money refunded	
	To Bank A/c		With excess money refunded

(4) On allotment of shares

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Allotment A/c Dr.	With allotment money	
	To Equity Share Capital A/c		With allotment money

(5) On receipt of Allotment Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	With allotment money received	
	To Equity Share Allotment A/c		With allotment money received

(6) On First Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share First Call A/c Dr.	With Ist call money	
	To Equity Share Capital A/c		With Ist call money

(7) On receipt of First Call Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	With first call money received	
	To Equity Share First Call A/c		With first call money received

(8) On Second and Final Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Second and Final Call A/c Dr.	With second call money	
	To Equity Share Capital A/c		With second call money

(9) On receipt of Second and Final Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	With second call money received	
	To Equity Share Second and Final Call A/c		With second call money received

When shares are issued at a premium the following entry is passed. Generally premium is payable along with allotment money, hence this entry is shown with allotment.

Particulars	Debit	Credit
Bank A/c Dr.	Total money received on Allotment	
To..... Share Allotment A/c		Face value of share
To Securities Premium A/c		Premium on share



Example 5

Assam Steel Company Ltd. issued 30,000 Equity shares of Rs. 10 each at a premium of Rs. 2 each, payable Rs. 2 on application, Rs. 5 on allotment (with premium), Rs. 3 on first call and the balance Rs. 2 on second and final call. Applications were received for 35,000 shares. Directors made allotment of 30,000 shares and the excess money paid for 5,000 shares was refunded. Pass necessary journal entries.

Solution

In the books of Assam Steel Company Ltd.

Journal Entries

(i) On receipt of application money:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	70,000	
	To Equity Share Application A/c		70,000
(Being the share application money received on 35,000 equity shares of Rs. 10 each @ Rs. 2 per share along with application.)			

(ii) Transfer application money to Share Capital Account

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Application A/c Dr.	60,000	
	To Equity Share Capital A/c		60,000
(Being transfer of share application money received on 30,000 equity shares of Rs. 10 each @ Rs. 2 per share along to share capital account as per Board's Resolution No..... dated....)			

(iii) Refund of Excess Application Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Application A/c Dr.	10,000	
	To Bank A/c		10,000
(Being refund of excess share application money received on 5,000 equity shares @ Rs. 2 per share as per Board's Resolution No..... dated....)			

(iv) On allotment of shares

Date	Particulars	DR. (Rs.)	CR. (Rs.)
	Equity Share Allotment A/c Dr.	90,000	
	To Equity Share Capital A/c		90,000
(Being allotment of 30,000 Equity shares and money due @ 3 per share as per Board's Resolution No..... dated.....)			

v) On receipt of Allotment Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	1,50,000	
	To Equity Share Allotment A/c		90,000
	To Securities Premium A/c		60, 000
(Being allotment money on 30,000 Equity shares of Rs. 10 each @ Rs. 5 per share, Rs, 2 per share being premium received)			

(vi) On First Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share First Call A/c Dr.	90,000	
	To Equity Share Capital A/c		90,000
(Being First Call money due on 30,000 Equity shares of Rs. 10 each @ 3 per share as per Board's Resolution No..... dated.....)			

(vii)On receipt of First Call Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	90,000	
	To Equity Share First Call A/c		90,000
(Being first call money on 30,000 Equity shares of Rs. 10 each @ Rs. 3 per share received)			

(viii) On Second and Final Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Second and Final Call A/c Dr.	60,000	
	To Equity Share Capital A/c		60,000
(Being Second and Final Call money due on 30,000 Equity shares of Rs. 10 each @ 2 per share as per Board's Resolution No..... dated.....)			

(ix) On receipt of Second and Final Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	60,000	
	To Equity Share Second and Final Call A/c		60,000
(Being second and final money on 30,000 Equity shares of Rs. 10 each @ Rs. 2 per share received)			

1.7 SUBSCRIPTION OF SHARES

Public limited company raises its major part of capital through issue of shares to the public. For this purpose public must know that a company is going for public subscription of shares. The company approaches the public through its prospectus by which the company invites the public to subscribe for its shares. If adequate response, i.e., subscription, from the public is received only then a company will be able to allot shares. Hence, **Subscription of Shares** is an important part in raising capital by public limited companies.



Banker to the Issue: A bank appointed by the company for carrying out the activities in relation to the issue of shares of the company.

A public limited company issues prospectus and invites the public to subscribe for its shares. Hence 'Subscription of shares' means applications from the public to the company in response to the prospectus issued by the company for offering shares to the public. These applications are received through 'Banker to the Issue' all throughout the country. After the closing date for subscription, all the applications are sent to the registered office of the company. The secretarial staffs at registered office of the company is entrusted with the task relating to issue of shares and the application forms are scrutinised to ascertain the total number of shares applied for by the public. In such a case there may be any of the following three situations: (i) **Full subscription,** (ii) **Under-subscription and** (iii) ***Over-subscription.***

1.7.1 Full Subscription of Shares

If the total number of shares applied for by the public is equal to the total number of shares offered by the company, it is known as **full subscription of shares.**

Example: If 20,000 shares of Rs. 10 each are offered to the public for subscription, and the company receives application for 20,000 shares, the issue is fully subscribed

In case the issue is fully subscribed, there is no difficulty on the part of the company regarding the allotment of shares. After observing the necessary formalities, the company can proceed with the allotment of shares.

1.7.2 Under-Subscription of Shares

When the total number of shares applied for by the public is less than the total number of shares offered by the company, it is known as **under-subscription of shares.**

Example: If 20,000 shares of Rs. 10 each are offered to the public for subscription, and the company receives application for 19,600 shares, the issue is under-subscribed.

In case the issue is under-subscribed, the percentage of subscription is to be ascertained. As per the SEBI Guidelines, in order to make allotment of shares, minimum subscription should be 90% of total shares offered for public subscription. If the subscription is less than 90%, the company cannot proceed with the allotment of shares and the money received on application must be refunded. If a delay occurs beyond 15 days from the date of closure of the issue, the company shall be liable to pay the amount with interest.

1.7.3 Over-Subscription of Shares

In case the total number of shares applied for by the public is more than the total number of shares offered by the company, it is known as **over-subscription of shares.**

Example: If 20,000 shares of Rs. 10 each are offered to the public for subscription, and the company receives application for 21,000 shares, the issue is over-subscribed.

Where the issue is over-subscribed, the Board of Directors have to decide the manner of dealing with the over-subscribed money keeping in view the provisions of the Companies Act, 1956 and SEBI (Disclosure and Investor Protection) Guidelines, on allotment. However, as the company cannot allot shares more than that offered for subscription; the Board of Directors will have to allot shares on **Pro-rata basis** (proportionately) as per SEBI Guidelines.



CHECK YOUR PROGRESS

Q 5: Give the meaning of subscription of share?

.....

.....

.....

Q 6: What is over-subscription of Share?

.....

.....

.....

1.7.4 Sebi Guidelines on Over-Subscription of Shares

At this stage you should acquaint yourself with the guidelines of SEBI regarding Over-subscription. The rules regarding Over-subscription as laid down by SEBI are-

(a) All applications should be categorised according to the number of shares applied for. Such categories may be set for applicants of 100, 500, 1,000 shares and so on.

(b) Allotment shall be made in marketable lots on a proportionate basis.

(c) An issue shall be subject to the reservation for small individual applicants.

Minimum Tradable/Marketable Lot

Minimum tradable/marketable lot implies that for the purpose of allotment of shares, no allottee shall be allotted the number of shares which is less than the tradable lot. This Minimum tradable/ marketable lot shall be fixed on the basis of the offer price. Minimum tradable lot on the basis of offer price shall be fixed as under:

Offer price (per share)	**Minimum tradable lot**
Up to Rs. 100	100 shares
From Rs.101 Up to Rs.400	50 shares
Above Rs. 401	10 shares

Allotment of shares must be made in the multiple of tradable/marketable lot.

Reservation for Small Individual Applicants

On reservation for small individual applicants the guidelines stated that-

(i) Minimum 50% of the net offer of securities will be made available to individual applicants, who have applied for securities equal to or less than 10 marketable lots.

(ii) The balance of securities will be made available for allotment to :

(a) Individual applicants who have applied for allotment of more than 10 marketable lots of shares or debentures or securities.

(b) Other investors including companies, corporations, corporate bodies and institutions irrespective of the number of shares applied for.

(iii) The unsubscribed portion of net offer can be offered to any one of the above categories (i) and (ii), if required.

Thus, in the process of allotment, in case the issue is over-subscribed, the following situations may arise in course of accounting treatment:

(i) Total rejection of some applications and Full Allotment to remaining applicants,

(ii) Pro-rata allotment among all applicants and

(iii) Refusing allotment to some applicants and making Pro-rata allotment among the remaining applicants.



ACTIVITY 1

Determine the situations in the following cases-

A) XY Company Limited issued 30, 000 shares @ Rs. 20 to raise the required capital. The company received applications for 25,000 shares.

What further step the company should take?

.....

.....

B) MN Company limited issued 10, 000 shares @ Rs. 10 for subscription. The company received applications for 15,000 shares.

Should the company proceed for the allotment of shares?

.....

.....

1.7.5 Accounting Treatment on Over-Subscription of Shares

Journal Entries

(i) On receipt of application money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	……	
	To ……Share Application A/c		…….
	(Being the share application money received on ……. shares of Rs… each @ Rs... per share along with application.)		

(ii) Transfer to Share Capital Account

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	……..Share Application A/c Dr.	……	
	To …… Share Capital A/c		…… .
	(Being transfer of share application money on …… shares of Rs. …. each @ Rs. …… per share to share capital account as per Board's Resolution No..... dated....)		

(iii) Refund of Excess Application Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	……. Share Application A/c Dr. To Bank A/c (Being refund of application money to unsuccessful applicants received on ……. shares @ Rs. …… per share as per Board's Resolution No..... dated....)	…….	 …….. ……

(iv) Transfer of application money to allotment/calls

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	…….. Share Application A/c Dr. To Share Allotment A/c To Call A/c (Being the surplus application money on ..... shares @ Rs.....per share transferred to share allotment account as per Board's Resolution No..... dated....)	…….	 …… ……



LET US KNOW

It should be noted that sometimes the surplus application money exceeds even the money due on allotment. Such amount has to be returned. However, it can be retained by the company for its utilisation towards future calls, if the Articles of Association of the company so authorise. Usually the prospectus contains a clause to this effect. If the amount is retained, it must be transferred to Calls in Advance Account by passing the following entry:

Share Application A/c Dr.

To Calls in Advance A/c

If the Articles of Association of the company does not authorise the retention of excess application money over the allotment money, the amount is refunded.

(v) On allotment of shares

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	……Share Allotment A/c Dr. To …… Share Capital A/c (Being allotment of ……. shares and money due @ …….. per share transferred to Share Capital account as per Board's Resolution No..... dated.....)	……..	…….

(vi) On receipt of Allotment Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr. To ……. Share Allotment A/c (Being allotment money on ……. shares received @ Rs……. per share)	……..	…….

(vii) On First Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	……Share First Call A/c Dr. To ……. Share Capital A/c (Being First Call money due on …….. shares @ …….. per share transferred to Share Capital account as per Board's Resolution No..... dated.....)	……..	…….

(viii) On receipt of First Call Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	…….	
	To ……. Share First Call A/c		……
	(Being first Call money received @ Rs. …… per share on ……. shares)		

On Second and Final Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Second and Final Call A/c Dr.	……	
	To …….Share Capital A/c		…..
	(Being Second and Final Call money due on …….. shares @ …….. per share transferred to Share Capital account as per Board's Resolution No..... dated.....)		

(x) On receipt of Second and Final Call Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	……..	
	To …… Share Second and Final Call A/c		……
	(Being Second and Final Call money received on …….. shares @ Rs. …… per share)		



EXAMPLE 6

Global Steel Company Ltd. issued 30,000 Equity shares of Rs. 10 each, payable Rs. 2 on application, Rs. 3 on allotment, Rs. 3 on first call and the balance Rs. 2 on second and final call.

Applications were received for 35,000 shares.

Directors accepted applications for 30,000 shares.

Application money on rejected 3000 shares was refunded.

Application money on 2000 shares was carried over to allotment.

All the moneys due were received on allotment and all calls.

Pass necessary journal entries.

Solution:

In the books of Global Steel Company Ltd.

Journal Entries

(i) On receipt of application money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	70,000	
	To Equity Share Application A/c		70,000
	(Being the share application money received on 35,000 equity shares of Rs. 10 each @ Rs. 2 per share along with application.)		

(ii) Transfer to Share Capital Account

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Application A/c Dr.	60,000	
	To Equity Share Capital A/c		60,000
	(Being transfer of share application money received on 30,000 equity shares of Rs. 10 each @ Rs. 2 per share to share capital account as per Board's Resolution No..... dated....)		

(iii) Refund of Excess Application Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Application A/c Dr. To Bank A/c (Being refund of excess share application money received on 3,000 equity shares @ Rs. 2 per share as per Board's Resolution No..... dated....)	6,000	 6,000

(iv) Transfer of part of Application Money to Allotment

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Application A/c Dr. To Equity Share Allotment A/c (Being transfer of application money received on 2,000 equity shares @ Rs. 2 per share to Allotment as per Board's Resolution No..... dated....)	4,000	 4,000

(v)) On allotment of shares

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Being allotment of 30,000 Equity shares and money due @ Rs. 3 per share as per Board's Resolution No..... dated.....)	90,000	 90,000

(vi) On receipt of Allotment Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	86,000	
	To Equity Share Allotment A/c		86,000
	(Being allotment money on 30,000 Equity shares @ Rs. 3 per share, less money transferred from Share Application, received; 30,000x Rs.3 – Rs. 4,000).		

(vii) On First Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share First Call A/c Dr.	90,000	
	To Equity Share Capital A/c		90,000
	(Being First Call money due on 30,000 Equity shares of Rs. 10 each @ Rs. 3 per share as per Board's Resolution No..... dated.....)		

(viii) On receipt of First Call Money

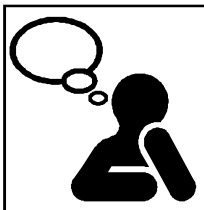
Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	90,000	
	To Equity Share First Call A/c		90,000
	(Being first call money on 30,000 Equity shares of Rs. 10 each @ Rs. 3 per share received)		

(ix) On Second and Final Call

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Equity Share Second and Final Call l A/c Dr.	60,000	
	To Equity Share Capital A/c		60,000
	(Being Second and Final Call money due on 30,000 Equity shares of Rs. 10 each @ Rs. 2 per share as per Board's Resolution No..... dated.....)		

(x) On receipt of Second and Final Call Money

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr.	60,000	
	To Equity Share Second and Final Call A/c		60,000
	(Being second and final call money on 30,000 Equity shares of Rs. 10 each @ Rs. 2 per share received)		



ACTIVITY 2

Coal India Limited invited applications for the issue of 5,000 Equity Shares of Rs. 100 each payable:

On Application	Rs. 20
On Allotment	Rs. 50
Balance Amount on Shares	As and when required

By July, 1 2009, the closing date of the subscription, the company received applications for 7,000 shares. Applications for 5,000 shares were accepted and the application money on rejected 2,000 shares were refunded. The shares were allotted by the company on July 25, 2009 and the allotment money was duly received on August 10, 2009 on 4,900 shares.

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



1.8 LET US SUM UP

In this unit we have discussed the following

- The total capital of a company is divided into a large number of equal parts. The total capital of the company is known as share capital.
- The equal parts of the company's share capital are known as share.
- A company collect its required funds by issuing the shares.
- People who purchase a company's share are known as shareholders. They are the owners of the company.
- Shares are of two types-
  - Equity share: the holders of these shares exercise full control over the company's affairs.
  - Preference share: The holders of theses shares have preferential rights over the equity shareholders regarding payment of dividend and repayment of capital.
- The share capital of a company is divided into as – Authorised capital, Issued capital, Subscribed capital, Called-up capital, Paid-up capital, Reserve capital, Calls-in-arrear, Calls-in-advance.
- Shares can be issued –
  - At par: Issue of shares at face value.
  - At a premium: Issue of shares at a price higher than its face value.
  - At a discount: Issue of shares at a price lower than its face value.
- Shares may be issued for cash and for consideration other than cash.
- There are various steps involved in the issue of shares.
- Letter of Regret are sent to those applicants to whom no shares have been allotted and application money is refunded.
- Accounting treatment for issue of shares
  - Where full consideration in cash is payable on application; and
  - Where full consideration in cash is payable in instalments.

- Subscription of shares means applications received from the public for purchasing the shares of the company.
- The company issuing shares for subscription may face any of the following situations-
  - Full subscription of shares
  - Under subscription of shares
  - Over subscription of shares
- When the company received applications for all the shares offered by it, it is known as full subscription of shares.
- Under subscription is a situation where the company received fewer applications for shares as compared to the number of shares offered for subscription.
- In case of under subscription of shares, to make allotment of shares, the company must receive minimum subscription, i.e. 90% of total shares offered for public subscription. If the subscription is less than 90%, the company cannot allot the shares and the money received on application must be refunded to the applicants.
- Where the number of applications received for shares is more than the number of shares offered for subscription by the company, it is the case of over subscription of shares.



1.9 FURTHER READING

1) Advanced Accounting 2 Corporate Accounting by Dr. A Sehgal and Dr. D Sehgal, Taxman.
2) Corporate Accounting K R Das and others, LBS publication.
3) Theory and Practice of Accountancy by B B Dam , Sarda and others, Capital Publishing.



1.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Share is a small part of the total share capital of a company. Share capital is the amount of 'investment in shares of a company' made by the promoters and members of that company.

Ans to Q No 2: (i) Authorised or nominal or registered capital,

(ii) Issued capital,

(iii) Subscribed capital,

(iv) Called up capital,

(v) Paid up capital,

Ans to Q No 3: *At par:* issue of shares at face value and the shareholders are required to pay an amount equal to the nominal or face value of the shares

At a premium: issue of shares at a price higher than its face value and a subscriber of share is required to pay an amount which is equal to the nominal value of shares plus the amount of premium.

At a discount: issue of shares at a price lower than its face value and a subscriber of share is required to pay an amount which is equal to the nominal value of shares less the amount of discount.

Ans to Q No 4: 'Letter of Allotment' is sent to those applicants to whom shares have been allotted and 'Letter of Regret' is sent to those applicants to whom no shares have been allotted.



1.11 MODEL QUESTIONS

Q 1: ***State whether the following statements are 'true' or 'false':***

a. Issue of shares means distribution of shares by a company to the employees.

b. Allotment of shares must be authorised by Board of Directors.

c. Preference shareholders have preferential rights in the allotment of shares.

d. Premium on issue of shares means an additional amount is required to pay by the subscriber of the shares.

Q 2: Fill in the blanks:

(a) ..... on issue of shares means the subscriber of the shares is required to pay less amount for the shares.

(b) Letter of ..... is sent to the allotees of shares.

(c) Issue of shares is regulated by .....

Q 3: What is allotment of share? Discuss the process for the allotment of shares of a company.

Q 4: Explain the meaning and the accounting treatment when application money is received and when allotment of share is made.

Q 5: Explain the terms 'Over-subscription' and 'Under-subscription'.

Q 6: What is Minimum subscription?

Q 7: State the SEBI guidelines on reservation for small individual applicants of shares.

Q 8: Sonal Ltd. issued 5,000 shares of Rs. 100 each at par. The amount payable was as under :

Rs. 25 on application; Rs. 25 on allotment;

Rs. 20 on first call; and Rs. 30 on final call.

The company received applications for 4,500 shares. The company did not make final call. Assuming all the monies called were received, pass Journal entries in the books of the company.

Q 9: Baruah limited was registered with a capital of Rs. 10,00,000 in shares of Rs. 10 each and issued 40,000 such shares at a premium of Rs. 2 per share, payable as Rs. 3 per share on application, Rs. 4 per share on allotment (including premium) and Rs. 2 per share on first call made three months later. All the money payable on application and allotment were duly received but when the first call was made, one shareholder paid the entire balance on his holdings of 600 shares, and another shareholder holding 2,000 shares failed to pay the first call money.

Give Journal entries to record the above transactions and show how they will appear in the company's Balance Sheet.

*[**Hint :** As per the question Second Call has not been made, hence the entries are to be passed upto first call only.]*

Q 10: Sabnam Limited invited applications for 40,000 shares of Rs. 10 each payable as follows :

Rs. 2.50 on Application	(on 1st Feb., 2008);
Rs. 2.50 on Allotment	(on 1st March, 2008);
Rs. 2 on First Call	(on 1st August, 2008); and

Rs. 3 on Second Call (on 1st Nov., 2008)

All the shares were applied and allotted. B Bora, holding 300 shares paid the whole of the amount along with allotment. Show Journal entries.

Q 11: On 1st January 2009, Tezpur Industries Ltd. made issue of 10,000 equity shares of Rs. 10 each payable as follows:

Rs. 2 on Application; Rs. 3 on Allotment; Rs. 5 on First and Final Call (3 months after allotment).

Applications were received for 12,000 shares and the directors refunded the excess application money and made allotment of 10,000 shares. Give journal entries in the books of the Company.

*** ***** ***

UNIT 2: FORFEITURE AND RE-ISSUE OF SHARES

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Meaning of Forfeiture of Shares

2.4 Effect of Forfeiture of shares

2.5 Accounting Treatment on Forfeiture of Share

2.6 Re-issue of Forfeited Shares

2.7 Accounting Treatment on Reissue of Forfeited Shares

2.8 Let Us Sum Up

2.9 Further Reading

2.10 Answers To Check Your Progress

2. 11 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit you will be able to -

- define the meaning of forfeiture of shares
- explain the procedure of forfeiture of shares
- illustrate the accounting treatment on forfeiture of shares
- explain the meaning of re- issue of forfeited shares
- describe the procedure of re- issue of forfeited shares
- illustrate the accounting treatment on re- issue of forfeited shares.

2.2 INTRODUCTION

In the earlier unit you have found that prospective shareholders apply for shares after going through the prospectus issued by the company. The company processes the applications and proceeds to allot shares after observing the legal and other formalities. Once an applicant is allotted any share, a contract is entered into between the company and the shareholder. If the shareholder fails to comply with the terms and conditions as per the agreement his/her shares may be forfeited.

In this unit we will discuss the meaning of forfeiture of shares, re-issue of forfeited shares and the related issues and accounting treatment on forfeiture of shares as well as re- issue of forfeited shares..

2.3 MEANING OF FORFEITURE OF SHARES

Let us first discuss the meaning of forfeiture and forfeiture of shares. In simple words, 'forfeiture' means the loss of a right, claim or property as a result of failure to meet legal obligations. In accounting for share, it assumes special meaning. Forfeiture of share means cancellation of the shares held by the defaulting member in a company.

After an applicant is allotted shares, a contract is entered into between the company and the shareholder. The shareholder is bound to contribute to the capital of the company to the extent the price of shares he has agreed to take. Where the amount of share money is payable in instalments, the shareholders are under obligation to pay the instalments as and when he/she is asked to pay by the company. If he/she fails to pay allotment/call money within the time mentioned in the allotment/call letters, his /her shares may be forfeited by the directors if authorised by the Articles of Association.

2.4 EFFECT OF FORFEITURE OF SHARES

Now let us discuss what will be the effect of share forfeiture. First, the directors must observe strictly all the legal formalities required by the Articles of Association, before forfeiting the shares. When the directors forfeit the shares, the person loses his membership of the company. Further the amount already paid by him/her towards the share capital is also forfeited. Therefore, on forfeiture of shares, the name of the member is removed from the Register of Members. In the financial books of the company also necessary entries are passed, cancelling the shares allotted to the member. The amount already paid by the defaulting member is not refunded and it is transferred to an appropriate account.

Summarily the following are the effects of forfeiture:

(a) Termination of membership of the shareholder;

(b) Seizure of money paid by the shareholder;

(c) Ownership of forfeited shares lies with the company;

(d) The money received on the forfeited shares becomes the property of the company;

(e) The defaulting shareholder shall remain liable to pay the amount in respect of his/ her shares, till the company receives the payment in full of such shares;

(f) On forfeiture of shares, the share capital account is reduced to the extent of amount called up on account of capital till the forfeited shares are reissued.

Disclosure in the Balance Sheet

The balance of Forfeited Shares Account is shown as an addition to the total paid-up share capital of the company under the head "Share Capital" under title "Equity and liabilities" of the Balance Sheet till the forfeited shares are reissued.



CHECK YOUR PROGRESS

Q 1: Explain the meaning of forfeiture of share.

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.....

Q 2: Mention any two effects of forfeiture of share.

i) .....

ii) .....

2.5 ACCOUNTING TREATMENT ON FORFEITURE OF SHARES

The accounting treatment relating to the forfeiture of shares may be discussed under the following heads:

(i) Forfeiture of Shares issued at par

(ii) Forfeiture of Shares issued at a discount

(iii) Forfeiture of Shares issued at a premium.

These are discussed below:

(i) Forfeiture of Shares originally issued at par:

If the unpaid amount was transferred to Calls in Arrear Account

Date	**Particulars**	**Debit (Rs.)**	**Credit (Rs.)**
Date of Forfeiture	Share Capital A/c Dr.	(Amount called up per share x no. of forfeited shares)	
	To Calls in Arrear A/c		(Amount unpaid)
	To Forfeited Shares A/c		(Amount received)

***Note*:** Instead of using the term Forfeited Shares A/c, Shares Forfeited A/c or Share Forfeiture Account may also be used.

If the unpaid amount was not transferred to Calls in Arrear Account:

Date	**Particulars**	**Debit (Rs.)**	**Credit (Rs.)**
Date of Forfeiture	Share Capital A/c Dr.	(Amount called up per share x no. of forfeited shares)	
	To Respective Calls A/c		(Amount unpaid)
	To Forfeited Shares A/c		(Amount received)

Note: *Respective Calls mean if there were arrears only on Allotment, Allotment Account will be credited. If there were arrears both on Allotment and First Call, both the Allotment Account and First Call Account will be credited and again if the arrears were on Allotment, First Call and Second Call, then the Allotment Account, First Call Account and Second Call Account will be credited and so on.*

(ii) Forfeiture of Shares issued at a Discount:

If shares to be forfeited were issued at a discount, the discount applicable to such shares shall be cancelled at the time of forfeiture of such

shares.

The journal entry to be passed is:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
Date of Forfeiture	Share Capital A/c Dr.	(Amount called up + Discount)	
	To Discount on Issue of Shares A/c		(Amount of Discount)
	To Respective Calls A/c		(Amount unpaid)
	or		
	To Calls - in- Arrear A/c		
	To Forfeited Shares A/c		(Amount received)

(iii) Forfeiture of Shares issued at a Premium:

Journal entries to be passed are:

(a) In case the premium money has been received:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
Date of Forfeiture	Share Capital A/c Dr.	(Amount called up...	
	To Respective Calls A/c		(Amount unpaid)
	or		
	To Calls in Arrear A/c		
	To Forfeited Shares A/c		(Amount received)

(b) In case the premium money has not been received:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
Date of Forfeiture	Share Capital A/c Dr.	(Amount of capital called up.)	
	Securities Premium A/c Dr.	(Amount of Premi -um not received)	
	To Respective Calls A/c		
	or		
	To Calls - in- Arrear A/c		(Amount unpaid)
	To Forfeited Shares A/c		(Amount received)



LET US KNOW

Forfeiture of Fully Paid-Up Shares

Forfeiture for non-payment of calls, premium, or the unpaid portion of the face value of the shares is one of the many causes for which a share may be forfeited. But fully paid-up shares may be forfeited for realization of debts of the shareholder if the Articles specially provide it.



CHECK YOUR PROGRESS

Q 3: In case shares issued at discount are forfeited what will be the accounting treatment of discount?

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Q 4: State whether the following statements are true or false-

i) When shares are forfeited 'Calls in Arrear A/c' is debited.

ii) Forfeiture of shares does not result in termination of membership of the defaulting shareholder.

iii) Shares which have been issued at premium cannot be forfeited even if the applicant fails to pay the allotment money.

iv) In forfeiture of shares, 'Share Capital A/c' is debited.



EXAMPLE 1

Vikash Ltd. issued 200 Equity Shares of Rs. 10 each at par to Akash who could not pay the first call of Rs. 3 per share and the final call of Rs.4 per share. For non-payment of money these shares were forfeited.

Pass journal entry for the forfeiture assuming (i) the unpaid amount has been transferred to Calls in Arrear A/c and (ii) unpaid amount has not been transferred to Calls in Arrear A/c:.

Solution:

Journal Entry in the books of Vikash Ltd.

(i) The unpaid amount was transferred to Calls in Arrear Account:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
Date of Forfeiture	Equity Share Capital A/c Dr.	2,000	
	To Calls in Arrear A/c		1,400
	To Forfeited Shares A/c		600
	(Being 200 equity shares of Rs. 10 each are forfeited for non-payment of the first call of Rs. 3 per share and the final call of Rs. 4 per share as per Board's Resolution No. .....dated.....)		

(ii) The unpaid amount was not transferred to Calls in Arrear Account:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
Date of Forfeiture	Equity Share Capital A/c Dr.	2,000	
	To Equity Share First Call A/c		600
	To Equity Share Final Call A/c		800
	To Forfeited Shares A/c		600
	(Being 200 equity shares of Rs. 10 each are forfeited for non-payment of the first call of Rs. 3 per share and the final call of Rs. 4 per share as per Board's Resolution No. .....dated.....)		

Note: As the shares have been fully called up, share capital account has been debited with the nominal value of shares which is equal to the amount called up.



ACTIVITY 1

Sima Ltd. Issued Equity Shares of Rs. 10 each payable as Rs. 2 on application, Rs. 5 on allotment and Rs. 3 on

First and final call. One shareholder who applied for 100 equity shares could not pay the allotment money and subsequently these shares were forfeited. Pass journal entry for the forfeiture

2.6 RE-ISSUE OF FORFEITED SHARES

You are aware that the directors of the company are empowered, through its articles, to forfeit the shares. They are also empowered to reissue such forfeited shares. Until the forfeited shares are reissued, the balance of the Shares Forfeited A/c will remain in the accounts. Shares Forfeited A/c will be shown as addition to the total paid up capital of the company under the heading 'Share Capital' under the title "Equity and Liabilities" of the Balance Sheet. The Directors may reissue such forfeited shares at discount also. But the amount of such discount in no case can exceed the capital value of shares received on such forfeited shares. In case a part of forfeited shares are issued the amount of such discount and amount of share forfeiture should be proportionate.

The Regulations of the Table 'F' has given absolute power to the Board of Directors regarding the reissue of forfeited shares. As per regulation 32(i) of the Table 'F' of Companies Act, a forfeited share may be sold or otherwise disposed off on such terms and in such manner as the Board thinks fit.

Treatment of discount on reissue of shares:

Generally discount is allowed on reissue of shares. This amount of discount allowed on re-issue is a loss to the company. The loss by way of a discount on reissued shares is to be adjusted from the Shares Forfeiture Account.

2.7 ACCOUNTING TREATMENT ON REISSUE OF FORFEITED SHARES

The accounting entries for reissue of forfeited shares will depend on the terms of original issue of the forfeited shares. Therefore, the entries for reissue are discussed under the following heads:

(a) When forfeited shares which were originally issued at par are also reissued at par:

(i) On reissue of shares

Date	Particulars	Debit (Rs.)	Credit (Rs.)
Date of reissue	Bank Dr. To.....Share Capital A/c	(Amount received on reissue)	 (Amount received on reissue)

(ii) On transfer of profit on reissue:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
Date of reissue	Forfeited Shares Dr. To Capital Reserve A/c	(Amount trasferred)	 (Amount transferred)

Note: When all the forfeited shares have been reissued at par, the whole of the balance of the forfeited shares account represents profit on reissue and transferred to Capital Reserve account, being a capital profit.

(b) When forfeited shares which were originally issued at par are now reissued at discount:

On reissue of shares

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank Dr. Forfeited Shares A/c Dr. To.....Share Capital A/c	(Amount received on reissue) (Discount allowed on reissue)	 (Paid up amount of Nominal Value of Shares)

On transfer of profit on reissue, if any:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Forfeited Shares A/c Dr. To Capital Reserve A/c	(Amount transferred)	 (Amount transferred)

(c) When forfeited shares which were originally issued at par are now reissued at premium:

On reissue of shares

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank Dr.	(Amount received on reissue)	
	To.....Share Capital A/c		(Paid up amount of Nominal Value of Shares
	To Securities Premium A/c		(Amount of Premium)

On transfer of profit on reissue, if any:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Forfeited Shares A/c Dr.	(Amount transferred)	
	To Capital Reserve A/c		(Amount transferred)

(d) Reissue of forfeited shares which were originally issued at premium:

On reissue of shares

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bank Dr.	(Amount received on reissue)	
	Forfeited Shares A/c Dr.	(discount allowed on reissue)	
	To Share Capital A/c		(called up amount of Nominal value of shares)

On transfer of profit on reissue, if any:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Forfeited Shares A/c Dr.	(Amount transferred)	
	To Capital Reserve A/c		(Amount transferred)



EXAMPLE 2

Baruah Limited forfeited 200 shares of Rs. 10 each, on which Rs. 9 per share called up, for non-payment of first call money of Rs. 3 per share. Subsequently, the company reissued 140 shares for Rs. 7 per share as Rs. 9 paid-up.

Pass journal entries for forfeiture and reissue of shares.

Solution :

In the books of Baruah Limited

Journal Entries

(i) on forfeiture of shares

Date	Particulars		Debit (Rs.)	Credit (Rs.)
	Share Capital A/c (200xRs. 9)	Dr.	1,800	
	To.....Share First Call A/c (200xRs.3)			600
	To Forfeited Shares A/c (200x Rs. 6)			1,200
	(Being the forfeiture of 200 shares of Rs. 10 each Rs. 9 per share called up for non- payment of first call money of Rs. 3 per share as per Board's Resolution No. .....dated.....)			

(ii) On reissue of shares

Date	Particulars		Debit (Rs.)	Credit (Rs.)
	Bank (140xRs.7)	Dr.	980	
	Forfeited Share A/c(140xRs. 2)	Dr.	280	
	To....Share Capital A/c (140xRs.9)			1,260
	(Being the reissue of 140 forfeited shares of Rs. 10 each as Rs. 9 per share called and paid up for Rs. 7 per share as per General meeting Resolution No.....date.....)			

(iii) On transfer of profit on reissue

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Forfeited Shares A/c (see note) Dr.	560	
	To Capital Reserve A/c Dr.		560
	(Being the transfer of balance of forfeited shares, being the profit on reissue to Capital Reserve Account)		

Note: Since a part of the forfeited shares have been reissued, profit on reissue of forfeited shares has been calculated on proportionate basis as under:

Calculation of Profit on Reissue:

Discount allowable on reissue of 200 shares (200X 6) = Rs. 1,200

Therefore, Discount allowable on reissue of 140 shares =

1,200 x 140 ÷ 200 = 840

Less : Actual amount of discount allowed on reissue (140 x 2) = 280

Therefore, profit on reissue (transferred to Capital Reserve) = 560



ACTIVITY 2

Swastik Ltd. forfeited 400 shares of Rs. 10 each, Rs. 8 per share called up for non-payment of first call of Rs. 3 per share. These shares were subsequently reissued by the company at par as Rs. 8 paid-up.

Pass journal entries for forfeiture and reissue of shares.



EXAMPLE 3

Chandan holds 300 shares of Rs.10 each on which he has paid Re.1 on application, Rs.2 on allotment. Badal holds 300 shares of Rs.10 each and he has paid Re 1 on application, Rs.2 on allotment and Rs 3 on first call. The amount unpaid was transferred to calls-in-arrear account.

They all fail to pay their arrears and the final call of Rs.4 per share and the directors thus forfeited their shares. The shares are reissued subsequently for Rs.8 per share as fully paid. Show the forfeiture and reissue entries in the books of the company.

Solution:

	In the books of the Company Journal Entries		
Date	**Particulars**	**Debit (Rs.)**	**Credit (Rs.)**
	Share Capital A/c [(300+300)x10] Dr.	6,000	
	To Calls-in-Arrear A/c [(300xRs.7)+(300xRs.4)]		3,300
	To Forfeited Shares A/c [(300xRs.3)+(300xRs.6)]		2,700
	(Being the forfeiture of 600 shares of Rs. 10 each fully called up for non-payment of call money as per Board's Resolution No.....dated.....)		
	Bank [(300+300)xRs. 8] Dr.	4,800	
	Forfeited Shares A/C [(300+300)xRs.2] Dr.	1,200	
	To.....Share Capital A/C (600 Rs. 10)		6,000
	(Being 600 forfeited shares of Rs.10 each reissued at Rs. 8 each as fully paid as per General Meeting Resolution No.....dated.....)		
	Forfeited Shares A/c (Rs. 2,700-Rs. 1,200) Dr.	1,500	
	To Capital Reserve A/c		1,500
	(Being the balance of forfeited shares account transferred to Capital Reserve Account)		

Note: Since all the forfeited shares have been reissued, the balance of Shares Forfeited Account represents the profit on reissue.

Workings:

1. Chandan: (300 shares x 10 per share) = Rs. 3000
   Badal: (300 shares x 10 per share) = Rs. 3000
   Rs. 6000
2. Chandan: (300 shares x 7 per share) = Rs. 2100
   Badal: (300 shares x 4 per share) = Rs. 1200
   Rs. 3300
3. Chandan: (300 shares x 3 per share) = Rs. 900
   Badal: (300 shares x 6 per share) = Rs. 1800
   Rs. 2700

4. (300 shares + 300 share) X Rs. 8 per share = Rs. 4800
5. (300 shares + 300 share) X Rs. 2 per share = Rs. 1200



ACTIVITY 3

Swastik Ltd. forfeited 400 shares of Rs. 10 each, Rs.8 per share called up for non-payment of first call of Rs. 3 per share. These shares were subsequently reissued by the company at par as Rs. 8 paid-up.

Pass journal entries for forfeiture and reissue of shares.



CHECK YOUR PROGRESS

Q 5: State whether the following statements are true or false-

i. A company can not reissue the forfeited shares.

ii. The discount allowed on reissue of forfeited shares is not a loss for the company.

iii. The forfeited shares which were originally issued at par cannot be reissued at par.

iv. In case of reissue of forfeited shares, 'Share capital A/c' is debited.



2.8 LET US SUM UP

In this unit we have discussed the following-

- When a shareholder fails to pay the share money in respect of his her shares, his shares are forfeited.
- Articles of Association of the company must authorise the directors for the forfeiture of shares.
- Forfeiture of shares results in termination of the contract between the company and the defaulting shareholder leading to removal of the name of the defaulting shareholder from the Register of Members of the company.
- Accounting entries for forfeiture of shares.

- In case of forfeiture of shares, 'Forfeited Shares A/c' is credited with the amount already received in respect of the forfeited shares.
- A company can reissue the forfeited shares.
- Accounting entries for reissue of shares.
- Profit on reissue of forfeited shares is transferred to Capital Reserve A/c.



2.9 FURTHER READING

1) Dam, B. B & Gautam H. C. (2008). Corporate Accounting : for B. Com part II(new course) of Gauhati University. Guwahati, CapitalPublishing Company.

2)) Maheshwari, S. N. & Maheshwari, S. K (2009). Corporate accounting. New Delhi, Vikas Publishing House Pvt. Ltd.

3) Mukherjee A. & Hanif M (2006). Corporate accounting. New Delhi,Tata McGraw- Hill Publishing Company.



2.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Forfeiture of share means cancellation of the shares held by the defaulting shareholder.

Ans to Q No 2: (i) Termination of membership of the shareholder;
(ii) Seizure of money paid by the shareholder.

Ans to Q No 3: If shares to be forfeited were issued at a discount, the discount applicable to such shares shall be cancelled at the time of forfeiture of such shares.

Ans to Q No 4: (i) False (ii) False (iii) False (iv) True

Ans to Q No 5: (i) False (ii) False (iii) False (iv) False



2.11 MODEL QUESTIONS

Q 1: ***State whether the following statements are 'true' or 'false' :***

(a) Preference shares can not be forfeited.

(b) Forfeited shares can not be reissued at premium.

(c) Profit on reissue of shares is transferred to Capital Reserve Account.

Q 2: **Write short notes on:**

(a) Share forfeiture

(b) Profit on reissue of forfeited shares

(c) Capital Reserve

Q 3: Explain the accounting treatment or 'Forfeiture of Shares'.

Q 4: A Ltd. forfeited 100 equity shares of Rs. 10 each, Rs. 8 per share called up, issued at par for non-payment of the first call of Rs. 3 per share.

Pass journal entry for the forfeiture.

Q 5: D Ltd. forfeited 100 equity shares of Rs. 10 each, issued at a discount of 10% for non-payment of the first call of Rs. 3 per share and final call of Rs. 4 per share.

Pass journal entry for the forfeiture.

Q 6: Amal Ltd. forfeited 100 shares of Rs. 10 each, fully called up for non-payment of final call money of Rs. 4 per share. These shares were subsequently reissued by the company at par as fully paid-up.

Pass journal entries for forfeiture and reissue of shares.

Q 7: Ajoy Ltd. forfeited 100 shares of Rs. 10 each, fully called up for non-payment of final call money of Rs. 4 per share. Of these 80 shares were subsequently reissued by the company at par as fully paid-up.

Pass journal entries for forfeiture and reissue of shares.

Q 8: Kamrup Bricks Ltd. has forfeited the following shares of Rs.10 each for non payment of call money and allotment money.

(a) 100 shares held by Steffie who has paid only application money @ Rs.1 each.

(b) 200 shares held by Martina who has paid only application and allotment money @ Rs.1 and Rs.2 each respectively.

(c) 300 shares held by Arancha who has paid only application, allotment and first call money @ Rs.1, Rs. 2 and Rs. 3 each respectively.

Shares are fully called. Out of the shares, 500 shares held by Martina and Arancha are reissued at 10% discount as fully paid. Expenses on issue are Rs.300.

Give journal entries in the books of the company

Q 9: A limited Company was registered with a capital of Rs. 5,00,000 in shares of Rs. 10 each and issued 20,000 such shares at a premium of Rs. 2 per share, payable as Rs. 3 per share on application, Rs. 4 per share on allotment (including premium) and Rs. 2 per share on first call made three months later. All the money payable on application and allotment were duly received but when the first call was made, one shareholder paid the entire balance on his holdings of 300 shares, and another shareholder holding 1,000 shares failed to pay the first call money.

Give Journal entries to record the above transactions and show how they will appear in the company's Balance Sheet.

*** ***** ***

UNIT 3: ISSUE OF BONUS SHARES AND RIGHT SHARES

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Meaning of Bonus Shares

3.4 Objectives, Advantages and Disadvantages of Issue of Bonus Shares

3.5 Accounting Treatment on Issue of Bonus Shares

3.6 SEBI guidelines on issue of bonus shares

3.7 Meaning of Right Shares

3.8 Objectives, Advantages and Disadvantages of Issue of Right Shares

3.9 Accounting Treatment on Issue of Right Shares

3.10 Let Us Sum Up

3.11 Further Reading

3.12 Answers To Check Your Progress

3.13 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit you will be able to-

- define the meaning of bonus shares
- explain the objectives of issuing bonus shares
- describe the advantages and disadvantages of issuing bonus shares
- list out the conditions for issue of bonus shares
- illustrate the accounting treatment on issue of bonus shares
- explain the meaning and objectives of right shares
- elaborate the advantages and disadvantages of right shares
- list out the conditions for issue of right shares
- illustrate the accounting treatment on issue of right shares.

3.2 INTRODUCTION

In the earlier units you have come to know about shares and issue of shares. These shares are generally issued by the companies to the public at a price. After the shares are allotted the persons who get the shares are called shareholders. These shareholders may get additional shares from the company after some years by way of bonus and by way of rights.

In this unit we will discuss about the bonus shares and right shares, their meaning, objectives, advantages and disadvantages, conditions for issue of these shares and accounting treatment on issue of these shares.

3.3 MEANING OF BONUS SHARES

Companies which are successful in earning profits from year to year do not distribute the whole amount of profit earned to its shareholders as dividend. This is in order to strike a balance between growth of the company and the satisfaction of its shareholders in terms of their earning per share. Every year a part of the profit is transferred to an account called Reserve or General Reserve Account. This transfer may be made either compulsorily due to statutory requirement or voluntarily.

A company which has large reserves accumulated out of profits in excess of the present or the future needs of the company can think of benefiting the shareholders by way of compensation for the loss of dividends which they suffered earlier due to transfer of profit to reserves. The method of compensating the shareholders is in the form of bonus payable out of the accumulated reserves. This bonus is paid in the form of fully paid shares.

As per Sec 63(1), a company may issue fully paid-up bonus shares to its members out of-

- Its Free Reserves
- Its Securities Premium Account; or
- Its Capital Redemption Reserve Account

Provided that no issue of bonus shares shall be made by capitalising reserves created by the Revaluation of Assets i.e. Revaluation Reserves.

In simple words bonus shares are the shares issued out of accumulated profit or accumulated reserves. The bonus shares shall not be issued in lie of dividend.

If bonus is paid in cash the liquid resources of the company is depleted. Hence, the Board of Directors of prudent companies generally prefer to offer such bonus to the shareholders by way of issuing additional shares free of charge. The shares so issued are termed as 'Bonus shares'. In other words, bonus shares are those shares which are issued to the existing shareholders in lieu of profits. Bonus share is a type of share which is issued to the existing shareholders without any consideration i.e. the shareholders are not required to pay any cash for such shares allotted to the members.

Issue of bonus shares is a machinery for capitalising profits. Capitalisation of profits and reserves means the ploughing back or utilisation of profit for internal use of company so that the profits are not distributed as dividends, that is, funds are not drained out of the company. Capitalisation of profits/reserves can be done by a company if its articles so provide. It should be noted that **a company cannot issue partly paid up bonus shares. However, it can utilise the bonus declared in making partly paid up shares fully paid up subject to the provisions of the Act.**

Conditions to be fulfilled for the Issue of Bonus Shares: [Sec 63(2)]

The following conditions must be fulfilled by a company before issuing Bonus Shares:

(i) The Articles of Association must permit such issue of Bonus Shares;

(ii) The issue must be recommended by the Board of Directors approved by the shareholders in the general meeting;

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

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

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

(vi) Provisions of the Companies Act regarding the issue of Bonus Shares must be complied with.

(vii) The company must also comply with the SEBI guidelines for issue of Bonus Shares.



CHECK YOUR PROGRESS

Q 1: Explain why bonus to shareholders is paid in the form of shares, not in cash?

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3.4 OBJECTIVES, ADVANTAGES AND DISADVANTAGES OF ISSUE OF BONUS SHARES

The following are the objectives of the issue of bonus shares by a company:

- Bonus shares are issued to expand the capital base of the company.
- Bonus shares are issued to attract more trading in the company's shares.
- The issue of bonus shares helps the company to retain cash.
- Bonus shares are issued to bring parity between share capital and fixed assets which is an indication of financial soundness.
- Bonus shares are issued to reflect the actual capital employed by the company.

Advantages of Issue of Bonus Shares:

The advantages of issue of bonus shares may be discussed as below:

- Since bonus shares are issued out of retained earnings, the liquidity position of the company is not affected.
- On capitalisation of reserves through the issue of bonus shares, the capital structure of the company becomes more realistic.

- On account of bonus issue, the number of shares held by the shareholders increases, without any payment, which helps the shareholders to increase their future earnings.
- The shares of the companies which make bonus issues can be easily sold and thereby realise cash. They may also make gain called capital gains. The shareholders can sale the bonus shares in the market and can realise cash immediataly.
- The shareholders feel happy and contented with the company on account of the issue of bonus shares as it is an indication of progress of the company.
- Issue of bonus shares are not treated as dividend income in the hands of shareholders since there is no distribution in the form of cash. Therefore, a shareholder is not required to pay any income tax on the value of bonus shares received.

Disadvantages of Issue of Bonus Shares:

The following are the disadvantages of issue of bonus shares:

- Issue of bonus shares may encourage speculation in share market.
- The rate of return per share would decline because dividend would have to be paid on increased number of shares unless the profits increase considerably in future. It would have negative impact on the minds of the prospective investors.
- There is a procedural difficulty relating to issue of bonus shares. The bonus issue is subject to the prior approval of the Securities and Exchange Board of India (SEBI).



CHECK YOUR PROGRESS

Q 2: State whether the following statements are true or false-

i) Issue of bonus shares adversely affect the liquidity position of the company.

ii) Bonus shares are issued out of retained profits of the company.

iii) Issue of bonus shares help the company to retain cash.

iv) Approval of SEBI is not required for issuing bonus shares.

v) The number of shares held by a shareholder decreases as a result of issue of bonus shares.



LET US KNOW

The following types of profits/reserves are available for the issue of bonus shares:

(a) Credit balance of Profit and Loss account,

(b) General Reserve and other revenue reserves,

(c) Capital profits or Reserve such as profits prior to incorporation, profit on purchase or acquisition of business, profit on sale of fixed assets and any realised capital profits.

(d) Securities Premium Account,

(e) Capital Redemption Reserve Account.

It may be noted that only fully paid bonus shares can be issued out of the balance of Securities Premium Account and Capital Redemption Reserve Account.

Balances of other reserves/profits can also be utilised for making the partly paid shares fully paid.

3.5 ACCOUNTING TREATMENT ON ISSUE OF BONUS SHARES



Partly paid up shares : The shares on which the company has not called up the entire value.

Accounting treatment relating to issue of bonus shares may be discussed under the following heads:

(A) Where Bonus is utilised in making partly paid up shares fully paid up.

(B) Where Bonus is utilised in issuing fully paid up shares.

These are discussed below:

(A) Where Bonus is utilised in making partly paid up shares fully paid up;

Where Bonus is utilised in making partly paid up shares fully paid up, the following three accounting steps are involved:

(i) Making the final call due;

(ii) Declaration of Bonus; and

(iii) Utilisation of bonus towards the payment of Final Call.

The following journal entries are required to be passed for carrying out the above accounting steps:

(i) For making the final call due:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	.....Share Final Call A/c Dr. To ..... Share Capital A/c		

(ii) For declaration of bonus:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Profit & Loss Account Dr. General Reserve Account Dr. Capital Reserve Account Dr. To Bonus to Shareholders Account		

(iii) Utilisation of bonus towards the payment of Final Call:

Date	Particulars	Debit (Rs.)	Credit (Rs.)
	Bonus to Shareholders Account Dr. To ..... Share Final Call Account		



EXAMPLE 1

Sharma Ltd. has a paid up capital of Rs. 14,00,000 divided into equity shares of Rs. 10 each, Rs. 7 paid up.

The following balances are available in the books of the company:

(i) Securities Premium Account Rs. 8, 00,000.

(ii) Profit and Loss Account Rs. 4, 80,000 after declaration of annual dividend;

(iii) General Reserve Rs. 3, 60,000.

The company has decided in the General Meeting to capitalise the necessary amount of the above balances by paying a bonus of Rs. 3 per share to make the shares fully paid-up.

Pass necessary journal entries in the books of the company to give effect to the above transactions.

Solution:

Calculation of amount of bonus to be declared:

Paid up Share Capital Rs. 14, 00,000

Paid up value per share Rs. 7

∴ Number of shares issued = Rs. 14, 00,000 ÷ Rs. 7= 2, 00,000

∴ Unpaid amount per share Rs. 10 – Rs. 7 = Rs. 3

∴ Amount of Share Final Call (Rs. 3 x 2, 00,000) = Rs. 6, 00,000

∴ Amount of Bonus to be declared which is equal to the amount of Share Final Call i.e. Rs. 6, 00,000

According to section 78(2) of the Companies Act, balance of Securities Premium Account cannot be utilised for making partly paid shares fully paid up. Therefore, the amount of Rs. 6, 00,000 will be provided out of the balances of Profit and Loss A/c and General Reserve which will be utilised for adjusting the Share Final Call. The amount available in Profit and Loss Account has been fully used and the balance has been taken from General Reserve.

In the books of Sharma Ltd.

Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Equity Share Final Call A/c Dr.		6,00,000	
	To Equity Share Capital A/c			6,00,000
	(Being the final call money made due on 2,00,000 shares of Rs, 10 each @ Rs. 3 per share as per Board's Resolution No..... dated.....)			
	Profit & Loss A/c Dr.		4,80,000	
	General Reserve A/c Dr.		1,20,000	
	To Bonus to Shareholders A/c			6,00,000
	(Being the amount of bonus declared as per General meeting's Resolution No. ..... dated.....)			

	Bonus to Shareholders A/c Dr. To Equity Share Final Call A/c (Being the amount of bonus utilised towards the payment of final call money to make the partly paid-up shares fully paid-up as per Board's Resolution No. ..... dated .....)		6,00,000	 6,00,000

(B) Where Bonus is utilised in issuing fully paid up shares:

In this case bonus share may be issued (a) at Par; or (b) at a Premium. Therefore, the entry for utilisation of bonus for issue of shares will be as under:

The following journal entries are required to be passed for carrying out the above accounting steps:

(i) For declaration of bonus:

Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Capital Redemption Reserve Account or Dr. Securities Premium Account or Dr. Capital Reserve Account or Dr. Any other Reserve Account or Dr. Profit & Loss Account or Dr. General Reserve Account or Dr. To Bonus to Shareholders Account			

(ii) For utilisation of bonus towards issue of fully paid up bonus shares:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bonus to Shareholders A/c Dr. To ..... Share Capital Account	.		



CHECK YOUR PROGRESS

Q 3: Give a single journal entry for issue of bonus share of Rs. 50,000 from general reserve.

.....

.....



EXAMPLE 2

Yamaha Company Limited having a paid-up capital of Rs. 10,00,000 in shares of Rs. 10 each, had a Reserve of Rs. 1,60,000 built up out of profits. It has resolved to capitalise Rs. 1,00,000 of the Reserve Account by issuing 10,000 fully-paid Bonus Shares of Rs. 10 each, a shareholder to get one such share for every ten shares held by him in the Company.

Pass journal entries recording the bonus issue.

Solution:

Working: No. of existing shares = Rs. 10, 00,000 ÷ Rs-. 10 = 1, 00,000

Ratio of Bonus issue:

For every 10 shares, 1 Bonus share

For 1, 00,000 shares, No. of Bonus Shares =1/10 x 1, 00,000= 10,000

In the books of Yamaha Company Limited

Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Reserve Account Dr.		1,00,000	
	To Bonus to Shareholders A/c			1,00,000
	(Being the amount of bonus declared out of Reserve as per Shareholder's Meeting Resolution No..... dated.....)			
	Bonus to Shareholders Account Dr.		1,00,000	
	To Equity Share Capital Account			1,00,000
	(Being the issue of 10,000 fully			

	paid Bonus Shares of Rs. 10 each towards the utilisation of bonus, at the rate of one Bonus share for every ten shares held in the company as per Board's Resolution No..... dated.....)			

(b) Where the bonus shares are issued at a premium:

The following journal entries will be passed:

(i) For declaration of bonus:

Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Capital Redemption Reserve Account or	Dr.		
	Securities Premium Account or Dr.			
	Capital Reserve Account or Dr.			
	Any other Reserve Account or Dr.			
	Profit & Loss Account or Dr.			
	General Reserve Account or Dr.			
	To Bonus to Shareholders Account			

(ii) For utilisation of bonus towards issue of fully paid up bonus shares:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bonus to Shareholders Account		Dr.	
	To ..... Share Capital Account			
	To Securities Premium Account			



EXAMPLE 3

Duncan Co. Ltd. had a paid up capital of Rs. 5, 00,000 in equity shares of Rs. 10 each. The company had an accumulated general reserve of Rs. 3, 50,000 out of which Rs. 1, 00,000 was distributed as bonus shares comprising of 5,000 shares of Rs. 20 each (Rs. 10 being premium).

Give journal entries showing the effect of issue of bonus shares.

Solution:

In the books of Duncan Co. Ltd.

Journal Entries

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	General Reserve A/c Dr.		1,00,000	
	To Bonus to Shareholders A/c			1,00,000
	(Being the amount of bonus declared out of General Reserve as per Shareholders' Meeting Resolution No..... dated.....)			
	Bonus to Shareholders A/c Dr.		1,00,000	
	To Equity Share Capital A/c			50,000
	To Securities Premium A/c			50,000
	(Being the utilisation of bonus towards issue of 5,000 bonus shares of Rs. 10 each at a premium @ Rs. 10 per share to be distributed among the members in the ratio of 1:10 i.e. one bonus share for every 10 shares held in the company as per Board's Resolution No. ..... dated.....)			

3.6 SEBI GUIDELINES ON ISSUE OF BONUS SHARES

A listed company proposing to issue bonus shares shall comply with the following requirements under the SEBI (Issue of Capital and Disclosure requirements) Regulations, 2009:

1. - The articles of association of the company must contain a provision for capitalisation of reserves, etc;
   - If there is no such provision in the articles the company must pass a resolution at its general meeting making provision in the articles of association for capitalization;
2. The company has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption;

3. The company has not defaulted in payment of statutory dues of the employees such as contribution to provident fund, gratuity etc.
4. The partly-paid shares, if any, outstanding on the date of allotment are required to be made fully paid-up.
5. (a) No company shall, pending conversion of FCDs/PCDs, issue any by way of bonus unless similar benefit is extended to the holders of such FCDs/though reservation of shares in proportion to such convertible part of FCDs or PCDs.

   (b) The shares so reserved may be issued at the time of conversion(s) of such debentures on the same terms on which the bonus issues were made.
6. The bonus issue shall be made out of free reserves built out of the genuine profits or securities premium collected in cash.
7. Reserves created by revaluation of fixed assets shall not be capitalised.
8. The declaration of bonus issue, in lieu of dividend, shall not be made.
9. A company which announces its bonus issue after the approval of the Board of directors must implement the proposal within a period of 15 days from the date of such approval (if Shareholders' approval is not required) or 2 months (if Shareholders' approval is required).
10. Once the decision to make a bonus issue is announced, the same cannot be withdrawn.

3.7 MEANING OF RIGHT SHARES

Right shares means shares which are issued to the existing equity shareholders by virtue of their shareholdership. Issue of right share means issue of further shares by a company to its existing equity shareholders in proportion to the shares held by them in the company. Section 62 of the Companies Act, 2013 makes it obligatory for companies regarding further issue of shares to offer new shares to existing equity shareholders in the first instance. Further, the total number of shares should not be more than the authorized share capital of the company.

The existing equity shareholders enjoy a right to either subscribe for

these shares or sell their rights or to reject the offer. In case the shareholder rejects the right shares the company can offer these shares to the public.

3.8 OBJECTIVES, ADVANTAGES AND DISADVANTAGES OF ISSUE OF RIGHT SHARES

The main objectives of issue of right shares are-

- The objective of issue of right shares is to increase the subscribed capital of the company.
- Another objective of issue of right shares is to comply with the statutory provision of the Companies Act, 2013 on the issue of shares by an existing company.
- The popular objective of issue of right shares is to offer shares at a price lower than the market price to the existing shareholders.

Advantages of Issue of Right Shares:

The advantages of issue of right shares are-

- One of the advantages of issue of right shares is that it leads to raise the subscribed capital of the company.
- Another advantage of issue of right shares is that it defuses the discontentment of the existing shareholders in regard to the expected benefits from the company.

Disadvantages of Issue of Right Shares:

The disadvantages of issue of right shares are-

- Issue of right shares may encourage speculation in share market.
- The rate of return per share would decline because dividend would have to be paid on increased number of shares unless the profits increase considerably in future. It would have negative impact on the minds of the prospective investors.
- The company gets less money since right shares are offered at a price lower than the market price to the existing shareholders.

3.9 ACCOUNTING TREATMENT ON ISSUE OF RIGHT SHARES

The accounting procedure on issue of right shares is same as we have discussed in Unit 1. The problem lies in this case is in regard to the Valuation of Rights.

Value of right means the value of the right of an existing shareholder to subscribe further shares issued by the company. It is the value of the benefit to be received by such shareholders when such rights are exercised. When expressed in monetary term, it is the difference between the market price and the average price of shares.

For the valuation of rights, the following points are to be considered:

(i) Market price per share

(ii) Price of each Right share.

(iii) Number of existing shares required to get one right share or the proportion of existing share and right share or the number of qualifying existing shares to get the specified number of right shares.



EXAMPLE 4

The following example will clarify the matter.

The issued and subscribed share capital of Abanti Ltd. is Rs. 1,80,000 divided into 18,000 shares of Rs. 10 each. The company issued right shares at Rs.15 per share to the existing shareholders in the proportion of 2 shares for every 9 shares held. The market price of each share is Rs. 35.

Calculate the value of each right.

Solution:

Calculation of value of each right:

Value of each right = (Market price of one share – Average price of the total shares)

Market value of 9 shares @ Rs. 35 each		= Rs. 315.00
Issue Price of 2 right shares @ Rs. 15 each	=	Rs. 30.00
	Total	= Rs. 345.00

Average price of (9 + 2) = 11 shares = Rs. 345.00 ÷11

= Rs. 31.36

Hence, Value of each Right = Rs. 35.00 – Rs. 31.36

= Rs. 3.64



3.10 LET US SUM UP

In this unit we have discussed the following-

- Bonus shares are issued to the existing shareholders out of accumulated profits.
- Bonus shares are issued by the company with different objectives like, expanding the capital base of the company, to take advantage of trading in shares, to retain cash etc.
- The issue of bonus shares is advantageous both for the company and the shareholders.
- Issue of bonus shares may result in speculation in share market.
- Accounting treatment on issue of bonus shares.
- Right shares are issued to the existing shareholders in proportion to the shares already held by them.
- Issue of right shares leads to increase in subscribed capital.
- The right shares are issued at a lower price than the market price.
- Accounting treatment on issue of right shares.



3.11 FURTHER READING

1) Ahmed N. (2007). Corporate Accounting: For B. Com (Hons.) and other professional courses. New Delhi, Atlantic Publishers and Distributors (P) Ltd.

2) Mukherjee A. & Hanif M. (2006).Corporate accounting. New Delhi, Tata McGraw - Hill Publishing Company Ltd.

3.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: If bonus is paid in cash the liquid resources of the company is depleted. Hence, the Board of Directors of prudent companies generally prefer to offer such bonus to the shareholders by way of issuing additional shares free of charge.

Ans to Q No 2: i) False.

ii) True.

iii) True.

iv) False.

v) False.

Ans to Q No 3:

General Reserve A/c	Dr.	50,000	
To Share Capital A/c			50,000

3.13 MODEL QUESTIONS

Q 1: Fill in the blanks:

(a) Securities Premium Account can not be utilised for issuing .....

(b) Bonus issue can be made out of .....

(c) A company can issue ..... paid up bonus shares.

Q 2: State whether the following are correct or incorrect:

(a) For declaration of bonus out of General Reserve, resolution in the Shareholders meeting is necessary.

(b) Capital Redemption Reserve Account can not be utilised for issuing partly paid up bonus shares.

(c) Companies Act 2013 prohibits the issue of bonus shares.

Q 3: Explain the meaning of bonus shares.

Q 4: What are the various sources from which bonus shares can be issued?

Q 5: What do you mean by 'Capitalisation of Profits'?

Q 6: Name the sources from which fully paid bonus shares can be issued.

Q 7: What is meant by Right Shares? Why are these issued?

Q 8: Discuss the legal conditions for issue of Right shares

Q 9: Bora Ltd. with a Subscribed Capital of Rs. 2,40,000 in Equity shares of Rs. 10 each, had called up Rs.8 per share. A bonus of 2 per share now declared out of Reserve to be utilised in making the existing shares fully paid up.

Pass journal entries recording the bonus issue.

Q 10: Coal & Coal Ltd. has a paid up capital of Rs. 4,00,000 divided into equity shares of Rs. 10 each, Rs. 6 paid up.

The following balances are available in the books of the company:

(i) Securities Premium Rs. 3,00,000.

(ii) Profit and Loss Account Rs. 2,80,000 after declaration of annual dividend;

(iii) General Reserve Rs. 1,90,000.

The company has decided in the General Meeting to capitalise the necessary amount of the above balances by paying a bonus of Rs. 4 per share to make the shares fully paid-up.

Pass necessary journal entries in the books of the company to give effect to the above transactions.

Q 11: The following are the extracts from the draft Balance Sheet of X Limited as at 31st December, 2018:

Authorised Capital :	Rs.
1,00,000 Equity Shares of Re. 1 each	1,00,000
Issued and Subscribed Capital	
50,000 Equity Shares of Re. 1	
each fully called up	50,000
Reserve Fund	30,000
Profit and Loss Account	15,000

A resolution was passed declaring bonus of 20% on Equity Shares to be provided as to Rs. 6,000 out of Reserve Fund and the balance out of balance of Profit & Loss Account. The bonus was to be satisfied as follows:

One fully paid Equity Share for every five Equity Shares held.

Pass journal entries to give effect to the above.

*** ***** ***

UNIT 4 : REDEMPTION OF PREFERENCE SHARE

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Meaning of Redemption of Preference Shares

4.4 Legal Conditions for Redemption of Preference shares

4.5 Methods of Redemption of Preference Shares

4.6 Accounting Treatment for Redemption of Preference Shares

4.7 Capital Redemption Reserve

4.8 Practical Problems

4.9 Let Us Sum Up

4.10 Further Reading

4.11 Answers To Check Your Progress

4.12 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the meaning of redemption of preference shares
- discuss the legal conditions for redemption of preference shares
- describe the methods of redemption of preference shares
- explain capital redemption reserve
- illustrate the accounting treatment for redemption of preference shares.

4.2 INTRODUCTION

We have already discussed in the previous chapters that preference shares are those shares which enjoy preferential rights with regard to payment of dividend or the capital amount. In other words, preference shareholders get preference over equity shareholders with respect to receipt of dividend from the company as well as the repayment of capital amount in the event of liquidation or winding up of the company. Now, before discussion

of redemption of preference shares, it will be relevant to have a look at the types of preference shares which are issued by companies. The different types of preference shares can be grouped as under-

a. **Cumulative Preference Shares**: As the name suggests, dividend payable on such preference shares is carried forward up to a specified period and paid only at the end of the specified period.

b. **Non-Cumulative Preference Shares**: Unlike, cumulative preference shares, dividend is paid to the shareholders of such preference shares every year and no arrear of dividend is carried over a period of time.

c. **Redeemable Preference Shares:** Redeemable preference shares are those preference shares which are to be paid back after the end of a specified period. It is important to note here that the Companies Act in India has prohibited companies to issue preference shares which are redeemable after the expiry of twenty years. In other words, redeemable preference shares can be issued for a maximum period of twenty years. However, companies engaged in in infra-structural projects can issue preference shares having life of maximum thirty years subject to the condition that minimum 10% of the preference shares must be redeemed every year after the end of twenty years.

d. **Irredeemable Preference Shares**: Irredeemable preference shares are those shares which cannot be redeemed during the whole lifetime of the company. In other words, such preference shareholders are paid back only at the time of liquidation of the company. It is important to note here that prior to 1988, companies were permitted to issue both redeemable and irredeemable preference shares, but the Companies (Amendment) Act, 1988 imposed restriction on companies to issue irredeemable preference shares and thereafter companies are allowed to issue only redeemable preference shares.

e. **Convertible Preference Shares:** Convertible preference shares are those preference shares which can be converted to equity shares after the expiry of a specified time period or as per the conditions laid down at the time of issue.

f. **Non-convertible Preference shares:** Contrary to the convertible preference shares, non- convertible preference shares cannot be converted in to equity shares any time during the life of the company.

g. **Participating Preference Shares:** Participating preference shareholders have the right to participate in the additional profits of the company left after paying the equity shareholders. The surplus dividend paid is in addition to the fixed amount of dividend paid to such shareholders.

h. **Non-Participating Preference Shares:** Non-participating preference shareholders do not get the right to participate in the additional profits left after paying dividend to the equity shareholders of the company.

4.3 MEANING OF REDEMPTION OF PREFERENCE SHARES

As mentioned above, the preference shares which can be redeemed by the company as per the terms of issue are called redeemable preference shares. The terms of issue normally stipulates the time of redemption and whether the redemption will be at par, premium or discount.

The term redemption means repayment or paying back. Hence, redemption of preference shares refers to the repayment of the amount due to the preference shareholders as per the terms laid down at the time of issue. The terms of issue contains the time period in which the preference shares are to be redeemed and also the price at which such shares are to be redeemed. Section 55 of the Companies Act, 2013 deals with issue and redemption of preference shares.



CHECK YOUR PROGRESS

Q 1: Mention the different types of preference shares.

.....

Q 2: What do you mean by redemption of preference shares?.

.....

4.4 LEGAL CONDITIONS FOR REDEMPTION OF PREFERENCE SHARES

As per the provisions of Companies Act, following legal conditions must be fulfilled for redemption of preference shares-

1. Redemption of preference shares must be authorised by the Articles of Association of the company.
2. Preference shares which are to be redeemed must be fully paid up. In other words, partly paid up preference shares cannot be redeemed. If the company wishes to redeem partly paid up preference shares, they must be converted to equity shares first.
3. Preference shares can be redeemed only out of the profits which would otherwise have been available for distribution as dividend. Moreover, preference shares can be redeemed out of the proceeds of fresh issue which is made exclusively for the purpose of redemption of preference shares.
4. When the preference shares are redeemed out of profits; an amount equal to the nominal value of preference shares redeemed out of profits must be transferred to Capital Redemption Reserve. The CRR is treated as paid up share capital of the company and can be utilised for issue of bonus shares in future.
5. When preference shares are redeemed out of proceeds of fresh issue of new preference shares; consent of at least 75% of the preference shareholders must be obtained and also obtaining approval for such arrangement from National Company Law Tribunal (NCLT) is necessary.
6. The NCLT shall order immediate redemption of preference shares held by the dissenting shareholders who do not have consent to such arrangement.
7. When the preference shares are redeemed at premium, the amount of premium payable at the time of redemption must be provided out of profits of the company or out of the company's securities premium account before the shares are redeemed.

4.5 METHODS OF REDEMPTION OF PREFERENCE SHARES

Based on the sources of funds for the purpose of redemption, the different methods of redemption of preference shares can be summed up as under-

1. **Redemption out of Profits:** This method is also called capitalisation of profit method as the distributable profit is utilised without making any change in the shareholding pattern of the company. Since, the amount of profits equal to the nominal value of preference shares redeemed is transferred to the CRR account which is equivalent to the paid up share capital, the redemption of preference shares by this method does not affect the shareholding pattern of the company.
2. **Redemption out of Fresh Issue:** Under this method, the amount payable to preference shareholders is collected by issuing fresh shares. However, it is important to note here that the amount collected from fresh issue of shares cannot be utilised for paying premium amount to the preference shareholders. In other words, the proceeds of fresh issue of shares can be utilised for paying back only the nominal value of the preference shares.
3. **Combination of both:** Under this method, preference shares are redeemed out of profits as well as out of the proceeds of fresh issue of shares.

4.6 ACCOUNTING TREATMENT FOR REDEMPTION OF PREFERENCE SHARES

Following journal entries are passed in the books of accounts of the company for redemption of preference shares-

1. When the preference shares are partly paid up, these are to be made fully paid up before redemption. The entry for making partly paid up shares fully paid up-

Sl.No.	Particulars
1.	When the preference shares are partly paid up, these are to be made fully paid up before redemption. The entry for making partly paid up shares fully paid up- **For making call due-** Preference Share Final Call a/c Dr. To Preference Share Capital a/c **For receipt of call money-** Bank a/c Dr. To Preference Share Capital a/c
2.	When the preference shares are redeemed out of the proceeds of fresh issue of shares- **For fresh issue of shares at par** Bank a/c Dr. To Equity/ Preference Share Capital a/c **For Fresh issue of shares at premium** Bank a/c (with amount received) Dr. To Equity/Preference Share Capital a/c (with nominal value) To Securities Premium a/c (with premium amount) **For fresh issue of shares at a discount** Bank a/c (with amount received) Dr. Discount on Issue of Shares a/c (with discount) Dr. To Equity/ Preference share Capital a/c
3.	When the preference shares are redeemed- **For redemption at par** a. Preference Share Capital a/c Dr. To Preference Shareholders a/c (For making the amount due) b. Preference Shareholders a/c Dr. To Bank a/c (For making payment) **For Redemption at premiuma.** Preference Share Capital a/c Dr.

	Premium on Redemption of Pref. Shares Dr. To Preference Shareholders a/c (For making the amount due) b. Preference Shareholders a/c Dr. To Bank a/c (For making payment) c. Securities Premium a/c Dr. or Statement of P/L Dr. To Premium on Redemption of Pref. Shares (For adjustment of premium on redemption)
4.	When the shares are redeemed out of distributable profits-All the entries above entries except entry no. 2 depending on whether the shares are redeemed at par or premium will be passed. In addition, the following entry will be passed for redemption of preference shares out of profit- General Reserve a/c Dr. Statement of P/L Dr. To Capital redemption Reserve a/c (For transfer of nominal value of preference shares redeemed out of profits to Capital redemption Reserve Account)

4.7 CAPITAL REDEMPTION RESERVE

As mentioned above, when the preference shares are redeemed out of profits which would have otherwise been available for distribution as dividend; an amount equal to the nominal value of preference shares redeemed out of profits should be transferred to an account which is called Capital Redemption Reserve Account. The amount transferred to CRR account cannot be used for distribution as dividend. However, the same can be used for issue of fully paid up bonus shares.



CHECK YOUR PROGRESS

Q 3: State the methods of redemption of preference shares.

.....

Q 4: Why capital redemption reserve is created?

.....

4.8 PRACTICAL PROBLEMS



Exercise 4.1

X. Ltd. has a part of its share capital in 1000 preference shares of Rs.10 each fully paid up and these have become due for redemption on 1st July, 2016. 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.15,000. Show the journal entries for the above transactions.

Solution:

Journal Entries in the Books of X Ltd.

Date	Particulars	LF	Dr.(Rs.)	Cr.(Rs.)
01.07.16	Preference share capital A/c …….Dr. To Preference shareholders A/c (Being amount payable on redemption of 1000 preference shares)		10,000	10,000
01.07.16	Bank A/c ……..…. Dr. To Equity Share Capital A/c (Being the amount received on issue of 1000 equity shares of Rs.10 each made for the purpose of redemption of preference shares as per Board's Resolution dated.....)		10,000	10,000
01.07.16	Preference shareholders A/c…….Dr. To Bank (Being the amount due to preference shareholders paid)		10,000	10,000



Exercise 4.2

PepsiCo Ltd. Issued 50,000 Equity shares of Rs.10 each and 4000, 10% Preference shares of Rs.100 each, all shares being fully paid. On 31.3.17, Statement of Profit and Loss showed an undistributed profit of Rs.70,000 and General Reserve Account stood at Rs.2,30,000. On 01.4.17, the directors decided to issue 1500, 6% Preference shares of Rs.100 each at par for cash and to redeem the existing preference shares at Rs.105 utilizing the balance from available profits. Show the journal entries to record the transactions relating to redemption of preference shares.

Solution:

Journal Entries in the Books of Pepsi Co Ltd.

Date	Particulars	LF	Dr.(Rs.)	Cr.(Rs.)
01.04.17	10% Preference share capital A/c Dr. Premium on Redemption of preference shares a/c……..Dr. To Preference shareholders A/c (Being amount payable on redemption of 4000 preference shares at Rs.105 each)		4,00,000 20,000	 4,20,000
01.04.17	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 10% preference shares as per Board's Resolution dated……).		1,50,000	 1,50,000
01.04.17	General Reserve a/c ……Dr. To Premium on redemption of preference shares a/c (Being the amount due to preference shareholders paid)		20,000	 20,000

01.04.17	General Reserve a/c ……Dr.		2,10,000	
	Statement of P/L ……..Dr.		40,000	
	To Capital Redemption Reserve a/c			2,50,000
	(Being nominal value of preference shares redeemed out of distributable profit transferred to CRR a/c)			
01.04.17	Preference shareholders A/c……Dr.		4,20,000	
	To Bank			4,20,000
	(Being the amount due to preference shareholders paid)			



Exercise 4.3

Bajaj Ltd's Balance sheet shows the following balance s on 31-3-17- 20,000 equity shares of Rs.10 each fully paid; 15,000 10% Redeemable Preference shares of Rs.10 each fully paid; 5000, 15% Redeemable Preference shares of Rs.10 each, Rs.8 paid up. General Reserve Rs.50,000; Securities Premium Rs.15,000; Statement of profit and Loss Rs.1,00,000 and capital Reserve Rs.35,000.

All the preference shares are redeemed on 1-4.17 at a premium of Re. 1 per share. For redemption, 5000 equity shares of Rs.10 each are issued at 10% premium. Show the journal entries to record the above transactions.

Solution:

Journal Entries in the Books of Bajaj Ltd.

Date	Particulars	LF	Dr.(Rs.)	Cr.(Rs.)
01.04.17	Share Final Call A/c Dr.		10,000	
	To Preference share Capital A/c			10,000
	(Being call money made due on 5000 preference shares @ Rs.2 each as per..)			
01.04.17	Bank a/c Dr.		10,000	
	To Share Final call a/c			10,000

	(Being the final call money on 5000 preference shares @ Rs. 2 received)			
01.04.17	10% Preference share capital A/c Dr. Premium on Redemption of preference shares a/c ……..Dr. To Preference shareholders A/c (Being amount payable on redemption of 4000 preference shares at Rs.105 each)		2,00,000 20,000	 2,20,000
01.04.17	Bank a/c Dr. To Equity Share Capital a/c To Securities Premium a/c (Being the amount received on issue of 5000 equity shares of Rs.10each at a premium of 10% made for the purpose of redemption of 10% preference shares as per Board's Resolution dated……).		55,000	 50,000 5,000
01.04.17	Securities Premium a/c ……Dr. To Premium on redemption of preference shares a/c (Being the amount written off against securities premium)		20,000	 20,000
01.04.17	General Reserve a/c ……Dr. Statement of P/L ……..Dr. To Capital Redemption Reserve a/c (Being nominal value of preference shares redeemed out of distributable profit transferred to CRR a/c)		50,000 1,00,000	 1,50,000
01.04.17	Preference shareholders A/c……Dr. To Bank (Being the amount due to preference shareholders paid)		2,20,000	 2,20,000



Exercise 4.4

Tata Ltd had 1, 00,000 6% redeemable preference shares of Rs. 100 each. Under the terms of the issue of shares, redemption was to take place on April 1, 2016. A general reserve of Rs. 65, 00,000 had already been built up out of past profits. For the purpose of the redemption, 35,000 new 5% preference shares of Rs. 100 each were offered to the public at a premium of Rs. 50, payable in full on application. The new issue was fully subscribed and paid for. Thereupon 6% redeemable preference shares were redeemed. Make journal entries to record the above transactions.

Solution:

Journal Entries in the Books of Tata Ltd.

Date	Particulars	LF	Dr.(Rs.)	Cr.(Rs.)
01.04.16	6% Preference share capital A/c Dr. To Preference shareholders A/c (Being amount payable on redemption of 1,00000 preference shares at Rs.100 each)		1,00,00,000	 1,0000,000
01.04.16	Bank a/c Dr. To 5% Preference Share Capital a/c To Securities Premium a/c (Being the amount received on issue of 35,000, 5% preference shares of Rs.100 each at a premium of Rs.50 each made for the purpose of redemption of 6% preference shares as per Board's Resolution dated.....).		35,00,000	 35,00,000 17,50,000
01.04.16	General Reserve a/c …….Dr. To Capital Redemption Reserve a/c (Being nominal value of preference shares redeemed out of distributable profit transferred to CRR a/c)		65,00,000	 65,00,000
01.04.16	Preference shareholders A/c……Dr. To Bank (Being the amount due to preference shareholders paid)		1,00,00,000	 1,00,00,000



4.9 LET US SUM UP

In this unit we have discussed the following:

- Redemption of preference shares refers to the repayment of the amount due to the preference shareholders as per the terms laid down at the time of issue
- Section55 of the Companies Act, 2013 deals with issue and redemption of preference shares.
- As per the provisions of Companies Act, a company have to fulfil certain legal conditions for redemption of preference shares.
- Based on the sources of funds for the purpose of redemption, the different methods of redemption of preference shares are:
  - Redemption out of Profits
  - Redemption out of Fresh Issue
  - Combination of both
- When the preference shares are redeemed out of profits which would have otherwise been available for distribution as dividend; an amount equal to the nominal value of preference shares redeemed out of profits should be transferred to an account which is called Capital redemption Reserve Account.
- The amount transferred to Capital Redemption Reserve Account cannot be used for distribution as dividend.
- The balance in Capital redemption Reserve Account can be used for issue of fully paid up bonus shares.



4.10 FURTHER READING

1) Ahmed N. (2007). Corporate Accounting: For B. Com (Hons.) and other professional courses. New Delhi, Atlantic Publishers and Distributors (P) Ltd.

2) Mukherjee A. & Hanif M. (2006).Corporate accounting. New Delhi, Tata McGraw - Hill Publishing Company Ltd.



4.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1:

a. Cumulative Preference Shares
b. Non-Cumulative Preference Shares
c. Redeemable Preference Shares
d. Irredeemable Preference Shares
e. Convertible Preference Shares
f. Non-convertible Preference shares
g. Participating Preference Shares
h. Non-Participating Preference Shares

Ans to Q No 2: Redemption of preference shares refers to the repayment of the amount due to the preference share holders as per the ferms laid down at the time of issue.



4.12 MODEL QUESTIONS

Q 1: What are the different types of preference shares?

Q 2: What do you mean by redemption of preference shares? What are the legal conditions to be fulfilled for redemption of preference shares?

Q 3: What are the methods of redemption of preference shares? Explain.

Q 4: Discuss the accounting treatment for redemption of preference shares.

Q 5: Write a short note on Capital Redemption Reserve (CRR) account.

Q 6: Swadeshi Ltd. has a part of its share capital in 3000 preference shares of Rs.10 each fully paid up and these have become due for redemption on 1st August, 2017. 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.30,000. Show the journal entries for the above transactions.

Q 7: P Ltd. Issued 30,000 Equity shares of Rs.10 each and 6000, 10% Preference shares of Rs.100 each, all shares being fully paid. On 31.3.17, Statement of Profit and Loss showed an undistributed profit of Rs.2,00,000 and General Reserve Account stood at Rs.1,50,000. On 01.4.17, the directors decided to issue 2500, 8% Preference shares of Rs.100 each at par for cash and to redeem the existing preference shares at Rs.105 utilizing the balance from available profits. Show the journal entries to record the transactions relating to redemption of preference shares.

Q 8: Ashoka Cement Ltd's Balance sheet shows the following balances on 31-3-16- 10,000 equity shares of Rs.10 each fully paid; 20,000, 8% Redeemable Preference shares of Rs.10 each fully paid; 4000, 10% Redeemable Preference shares of Rs.10 each, Rs.8 paid up. General Reserve Rs.30,000; Securities Premium Rs.14,000; Statement of profit and Loss Rs.1,10,000 and Capital Reserve Rs.30,000.

All the preference shares are redeemed on 1-4.16 at a premium of Re. 1 per share. For redemption, 10,000 equity shares of Rs.10 each are issued at 10% premium. Show the journal entries to record the above transactions.

Q 9: Guwahati Motors Ltd had 2, 00,000 5% redeemable preference shares of Rs. 100 each. Under the terms of the issue of shares, redemption was to take place on April 1, 2017. A general reserve of Rs. 1,40, 00,000 was already available on the liability side of the balance sheet of the company. For the purpose of the redemption, 60,000 new 8% preference shares of Rs. 100 each were offered to the public at a premium of Rs. 40, payable in full on application. The new issue was fully subscribed and paid for. There upon 5% redeemable preference shares were redeemed. Make journal entries to record the above transactions.

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UNIT 5: ISSUE OF DEBENTURES

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Meaning and Features of Debentures

5.4 Types of Debentures

5.5 Differences between Shares and Debentures

5.6 Methods of Issue of Debentures

5.7 Accounting Treatment on Issue of Debentures when Consideration is Received in Cash

5.8 Issue of Debentures for Consideration other than Cash

5.9 Let Us Sum Up

5.10 Further Reading

5.11 Answers To Check Your Progress

5.12 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning of shares and debentures
- describe the features of debentures
- distinguish between shareholders and debentureholders
- classify the various types of debentures
- illustrate the accounting treatment on issue of debentures

5.2 INTRODUCTION

Companies generally requires substantial amount of fund for day to day business. Moreover, it requires fund for expansion of business. To meet such financial requirement it indulges in short-term and long-term borrowings. Short-term borrowings are needed by a company to provide for its working capital while long-term borrowings are needed by a company for financing expenditure of a capital nature such as, expansion of business, purchasing

of fixed assets etc. The long-term loan requirement of a company may not, therefore, be met by a single lender. One very convenient method of doing so is to borrow by issuing debentures.

In this unit we will discuss the meaning and features of debentures, types of debentures, differences between shares and debentures, methods of issue of debentures and accounting treatment on issue of debentures

5.3 MEANING AND FEATURES OF DEBENTURES

The Companies Act, 2013 has not defined the term 'debenture'. It has simply states in Section 2(30) that *"Debenture includes debenture inventory, bonds and any other securities of a company whether constituting a charge on the company's assets or not"*. Various authors have defined debentures in terms of document recognizing as debt. According to Topham, *"Debenture is a document given by a company as evidence of a debt to the holder usually arising out of a loan and most commonly secured by charge"*. According to CHITTY J, *"Debenture means a document which either creates a debt or acknowledges it, and any document which fulfils either of these conditions is a debenture".*

In short, a debenture is a written acknowledgement of debt by a company under its common seal, agreeing to repay the same after a specified period and to pay interest at regular intervals. It is a part of ''Loan Capital'' of a company and also known as borrowed capital.

Debenture is expressed in term of number of debentures with its face value and rate of interest to be paid on it. For example if a company issues 8%, 20,000 Debentures of Rs. 100 each, then it means debentures of Rs. 20,00,000 at 8% rate of interest have been issued. It means the holders of these debentures would be entitled to get interest at the rate of 8 % p.a. The persons who invest their money by purchasing debentures of a company are called debentureholders. The company will certify the number of units he holds. A debenture is therefore, a certificate of loan issued by a company.

Features of Debentures

Following are the features of a debenture:

- It is an acknowledgement of debt or loan taken by a company.
- It is issued in the form of a certificate in written form to the lender.
- Its face value is predetermined.
- It is issued under the common seal of the company.
- Rate of interest payable on the debentures is stated on the certificate.
- It does not carry voting right like shares.
- The amount of debentures is repaid after a fixed period as per the terms of issue.
- These are generally secured by floating charge on the company's assets.
- It may be fully convertible (FCD) or partly convertible (PCD) or non-convertible (NCD) into equity or preference shares.



CHECK YOUR PROGRESS

Q 1: What is debenture?

.....

.....

.....

Q 2: Mention three features of debenture.

i) .....

ii) .....

iii) .....

5.4 TYPES OF DEBENTURES

A company may issue different types of debentures. These can be classified as under-

Types of Debentures

↓ Security ↓ Permanence ↓ Negotiability ↓ Convertibility ↓ Priority

↓ ↓ ↓ ↓ ↓

(Simple Debentures)	(Redeemable Debentures)	(Registered Debentures)	(Convertible Debentures	(First Mortgaged Debentures)
↓	↓	↓	↓	↓
(Mortgaged Debentures)	(Irredeemable Debentures)	(Bearer Debentures)	(Non-convertible Debentures)	(Second Mortgaged Debentures)

(1) Classification of Debentures on the basis of Security:

(i) ***Naked or Simple Debentures:*** Naked or Simple Debentures are not backed by any security or guarantee either for payment of interest or for the repayment of loan. Such debentures are not very popular among the public and hence they are not very common.

(ii) ***Mortgaged Debentures:*** Mortgaged Debentures are secured by a fixed or floating charge on the whole or part of the company's assets. If required, the uncalled shares of the company may also be charged.

(2) Classification of Debentures on the basis of Permanence:

(i) **Redeemable Debentures:** Redeemable Debentures are those which are paid off by the company after a stipulated period during the existence of the company. Generally, at the time of issue, the terms of redemption is stated in the prospectus.

(ii) **Irredeemable Debentures:** Irredeemable debentures are not repayable so long as the company continues to be in existence. These debentures will be repaid only on the winding up of the company.

(3) Classification of Debentures on the basis of Negotiability/Record:

(i) **Registered Debentures:** Registered Debentures are those debentures where the names of the holder of such debentures appear in debenture certificate issued by the company. The names, addresses and particulars of the debentures possessed by each of them are entered in the Register of Debentureholder.

(ii) **Bearer Debentures :** Bearer Debentures are unregistered debentures which are payable to the bearers or holders. They

are negotiable/transferable by mere delivery. No record is kept by the company about the particulars of holder of such debentures.

(4) Classification of Debentures on the basis of Convertibility:

(i) Convertible Debentures: Convertible Debentures are those debentures the holders of which are given the option to get the debentures held by them converted into shares or new debentures after a specified time as per the terms of issue.

Such debentures may be fully convertible, called ‘‘Fully Convertible Debentures‘‘ (FCD) or partly convertible, called ‘‘Partly Convertible Debentures’’ (PCD).

According to SEBI’s guidelines the debentures, if convertible, must be converted within 36 months of issue.

(ii) Non-convertible debentures: Non-convertible (NCD) Debentures are those debentures the holders of which do not have the option to get the debentures held by them converted into shares or new debentures.

(5) Classification of Debentures on the basis of Priority:

(i) First Mortgaged Debentures: The First Mortgaged Debentures are those debentures which have a first claim on the property charged as regards the repayment of interest and principal at the time of winding up.

(ii) Second Mortgaged Debentures*: Second Mortgaged Debentures* are those debentures which are payable only after the redemption of the first mortgage debentures.



CHECK YOUR PROGRESS

Q 3: Explain the meaning of Convertible Debentures.

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5.5 DIFFERENCES BETWEEN SHARES AND DEBENTURES

Differences between shares and debentures may be drawn in terms of differences between shareholders and debentureholders. The main differences are-

Point of Difference	Shareholders	Debentureholders
1. Status	Shareholders are the owners of the company.	Debentureholders are the creditors of the company.
2. Regularity of Return	Shareholders get dividend on their holdings when there are sufficient profits. The rate of dividend is not fixed on equity shares.	Debentureholders are paid interest on debentures held by them. Interest on debentures is paid at fixed rate at regular intervals.
3. Security	Shares are not secured.	Debentures are ordinarily secured.
4. Right to attend meetings	Shareholders are invited to attend the annual general meeting of the company.	Debentureholders do not have any right to attend any meeting unless any decision affecting their interest is taken.
5. Priority on Repayment	Share capital is not returned except in case of preference shares and buy back of shares. In case of liquidation of the company, shareholders funds are refunded after the claims of all outsiders are settled.	Debentures being loan is repaid by the company. Debentureholders have a right of priority of the refund of their loan over the shareholders.
6. Control	Shareholders control the affairs of the company. It is managed by the elected representatives of the shareholders called the Board of Directors.	Debenture holders are not involved in the management and control of the company.

5.6 METHODS OF ISSUE OF DEBENTURES

The methods of issue of debentures may be discussed from the following view point:

(a) ***From the point of view of Price of Issue:*** From the point of view of pricing of issue, the debentures, like shares may be issued at par, at premium and at discount.:

(i) ***At par:*** Issue of debentures at par means issue of debentures at face value. For example, if the face value of a debenture is Rs.100 and the same is issued at Rs.100, it means that the debentures have been issued at par.

(ii) ***At a premium:*** Issue of debentures at a premium means issue of debentures at a price higher than its face value. For example, if the face value of a debenture is Rs.100 and the same is issued at Rs.120, it means that the debentures have been issued at a premium, Rs. 20 being the amount of premium. The amount of premium is credited to Securities Premium Reserve account and is shown on the liabilities side of the balance sheet under the head “Reserves and Surpluses”.

(iii) ***At a discount:*** Issue of debentures at a discount means issue of debentures at a price lower than its face value. For example, if the face value of a debenture is Rs.100 and the same is issued at Rs.90, it means that the debentures have been issued at a discount, Rs.10 being the amount of discount. Discount on issue of debentures is a capital loss and is shown under the line item ‘Other Non-Current Assets’ or ‘Other Current Assets’ depending upon the time period in which it is to be written off. The discount on issue of debentures can be written off either by debiting it to Statement of Profit and Loss or out of Securities Premium Reserve A/c, if any, during the life time of debentures. Discount on issue of debentures to be written off within 12 months of the balance sheet date or the period of operating cycle is shown under ‘Other Current Assets’ and the part which is to be written

off after 12 months of balance sheet is shown under 'Other Non-Current Assets'.

The Companies Act, 2013 does not impose any restrictions upon the issue of debentures at a discount.

(b) ***From the Consideration point of view:*** From the consideration point of view, the debentures may be issued for cash and for other than cash.

(i) ***For cash:*** Debentures may be issued for cash means collection of cash either in lump sum or in instalments against the issue of debentures. Hence, full consideration in cash may be received on application in single instalment; or in number of instalments.

(ii) ***For* other than cash*:***

Sometimes debentures may be issued for other than cash, i.e., in exchange of assets, or technology for their consideration.

5.7 ACCOUNTING TREATMENT ON ISSUE OF DEBENTURES WHEN CONSIDERATION IS RECEIVED IN CASH

(a) (i) Full consideration in cash is payable in single instalment on application

Journal Entries

On receipt of money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr. To Debentures A/c		Money received	 Money received



Example 1

Sintex Ltd. issued 2,000, 8% debentures of Rs. 100 each at par, payable in full along with the application and all the debentures were subscribed.

Pass necessary journal entries.

Solution :

Journal Entries in the books of Sintex Ltd

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr.		2,00,000	
	To 8% Debentures A/c			2,00,000
	(Being the issue of 2,000 8% debentures of Rs. 100 each and payment received in full along with the application as per Board's Resolution No..... dated....)			

(ii) Issue of Debentures at a premium and full consideration in cash is payable in single instalment on application.

Journal Entries

On receipt of money

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr.		(Money received)	
	To Debentures A/c			(Nominal value)
	To Securities Premium A/c			(Amount of premium)

(iii) Issue of Debentures at a discount and cash is payable in single instalment on application.

Journal Entries

On receipt of money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr.		(money received)	
	Discount on Issue of Debentures A/c Dr.		(amount of discount)	
	To Debentures A/c			(nominal value)

(b) (i) Full consideration in cash is payable in instalments :

1. On receipt of application money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr.		(application money received)	
	To Debentures Application A/c			(application money received)

2. On Allotment:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures Application A/c Dr.		(application money)	
	To Debentures A/c			(application money)

3. On making allotment money due:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures Allotment A/c Dr.		(allotment money due)	
	To Debentures A/c			(Allotment money due)

4. On receipt of allotment money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr.		(Allotment money received)	
	To Debentures Allotment A/c			(Allotment money received)

5. On making call money due:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debenture Call A/c Dr		(Call money due	
	To Debentures A/c			(Call money due)

6. On receipt of call money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr		(call money received)	
	To Debentures Call A/c			(call money received)

(b) (ii) Issue of Debentures at a premium and full consideration in cash is payable in instalments :

If debentures are issued at a premium and full consideration in cash is payable in instalments, then such premium is generally collected along with allotment money. The journal entries in this case are passed at the time of making the allotment due as shown below:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures Allotment A/c Dr		(Total money due)	
	To Debentures A/c			(Allotment money due)
	To Securities Premium A/c			(Premium money due)

(b) (iii) Issue of Debentures at a discount and consideration in cash is payable in instalments :

If debentures are issued at a discount and the consideration in cash is payable in instalments, then such discount is generally allowed in allotment. The journal entries in this case are passed at the time of making the allotment money due as shown below:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures Allotment A/c Dr.		(allotment money due)	
	Discount on Issue of Debentures A/c Dr.		(amount of discount)	
	To Debentures A/c			(total amount)



Example 2

Dunlop Ltd. invited applications for the issue of 1,000, 8% Debentures of Rs. 100 each at a premium of 10% payable as follows:

Rs. 30 on Application

Rs. 40 on Allotment including Premium

Balance on First and Final Call

All the debentures have been subscribed and all the instalments have been paid. Pass Journal Entries in the books of Dunlop Ltd.

Solution

In the books of Dunlop Ltd.

Journal Entries

1. On receipt of application money :

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr.		30,000	
	To Debentures Application A/c			30,000
	(Being the debenture application money received on 1000 debentures of Rs. 100 each @ Rs.30 per debenture)			

2. On Allotment:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures Application A/c Dr.		30,000	
	To 8% Debentures A/c			30,000
	(Being transfer of debenture application money on 1,000 debentures of Rs. 100 each @ Rs.30 per debenture to 8% Debentures A/c as per Board's Resolution No..... dated .....)			

3. On making allotment money due:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures Allotment A/c Dr.		40,000	
	To 8% Debentures A/c			30,000
	To Securities Premium A/c			10,000
	(Being the allotment money on 1,000, 8% debenture @ Rs. 100 per debenture including premium of Rs. 10 each made due as per Board's Resolution No...dated ...)			

4. On receipt of allotment money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr. To Debentures Allotment A/c (Being allotment money on 1000, 8% debentures @ Rs.40 per debenture including premium of Rs. 10 each received.)		40,000	40,000

5. On making call money due:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures First and Final Call A/c Dr. To 8% Debentures A/c (Being the call money on 1000, 8% debentures @ Rs.40 per debenture made due as per Board's Resolution No..... dated .....)		40,000	40,000

6. On receipt of call money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr. To Debentures First and Final Call A/c (Being the first and final call money on 1,000, 8% Debentures @ Rs. 40 per debenture received)		40,000	40,000



Example 3

Assam Ltd. invited applications for the issue of 1,000, 8% Debentures of Rs. 100 each at a discount of 10% payable as follows:

Rs. 30 on Application

Rs. 30 on Allotment (after deducting discount)

Balance on First and Final Call

All the debentures have been subscribed and all the instalments have been paid. Pass Journal Entries in the books of Assam Ltd.

Solution:

In the books of Assam Ltd.

Journal Entries

1. On receipt of application money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr.		30,000	
	To Debentures Application A/c			30,000
	(Being the debenture application money received on 1000 debentures of Rs. 100 each @ Rs.30 per debenture)			

2. On Allotment:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures Application A/c Dr.		30,000	
	To 8% Debentures A/c			30,000
	(Being transfer of debenture application money on 1000 debentures of Rs. 100 each @ Rs.30 per debenture to 8% Debentures A/c as per Board's Resolution No..... dated .....)			

3. On making allotment money due:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures Allotment A/c Dr.		30,000	
	Discount on Issue of Debentures A/c Dr.		10,000	
	To 8% Debentures A/c			40,000
	(Being the debenture allotment money on 1000 debentures of Rs.100 each @ Rs. 30 per debenture excluding discount of Rs. 10 each made due as per Board's Resolution No..... dated .....)			

4. On receipt of allotment money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr.		30,000	
	To Debentures Allotment A/c			30,000
	(Being allotment money on 1,000, 8% debentures @ Rs.30 per debenture after discount of Rs. 10 each received)			

5. On making call money due:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Debentures First and Final Call A/c Dr. To 8% Debentures A/c (Being the first call money on1,000, 8% debentures @ Rs.30 per debenture made due as per Board's Resolution No..... dated .....)		30,000	30,000

6. On receipt of call money:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr. To Debentures First and Final Call A/c (Being the first and final call money on 1,000, 8% Debentures @ Rs. 30 per debenture received)		30,000	30,000

5.8 ISSUE OF DEBENTURES FOR CONSIDERATION OTHER THAN CASH

Issue of debentures for consideration other than cash means that the debentures have been allotted against the receipt of benefit in kind by the company. When a company purchases some assets from vendor, instead of making payment to the vendor in cash, the company may allot debentures in discharge of purchase consideration. Such issue of debentures to vendors is known as issue of debentures for consideration other than cash.

The following accounting entries will be passed in the books of account of the company:

(i) For assets taken over :

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Sundry Assets A/c Dr. To Vendor (Being various assets taken over)			

(ii) For issue of Debenture :

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Vendor Dr. To Debentures A/c (Being the issue of .... debentures of Rs. .... each in discharge of the purchase consideration.)			



Example 4

On April 1, 2009 Gamma Ltd. has purchased the following assets from M/s. Samma & Co.

Furniture Rs. 10,000

Stock Rs. 50,000

Machinery Rs. 60,000

The purchase consideration for the above assets is discharged by the issue of sufficient number of 8% debentures of Rs. 100 each at par. Pass journal entries.

Solution:

Total Value of Assets = Rs. (10,000 + 50,000 + 60,000) = Rs.1,20,000

Number of debentures of Rs. 100 each to be issued = 1,20,000 ÷ 100 = 1,200

In the books of Gamma Ltd.

Journal Entries

(i) For assets taken over :

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Furniture A/c Dr.		10.000	
	Stock A/c Dr.		50,000	
	Machinery A/c Dr.		60,000	
	To M/S Samma & Co.			1,20,000
	(Being purchase of various assets from M/S Samma &Co.			

(ii) For issue of Debenture :

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	M/S Samma & Co. Dr. To 8% Debentures A/c (Being the issue of 1,200 debentures of Rs. 100 each to M/S Samma & Co. in discharge of the purchase consideration)		1,20,000	1,20,000



5.9 LET US SUM UP

In this unit we have discussed the following-

- A company can borrow funds by issuing debentures.
- Debentures are acknowledgement of debt.
- The various features of debentures- its face value is predetermined, it is issued under the common seal of the company etc.
- The various types of debentures are classified on the basis of security, permanence, negotiability, convertibility and priority.
- The differences between shares and debentures.
- From the point of view of price of issue, debentures can be issued at par or at premium or at a discount.
- From the point of view of consideration, debentures can be issued for cash or for other than cash.
- Accounting treatment on issue of debentures.



5.10 FURTHER READING

1) Dam, B. B & Gautam H. C. (2008). Corporate Accounting : for B. Com part II(new course) of Gauhati University. Guwahati, Capital Publishing Company.

2) Maheshwari, S. N. & Maheshwari, S. K (2009). Corporate accounting. New Delhi, Vikas Publishing House Pvt. Ltd.

3) Mukherjee A. & Hanif M (2006). Corporate accounting. New Delhi,Tata McGraw- Hill Publishing Company.



5.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A debenture is a written acknowledgement of debt by a company under its common seal, agreeing to repay the debt after a specified period and to pay interest at regular intervals.

Ans to Q No 2: i) Debenture is an acknowledgement of debt.

ii) Its face value is predetermined.

iii) It is issued under the common seal of the company.

Ans to Q No 3: Convertible Debentures are those debentures the holders of which are given the option to get the debentures held by them converted into shares or new debentures after a specified time as per the terms of issue. Such debentures may be fully convertible, called "Fully Convertible Debentures"(FCD) or partly convertible, called "Partly Convertible Debentures" (PCD). According to SEBI's guidelines the debentures, if convertible, must be converted within 36 months of issue.

Ans to Q No 4: Issue of debentures for consideration other than cash means that the debentures have been allotted against the receipt of benefit in kind by the company. When a company purchases some assets from vendor, instead of making payment to the vendor in cash, the company may allot debentures in discharge of purchase consideration. Such issue of debentures to vendors is known as issue of debentures for consideration other than cash.



5.12 MODEL QUESTIONS

Q 1: Write True or False:

(a) Debentureholders are the financiers of the company.

(b) Irredeemable Debenture can not be issued.

(c) Convertible debentures can be converted according to the convenience of the company.

Q 2: Explain the following statements

(a) Debentures can be redeemed out of capital.

(b) Debentures cannot be issued for consideration other than cash.

Q 3: Explain the meaning of debenture and its various types.

Q 4: State the differences between a shareholder and debentureholder?

Q 5: Discuss the procedure of issue of debentures.

Q 6: Give the accounting entries for issue of debentures under different situations.

Q 7: Write short notes on:

(i) Convertible Debenture, (ii) Redeemable Debenture,

Q 8: Show by means of journal entries how you will record the following issues.

(a) H. Ltd. issues 5,000, 9% Debentures of Rs. 100 each at a premium of 5%.

(b) X Ltd. issues 6,000, 8% Debentures of Rs. 100 each at a discount of 5%.

(c) R Ltd. issues 8,000, 12% Debentures of Rs. 100 each at par.

Q 9: Fair Deal Ltd. invited applications for the issue of. 2,000, 10% Debentures of Rs. 100 each at a discount of 10% payable Rs. 30 on application on 1st May, 2019, Rs. 30 on allotment (after deducting discount) on 1st June, 2019 and the balance on first and final call on 1st July, 2019. All the debentures were fully subscribed. Debenture money was duly called and paid-up.

Give journal entries and draw the opening Balance Sheet of the Company.

Q 10: Gulf India Ltd. issued 15,000 10% debentures of Rs. 100 each payable in full along with the application which has been taken up by public.

Pass journal entries for the issue of debentures in the books of the company under the following situations:

(a) If the debentures are issued at par.

(b) If the debentures are issued at a discount of 6%.

(c) If the debentures are issued at a premium of 4%.

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UNIT 6 : REDEMPTION OF DEBENTURES

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Meaning of Redemption of Debentures

6.4 Debenture Redemption Reserve

- 6.4.1 Debenture Redemption Reserve Investment
- 6.4.2 Balance in Debenture Redemption Reserve
- 6.4.3 Journal Entries

6.5 Methods of Redemption of Debentures

6.6 Let Us Sum Up

6.7 Further Reading

6.8 Answers To Check Your Progress

6.9 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning of redemption of debentures
- discuss about legal provisions regarding redemption of debentures
- explain the debenture redemption reserve account
- describe the various methods of redemption of debentures
- illustrate the accounting treatment on redemption of debentures

6.2 INTRODUCTION

In our previous unit, we have discussed about debentures, its meaning, types and features. We also learned about methods of issue of debentures and accounting treatment on issue of debentures. In this unit, we shall continue our discussion on debentures. We shall learn about redemption of debentures, methods of redemption of debentures and also sources of finance for redemption of debentures. Further, we shall also discuss the legal provisions for redemption of debentures. We shall finally

conclude by discussing the accounting treatment on redemption of debentures.

6.3 MEANING OF REDEMPTION OF DEBENTURES

Redemption of debentures means repayment of the amount of debentures issued by a company. It refers to the discharge of liability in respect of the debentures of a company. According to Section 71 (1) of the Companies Act, 2013, a company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, should be approved by a special resolution. According to Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014, the company shall not issue secured debentures, unless it complies with the following conditions, namely:- An issue of secured debentures may be made, provided the date of its redemption shall not exceed ten years from the date of issue. Provided that a company engaged in the setting up of infrastructure projects may issue secured debentures for a period exceeding ten years but not exceeding thirty years.

Therefore, for secured debentures, the date of Redemption of debenture shall not exceed 10 years from the date of issue. A company engaged in the setting up of infrastructure projects may issue secured debentures upto redemption period of thirty years.

From the above discussion we have come to know that the debentures issued by a company may be redeemed after a fixed number of years or any time after a certain number of years has elapsed since their issue.

6.4 DEBENTURE REDEMPTION RESERVE

Section 71(4) provides that where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be

utilised by the company except for the redemption of debentures. Such an arrangement would ensure that the company will have sufficient funds/ reserves for the redemption of debentures.

Rule 18(7) of Companies (Share Capital and Debentures) Rules, 2014 prescribes the following conditions regarding creation of Debenture Redemption Reserve for the purpose of redemption of debentures—

(a) The Debenture Redemption Reserve shall be created out of the profits of the company available for payment of dividend;

(b) The company shall create Debenture Redemption Reserve (DRR) in accordance with following conditions:-

  (i) No DRR is required for debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures. For other Financial Institutions (FIs) within the meaning of clause (72) of section 2 of the Companies Act, 2013, DRR will be as applicable to NBFCs registered with RBI.

  (ii) For NBFCs registered with the RBI under Section 45-IA of the RBI (Amendment) Act, 1997, 'the adequacy' of DRR will be 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities) Regulations, 2008, and no DRR is required in the case of privately placed debentures.

  (iii) For other companies including manufacturing and infrastructure companies, the adequacy of DRR will be 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities), Regulations 2008 and also 25% DRR is required in the case of privately placed debentures by listed companies. For unlisted companies issuing debentures on private placement basis, the DRR will be 25% of the value of debentures.

(c) Every company required to create Debenture Redemption Reserve shall on or before the 30th day of April in each year, invest or deposit, as the case may be, a sum which shall not be less than fifteen percent,

of the amount of its debentures maturing during the year ending on the 31st day of March of the next year, in any one or more of the following methods, namely:-

(i) in deposits with any scheduled bank, free from any charge or lien;

(ii) in unencumbered securities of the Central Government or of any State Government;

(iii) in unencumbered securities mentioned in sub-clauses (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882;

(iv) in unencumbered bonds issued by any other company which is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882;

(v) the amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above: Provided that the amount remaining invested or deposited, as the case may be, shall not at any time fall below fifteen per cent of the amount of the debentures maturing during the year ending on the 31st day of March of that year;

(d) In case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non-convertible portion of debenture issue in accordance with this sub-rule.

(e) The amount credited to the Debenture Redemption Reserve shall not be utilised by the company except for the purpose of redemption of debentures.

6.4.1 Debenture Redemption Reserve Investment

The fund deposited in the Debenture Redemption Reserve can be invested in corporate or Government Bonds or deposited in a scheduled bank and such investment is termed as Debenture Redemption Reserve Investment. Any income earned from these investments is reinvested together with the fixed appropriated amount

for the purpose in subsequent years. At the time redemption of debentures, the fund invested through Debenture Redemption Reserve Investment is encashed and the amount so obtained is used for the redemption of debentures. Any profit or loss made on the encashment of Debenture Redemption investments is transferred to Debenture Redemption Reserve.

6.4.2 Balance in Debenture Redemption Reserve(DRR)

The balance to the credit of Debenture Redemption Reserve, in certain circumstances may either be more or less as compared to the amount of debentures which are proposed to be redeemed.

- If it is in excess, the amount is transferred to the Capital Reserve
- On the other hand, if it is short, the deficit is made up by the transfer from Profit and Loss A/c.

6.4.3 Journal Entries

The necessary journal entries passed in the books of a company are given below:

1. At the end of 1st Year
   (a) For setting aside the fixed amount of profit for redemption
   Profit and Loss A/c Dr.
   To Debenture Redemption Reserve A/c
   (b) For investing the amount set aside for redemption
   Debenture Redemption Reserve Investment A/c Dr.
   To Bank A/c
2. At the end of second year and subsequent years other than last year
   (a) For receipt of interest on Debenture Redemption Reserve
   Investments Bank A/c Dr.
   To Interest on Debenture Redemption
   Reserve Investment A/c

(b) For transfer of Interest on Debenture Redemption Reserve Investment (DRRI) to Debenture Redemption Reserve Account Interest on Debenture Redemption Reserve Investment A/c Dr.

To Debenture Redemption Reserve A/c

(c) For setting aside the fixed amount of profit on redemption Profit and Loss A/c

To Debenture Redemption Reserve A/c

(d) For investments of the amount set aside for redemption and the interest earned on DRRI

Debenture Redemption Reserve Investment A/c Dr.

To Bank A/c

3. At the end of last year

(a) For receipt of interest

Bank A/c Dr.

To Interest on Debenture Redemption Reserve Investment A/c

(b) For transfer of interest on Debenture Redemption Reserve Investment to Debenture Redemption Reserve Investment A/c

Interest on Debenture Redemption Reserve Investment A/c Dr.

To Debenture Redemption Reserve A/c

(c) For setting aside the fixed amount of profit for redemption

Profit and Loss A/c Dr.

To Debenture Redemption Reserve A/c

(d) For encashment of Debenture Redemption Reserve Investments

Bank A/c Dr.

To Debenture Redemption Reserve Investment A/c

(e) For the transfer of Profit/Loss on realisation of Debenture Redemption Reserve Investments

(i) In case of Profit

Debenture Redemption Reserve Investment A/c Dr.

To Debenture Redemption Reserve A/c

OR

(ii) In case of Loss

Debenture Redemption Reserve A/c Dr.

To Debenture Redemption Reserve Investment A/c

(f) For amount due to debentureholders on redemption

Debenture A/c Dr.

To Debentureholder A/c

(g) For payment to debentureholders

Debentureholders A/c Dr.

To Bank A/c



CHECK YOUR PROGRESS

Q 1: Give the meaning of redemption of debentures.

.....

Q 2: State the purpose of creation of Debenture Redemption Reserve Account.

.....

6.5 METHODS OF REDEMPTION OF DEBENTURES

Redeemable debentures are redeemed either at par or at a premium and there are four methods of redemption of debentures.

These are:

1. Payment in lump sum

The company redeems the debentures by paying the amount in lump sum to the debentureholders at the maturity thereof as per terms of issue.

2. Payment in instalments

Under this method, the payment of specified portion of debenture is made in instalments at specified intervals.

3. Purchase of its own Debentures in open market

A company is entitled to purchase its own debentures in open market, i.e., through the stock exchange. When the company purchases its own debentures for immediate cancellation, it leads to automatic redemption. Own debentures may also be purchased by the company for its own investment and same may be reissued in future too.

4. By conversion into shares

A company may issue convertible debentures giving option to the debentureholders to exchange their debentures for equity shares or preference shares in the company. The debentureholders are given the right on certain dates or before a specified date to exchange the debentures for the shares. A certain number of shares are offered for each debenture. When the debenture-holders exercise this option and the company issues the shares, it is referred as redemption by conversion.



CHECK YOUR PROGRESS

Q 3: State the various methods of redemption of debentures.

.....



6.6 LET US SUM UP

In this unit we have discussed the following-

- Meaning of redemption of debentures
- Various provisions of Companies Act 2013 regarding redemption of debentures
- Creation, maintenance and accounting treatment of Debenture Redemption Reserve
- The methods of redemption of debentures are:
  1. Payment in lump sum
  2. Payment in instalments
  3. Purchase of its own Debentures in open market

4. By conversion into shares or new debentures.



6.7 FURTHER READING

1) Advanced Accounting 2 Corporate Accounting by Dr. A Sehgal and Dr. D Sehgal, Taxman.

2) Advanced Accountancy by S N Maheshwari, Vani Educational Books;

3) Modern Accountancy by Mukherjee and Hanif, Tata Mcgraw.



6.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Redemption of debentures means repayment of the amount of debentures issued by a company. It refers to the discharge of liability in respect of the debentures of a company.

Ans to Q No 2: Section 71(4) provides that where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures. Such an arrangement would ensure that the company will have sufficient funds/reserves for the redemption of debentures.

Ans to Q No 3: 1. Payment in lump sum

2. Payment in instalments
3. Purchase of its own Debentures in open market
4. By conversion into shares or new debentures



6.9 MODEL QUESTIONS

Q 1: Write True or False:

(a) A debentureholders can get his money back only on the liquidation of the company.

(b) Irredeemable Debenture can not be issued.

(c) Debentures can be redeemed by payment in lump sum at the end of a specified period.

Q 2: What is meant by redemption of debentures?

Q 3: Write short note on Debenture Redemption Reserve.

Q 4: Can a company purchase its own debentures in the open market? Explain.

Q 5: Explain the guidelines prescribed under rule 18(7) of Companies (Share Capital and Debentures) Rules, 2014 for creating Debenture Redemption Reserve.

Q 6: Explain the methods of redemption of debentures.

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UNIT 7: BUY BACK OF SHARES

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Meaning of Buy Back of Shares

7.4 Advantages and Disadvantages of Buy-Back of Share

7.5 Legal Provisions and Sources of Funds for Buy-Back of Shares

7.6 Accounting Treatment on Buy-Back of Shares

7.7 Let Us Sum Up

7.8 Further Reading

7.9 Answers To Check Your Progress

7.10 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit you will be able to-

- explain the meaning of buy back of shares
- describe the advantages and disadvantages of buy back of shares
- examine the legal provisions for buy back of shares
- list out the sources of funds for buy back of shares
- illustrate the accounting treatment on buy back of shares

7.2 INTRODUCTION

In Unit 1 we have discussed the issue and subscription of shares. You know that there are basically two types of shares: equity share and preference share. So far as equity shares are concerned these are not redeemable, only can be bought back by the company after fulfilling certain conditions. The companies Act, 2013 under section 68(1) permits companies to buy back their own shares and other specified securities out of :

(i) its free reserves; or

(ii) the securities premium account, or

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

In this unit we shall discuss the meaning of buy back of shares, advantages and disadvantages of buy back of shares, legal provisions for buy back of shares, sources of funds for buy back of shares and accounting treatment on buy back of shares

7.3 MEANING OF BUY BACK OF SHARES

In general sense, to buy back means once something was sold and now that sold item is bought back. The term 'Buy back of Share' means earlier shares were sold and now the same are bought back. 'Buy back of Share' is also a different type of redemption of share, but the term 'redemption' is not used in this case. This is because equity shares can not be redeemed as per the concern rules. Hence, 'Buy back of Share' means buying or purchasing of equity shares of a company by the company itself.

Normally, a company is allowed to invest its surplus money by purchasing shares of other companies. But if the company utilises its surplus money in purchasing its own equity shares, it is called buy back of shares. It is a method used by a company to cancel a part of its own share capital. Though it is not mentioned in the Companies Act, share buy back means buy back of equity shares. **It leads to reduction in the paid up share capital of a company**. Buy back of share does not affect the authorised share capital of a company.



CHECK YOUR PROGRESS

Q 1: What is the meaning of Buy-back of Shares?

.....

.....



Capital Restructuring: Changing the capital structure of a company.

7.4 ADVANTAGES AND DISADVANTAGES OF BUY-BACK OF SHARES

In this section, we will discuss the advantages and the disadvantages of buy back of shares. The following are the principal advantages of buy-back of shares:

- Capital restructuring of the company is possible through buy back of share;
- The excess capital may be reduced to a suitable level;
- Earning per share of the company may be raised through buy-back of shares;
- The buy-back can also be used by the company to prevent the hostile take-over of the company by undesirable persons;
- It helps to avoid corporate dividend tax as cash resources are used for buy-back instead of declaration of dividend.

Disadvantages of buy-back of shares

The following are the principal disadvantages of buy-back of shares

- There may be risk of manipulation of stock prices by management.
- There is the possibility of insider trading in case of buy-back of shares.



Insider Trading: Buying and selling of securities by any employee or close associate on the basis of privileged knowledge which is not available to the public, about the transactions of the company.

CHECK YOUR PROGRESS

Q 2: Write any two advantages and two disadvantages of Buy-back of Shares.

Advantages

i) .....

ii) .....

Disadvantages

i) .....

ii) .....

7.5 LEGAL PROVISIONS AND SOURCES OF FUNDS FOR BUY-BACK OF SHARES

Section **68**(1) of the Companies Act, 2013 empowers a company to buy back its own shares subject to fulfilment of certain conditions.

(1) No buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

(2) No company shall purchase its own shares or other specified securities, unless—

(*a*) the buy-back is authorised by its articles;

(*b*) a special resolution has been passed at a general meeting of the company authorising the buy-back:

Provided that nothing contained in this clause shall apply to a case where—

(*i*) the buy-back is, ten per cent or less of the total paid-up equity capital and free reserves of the company; and

(*ii*) such buy-back has been authorised by the Board by means of a resolution passed at its meeting;

(*c*) the buy-back is twenty-five per cent or less of the aggregate of paid-up capital and free reserves of the company:

Provided that in respect of the buy-back of equity shares in any financial year, the reference to twenty-five per cent in this clause shall be construed with respect to its total paid-up equity capital in that financial year;



Solvency: Financial capacity of an organisation to pay its debts when they become due.

(*d*) the ratio of the aggregate of secured and unsecured debts owed by the company after buy-back is not more than twice the paid-up capital and its free reserves:

Provided that the Central Government may, by order, notify a higher ratio of the debt to capital and free reserves for a class or classes of companies;

(*e*) all the shares or other specified securities for buy-back are fully paid-up;

(*f*) the buy-back 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 in this behalf; and

(*g*) the buy-back in respect of shares or other specified securities shall be in accordance with such rules as may be prescribed:

Provided that no offer of buy-back under this sub-section shall be made within a period of one year reckoned from the date of the closure of the preceding offer of buy-back, if any.

(3) The notice of the meeting at which the special resolution is proposed to be passed for buy back of shares shall be accompanied by an explanatory statement stating—

(*a*) a full and complete disclosure of all material facts;

(*b*) the necessity for the buy-back;

(*c*) the class of shares or securities intended to be purchased under the buy-back;

(*d*) the amount to be invested under the buy-back; and

(*e*) the time-limit for completion of buy-back.

(4) Every buy-back shall be completed within a period of one year from the date of passing of the special resolution, or as the case may be.

(5) The buy-back of shares may be—

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

(*b*) from the open market;

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

(6) Where a company proposes to buy-back its own shares or other specified securities, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board, a declaration of solvency signed by at least two directors of the company, one of whom shall be the managing director, if any, in such form as may be prescribed and verified by an affidavit to the effect that the Board of Directors of the company has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year from the date of declaration adopted by the Board:

Provided that no declaration of solvency shall be filed with the Securities and Exchange Board by a company whose shares are not listed on any recognised stock exchange.

(7) Where a company buys back its own shares or other specified securities, it shall extinguish and physically destroy the shares or securities so bought back within seven days of the last date of completion of buy-back.

(8) Where a company completes a buy-back of its shares or other specified securities, it shall not make a further issue of the same kind of shares or other securities including allotment of new shares or

other specified securities within a period of six months except by way of a bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

(9) Where a company buys back its shares or other specified securities under this section, it shall maintain a register of the shares or securities so bought, the consideration paid for the shares or securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities and such other particulars as may be prescribed.

(10) A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed:

Provided that no return shall be filed with the Securities and Exchange Board by a company whose shares are not listed on any recognised stock exchange.

(11) If a company makes any default in complying with the provisions of this section or any regulation made by the Securities and Exchange Board, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

Explanation I.—For the purposes of this section and section 70, ”specified securities” includes employees’ stock option or other securities as may be notified by the Central Government from time to time.

Explanation II.—For the purposes of this section, “free reserves” includes securities premium account.

Further, Section 70B of the Companies Act, 2013 has imposed certain restrictions on buy-back of shares. According to this provision buy-back of shares cannot be made:

(i) Through any subsidiary company including its own subsidiary company; or

(ii) Through any investment company or group of investment companies; or

(iii) If the company is in default in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholders or repayment of any term loan or interest payable thereon to any financial institution or bank.

(iv) If the company has not complied with the provisions of section 92 (filing of annual return), Section 123 (payment of dividend with 30 days of declaration), 127 (failure its distribute dividend) and section 129 (preparation of financial statement of the company).

Prohibition for Buy-Back in Certain Circumstances

70. (1) No company shall directly or indirectly purchase its own shares or other specified securities—

(*a*) through any subsidiary company including its own subsidiary companies;

(*b*) through any investment company or group of investment companies; or

(*c*) if a default**,** is made by the company**,** in the repayment of deposits accepted either before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company:

Provided that the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.

(2) No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of sections 92 (filing of annual return), 123 (payment of dividend with 30 days of declaration), 127(failure to distribute dividend) and section 129 (preparation of financial statement of the company).



CHECK YOUR PROGRESS

Q 3: State whether the following statements are true or false-

i. The buy back of shares must be authorised by the articles of association of the company.

ii. Partly paid- up shares can be bought back.

iii. The process of buy back of shares must be completed within 14 months.

iv. The company must file a return after the buy back of shares with the Registrar of Companies and the SEBI.

v. The buy back is limited to 25% of the total paid- up capital and free reserves of the company

Q 4: Mention two sources of funds that a company can utilise for buy back of shares.

i) .....

ii) .....

7.6 ACCOUNTING TREATMENT ON BUY-BACK OF SHARES

Journal Entries

(i) For issue of Preference shares / Debentures/ other specified securities:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank Dr. To Preferece Share Capital A/c To Debentures/Specified Securities A/c To Securities Premium A/c (if any)			

(ii) For the amount paid to shareholders against buy back:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Equity Shareholders Dr. To Bank		Amount paid	 Amount paid

(iii) For cancellation of Equity Share Capital

(a) When buy back is at par:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Equity Share Capital A/c Dr.		Nominal value of the shares purchased	
	To Equity Shareholders			Nominal value of the shares purchased

(b) When buy back is at a price higher than their face value i.e at a premium:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Equity Share Capital A/c Dr.		Nominal value of shares	
	General Reserve or Securities Premium A/c Dr.		amount of premium	
	To Equity Shareholders			amount payable

(c) When buy back is at a price lower than their face value i.e. at discount:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Equity Share Capital A/c Dr.		Nominal value of shares	
	To Capital Reserve or Securities Premium A/c			Amount of discount
	To Equity Shareholders			Amount payable

(iv) If the buy back is made out of free reserves, an amount equal to the nominal value of the shares bought back shall be transferred to Capital Redemption Reserve Account.

The journal entries will be as under:

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
	Security Premium A/c	Dr.		Amount transferred	
	General Reserve A/c	Dr.		Amount transferred	
	(Any) Free Reserve A/c	Dr.		Amount transferred	
	Profit & Loss A/c	Dr.		Amount transferred	
	To Capital Redemption Reserve A/c				Amount transferred



LET US KNOW

Free reserves for the purpose of buy back of shares mean those reserves which, as per the latest audited balance sheet of the company, are free for distribution as dividend and include Securities Premium Account.

(v) For expenses incurred on buy back:

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
	Expenses on Buy Back A/c	Dr.		Amount paid	
	To Bank				Amount paid

(vi) Treatment of expenses on buy back:

Expenses on buy back may be treated in any one of the following ways:

(a) All expenses are debited to Profit and Loss Account of the year in which buy back takes place.

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
	Profit & Loss A/c	Dr .		Amount paid	
	To Expenses on Buy Back A/c				Amount paid

(b) The expenses may be debited to 'Free Reserves'

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
	General Reserve A/c	Dr.		Amount paid	
	To Expenses on Buy Back A/c				Amount paid



EXAMPLE 1

Polar Ltd. has a part of its share capital in 30,000 Equity shares of Rs. 10 each, fully paid. The company purchased 2,000 of its equity shares at par out of free reserves.

Pass necessary journal entries.

Solution:

In the books of Polar Ltd.

Journal Entries

(i)

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
	Equity Shareholders	Dr.		20,000	
	To Bank				20,000
	(Being the payment made to equity shareholders for buy-back of 2,000 equity shares of Rs. 10 each at par as per Board's Resolution No. ..... dt.....)				

(ii)

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
	Equity Share Capital A/c	Dr.		20,000	
	To Equity Shareholders				20,000
	(Being the cancellation of 2,000 equity shares of Rs. 10 each bought back at par)				

(iii)

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
	General Reserve A/c	Dr.		20,000	
	To Capital Redemption Reserve A/c				20,000
	(Being the transfer of Rs 20,000 from General Reserve to Capital Redemption Resereve				

	Account, being the nominal value of equity shares bought-back out of free reserves)			



EXAMPLE 2

Bajaj Ltd. purchased 4,000 of its equity shares of Rs.10 each at a premium of Rs. 5 per share out of free reserves.

Pass necessary journal entries.

IN THE BOOKS OF BAJAJ LTD.

JOURNAL ENTRIES

(i)

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
	Equity Shareholders	Dr.		60,000	
	To Bank [4,000 x Rs. 15]				60,000
	(Being the payment made to equity shareholders for buy-back of 4,000 equity shares of Rs. 10 each at a premium of Rs. 5 per share as per Board's Resolution No. ..... dt.....)				

(ii)

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
	Equity Share Capital A/c	Dr.		40,000	
	General Reserve A/c	Dr.		20,000	
	To Equity Shareholders				60,000
	(Being the cancellation of 4,000 equity shares of Rs. 10 each bought back at a premium of Rs. 5 per share, premium provided out of General Reserve)				

(iii)

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	General Reserve A/c Dr.		40,000	
	To Capital Redemption Reserve A/c			40,000
	(Being the transfer of Rs 40,000 from General Reserve to Capital Redemption Reserve Account, being the nominal value of equity shares bought-back out of free reserves)			



ACTIVITY 1

XY Company purchased 5, 000 of its equity shares of Rs. 10 each at a discount of Rs. 2 per share out of free shares.

Pass journal entries



7.7 LET US SUM UP

In this unit we have discussed the following-

- A company can buy back its equity shares.
- Buy back of shares results in reduction in the paid- up capital.
- The buy back of shares have certain advantages like, the excess capital may be reduces, capital restructuring of the company is possible etc.
- The buy back of shares have certain disadvantages like, prices of stocks can be manipulated, possibility of insider trading is possible etc.
- The company must fulfil certain legal conditions for the buy back of shares such as-
  - The buy back of shares must be authorised by the articles of association of the company.

- The shares must be fully paid- up etc.



7.8 FURTHER READING

1) Dam, B. B & Gautam H. C. (2008). Corporate Accounting : for B. Com part II (new course) of Gauhati University. Guwahati, Capital Publishing Company. .

2) Maheshwari, S. N. & Maheshwari, S. K (2009). Corporate accounting. New Delhi, Vikas Publishing House Pvt. Ltd.

3) Grewal T. S. (2005). Introduction to accountancy. New Delhi, S. Chand & Company Ltd.



7.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: It is a method used by a company to cancel a part of its own share capital. Though it is not mentioned in the Companies Act, share buy back means buy back of equity shares. It leads to reduction in the paid up share capital of a company. Buy back of share does not affect the authorised share capital of a company.

Ans to Q No 2: Advantages

- Capital restructuring of the company is possible through buy back of share.
- Earning per share of the company may be raised through indulging Buy-back of shares.

Disadvantages

- There may be risk of manipulation of stock prices by management.
- There is the possibility of insider trading in case of buy-back of shares.

Ans to Q No 3: i. True ii. False iii. False iv. True v. True

Ans to Q No 4: i. Free reserves ii. Securities Premium Account



7.10 MODEL QUESTIONS

Q 1: State whether the following statements are 'True' or 'False':

(i) Buy back of shares means purchase of shares by a company.

(ii) Buy back of shares must be authorised by SEBI.

(iii) Securities Premium Account cannot be used for buy back of shares.

(iv) The Provision for buy back is given in section *68* of Companies Act, 2013.

Q 2: Explain the meaning of buy back of shares.

Q 3: Mention any four advantages of buy back of shares.

Q 4: What are the various sources of funds for buy back of shares?

Q 5: Explain the accounting treatment of expenses on buy back of shares.

Q 6: Bajaj Ltd. resolved to buy back 60,000 of its fully paid equity shares of Rs. 10 each at Rs.15 per share. Pass journal entries for all the transactions involving the buy- back.

Q 7: Prag Ltd. has Rs. 2,00,000 in equity shares of Rs. 10 each, Rs. 18,000 in General Reserve Account and Rs. 6,000 in Security Premium Account. The Company has passed necessary resolutions to buy back 4,000 equity shares at par.

Give Journal entries relating to buy back of shares.

Q 8: Share capital of Purna Ltd. consists of Rs. 60,000 in equity shares of Rs.10 each. It has Rs. 30,000 in general reserve, Rs. 7,000 in securities premium account. The company resolved to buy back 1,000 equity shares at par out of its free reserve.

Pass necessary journal entries.

*** ***** ***

UNIT 8: VALUATION OF GOODWILL

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Meaning and Features of Goodwill

8.4 Goodwill as an Asset

8.5 Methods of Valuation of Goodwill

8.5.1 Average Profit Method

8.5.2 Weighted Average Profit Method

8.6 Let Us Sum Up

8.7 Further Reading

8.8 Answers To Check Your Progress

8.9 Model Questions

8.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- describe the meaning and features of goodwill
- identify the factors influencing goodwill
- elaborate the methods of valuation of goodwill
- illustrate the accounting treatment on goodwill.

8.2 INTRODUCTION

While discussing something with your friends you have certainly used the words 'fame' or 'reputation'. Without knowing the meaning, perhaps you have not used these words. Generally we prefer a reputed shop for shopping. Another word generally used in the commerce literature is 'goodwill'. The dictionary meaning of the word 'goodwill' is benevolence or well-wishing, i.e., disposition to do good. In trade and commerce, it has special meaning. Therefore, it is expected that a commerce student should know the meaning and accounting significance of goodwill.

In this unit we shall discuss the meaning of goodwill, its features,

factors influencing goodwill and a few methods of valuation of goodwill.

8.3 MEANING AND FEATURES OF GOODWILL

The Institute of Chartered Accountants of India defines it as 'an intangible asset arising from business connections or trade name or reputation of an enterprise'.

In this context, some of the definitions forwarded by various authors and experts in accounting are given below.

According to **Braden** and **Allyn** ''Goodwill is an intangible asset compounded from a variety of successful business ingredients – competent and energetic management, customer acceptance, a favourable location, a quality and profitable product, efficient production methods, an outstanding reputation, plus the expectation that these ingredients will continue to produce an above – normal rate of return for an indefinite period of time.''

Dr. Canning defines goodwill as ''the present value of a firm's anticipated excess earnings''.

According to **Lord Eldon**, ''Goodwill is nothing more than the probability that the old customers will resort to the old place."

Another important explanation of goodwill comes from **Lord Lindley**. He says, ''it is generally used to denote the benefit arising from connection and reputation and its value is what can be got for the chance of being able to keep that connection and improve it. Upon the sale of an established business its goodwill has a marketable value..... But it is plain that goodwill has no meaning except in connection with a continuing business.....''

Therefore, it may be concluded that-

(a) Goodwill is a capacity to retain its customer, to attract more customers and to sale more of its goods or services than what can be sold normally.

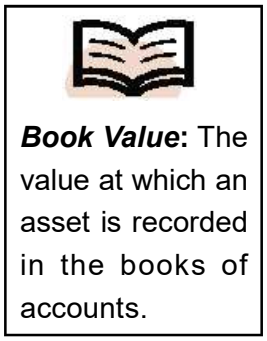
(b) Goodwill is a capacity to earn super profit which is more than normal profit in the concern industry.

(c) Goodwill is an asset which is not visible but which raises the worth of a business firm. Thus, with goodwill the worth of the firm will be more than its book value.

Features of Goodwill

In brief the following are the features of goodwill.

- Goodwill has no physical existence. Goodwill is an intangible asset.
- Only for a going concern business goodwill is relevant.
- Goodwill has the ability to generate additional income for the business firm like any other asset.
- Goodwill of a firm represents the excess of real net worth of assets over their book value.
- It is attached with the firm and cannot be isolated from the business. It cannot be realised (sold) separately.



***Book Value*:** The value at which an asset is recorded in the books of accounts.



CHECK YOUR PROGRESS

Q 1: Explain the meaning of Goodwill.

.....

.....

Q 2: State two features of goodwill.

i. .....

ii. .....

8.4 GOODWILL AS AN ASSET

From financial accounting point of view, goodwill is considered as an intangible asset of a firm. Walton defines goodwill as ‘‘The element of an established business which makes the business as a going concern worth more than its book value, that is, its net worth as shown by the books’’.

Assets are acquired to facilitate the income generating capacity of the business. Goodwill also facilitates earning of income. In the words of C.L. Woelfel: ‘‘Goodwill is the superior earning power of a business beyond the earning power that would be expected of a firm in a similar business and with a similar amount of other assets”.

Several factors contribute to create the goodwill like competent management, favourable location, quality product, good relations with customers and employees and managerial efficiency etc. Some say that since no money is paid for creation of goodwill, so it can not be called an asset. But it is not true. A lot of money is spent on those factors which create goodwill. Recruitment and retention of qualified and skilled personnel, setting up of the establishment in a prime location, production of quality goods or providing of quality services, etc. require a considerable amount of expenditure.

It takes time for a firm to become well established and earn a name for it. All these ultimately create a reputation in the market giving an edge to the firm over its competitors. This is called goodwill which facilitates to attract and retain more customers which results in more sales and more income. Thus, like other assets, goodwill also facilitates to earn income, hence it is regarded as an asset.

Factors Influencing Goodwill

Goodwill is influenced by many factors. These are mentioned below:

- Location of firm
- Quality of the product or service
- Quality and skill of management
- Acceptance of the firm's product or service by the customers
- After sale service provided by the firm
- Price of the product or service
- Behaviour of the sales executive and other sales personnel towards the customer.
- Work-culture and Team-culture of the employees of the firm.
- Trademark, Trade name and Brand name.
- Patent rights
- Copyrights
- Licenses
- Franchises



CHECK YOUR PROGRESS

Q 3: Mention three important factors which have influence on goodwill.

.....

.....

.....



LET US KNOW

Accounting Standard 10 issued by the Institute of Chartered Accountants of India on 'Accounting for fixed Assets' has prescribed that goodwill for which no money is paid, should not be recorded. The standard has not prescribed any procedure for valuation of goodwill. It has stated that goodwill should be recorded in the books of accounts only when some consideration in money or money's worth has been paid for it. When a business is acquired for a price which is in excess of the value of net asset of the business taken over, the excess should be termed as "goodwill"

8.5 METHODS OF VALUATION OF GOODWILL

There are various methods of valuation of goodwill. These are:

(a) Arbitrary Method

(b) Average Profit Method or Year's Purchase of Past Profit Method.

(c) Weighted Average Profit Method

(d) Capitalisation of Average Profit Method or Capitalisation of Future Profit Method.

(e) Capitalisation of Weighted Average Profit Method.

(f) Super Profit Method or Year's Purchase of Super Profit Method.

(g) Weighted Average Super Profit method or Year's Purchase of Weighted Average Super Profit Method.

(h) Sliding Scale Valuation of Super Profit Method.

(i) Capitalisation of Super Profit Method.

(j) Capitalisation of Weighted Average Super Profit Method.

(k) Annuity Method

Out of these various methods of valuation of goodwill Average Profit Method and Weighted Average Profit Method are explained below:

8.5.1 Average Profit Method

This method is also called **Year's Purchase of Past Profit Method** which is the most commonly used method in partnership firms. Under this method the average profit of immediate past few years is multiplied by a certain number. Generally three to five years average profit is taken for the purpose. The procedure is applied in the following manner:

(a) First, average profit of last three or five years is calculated.

(b) Second, the average profit determined as above is multiplied by a certain number of year's purchase, e.g. 2,3,4,5 etc.

(c) The result is the value of Goodwill.



EXAMPLE 1

The profits of a firm for the last three years were as follows: Rs. 60,000, Rs 70,000, and Rs. 50,000.

Calculate the goodwill of the firm taking 5 year's purchase of the average profits.

Solution:

Average Profit = Rs. (60,000 + 70,000 + 50,000) ÷ 3 = Rs. 60,000

Therefore, Value of Goodwill at 5 years' purchase of average profit

= Average profit X 5

= Rs. 60,000x5

= Rs. 3, 00, 000

EXAMPLE 2



Shyam & Co proposed to purchase the business of M/s. Anand & Co. Goodwill for this purpose is agreed to be valued at 3 years' purchase of the average profit of the last five years. Calculate the value of goodwill from the information given below:

Profits for last five years

Years	*Profit (Rs.)*
2000	40,000
2001	45,000
2002	49,000
2003	38,400
2004	52,000

(a) The profits of Anand & Co. for 2002 include a non-recurring profit of Rs. 5,500;

(b) The profits of 2003 have been arrived after deducting an extraordinary loss on account of embezzlement for Rs. 4,300.

Solution:

Calculation of Net Average Profit:

Years	Profits		
		Rs.	Rs.
2000			40,000
2001			45,000
2002		49,000	
	less, Non-recurring profit	5,500	43,500
2003		38,400	
	Add : Extraordinary loss	4,300	42,700
2004			52,000
Total			**2,23,200**

Calculation of Value of Goodwill:

Net Average Profit of 5 Years 2, 23,200 ÷ 5=44,640

Value of goodwill =

Net average profit x Number of years' purchase =

Rs. 44,640 x 3 = **1, 33,920**



ACTIVITY 1.1

Ascertain the value of goodwill of Y Company from the following information: Calculate the value of goodwill of Y Company taking 3 year's purchase of the average profits of 4 years.

Profits for the last 4 years after tax were:

Rs. 10,000; Rs. 8,000; Rs. 5,000; Rs. 7,000;

8.5.2 Weighted Average Profit Method

In this method instead of simple average, weighted average is used to determine the average profit. Weights are assigned to each year's profit. The sum total of the products of profits and corresponding weights is divided by the sum total of all weights to find out the weighted average profit. This figure is then multiplied by number of year's purchase to determine the value of goodwill. This method is generally not used by small firms due to the problem of selecting weights.



EXAMPLE 3

The profit of X Ltd. for the last five years and the corresponding weights are as follows.

Year	2004	2005	2006	2007	2008
Profit Rs)	90,000	1,10,000	1,40,000	1,50,000	1,60,000
Weight	1	2	3	4	5

Calculate the value of goodwill on the basis of 3 years' purchase of the weighted average profit.

Solution:

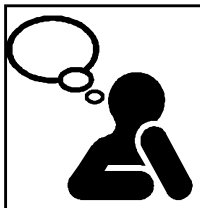
Year	Profit	Weight	Product
2004	90,000	1	90,000
2005	1,10,000	2	2,20,000
2006	1,40,000	3	4,20,000
2007	1,50,000	4	6,00,000
2008	1,60,000	5	8,00,000
Total		15	21,30,000

Weighted Average Profit =

Rs. 21, 30,000 ÷ 15 = Rs. 1, 42,000.

Value of Goodwill = 3 years' purchase of weighted average profit:

Rs. 1, 42,000 x 3 = Rs. 4, 26,000



ACTIVITY 1.2

The profit of Ram & co. Ltd. for the last five years and the corresponding weights are as follows.

Year	2003	2004	2005	2006	2007
Profit Rs)	20,000	30,000	40,000	50,000	60,000
Weight	1	2	3	4	5

Calculate the value of goodwill on the basis of 3 years' purchase of the weighted average profit.



8.6 LET US SUM UP

In this unit we have discussed the following aspects-

- Goodwill is the capacity of the business to retrain its customers.
- Goodwill is an intangible asset.
- Goodwill represents the excess of real net worth of assets over their book values.
- Goodwill is influenced by various factors like, location of firm, quality of the product, behaviour of the sales executives etc.

- In average profit method of valuation of goodwill, the average profit of past few years is multiplied by a certain number.
- In weighted average profit method, weights are assigned to each year's profit and the sum total of the products of profits and corresponding weights is divided by the sum total of all weights to find out the weighted average profit. Then this figure is multiplied by number of year's purchase to determine the value of goodwill.



8.7 FURTHER READING

1) Dam B B and Gautam H. C.(2008). Corporate Accounting : For B.Com Part II (new course) of Gauhati University. Guwahati, Capital Publishing Company
2) S.N. Maheshwari & S.K. Maheshwari (2009). Corporate accounting. Noida, Vikar Publishing House Pvt. Ltd.
3) Sinyal R.S. (2010). Corporate accounting. New Delhi, V.K. (India) Enterprise.
4) Goyal V.K. & Goyal R. (2012). Corporate accounting. New Delhi, PHI Learning Pvt. Ltd.



8.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Goodwill is a capacity to retain its customer, to attract more customers and to sale more of its goods or services than what can be sold normally. Goodwill is a capacity to earn super profit which is more than normal profit in the concern industry. Goodwill is an asset which is not visible but which raises the worth of a business firm. Thus with goodwill the worth of the firm will be more than its book value.

Ans to Q No 2: i) Goodwill has no physical existence.

ii) Goodwill generates additional income for the business.

Ans to Q No 3: 1. Location of firm

2. Quality of the product or service

3. Quality and skill of management



8.9 MODEL QUESTIONS

Q 1: Define the term goodwill.

Q 2: What are the distinguishing features of goodwill?

Q 3: Why goodwill is considered as an asset?

Q 4: Write short note on

(i) Super profit

(ii) Intangible Asset

(iii) Goodwill

Q 5: A Ltd. agreed to purchase business of a sole trader. For that purpose, goodwill is to be valued at 3 years' purchase of the average profits of last 5 years. Profits for these years are:

2004 – Rs. 80,000; 2005 – Rs. 90,000; 2006 – Rs. 72,000; 2007 – Rs. 90,000; 2008 – Rs. 1, 00,000.

Q 6: A firm earned profits of Rs. 8,000, Rs. 10,000 Rs. 12,000 and Rs. 18,000 during the last four years. Taking weights as 1, 2, 3, and 4 respectively calculate the value of goodwill of the firm based on three years purchase.

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UNIT 9: VALUATION OF SHARES

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Meaning of Value of Shares

9.4 Types of Share Value

9.5 Importance of Valuation of Shares

9.6 Factors Affecting the Value of Shares

9.7 Methods of Valuation of Shares

9.8 Let Us Sum Up

9.9 Further Reading

9.10 Answers To Check Your Progress

9.11 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- explain the meaning of shares and valuation of shares
- describe the importance of valuation of shares
- identify the factors influencing the valuation of shares
- elaborate the methods of valuation of shares
- illustrate the accounting treatment on shares.

9.2 INTRODUCTION

You are familiar with accounting process. It is the process of recording financial transactions as well as reporting on the financial status of a business. Two reports (statements) are typically generated in accounting process. These are (i) Balance sheet, which summarizes the firm's assets, liabilities and capital or share capital and (ii) income statement, which reports the firm's gross proceeds, expenses, and profit or loss. These basic financial statements provide accounting information on five elements. These five elements are (a) assets (b) liabilities (c) equities (capital) (d) incomes and

gains and (e) expenses and losses. Hence, capital is an important component or element of financial statements.

Capital of a company is represented through number of shares issued and the value of such issued shares. The value shown against such shares in the balance sheet is the face or nominal value not the real value. In this context we may refer to the basic accounting equation:

Assets = Capital + Liabilities

Or

Capital = Assets – Liabilities

Assets – Liabilities is equal to Net Worth. Hence, the real value of a company, i.e., net worth is the real value of shares of a company or, in other words, the real value of shares of a company is the net worth of that company.

In Unit 1 you have learnt about meaning of share and share capital, kinds of shares and issue of shares. In this unit we shall discuss the meaning of value of shares, importance of valuation of shares, factors influencing the value of shares and methods of valuation of shares.

9.3 MEANING OF VALUE OF SHARES

The meaning of value may be subjective and objective. Value of a pen for an examinee in the examination hall is subjective, called 'value-in-use'. Its value for a buyer is the monetary value, i.e., its price is objective value, called 'value-in-exchange'. **Value of a share means the money value attached to the share**. It may be the book value (value written in the books of account), or the price at which it can be sold or purchased.

The value of a share is first stated in the Articles of Association of the Company. It is also stated in the Balance sheet of all companies. The value, stated in the Balance Sheet (or in the books of account and Articles of Association) is called '**book-value'** of a share. The value of a share (the price) at which it can be sold or purchased is **market value** which may be more or less than the book-value.

The problems relating to valuation of shares may be discussed under the following broad heads:

(A) Valuation of Equity Shares; and

(B) Valuation of Preference Shares.

In this unit we shall discuss valuation of equity shares only.



CHECK YOUR PROGRESS

Q 1: Explain the meaning of valuation of share.

.....

.....

9.4 TYPES OF SHARE VALUE

There are various types of value of a share. These are:

1. Book-value
2. Par Value
3. Value at a Premium
4. Value at a Discount
5. Quoted Value
6. Market Value
7. Fair Market Value
8. Intrinsic Value
9. Yield Value

They are discussed below-

1. **Book-value*:*** Book value of share is the value stated in the Articles of Association. It is also known as **Face Value or Nominal value** and shown in the books of accounts and Balance Sheet.
2. **Par Value:** Par value is the nominal or face value of a share.
3. **Value at a Premium*:*** If shares are sold or issued at a price more than the book value, then it is called value at a premium. Suppose shares of Rs. 10 each are sold or issued at Rs. 12 each, this value of Rs 12 is called value at a premium. Rs. 2 is premium paid on the share of Rs. 10.
4. **Value at a Discount:** If shares are sold or issued at a price lower than their book or face value, it is called Value at a Discount. If a share of Rs. 10 is sold at Rs. 9, then it is a case of Value at a Discount. But for all accounting purpose, the book value of Rs. 10 is recorded.

5. **Quoted Value:** Quoted value is the value of a share stated by the stock exchange at the end of a day's trade.
6. **Market Value*:*** Market value of a share is the price at which the share is purchased or sold in the market. For all practical purposes, stock exchange quoted price is taken as the market price.
7. **Fair Market Value*:*** It is the price of a share which agreed in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.
8. **Intrinsic Value*:*** Realisable value of total net assets divided by the number of shares outstanding is the intrinsic value of a share This value is also known as Asset Back Value of shares.
9. **Yield Value:** This value of a share is also known as Capitalised value of Earning Capacity. Normal rate of return in the industry and actual or expected rate of return of the firm are taken into consideration to find out yield value of a share.



CHECK YOUR PROGRESS

Q 2: What is the market value of shares?

.....

.....

9.5 IMPORTANCE OF VALUATION OF SHARES

The importance of valuation of shares can be understood from the following:

- Stock Exchange quoted value often fails to reflect the real worth of share. This is applicable only to ordinary transactions of shares, when a small number of shares are purchased or sold. Quoted price is not suitable for purchase or sale of major or controlling shares. Further, all shares are not quoted on Stock Exchange. Hence, valuation of unquoted shares is also necessary **for transferring shares** from one person to another person.

- The importance of valuation of shares also arises in case of **amalgamation of companies** when there is the need for having a fair valuation of shares to settle the purchase price.
- Sometimes preference shares and debentures are converted into equity shares as per the terms of issue. In such case, a fresh valuation method should be adopted for equity shares **to calculate the exchange ratio**.
- **To obtain loans from financial institutions** shares and debentures can be offered as security. For such a purpose valuation of shares is essential to assess the real worth of the shares pledged for getting loans.
- When a **Public Sector Undertaking is converted** into a limited company by means of public issue of shares of such undertaking, valuation of these shares becomes essential. **When the shares of a limited company are taken over by the government** under a scheme of nationalisation, it is necessary to value the shares of the concerned company in order to compensate the shareholders.



CHECK YOUR PROGRESS

Q 3: Explain the meaning of intrinsic value.

.....

Q 4: State two points of importance of valuation of shares.

i) .....

ii) .....

9.6 FACTORS AFFECTING THE VALUE OF SHARES

The factors which influence the value of shares can be broadly classified into two groups- internal and external factors. They are stated below-

(i) Internal factors:

- Net worth of Assets (realisable value of all assets minus all liabilities)

- Earning capacity of assets
- Return on investments
- Profit after tax
- Profit available to equity shareholders
- Earnings per share
- Dividend per share or Rate of dividend.

(ii) External Factors:

- General economic condition of the country.
- Political and social environment.
- International economic scenario.
- International political environment.
- Demand for shares.
- Growth prospect of the industry.
- Transparency in information flow.
- Insider trading
- General impulse in capital and securities market.
- Investor's education and their perspective towards capital market.

9.7 METHODS OF VALUATION OF SHARES

The issues relating to valuation of shares may be discussed under the following broad heads:

(A) Valuation of Equity Shares.

(B) Valuation of Preference Shares.

Here we will discuss the valuation of equity shares only.

Generally the following methods of valuation of shares are in use. These are:

(a) Intrinsic Value Method; and

(b) Yield Method.

(a) Net Asset Method

This method is also known as Intrinsic Value Method, Asset Backing Method, Equity Method, Assets Balancing Method or Assets Valuation Method.

Generally, under this method, value of one equity share is calculated as under:

Value of one equity share = Net Assets ÷ Number of equity shares.

An estimate of worth of the net assets is made by deducting the liabilities from the total realisable assets. Net backing for each share is obtained by dividing the worth of the net assets by the number of outstanding shares.

Net Assets means value of total realisable assets less all outside liabilities.

Realisable value of Assets means the value which can be realised from the market if assets are put to sale.

Outstanding shares means the number of shares issued and subscribed by the public.

Net Asset Method can be fairly used to value shares when the firm is liquidated. This method takes into account the real worth of the business and is also related to the market value of assets. But it is difficult to estimate the realisable value of shares in case of going concern. This method does not give any weight to earning capacity of the company. This method is suitably applicable when two or more companies are going to be amalgamated or merged and also when controlling shares are being acquired.

Precaution to be taken while using the Net Asset Method:

The following precautions should be taken into account for calculation of the value of each equity share under Net Asset Method:

(i) Assets should be taken at Book value, only when market value or realisable value is not available.

(ii) Adequate provision should be maintained for depreciation.

(iii) For investments outside the firm, (e.g., investment in shares, debentures of other companies etc.) and inventory, current market price should be applied.

(iv) In case of bills receivable and trade debtors, adequate provision for bad and doubtful debts should be made.

(v) Fictitious assets like preliminary expenses, debit balance of Profit and

Loss account, or any unamortized expenses and deferred revenue expenses should not be taken into account.

(vi) If there is any unrecorded asset which can be realised, it should be considered. In the same way, all unrecorded liabilities should also be provided.

(vii) From the total value of all realisable assets, the value of all liabilities (including contingent liabilities and liabilities relating to the employees) is to be deducted.

(viii) From the figure ascertained as above, the paid up amount of preference share capital, if any, and the unpaid amount of preference dividend (if not deducted as liabilities) are deducted to obtain the value of net asset available for equity shareholders.

(ix) The value of net asset available for equity shareholders is divided by the number of equity shares (issued and subscribed) to ascertain the value of each equity share.



EXAMPLE 1

The following information is available from Tina Ltd. as at 31st March, 2009:

Capital: 1,000, 5% Preference Shares of Rs. 100 each fully paid	Rs. 1,00,000
2,000 Equity Shares of Rs. 100 each fully paid	Rs. 2,00,000
Reserve and Surplus	Rs. 2,00,000
6% Debentures	Rs.1,00,000
Current Liabilities	Rs. 1,00,000
Assets: Fixed Assets	Rs. 4,00,000
Current Assets	Rs. 3,00,000

For the purpose of valuation of shares, fixed assets and current assets are to be depreciated by 10%; Interest on debentures is due for six months; preference dividend is also due for the year. Neither of these has been provided for in the balance sheet.

Calculate the value of each equity share under Net Asset Method.

Solution:

Note: Since there is only one class of equity shares and all the shares are fully paid up, the value of each equity share will be ascertained as under:

Value of one equity share = Net Assets available for equity shareholders ? Number of equity shares

Net Assets Available to Equity Shareholders:	***Rs.***
	Assets:
Fixed Assets (4,00,000 - 10% on Rs. 4,00,000)	3,60,000
Current Assets (3,00,000 - 10% on Rs. 3,00,000)	2,70,000
Value of Assets	6,30,000
Less : Liabilities:	
Current Liabilities	1,00,000
6% Debentures	1,00,000
Add : Interest Outstanding	
(Rs. 1,00,000 x 6/100 x 6/12)	3,000
	1, 03, 000
5% Preference Share Capital	1,00,000
Add : Arrear Dividend	
(Rs. 1,00,000 x 5%)	5,000
	1,05,000
	3, 08,000
Net Assets available to Equity Shareholders	3, 22,000
No. of equity shares	2,000

Value of each share under Net Assets Method:

Value per share = Net Assets available to Equity Shareholders / No. of Equity Shares

= Rs. 3,22,000/ 2,000 = **Rs. 161**

(b) Yield Method:

Yield value of a share is also known as Capitalised value of Earning Capacity. Normal rate of return in the industry and actual or expected rate of return of the firm are taken into consideration to find out yield value of a share. Instead of rate of return (ROI), rate of dividend may also be taken. Yield refers to the earning or productivity of a firm in relation to its investments.

Such yield may be Earning Yield or Dividend Yield.

Earning Yield = Profits available to equity shareholders ÷ Number of equity shares

Dividend Yield = Total dividend for equity shareholders ÷ Total paid up equity share capital x 100

Generally for valuation of equity shares Earning Yield method is applied.

Earning Yield method:

Under this method value of each equity share is calculated as under**:**

Expected Rate of Earnings ÷ Normal rate of return x Paid up value of a share.

Sometimes actual rate of earnings is used in place of Expected Rate of Earnings.

Dividend Yield Method:

Under this method value of each equity share is calculated as under**:**

Rate of Dividend ÷ Normal rate of return x Paid up value of a share.



EXAMPLE 2

Sailee Ltd has a paid up capital of Rs. 3,00,000 divided into 20,000 Equity shares of Rs. 10 each and 5%, 1,000 Preference Shares of Rs. 100 each. The company has Rs. 1,00,000 debentures; the interest payable is 10% p.a. During the year 2008-09 the company earned a profit of Rs. 1,60,000 before charging interest. The company declared dividend at the rate of Rs. 2 per share for the last year. The normal rate of return is 20%. Assume tax rate of 30%.

Calculate value per share under Earning Yield method and Dividend Yield Method.

Solution:

	Rs.
Profits before interest and Tax:	1,60,000
Less: Interest 10% on Rs. 1,00,000	10,000
Profits after interest	1,50,000
Less: Tax 30% on Rs. 1,50,000	45,000

Profits after Tax:	1,05,000
Less: Preference Dividend: 5% on Rs. 1,00,000	5,000
Profit available to Equity share holders:	**1,00,000**

Earning Yield method:

Value of each equity share is calculated as under**:**

Rate of Earnings ÷ Normal rate of return x Paid up value of a share.

Rate of Earnings = Rs. 1,00,000 ÷ Rs. 2,00,000 x 100 = 50%

Value of each equity share = (50% ÷ 20%) x Rs. 10 = Rs. 25

Dividend Yield method:

Under this method value of each equity share is calculated as under**:**

Rate of Dividend ÷ Normal rate of return x Paid up value of a share.

Rate of Dividend = Rs. 4 per share or 4 ÷ 10 x100 = 40%

Value of each equity share = (40% ÷ 20%) x Rs. 10 = Rs. 20



9.8 LET US SUM UP

In this unit we have discussed the following aspects-

- Value of shares means the money value attached to the shares.
- The value of shares which is stated in the Articles of Association and the Balance Sheet of the company is the book value of the shares.
- The various types of value of shares are- book value, par value, value at a premium, value at a discount, market value etc.
- The valuation of shares becomes important in case of transfer of shares from one person to another person, amalgamation of companies, conversion of preference shares and debentures into equity shares etc.
- The factors which influence the value of shares are classified as internal factors like, earning capacity of assets, return on investment etc. and external factors like, general economic condition of the country, political and social environment, demand for shares etc.
- Under the Net Asset method of valuation of shares, the value of one equity share is calculated as –

Value of one equity share = Net Assets ÷ Number of equity shares.

- Under Earning Yield method, value of each equity share is calculated as-

  Expected Rate of Earnings ÷ Normal rate of return x Paid up value of a share.

- Under Dividend Yield method, value of each equity share is calculated as-

  Rate of Dividend ÷ Normal rate of return x Paid up value of a share.



9.9 FURTHER READING

1) Dam B B and Gautam H. C.(2008). Corporate Accounting : For B.Com Part II (new course) of Gauhati University. Guwahati, Capital Publishing Company.
2) S.N. Maheshwari & S.K. Maheshwari (2009). Corporate accounting. Noida, Vikar Publishing House Pvt. Ltd.
3) Sinyal R.S. (2010). Corporate accounting. New Delhi, V.K. (India) Enterprise.
4) Goyal V.K. & Goyal R. (2012). Corporate accounting. New Delhi, PHI Learning Pvt. Ltd.



9.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Value of a share means the money value attached to the share. It may be the book value (value written in the books of account), or the price at which it can be sold or purchased. Valuation of share means the procedure of finding out the value per share on the basis of certain factors.

Ans to Q No 2: The price at which the shares are purchased or sold in the market is called the market value of shares.

Ans to Q No 3: Intrinsic Value*:* Realisable value of total net assets divided by the number of shares outstanding is the intrinsic value of a share. This value is also known as Asset Back Value of shares.

Ans to Q No 4: i) In case of amalgamation of companies, valuation of shares is important.

ii) In case of conversion of preference shares and debentures, valuation of shares becomes important.



9.11 MODEL QUESTIONS

Q 1: What is meant by 'Valuation of Share'?

Q 2: Discuss the various reasons for which shares are valued.

Q 3: What precautions should be taken while valuing shares under Net Asset Method?

Q 4: Explain the procedure of valuation of shares under (a) Intrinsic value method and (b) Yield value method

Q 5: A company has 20,000 shares of Rs. 10 each fully paid and 10,000 equity shares of Rs. 8 each fully paid; the net assets of the company are Rs. 4,20,000.

Ascertain the value of each class of equity shares.

Q 6: The following is the Balance Sheet of Assam Company (P) Ltd. as at 31st March, 2003.

Balance Sheet of Assam Company (P) Ltd.

Liabilities	Amount Rs.	Assets	Amount Rs.
Equity Share Capital	2,00,000	Goodwill	5,000
6% Preference Share Capital of Rs. 1,000 each	50,000	Land & Building	1,50,000
		Furniture	10,000
Reserve	30,000	Stock	80,000
Profit & Loss Account	10,000	Debtors	60,000
Sundry Creditors	20,000	Cash & Bank	10,000
Other Liabilities	10,000	Publicity	5,000
	3,20,000		3,20,000

Goodwill is valued at Rs. 11,000 and Building at Rs. 250,000. Stock is worth Rs. 1,00,000. Debtors are expected to realise 90% of book value. Equity Share capital represents 20,000 shares of Rs. 10 fully paid up Find out the value of Equity Share.

Q 7: From the following Balance Sheet of N. E. Products (P) Ltd. find out the valuation of Equity shares.

Balance Sheet of N. E. Products (P) Ltd.

Liabilities	Amount Rs.	Assets	Amount Rs.
80,000 Equity Share Capital of Rs. 10	80,000	Goodwill	17,000
8% 4,000 Preference Share Capital of Rs. 10	40,000	Furniture	15,000
		Stock	60,000
Reserve	12,000	Debtors	45,000
Profit & Loss Account	4,000	Cash	32,000
Sundry Creditors	24,000	Preliminary Expenses	1,000
Proposed Preference Dividend	3,200		
Overdraft	2,000		
Other Liabilities	4,800		
	1,70,000		1,70,000

Goodwill is valued at Rs. 15,000. Debtors is overvalued by Rs. 10,000 stock is undervalued by Rs. 15,000.

*** ***** ***

UNIT 10: PURCHASE OF BUSINESS

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Meaning of 'Purchase of Business'

10.4 Meaning of – 'Business taken over', 'Assets taken over' and 'Assets and Liabilities taken over'

10.5 Purchase consideration

10.6 Methods for determining Purchase Consideration

10.7 Mode of Discharge of Purchase Consideration

10.8 Accounting Entries

10.9 Let Us Sum Up

10.10 Further Reading

10.11 Answers To Check Your Progress

10.12 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- explain the meaning of 'Purchase of Business',
- explain the meaning of 'Business Taken Over', 'Assets Taken Over' and 'Assets and Liabilities Taken Over'
- describe the basis of calculating consideration for purchase of a business
- describe the methods of consideration for purchase of a business
- illustrate the accounting treatment on purchase of business

10.2 INTRODUCTION

The purpose of establishing a business firm by its proprietor is to earn profit. But at the same time they are ready to bear the risk of loss also. In other words, if the proprietor can not earn profit he has to bear the loss and if can not bear the loss, he has to leave the business by selling it or

liquidating by other means. If a proprietor earns a good amount of profit his natural business instinct is to expand the business. The proprietor wants to take opportunity of venturing in the related or other form of business. All these give rise to diversification of the present form of business, merger of business units, sale of one business unit and purchase of it by another etc. In this unit we shall discuss the meaning of certain terms used in 'Purchase of Business', consideration for purchase of a business; the basis for calculation of consideration for purchase of a business; calculation of purchase consideration by applying Lump Sum Method and Net Asset Method and accounting entries in the books of purchasing company.

10.3 MEANING OF 'PURCHASE OF BUSINESS'

'Purchase of Business' generally means buying of one business firm by another business firm. But the term is used differently in different cases. 'Purchase of Business' basically refers to the acquisition of a sole proprietorship firm or a partnership firm or a company by a limited company. Acquisition of a limited company by another limited company is not called 'Purchase of Business'. It is called ''Amalgamation'' or "Merger". Therefore, purchase or acquisition of business by a limited company generally refers to the purchase of a non-corporate form of business organisation like sole-proprietorship or partnership form of business by a company.

Purchase of business by a limited company may take any of the following two forms:

(i) An existing company may purchase an existing sole-proprietorship or partnership business; or

(ii) A new company may be formed to take over an existing business of a sole proprietor or a partnership firm, i.e., the existing business unit may be converted into a limited company.

10.4 MEANING OF – 'BUSINESS TAKEN OVER', 'ASSETS TAKEN OVER' AND 'ASSETS AND LIABILITIES TAKEN OVER'

When a sole-proprietorship or partnership firm is purchased by a company, it generally purchases active assets which can be used by the

purchasing company. In 'Purchase of Business' the terms '**Business taken over**', '**Assets taken over**' and '**Assets and Liabilities taken over**' have to be understood.

If it is mentioned in the problem that the business has been purchased by the company, it means that all the assets including cash and bank balances except fictitious assets have been purchased and all third party liabilities have been taken over. Third party liabilities mean all liabilities due to the external parties.

If it is mentioned that the company has taken over the assets, it means it has taken over all assets appearing on the assets side of the balance sheet of the business proposed to be purchased but does not include debit balance in the Profit and Loss Account and expenses not written off appearing on the assets side of the balance sheet.

When it is mentioned that the company takes over some assets and liabilities but does not mention the value at which it has been taken over, it will be assumed that the same has been taken over at book values. If any asset is not taken over by the new company, the same must not be taken into account while calculating purchase consideration.



LET US KNOW

Fictitious assets are shown in the balance sheet on 'asset' side. But they have neither physical existence nor realisable value. It represents cash expenditure, like expenses in starting a business. These expenditures are gradually adjusted against the earning of the company.



CHECK YOUR PROGRESS

Q 1: What is the meaning of Purchase of Business'?

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10.5 PURCHASE CONSIDERATION

'Purchase consideration' means the purchase price payable by the company for the business acquired. Generally, an agreement is made between the company and the vendor (the firm which is going to be sold out) which contains the terms and conditions of the acquisition of business, the basis for determining the purchase consideration and the mode of payment of the purchase consideration. Hence, at first the purchase consideration is to be determined.

Consideration, i.e., the purchase price may be paid in cash, in shares & debentures of the purchasing company or in both cash and shares & debentures. The meaning of consideration is defined by the ICAI in Accounting Standard 14 in the following way:

Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Basis for Calculation of Purchase Consideration

The purchase price payable is the money value of Consideration. Therefore when the consideration is calculated there must be certain basis.. For this the following points are considered:

(i) the value of the tangible assets acquired by the company as per agreement;

(ii) the amount payable for goodwill; and

(iii) the amount of liabilities of the vendor firm to be taken over by the purchasing company.



CHECK YOUR PROGRESS

Q 2: What is the meaning of Purchase of Consideration'?

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.....

10.6 METHODS FOR DETERMINING PURCHASE CONSIDERATION

In this section we will discuss the different methods for calculating the amount of purchase consideration. Depending on the terms and conditions of acquisition of business the basis for determining the purchase consideration also varies from case to case. The following are the different methods generally used for determining the purchase consideration:

(a) Lump sum method;

(b) Net Assets method; and

(c) Payment method

Let us discuss these methods.

Lump Sump Method : When the purchasing company agrees to acquire the business of the vendor firm by paying lump sum amount it is known as ‘‘Lump sum basis’’. For example, Assam Trade Company Ltd is formed to take over the assets and liabilities of M/s. Sarma Brothers for a consideration of Rs. 20,00,000 to be discharged in fully paid shares of Rs. 10 each. This amount of Rs. 20,00,000’ is termed as Purchase Consideration under ‘Lump sum basis’.

Net Assets Method : Under Net Asset method, purchase consideration is equal to the total value of Net Assets taken over by the company from the firm.

The amount of Net Assets is ascertained as under:

Total value of Net Assets = (Total agreed value of fixed assets taken over by the Company + Total agreed value of current assets taken over by the Company) – Total liabilities agreed to be paid by the Company.



EXAMPLE 1

X and Y are partners sharing profits and losses in the ratio of 3 : 2 . On 31-12-2008, their financial standing was as follows: Current **Liabilities:** Rs. 10,000; Loan on Mortgage: Rs. 8,000; General Reserve Rs. 4,000; X Capital: Rs.10,,000: Y Capital: Rs.8,000 **Furniture:** Rs. 6,000; Cash: Rs.18,000; Sundry Debtors: Rs. 9,000;

Stock: Rs. 7,000.On the above date a new company XY Ltd. was formed. The company took over the business of X and Y. Calculate the amount of purchase consideration.

Solution:

Statement showing the calculation of purchase consideration:

Assets taken over:		**(Rs.)**
Furniture		6,000
Sundry Debtors		9,000
Stock		7,000
Cash		18,000
Total		**40,000**
Less:		
Liabilities taken over:	**(Rs.)**	
Current Liabilities:	Rs. 10,000;	
Loan on Mortgage:	Rs. 8,000	
		18,000
Net Assets taken over		**22,000**

Therefore, the amount of purchase consideration is 22, 000



EXAMPLE 2

Assam Ltd. acquired the business of Bora and Saha who are in partnership sharing profits and losses in the ratio of 2:1 on 31-12-2008. Their Balance Sheet on that date stood as follows:

BALANCE SHEET

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	20,000	Building	20,000
Bills Payable	10,000	Furniture	7,000
Loan on Mortgage	7,000	Sundry Debtors	15,000
Reserve	5,000	Stock	17,000
Capital Accounts :		Cash at Bank	11,000
Bora	18,000		
Saha	10,000		
	70,000		70,000

The Company would acquire all assets and liabilities, except Cash and Loan on Mortgage, at their existing book-values and pay Rs.16,000 for Goodwill.Calculate the amount of purchase consideration.

Solution:

Statement showing the calculation of purchase consideration:

Assets taken over:		**(Rs.)**
Buildings		20,000
Furniture		7,000
Sundry Debtors		15,000
Stock		17,000
		59,000
Less:		
Liabilities taken over:	**Rs.**	
Sundry Creditors	20,000	
Bills Payable	10,000	30,000
		29,000
Add: Amount agreed to be paid for Goodwill		16,000
		45, 000

Therefore, the amount of purchase consideration is 45,000

Note: The liabilities taken over do not include capital of the partners and the balance in General Reserve.



EXAMPLE 3

Sunil and Rohan are in partnership sharing profits and losses in the ratio of 4 :1 . On 31-12-2003, their Balance Sheet stood as follows:

BALANCE SHEET

LIABILITIES		**ASSETS**	
Sundry Creditors	20,000	Buildings	46,000
Bills Payable	17,000	Machinery	20, 000
Furniture	7, 000		

Loan on Mortgage	6,000	Sundry debtors:	16, 500
Reserve	5,000	Less: provision for	
		bad debts	1, 500
Capital Accounts :			15, 000
Sunil 30,000		Stock	7, 000
Rohan 20,000	50,000	Cash	1, 000
		Preliminary expenses	2, 000
	98,000		**98, 000**

On the above date a new company, PQR (P) Ltd. was formed which took over all assets except Cash at the following value : Building at Rs. 58,000, Machinery at Rs. 16,000, Furniture at Rs. 5,000, Stock and Debtors at existing book-values. The company also agreed to pay Rs.15,000 for Goodwill.

Calculate the amount of purchase consideration.

Solution:

Statement showing the calculation of purchase consideration:

Assets taken over:	**(Rs.)**	**(Rs.)**
Buildings	58,000	
Machinery	16,000	
Furniture	5,000	
Sundry Debtors		
(Rs.16, 500 -Rs.1, 500)	15,000	
Stock	7,000	

		1, 01,000
Add: Amount agreed to be paid for Goodwill		15,000
		1, 16,000

Therefore, the amount of purchase consideration is 1, 16,000

Note: Since the Company took over only the specified assets, the purchase consideration is the total of all agreed value of specified assets taken over plus the amount agreed to be paid on account of goodwill. Cash has not been taken into account as the company did not take over the cash. No

deduction has been made for any of the liabilities as the company did not take over any liability.

Payment Method

Sometimes, the agreed values of assets and liabilities, taken over by the purchasing company may not be given in the question. The problem specifies the payments to be made by the company in cash/shares/ debentures etc. In such cases, the amount of purchase consideration is arrived at by adding all the payments made by the purchasing company irrespective of the form of payment such as cash, issue of shares, issue of debentures etc.

Under this method while calculating the amount paid in the form of issue of shares and debentures, the issue price of such shares and debentures and not their face value, is to be taken into account. This method of ascertaining purchase consideration is known as **'Payment Method'.**

Under this method purchase consideration is calculated as under:

Cash Paid	XXX
Issue Price of Equity Shares, if any	XXX
Issue Price of Preference Shares, if any	XXX
Issue Price of Debentures, if any	XXX
Total Payment being the amount of purchase consideration	XXX



EXAMPLE 4

A Ltd. decided to take over the business of M/s. AB. The purchase consideration was to be discharged as to Rs. 36,500 in cash, Rs. 33,000 in 7½% debentures of Rs. 100 each and by the issue of 5,000 fully paid equity shares of Rs. 10/- each at par.

Calculate the purchase consideration.

Solution:

Amount of Purchase consideration will be calculated as under:

Cash Paid	Rs. 36,500
7½% Debentures of Rs. 100 each	Rs. 33,000
5,000 Equity Shares of Rs.10/- each, fully paid	Rs. 50,000
Total Payment being the amount of purchase consideration	Rs. 1,19,500



EXAMPLE 5

A Ltd. decided to take over the business of M/s. AB. The purchase consideration was to be discharged as to Rs. 36,500 in cash, Rs. 33,000 in 7½% debentures of Rs. 100 each and by the issue of 5,000 fully paid equity shares of Rs. 10/- each at Rs.14/- per share.

Calculate the purchase consideration.

Solution:

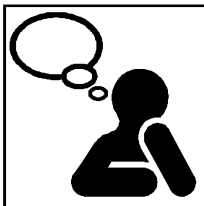
Amount of Purchase consideration will be calculated as under:

Cash Paid	Rs 36,500
7½% Debentures of Rs. 100 each	Rs. 33,000
5,000 Equity Shares of Rs.10/- each, at Rs. 14/- per share	Rs. 70,000
Total Payment being the amount of purchase consideration	Rs. 1,39,500

Note : Under this method, Purchase Consideration is equal to the amount of cash agreed to be paid plus agreed value of shares and debentures given by the purchasing company to the vendor firm.

Note :

Method to be followed for ascertaining the amount of purchase consideration will depend on the nature of information given in the problem.



ACTIVITY 3.1

A Ltd. decided to take over the business of M/s. AB. The purchase consideration was to be discharged as to Rs. 45,000 in cash, Rs. 50,000 in 7½% debentures of Rs. 100 each and by the issue of 10,000 fully paid equity shares of Rs. 10/- each at Rs.9/- per share.

Calculate the purchase consideration.

10.7 MODE OF DISCHARGE OF PURCHASE CONSIDERATION

The purchase consideration (i.e. sale price for the firm) can be discharged by the company in any or all of the following forms :

(a) the entire purchase consideration may be paid in cash;

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

(c) the entire purchase consideration may be paid by the issue of debentures;

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

Calculation of Goodwill / Capital Reserve:

In course of purchase of a business by a company, it may so happen that the purchase consideration paid to the vendor is not always equal to the net assets acquired. Sometimes the net assets acquired may be less or more than the amount paid.

(a) Where the purchase consideration i.e. the price paid for purchase of a business is more than the total net assets acquired, the difference is termed as goodwill and the same should be debited accordingly.

(b) Where the purchase consideration i.e. the price paid for purchase of a business is less than the total net assets acquired, the difference is termed as capital profit and the same should be credited to an account called Capital Reserve Account.

It should be kept in mind that while calculating net assets, revalued figure or market value of the assets, where available, are to be taken into consideration and not the book value of the assets.

For example, a company agrees to pay Rs. 1, 50,000 for the purchase of a business owned by Ram. The business has tangible assets amounted to Rs. 1,45,000 and the business owes Rs. 20,000 to creditors. Here the net tangible assets of the vendor firm is (Rs. 1, 45,000 – Rs. 20,000) = Rs. 1, 25,000. Since the purchase consideration of Rs. 1, 50,000 is more than the total net tangible assets (Rs.1,25,000) by Rs. 25,000, the same is

treated as goodwill. Again, for acquiring the same firm if the amount paid i.e. purchase consideration is Rs. 1, 10,000, it will mean that the company has earned a profit of Rs. 15,000 in course of acquisition of the business. This amount of Rs. 15,000 is termed as capital profit and will have to be transferred to Capital Reserve Account.

Treatment of liquidation expenses:

Sometimes, the purchasing company may agree to bear the liquidation expenses or realisation expenses of the vendor firm. Such expenses are to be treated as capital expenditure of the company and should be debited to Goodwill Account. If there is any Capital Reserve on purchase of the business, the amount of such expenses paid should be debited to Capital Reserve Account.

10.8 ACCOUNTING ENTRIES

Now we shall discuss the accounting entries to record transactions relating to purchase of a business. Recording of transactions relating to the purchase of business by a company will depend on the decision of the purchasing company whether to open new set of books of accounts or to continue with the same sets of books of accounts of the firm. Therefore, the accounting entries for recording of transactions relating to the purchase of business by a company may be discussed under the following two heads:

I. When new set of books of accounts are opened.

II. When same set of books of account of the firm are continued i.e. new set of books of accounts are not opened.

I. When new set of books are opened:

The following entries are to be passed in the books of the purchasing company:

1. For recording the amount of purchase consideration due :

Business Purchase A/c Dr.

To Vendor A/c

2. For recording the assets and liabilities taken over:

(a) In case the purchase consideration is more than the net assets taken over:

If the total credit (i.e. Sundry Liabilities and Purchase Consideration) is more than the total assets taken over, the difference will called 'Goodwill' and will be debited to Goodwill A/c.

Sundry Assets A/c (Individually) Dr.
Goodwill A/c (balancing figure) Dr.
To Sundry Liabilities A/c
(liabilities taken over individually)
To Business Purchase A/c

(b) Where the purchase consideration is less than the net assets taken over: **:**

If the total of Sundry Assets taken over is more than the total of Sundry Liabilities and purchase consideration the difference will represent capital profit and will be credited to Capital Reserve Account.

Sundry Assets A/c (Individually) Dr.
To Sundry Liabilities A/c
(liabilities taken over individually))
To Business Purchase A/c
To Capital Reserve A/c (balancing figure)

3. For the payment of purchase consideration :

Vendor A/c Dr.
To Preference Share Capital A/c
To Equity Share Capital A/c
To Security Premium A/c
To Debentures A/c
To Cash/Bank A/c

4. For liquidation expenses of the firm, if any, paid by the purchasing company but not included with the amount of purchase consideration:

Goodwill A/c Dr.
To Cash/Bank A/c

Or, Where there is capital profit on purchase of business which has been transferred to Capital Reserve Account, the entry for

liquidation expenses of the firm, if any, paid by the purchasing company but not included with the amount of purchase consideration :

Capital Reserve A/c Dr.

To Cash/Bank A/c

5. For payment of Formation Expenses of the purchasing company, if any :

Preliminary Expenses A/c Dr.

To Cash/Bank A/c



EXAMPLE 6

X and Y were in partnership sharing profits and losses equally. Their Balance Sheet on 31-3-2009 was as given below:

Balance Sheet of X and Y

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	18,000	Fixed Assets	55,000
Capital Accounts:		Cash at Bank	3,000
X	40,000	Other Current	
Y	32,000	assets	32,000
	90,000		**90,000**

On 1-4-2009 a company, XY Ltd. was formed with an Authorised Capital of Rs. 1,00,000 divided into 10,000 shares of Rs. 10 each to take over the business of X and Y on the basis of the above Balance Sheet.

The Company agreed to acquire the Liabilities and all Assets excluding cash at a purchase consideration fixed at Rs. 80,000 which was to be discharged by the issue of fully paid Equity shares of Rs.10 each.

The expenses of liquidation of the business of X and Y amounted to Rs. 1,000 which is included in the purchase consideration stated above.

Pass journal entries to record the above transactions and prepare the balance sheet of the company on the above date. The company opened its new set of books.

Solution:

In the books of XY LTD.

Journal entries

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
2009 April 1	Business Purchase A/c Dr. To M/s X and Y A/c (Being the amount of purchase consideration agreed up on as per the agreement dated.....)		80,000 80,000 80,000	 80,000
2009 April 1	Fixed Assets A/c Dr. Other Current Assets A/c Dr. Goodwill A/c Dr. To Sundry creditors A/c To Business Purchase A/c (Being various assets and liabilities taken over and the difference between the amount of purchase consideration and the net assets debited to goodwill account as per the agreement dated.....)		55,000 32,000 11,000	 18,000 80,000
2009 April 1	M/s X and Y A/c Dr. To Equity Share Capital A/c (Being the issue of 8,000 Equity shares of Rs.10 each as fully paid up in full satisfaction of the purchase consideration as per Board's Resolution No.... dtd.....)		80,000	 80,000



EXAMPLE 7

Bora and Nath were in partnership sharing profits and losses equally. Their Balance Sheet on 31-3-2009 was as given below:

Balance Sheet of Bora and Nath

Liabilities	Rs.	Assets	Rs.
Sundry Creditors...	10,000	Fixed Assets	60,000
Bills Payable	5,000	Cash at Bank	5,000
Capital Accounts		Other Current	
Bora	50,000	assets	30,000
Nath	30,000		
	95,000		**95,000**

On 1-4-2009 a company, Asomi Ltd. was formed with an Authorised Capital of Rs. 1,00,000 divided into 10,000 shares of Rs. 10 each to take over the business of Bora and Nath on the basis of the above Balance Sheet.

The Company agreed to acquire the Liabilities and all Assets including cash at a purchase consideration fixed at Rs. 75,000 which was to be discharged by the issue of fully paid Equity shares of Rs.10 each.

Pass journal entries to record the above transactions and prepare the balance sheet of the company on the above date. The company opened its new set of books.

Solution:

In the books of Asomi Ltd.

Journal entries

Date	Particulars	LF	Debit Rs.	Credit Rs.
2009	Business Purchase A/c Dr.		75,000	
April 1	To M/s Bora and Nath A/c			75,000
	(Being the amount of purchase consideration agreed up on as per the			

	agreement dated.....)			
2009	Fixed Assets A/c Dr.		60,000	
April 1	Cash at Bank A/c Dr.		5,000	
	Other Current Assets A/c Dr.		30,000	
	To Sundry creditors A/c			10,000
	To Bills Payable A/c			5,000
	To Business Purchase A/c			75,000
	To Capital Reserve A/c			5,000
	(Being various assets and liabilities taken over and the difference between the amount of purchase consideration and the net assets credited to capital reserve account as per the agreement dated.....)			
2009	M/s Bora and Nath A/c Dr.		75,000	
April 1	To Equity Share Capital A/c			75,000
	(Being the issue of 7,500 Equity shares of Rs.10 each as fully paid up in full satisfaction of the purchase consideration as per Board's Resolution No.... dtd.....)			



10.9 LET US SUM UP

In this unit we have discussed the following-

- Purchase of business means buying of a sole trade business or a partnership firm by a company.
- Acquisition of a limited company by another limited company is called 'amalgamation' or 'merger'.
- The amount paid by the purchasing company to the vendor is known as purchase consideration.
- In calculating purchase consideration the following aspects are considered-

- the value of the tangible assets acquired by the company as per agreement;
- the amount payable for goodwill; and
- the amount of liabilities of the vendor firm to be taken over by the purchasing company.

- The different methods for determining the purchase consideration are
  - Lump sum method;
  - Net assets method; and
  - Payment method.
- The different modes for discharging purchase consideration are-
  - the entire purchase consideration may be paid in cash;
  - the entire purchase consideration may be paid by the issue of shares of the company;
  - the entire purchase consideration may be paid by the issue of debentures;
  - the purchase consideration may be paid partly in cash and partly by the issue of shares and/or debentures of the company.
- Recording of transactions relating to purchasing of business in the books of account of the purchasing company.



10.10 FURTHER READING

1) Dam B B and Gautam H. C.(2008). Corporate Accounting : For B.Com Part II (new course) of Gauhati University. Guwahati, Capital Publishing Company
2) S.N. Maheshwari & S.K. Maheshwari (2009). Corporate accounting. Noida, Vikar Publishing House Pvt. Ltd.
3) Sinyal R.S. (2010). Corporate accounting. New Delhi, V.K. (India) Enterprise.
4) Goyal V.K. & Goyal R. (2012). Corporate accounting. New Delhi, PHI Learning Pvt. Ltd.

10.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: 'Purchase of Business' basically refers to the acquisition of a sole proprietorship firm or a partnership firm or a company by a limited company.

Ans to Q No 2: 'Purchase consideration' means the purchase price payable by the company for the business acquired. Generally, an agreement is made between the company and the vendor (the firm which is going to be sold out) which contains the terms and conditions of the acquisition of business, the basis for determining the purchase consideration and the mode of payment of the purchase consideration.

10.12 MODEL QUESTIONS

Q 1: What is meant by purchase consideration?

Q 2: Explain the lump Sum method and Net Asset method used for determining the purchase consideration.

Q 3: Tangla Ltd. decided to take over the business of M/s. Babla. The purchase consideration was to be discharged as to Rs. 20,000 in cash, Rs. 66,000 in 7½% debentures of Rs. 100 each and by the issue of 16,000 fully paid equity shares of Rs. 10/- each at par.

Calculate the purchase consideration.

Q 4: Nagaon Ltd. decided to take over the business of M/s. Tezpur & Co. The purchase consideration was to be discharged as to Rs. 40,000 in cash, Rs. 60,000 in 7½% debentures of Rs. 100 each and by the issue of 15,000 fully paid equity shares of Rs. 10/- each at Rs.14/- per share.

Calculate the purchase consideration.

Q 5: Tintin Ltd. was formed with an authorised capital of Rs. 8 lakh divided into Equity Shares of Rs. 10 each and 3,000 6% Preference Shares of Rs. 100 each to purchase the going concern Rimrim Ltd. whose Balance Sheet stood as follows :

Liabilities	**Rs.**	**Assets**	**Amount**
Bills Payable	44,000	Cash	58,000
Sundry Creditors	1,26,000	Book Debts	2,22,000
Capital	5,00,000	Stock-in-Trade	1,50,000
		Machinery	2,40,000
		6,70,000	**6,70,000**

The purchase price was agreed at Rs. 5,50,000 payable as to : Rs. 3,00,000 in fully paid Equity Shares, Rs. 2,00,000 in fully paid Preference Shares, Rs. 30,000 in Debentures redeemable after 10 years, and the balance in cash.

Of the remaining equity shares 50 p.c. were issued to and paid by the public in full along with the application.

Journalise the transactions and prepare the balance sheet.

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UNIT 11: AMALGAMATION OF COMPANIES

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Meaning and Objectives of Amalgamation of Companies

11.4 Meaning of Different Terms Used in Amalgamation

11.5 Provisions for Amalgamation of Companies as Per Accounting Standard 14

11.6 Basis for Arriving At Purchase Consideration

11.7 Accounting Entries in the Books of Transferee Company

11.8 Let Us Sum Up

11.9 Further Reading

11.10 Answers To Check Your Progress

11.11 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the meaning of 'Amalgamation of Companies',
- describe the objectives of amalgamation of companies
- explain the different terminology in amalgamation
- describe the provisions for amalgamation of companies as per Accounting Standard 14
- illustrate accounting treatment on 'Purchase of Business'.

11.2 INTRODUCTION

In the preceding unit (Unit 10) we have discussed the accounting process in case of Purchase of Business. In this unit we will discuss the accounting problems on amalgamation of companies. Dictionary meaning of 'amalgamation' is, 'to join together to form a single organisation' (Oxford English Dictionary). It means blending of two or more existing business enterprises to carry the existing or expanded or new business activities. In

amalgamation, two or more firms join hands to take the advantage of various economic issues

Generally amalgamation is done between two or more companies engaged in the same line of activity. Again the companies may also combine for diversification of activities or for expansion of services such as banking, transport, communication and so on. Such business combination is generally termed as 'Amalgamation'. In this unit we will confine ourselves to discuss meaning and objectives of amalgamation of companies, different terminology used in amalgamation, certain provisions as per Accounting Standard 14, basis for calculation of consideration for amalgamation and accounting entries in the books of transferee company under Purchase Method of Amalgamation.

11.3 MEANING AND OBJECTIVES OF AMALGAMATION OF COMPANIES

Amalgamation of companies means to form one company by merging two or more companies. It may also mean that one company has acquired another company. In India, accounting problems regarding amalgamations are dealt with in accordance with the Accounting Standard (AS) - 14 issued by the Institute of Chartered Accountants of India (ICAI). In India, Amalgamation is used in the same sense as Business Combination is used in the USA. In case of amalgamation, as the transferor company is dissolved, its assets and liabilities find place in the financial statements of the transferee company, prepared subsequent to the date of amalgamation.

There are two types of amalgamation: According to AS-14 amalgamation is divided into the following two categories for accounting purposes:

(A) Amalgamation in the nature of merger; and

(B) Amalgamation in the nature of purchase.

These are discussed in the next section under the subhead Accounting Standard 14.

Objectives of amalgamation of companies

Here you should know the reasons for which companies amalgamate with one another. The following are the main objectives of amalgamation of companies:

(a) **To avoid competition:** The main purpose of amalgamation of companies is to avoid competition among themselves. This will give the company an edge over its competitors.

(b) **To reduce cost:** The amalgamated company can derive the operating cost advantage through lowering the cost of production. This is possible because of 'economies of large scale'.

(c) **To gain financially:** The amalgamated company can derive financial gain which may be in the form of tax advantage, higher credit worthiness and lower rate of borrowing.

(d) **To achieve growth:** The amalgamated company can pool its resources to facilitate internal growth and to prevent the advent of a new competitor.

(e) **To diversify the activities:** The risk of a company can be lowered by diversifying its activities into two or more industries. At times, amalgamation may act as hedging the weak operation with a stronger one.



CHECK YOUR PROGRESS

Q 1: Explain the meaning of Amalgamation of Companies.

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11.4 MEANING OF DIFFERENT TERMS USED IN AMALGAMATION

It will be worthwhile here to explain certain terms used in Amalgamation.

(a) Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies.

(b) Transferor company means the company which is amalgamated into another company.

(c) Transferee company means the company into which a transferor company is amalgamated.

(d) Reserve means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.

11.5 PROVISIONS FOR AMALGAMATION OF COMPANIES AS PER ACCOUNTING STANDARD 14

In order to provide a clear guideline for accounting for amalgamation, the Institute of Chartered Accountants of India has issued Accounting Standard 14 (AS-14) which deals with 'Accounting for Amalgamation.'

AS-14 is effective since the accounting period beginning on or after 1.4.1995 and is mandatory in nature. The statement to these standard states that 'Amalgamation' means 'an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies'. As per AS 14 there are two types of Amalgamation:

- Amalgamation in the nature of Merger; and
- Amalgamation in the Nature of Purchase.

Amalgamation in the nature of Merger

The amalgamations where there is a genuine pooling not merely of

the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies, is called amalgamations in the nature of 'merger'.

An amalgamation which satisfies all of the following conditions is considered as amalgamation in the nature of merger:

(i) All the assets and liabilities of the transferor company become the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90 per cent of the face value of the equity shares of the transferor company (other than the equity shares already held therein immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

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

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

In this type of amalgamation (amalgamation in the nature of merger), there is a genuine pooling of assets and liabilities of the combining entities. In addition, equity shareholders of the combining entities continue to have a proportionate share in the combined entity.

Amalgamation in the Nature of Purchase

An amalgamation is considered to be in the nature of purchase when *any one or more of the five conditions* specified for amalgamations in the nature of merger as stated above is not satisfied. *In this type of*

amalgamation, one company acquires another company and the equity shareholders of the combining entities do not continue to have a proportionate share in the equity of the combined entity or the business of the company which is acquired is not intended to be continued after the amalgamation.

For example, X Ltd. acquires the business of Y Ltd. with no intention to continue such business, it is a case of amalgamation in the nature of purchase and not in the nature of merger. Similarly, if shareholders of Y Ltd. holding 90% or more of the share capital do not become shareholders of X Ltd., the amalgamation is in the nature of purchase. Further, if the assets and liabilities are recorded at revised values in the books of the transferee company, it is an amalgamation in the nature of purchase.



CHECK YOUR PROGRESS

Q 2: What are the various types of amalgamation?

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11.6 BASIS FOR ARRIVING AT PURCHASE CONSIDERATION

Now we shall discuss the different basis for arriving at purchase consideration. In the preceding unit you have learnt the meaning of purchase consideration. The consideration for amalgamation to be paid to the transferor company is ascertained on some basis. The different basis for calculating the consideration for amalgamation is discussed below:

(i) Lump sum method: Where the terms of amalgamation provide for payment of a specified sum of money, the consideration for amalgamation will be taken at that sum. For example, If Bear Ltd is amalgamated with Bull ltd and the total consideration for amalgamation payable by Bull Ltd. is Rs. 8,80,000 to be discharged by issue of 80,000 equity shares of Rs. 10 each, fully paid and the balance in cash. It is

known as lump sum method of purchase consideration.

(ii) Intrinsic value of share method: In unit 10, you have found the meaning of Intrinsic Value. The realisable value of total net assets divided by the number of shares outstanding is the intrinsic value of a share. This value is also known as Asset Back Value of shares.

Where the terms of amalgamation provide for payment of consideration on the basis of intrinsic value of shares of the transferor company, it is known as 'Intrinsic value of share method' of payment of consideration for amalgamation. In such a case, the amount of consideration payable will be ascertained as under:

Number of shares of Transferor Company X Intrinsic Value of shares of Transferor Company.

Example 1

Uma Ltd. is taken over by Shiv Ltd. As per the terms of amalgamation, the consideration for amalgamation is to be discharged on the basis of intrinsic value of shares of Uma Ltd. The share capital of Uma Ltd. consists of 50,000 Equity shares of Rs. 10 each and the intrinsic value of each Equity share of Uma Ltd. is Rs 22.

Calculate the consideration for amalgamation.

Solution:

Since the number of shares of Uma Ltd. (transferor company) is 50,000 and the intrinsic value of its shares is Rs. 22, the consideration for amalgamation to be discharged by Shiv Ltd. on the basis of intrinsic value of shares will be 50,000 x Rs. 22= Rs. 11,00,000.

(iii) Share Exchange Method: Sometimes the transferee company takes over the business of the transferor company on the basis of the ratio in which the shares of the transferee company are to be exchanged for the shares of the transferor company.

Example 2

Milan Ltd. and Maya Ltd. decide to amalgamate. Maya Ltd is having a share capital of Rs. 1,00,000 divided into Equity shares of Rs. 10 each. The scheme of amalgamation states that for every 4 shares held in Maya Ltd .its shareholders are to get:

(i) Rs. 10 in cash ; and

(ii) 5 equity shares of Rs.10 each at par of Milan Ltd.

Calculate the consideration for amalgamation.

Solution:

(a) ***Calculation of No. of Equity shares of Maya Ltd.:***

Share Capital = Rs. 1,00,000

Face value of each equity share = Rs. 10

Therefore, the number of shares = Rs. 1,00,000 ÷ Rs. 10 = 10,000

(b) ***Calculation of consideration for amalgamation:***

		Rs.
Cash (10,000 ÷ 4 x Rs.10)	=	25,000
Shares (10,000 ÷ 4 x 5 x Rs.10)	=	1,25,000
Consideration		**1,50,000**

(iv) Net asset method: Under this method, the amount of consideration for amalgamation is determined on the basis of agreed value of assets and liabilities taken over. The amount payable by the transferee company is determined as follows:

Total agreed value of Assets taken over - Total agreed value of Liabilities taken over = Value of Net Assets taken over being the amount of consideration for amalgamation.

Example 3

Y. Ltd. decides to amalgamate with X Ltd. X Ltd takes the assets of Y Ltd at Rs. 7,00,000, and amount payable to debenture holders of Y Ltd is Rs.3,00,000 and to creditors is Rs. 2,00,000 which are taken over by X Ltd. Ascertain the amount of consideration for amalgamation.

Solution:

Calculation of Consideration for Amalgamation:			**Rs.**
Value of Assets taken over			= 7,00,000
Less : Value of liabilities taken over : Rs.			
Creditors	=	2,00,000	
Debentures	=	3,00,000	5,00,000
Value of Net assets taken over being			= 2,00,000

Hence the amount of consideration for amalgamation is Rs. 2,00,000.



CHECK YOUR PROGRESS

Q 3: What are the different methods of calculation of purchase consideration for amalgamation of companies?

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LET US KNOW

(a) AS-14 states the accounting treatment to be followed by the transferee company only in case of amalgamation.

(b) The accounting treatment which is to be made by the transferee company depends on the nature of amalgamation.

(c) AS-14 has not stated the accounting treatment to be followed by the transferor company. The transferor company will make the accounting treatment for liquidation consequent upon sale. In other words, it will pass entries for liquidation of its business and closure of its books of accounts.

11.7 ACCOUNTING ENTRIES IN THE BOOKS OF TRANSFEREE COMPANY

It should be noted that AS-14 regulates the accounting treatment of amalgamation in the nature of merger and in the nature of purchase in the books of Transferee Company only.

As per AS-14 there are two methods of recording the entries for the assets and liabilities taken over: Pooling of Interest Method and Purchase Method.

Here we will discuss accounting entries in the books of Transferee Company under Purchase Method only.

Features of the Purchase Method :

Before we proceed to discuss the accounting entries in the books of the transferee company it will be worthwhile to list out the features of the purchase method:

(i) The assets and liabilities of the transferor company should be incorporated in either revalued figures or at their carrying amount.

(ii) General reserve, capital reserve or revaluation reserve of the transferor company other than the statutory reserves should not be included in the financial statements of the transferee company.

(iii) Statutory reserve of the transferor company such as Development Allowance Reserve Account, Investment Allowance Reserve Account etc., should be carried forward in the books of the transferee company for legal compliance.

(iv) The Amalgamation Adjustment Account should be disclosed under the head : Miscellaneous Expenditure in the asset side of the balance sheet. When it is found that the statutory reserve is no longer required to be maintained, both the Statutory Reserve and Amalgamation Adjustment Account will be eliminated by means of reverse entry.

(v) Any excess of the amount of purchase consideration over the value of net assets of the transferor company acquired by the transferee company shall be treated as goodwill arising on amalgamation in the books of the transferee company. If the value of net assets is more than the purchase consideration than the difference is credited to Capital Reserve Account.

Accounting entries under purchase method

Accounting entries under purchase method are given below:

(1) *For purchase consideration on acquisition of the business :*

Business Purchase A/c	Dr.	(with the amount of
To Liquidator of Transferor Company A/c		purchase consideration)

(2) *On acquisition of assets and liabilities of the transferor company* :

Assets A/c	Dr.	(with value of assets taken over)
Goodwill A/c	Dr.	(with difference, see note below)
To Liabilities A/c		(with the value of liabilities taken over)

To Business Purchase A/c		(with the amount of purchase consideration)
To Capital Reserve A/c		(with difference, see note below)

Note: In (2) above if the total amount of the debit accounts is greater than the total amount of the credit accounts, the difference is credited to Capital Reserve Account.

Similarly if the total amount of the credit accounts is more than the debit total, the difference is debited to Goodwill Account.

(3) *On discharge of purchase consideration:*

Liquidator of Transferor Company A/c	Dr.	(amount of purchase consideration)
Discount on Issue of Shares/ Debentures A/c	Dr.	(amount of discount)
To Share Capital A/c		(nominal value of shares)
To Securities Premium A/c		(amount of premium, if any)
To Debentures A/c		(nominal value of debentures issued)
To Bank A/c		(amount paid in cash)

There may be either discount on issue of shares/debentures account or securities premium account.

(4) *For maintenance of statutory reserves such as Development Rebate Reserve, Investment Allowance Reserve, Export Profit Reserve:*

Amalgamation Adjustment A/c	Dr.	(amount of reserve)
To Statutory Reserves A/c		

(5) *If liquidation expenses of the transferor company are borne by the transferee company:*

Goodwill A/c	Dr.	(amount of expenditure)
To Bank A/c		

(6) *For the formation expenses of the transferee company, if any :*

Preliminary Expenses A/c	Dr.	(amount of expenditure)
To Bank A/c		

(7) *In case there are both Goodwill and Capital Reserve Account, Goodwill may be set off against capital reserves :*

Capital Reserve A/c	Dr.	(amount of goodwill written off)
To Goodwill A/c		

Note : Capital Reserve Account and Goodwill Account should not appear simultaneously in the balance sheet.

(8) *On payment of liability by the transferee company :*

Respective Liability A/c	Dr.	(amount payable)
To Share Capital A/c		
To Debentures A/c		(As the case may be)
To Bank A/c		

Example 4

S Ltd., which is having 40,000 Equity shares of Rs. 10 each, is taken over by H Ltd.. H Ltd. agrees to make the following payments :

(i) Cash @ Rs. 4.00 per share for every share held in S Ltd.

(ii) Issue 1 shares of Rs. 10 each at par for every 2 shares held in S Ltd.

(iii) Discharge of Rs. 1,00,000, 8% debentures of S Ltd. at 10% premium by issuing 10% Debentures in H Ltd. at par, and

(iv) Rs. 90,000 cash to creditors of S Ltd. in final settlement of their account.

Determine the amount of consideration for amalgamation as per AS-14.

Solution :

Calculation of Consideration for Amalgamation:		**Rs.**
(i) Cash for shareholders (40,000 x Rs.4.00)	=	1,60,000
(ii) Shares for shareholders (40,000 ÷ 2 x Rs.10)	=	2,00,000
Consideration for Amalgamation	=	3,60000

Discharge of 8% Debentures and payment to creditors are not taken into account for determining consideration for amalgamation as these are payments made to the outsiders (discharge of liabilities).

Example 5

M Ltd. is taken over by S Ltd. on the following terms and conditions :

(i) The assets of M Ltd. are valued at Rs.6,00,000.

(ii) The liabilities of M Ltd. are valued at Rs. 2,00,000.

(iii) Rs. 2,00,000 in cash is paid to the shareholders of M Ltd.

(iv) The balance of consideration is discharged by issue of shares of Rs. 10 each at Rs. 20 per share.

Show how the consideration for amalgamation is discharged by S Ltd. and number of shares issued to the shareholders of M ltd

Solution :

Net assets of M Ltd:	Rs.
Assets taken over	= 6,00,000
Less : Liabilities taken over	= 2,00,000
Net Assets taken over being the amount of consideration for amalgamation.	= 4,00,000

Net Assets of Rs. 4,00,000 taken over is the amount of consideration for amalgamation.

Consideration for amalgamation is discharged as follows :

	Rs.
Consideration for amalgamation:	4,00,000
Less: Discharged in Cash	2,00,000

Therefore, amount to be discharged by Issue of Shares 2,00,000

Number of shares to be issued =

Amount to be discharged by the issue of shares ÷ Issue Price of each share

= Rs. 2,00,000 ÷ 20 = 10,000 shares



11.8 LET US SUM UP

In this unit we have discussed the following-

- In amalgamation of companies, two or more companies are merged to carry on the business.
- Accounting Standard 14 issued by ICAI deals with the accounting problems of amalgamation of companies.

- Amalgamation are of two types-
  - amalgamation in the nature of merger; and
  - amalgamation in the nature of purchase.
- Companies are amalgamated for various reasons like, to avoid competition, to achieve growth, to diversify business activities etc.
- Different methods are followed for calculating the purchase consideration like, lump sum method, intrinsic value of share method, share exchange method and net asset method.
- Accounting treatment in the books of Transferee Company.



11.9 FURTHER READING

1) Dam B B and Gautam H. C.(2008). Corporate Accounting : For B.Com Part II (new course) of Gauhati University. Guwahati, Capital Publishing Company

2) S.N. Maheshwari & S.K. Maheshwari (2009). Corporate accounting. Noida, Vikar Publishing House Pvt. Ltd.

3) Sinyal R.S. (2010). Corporate accounting. New Delhi, V.K. (India) Enterprise.

4) Goyal V.K. & Goyal R. (2012). Corporate accounting. New Delhi, PHI Learning Pvt. Ltd.



11.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Amalgamation of companies means to form one company by merging two or more companies. It may also mean that one company has acquired another company. In India, the accounting problems of amalgamation of companies are dealt with according to AS 14 issued by ICAI.

Ans to Q No 2: As per AS 14 there are two types of Amalgamation:

Amalgamation in the nature of Merger; and

Amalgamation in the Nature of Purchase.

Ans to Q No 3:

i. Lump sum method;

ii. Intrinsic value of share method

iii. Share exchange method; and

iv. Net asset method



11.11 MODEL QUESTIONS

Q 1: Explain the meaning of amalgamation as AS 14.

Q 2: describe the feartures of amalgamation in the nature of purchase.

Q 3: What is meant by consideration for amalgamation as per AS-14 ?

Q 4: Distinguish between amalgamation in the nature of merger and amalgamation in the nature of purchase ?

Q 5: X Ltd., which is having 50,000 Equity shares of Rs. 10 each, is taken over by Y Ltd.. Y Ltd. agrees to make the following payments :

(i) Cash @ Rs. 5.00 per share for every share held in X Ltd.

(ii) Issue 1 shares of Rs. 10 each at par for every 2 shares held in X Ltd.

(iii) Discharge of Rs. 2,00,000, 8% debentures of X Ltd. at 10% premium by issuing 10% Debentures in Y Ltd. at par, and

(iv) Rs. 20,000 cash to creditors of X Ltd. in final settlement of their account.

Determine the amount of consideration for amalgamation as per AS-14.

Q 6: Q Ltd. is taken over by R Ltd. on the following terms and conditions :

(i) The assets of Q Ltd. are valued at Rs.3,00,000.

(ii) The liabilities of Q Ltd. are valued at Rs. 1,00,000.

(iii) Rs. 1,00,000 in cash is paid to the shareholders of Q Ltd.

(iv) The balance of consideration is discharged by issue of shares of Rs. 10 each at Rs. 15 per share. Show how the consideration for amalgamation is discharged by R Ltd. and number of shares issued to the shareholders of Q ltd.

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UNIT 12: INTERNAL RECONSTRUCTION OF COMPANIES

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Meaning of External Reconstruction and Internal Reconstruction

12.4 Situations which Call For Internal Reconstruction of a Company

12.5 Forms of Internal Reconstruction

- 12.5.1 Alteration of Share Capital
- 12.5.2 Reduction in Share Capital

12.6 Let Us Sum Up

12.7 Further Reading

12.8 Answers To Check Your Progress

12.9 Model Questions

12.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the meaning of 'Internal Reconstruction',
- explain the meaning of 'External Reconstruction',
- describe the situations which call for Internal Reconstruction of a Company
- list out different forms of Internal Reconstruction of a Company
- discuss the Alteration of Share Capital and Reduction of Share Capital
- illustrate Accounting treatment on Internal Reconstruction of Companies

12.2 INTRODUCTION

In Unit 11, we have discussed 'Amalgamation of Companies' where two companies are merged together or one company is purchased by another to become a single company. In this unit we shall discuss another type of

administrative and financial arrangement by which the capital structure of the company in question may be legally reconstructed. This is generally called Internal Reconstruction of company. The term 'Reconstruction' implies the process followed for reorganisation of a company with respect to its **capital structure** including the reduction of claims of both the shareholders and the creditors of the company. Reconstruction of a company is required when it faces acute financial problems due to over-capitalisation or accumulation of operating losses.



Capital Structure: The composition of a company's capital, which may be composed of equity shares, preference shares, debts etc.

In this unit we will discuss the meaning of Internal Reconstruction and External Reconstruction of Companies, the situation for Internal Reconstruction of Companies, Internal Reconstruction by alteration of share capital and reduction of share capital and accounting treatment on Internal Reconstruction of companies

12.3 MEANING OF EXTERNAL RECONSTRUCTION AND INTERNAL RECONSTRUCTION

A company can be reconstructed in any of the two ways. These are:

(i) 'External' Reconstruction: and

(ii) 'Internal' Reconstruction.

(i) External Reconstruction : The term 'External Reconstruction' means the winding up of an existing company and registering itself into a new one after a rearrangement of its financial position Thus, there are two aspects of External Reconstruction', one, winding up of an existing company and the other, rearrangement of the company's financial position. Such arrangement shall be approved by its shareholders and creditors and shall be sanctioned by the National Company Law Tribunal (NCLT). Such a step usually involves the writing off of a debit balance on Profit and Loss Account, elimination of all fictitious assets if any from the Balance Sheet, and the consequent readjustment of Share Capital.

(ii) Internal Reconstruction: Internal reconstruction means a recourse undertaken to make necessary changes in the capital structure of a company without liquidating the existing company. In internal

reconstruction neither the existing company is liquidated, nor is a new company incorporated. It is a scheme in which efforts are made to bail out the company from losses and put it in profitable position. Internal reconstruction of a company is done through the reorganisation of its share capital. It is a scheme of reorganisation in which all interested parties in the capital structure volunteer to sacrifice. They are the company's shareholders, debenture holders, creditors etc. Under internal reconstruction, the accumulated trading losses and fictitious assets are written off against the sacrifice made by these interest holders in the form of reduction of paid up value of their interest.



CHECK YOUR PROGRESS

Q 1: Mention one distinguishing feature of 'External' Reconstruction and 'Internal' Reconstruction.

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12.4 SITUATIONS WHICH CALL FOR INTERNAL RECONSTRUCTION OF A COMPANY

Now let us discuss the situations which call for internal reconstruction of a Company. The following situations are generally responsible for the internal reconstruction of a company:

(i) When the capital structure of a company is complex and it is required to make it simple.

(ii) When there are huge accumulated losses and it is required to write off these losses to depict a better position of the company.

(iii) When a part of the capital is not represented by available tangible assets.

(iv) When change is required in the face value of shares of the company so that they can become attractive for future investors.



CHECK YOUR PROGRESS

Q 2: Mention three situations which call for internal reconstruction of a Company.

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12.5 FORMS OF INTERNAL RECONSTRUCTION

Internal reconstruction of a company can be carried out in the following different ways. These are as under:

(A) Alteration of Share Capital; and

(B) Reduction in Share Capital

Reduction in capital may be either involving sacrifice of shareholders only or involving sacrifice from Shareholders and other stakeholders, viz., debenture holders and creditors..

Learners should note that the sacrifice is made either by the shareholders only or by the shareholders and other stakeholders jointly. It never happens that sacrifice is made by the creditors and debenture holders only.

12.5.1 Alteration of Share Capital

Memorandum of Association contains capital clause of a company. Under Section 61 of the Companies Act 2013, a company, limited by shares, can alter this capital clause, if is permitted by (i) the Articles of Association of the company; and (ii) if a resolution to this effect is passed by the company in the general meeting.

A company can alter share capital in any of the following ways:

(a) The company may increase its capital by issuing new shares.

(b) It may consolidate the whole or any part of its share capital into shares of larger amount.

(c) It may convert shares into stock or *vice versa*.

(d) It may Sub-divide the whole or any part of it share capital into shares of smaller amount.

(e) It may cancel those shares which have not been taken up and reduce its capital accordingly.

To alter capital by any of the above modes require a resolution at a general meeting, but does not require confirmation by the National Company Law Tribunal. The company is required to give a notice to the Registrar within thirty days of alteration..

The accounting treatment of the above five types of capital alteration is discussed below.

Accounting Entries on Capital Alteration:

(a) If the company has issued all of its authorised capital, then, for the purpose of raising fund by the issue of fresh shares, it will have to increase its authorised capital first. For increasing the authorised capital, the Capital clause of Memorandum of Association of the company is required to be altered and permission of SEBI is also required to be obtained.

No accounting entry is necessary for increasing authorised share capital. The company will have to observe the formalities prescribed under the Companies Act, 2013. After the increase in authorised capital, **if the company issues fresh shares to the public, necessary entries for the issue of shares shall have to be passed.**

The learners are advised to recall and refer Unit 1 for accounting entries on issue of shares.

(b) The company may decide to change the shares of smaller denomination into larger denomination. This process is called consolidation of shares. On account of consolidation, the total amount of capital of the company will not change but the number of shares will decrease.

The following journal entry is required to be passed:

Share Capital A/c (Old Denomination) Dr. To Share Capital A/c (New Denomination) (Being the consolidation of..... Shares of Rs..... each into ..... Shares of Rs..... each as per General Meeting Resolution No..... Dtd.....)



Example 1

On 1.4.2009 Sun Ltd. passed a resolution consolidating 20,000 fully paid equity shares of Rs. 10 each into 4,000 fully paid equity shares of Rs. 50 each.

Show entry for consolidation of shares.

Solution:

In the books of Sun Ltd.

Journal Entries

Date	Particulars	L F.	Dr. Rs.	Cr. Rs.
2009 01-04	Equity Share Capital (Rs. 10) A/c Dr. To Equity Share Capital (Rs. 50) A/c (Being the consolidation of 20,000 equity shares of Rs. 10 each fully paid into Rs. 4,000 equity shares of Rs. 50 each fully paid as per general meeting's resolution No..... dated.....)		2,00,000	2,00,000

(c) A company, in order to alter its share capital, may convert all or any of its fully paid up shares into Stock or Stock into fully paid up shares. In case, shares are converted into Stock, the members get a part of Stock Capital in place of shares. By converting Shares into Stock, any amount of Stock Capital can be transferred to any other person. Following entry will be passed on such conversion:

(1) *Conversion of Shares into Stock:*

Equity Share Capital A/c Dr. To Equity Stock A/c (Being .....Equity Shares of Rs.....each fully paid up converted into ..... Equity Stock of Rs.....)



Example 2

Sun Ltd. has share capital of Rs. 50,000 divided into 5,000 equity shares of Rs. 10 each. On 1.4.2009 the company passed a resolution converting the shares into stock.

Show necessary journal entry in the books of the company.

Solution :

In the books of Sun Ltd.

Journal Entries

Date	Particulars	L F	Dr. Rs.	Cr. Rs.
2009-01-04	Equity Share Capital (Rs. 10) A/c Dr. To Equity Stock A/c (Being the conversion of 5,000 fully paid Equity shares of Rs. 10 each into Rs. 50,000 equity stock as per general Meeting's resolution No....dated.....Ist April, 2009.)		50,000	50,000

(2) *Conversion of Stock into fully paid Equity Shares :*

Equity Stock A/c ..... Dr.

To Equity Share Capital A/c

(Being ..... Equity Stock of Rs.....converted into.....Equity Shares of Rs.....each fully paid up as per general meeting's resolution No..... dated.....)



Example 3

Moon Ltd. passed a resolution in the general meeting held on 25th April, 2009 to convert its equity stock of Rs. 5,00,000 into 50,000 equity shares of Rs. 10 each fully paid up.

Pass necessary journal entry.

Solution:

In the books of Moon Ltd.

Journal Entries

Date	Particulars	L F	Dr. Rs.	Cr. Rs.
2009-25-04	Equity Stock Account Dr. To Equity Share Capital Account (Being Equity stock of Rs. 5,00,000 converted into 50,000 equity shares of Rs. 10 each fully paid up as per general meeting's resolution No..... dated 25th April, 2009.)		5,00,000	5,00,000

(d) When the shares of a company are sub-divided in shares of small value, it is known as sub-division of shares. In sub-division of shares, the face value of a share is converted into smaller denomination from larger denomination. The total capital of the company remains unaffected by sub-division but the total number of shares increase.

The following entry is passed for effecting sub-division :

Share Capital (Old Denomination) A/c Dr.
To Share Capital (New Denomination) A/c
(Being the sub-division of..... Shares of Rs.....each into..... Shares of Rs.....each. as per General Meeting Resolution No..... Dated.....)



LET US KNOW

If the company sub-divides its partly paid up shares then after sub-division the ratio between paid-up value and face value should not change.



Example 4

Polar Ltd. decided on 01-04-2009 to sub-divide its 5,000 Equity Shares of Rs. 100 each fully paid up into Equity Shares of Rs. 10 each fully paid up.

Pass the necessary journal entry.

Solution :

In the books of Polar Ltd.

Journal Entries

Date	Particulars	L F	Dr. Rs.	Cr. Rs.
2009-01-04	Equity Share Capital A/c (Rs. 100) Dr. To Equity Share Capital A/c (Rs. 10) (Being the Sub-division of 5000 Equity Shares of Rs. 100 each into 50,000 Equity Shares of Rs. 10 each as per general meeting's resolution No.... dated.....)		5,00,000	5,00,000

(e) Cancellation of capital may take the following form:

(i) *Cancellation of unissued capital;* and

(ii) *Cancellation of uncalled capital* .

(i) Cancellation of unissued capital: Cancellation of unissued capital means cancellation of unissued shares by a company. It means that the part of the authorised capital which has not yet been issued to the public may be cancelled by the company. This cancellation does not have any impact on the accounts of the company and hence no entry is required to be passed for such cancellation. Only the capital clause in the memorandum of association of the company is required to be altered and the altered (reduced) authorised capital is shown in the balance sheet of the company prepared subsequent to the alteration. The alteration is required to be registered with the Registrar of companies.

(ii) Cancellation of uncalled capital : Cancellation of uncalled capital

means cancellation of that part of the face value of the share which has not yet been called by the company.

12.5.2 Reduction of Share Capital

Sometimes there may be a genuine necessity for the reduction of capital. This power is, given by Section 100 of the Companies Act, subject to the compliance of conditions. According to this, a company may,

(1) extinguish or reduce the liability on any of its shares in respect of share capital not paid up

(2) cancel any paid-up share capital which is lost or is unrepresented by any available assets;

(3) pay off any paid-up share capital which is in excess of what is required by the company.

Conditions for effecting a reduction

Following conditions are required to be fulfilled by a company to reduce its share capital -

(a) The Articles of Association of the company must permit it to reduce its capital;

(b) The company in general meeting shall pass a special resolution to reduce its capital; and

(c) The approval of National Company Law Tribunal (previously Court) shall be obtained for the scheme of reduction in share capital.

Methods of Reduction in Share Capital:

There are three ways to give effect to the scheme of Reduction in Share Capital. These are as follows:

(1) By extinguishing or reducing the liability on any of its shares.

(2) By paying off any paid-up share capital which is in excess of what is required by the company.

(3) By cancelling any paid- up capital which is lost or is unrepresented by any available assets.



CHECK YOUR PROGRESS

Q 3: Mention the options available to a company for the reduction of capital.

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Accounting Entries on Reduction in Share Capital in the books of company

Accounting of reduction in Share Capital by company in case of the above three methods is shown below:

(1) Journal entry for reduction of liability in respect of the uncalled amount on Shares:

Share Capital A/c (Old Denomination) Dr.

To Share Capital A/c (New Denomination)

(Being the uncalled amount of Rs..... per share cancelled.)



Example 5

Glow Sign Ltd. has an issued capital of 4,000 equity shares of Rs. 100 each, Rs. 80 called and paid up. Necessary formalities being complied with, the company decided on 1.4.2009 to reduce the share of Rs. 100 to the share of Rs. 80 as fully paid up by cancelling unpaid amount of Rs.20 per share.

Pass necessary journal entry and show the share capital as it will appear in the balance sheet of the company after cancellation.

Solution:

In the Books of Glow Sign Ltd.

Journal Entries

Date	Particulars	L F	Dr. Rs. Rs.	Cr. Rs.
2009-01-04	Equity Share Capital A/c (Rs. 100) Dr. To Equity Share Capital A/c (Rs. 80) (Being the cancellation of uncalled amount of Rs. 20 per share on 4,000 Equity Shares as per general meeting's resolution No..... dated.....)		3,20,000	3,20,000

Glow Sign Ltd.

Balance Sheet as at.....

(Liability side only)

	Rs.
Authorised Capital	.....
Issued and Subscribed Capital	.....
4,000 Equity Shares of Rs. 80 each fully paid	3,20,000

(2) Journal entry for reduction by refund of excess capital to shareholders:

There may be two situations:

(i) When denomination of Shares is changed i.e. Reduction by way of refund with change in the face value, and

(ii) When denomination of Shares is not changed i.e. Reduction by way of refund without change in the face value.

(i) *When denomination of Shares is changed i.e. Reduction by way of refund with change in the face value*

(a) To record the change:

Share Capital A/c (Old Denomination) Dr. (Old Paid up capital)

To Share Capital A/c (New Denomination) (New Paid up capital)

To Sundry Shareholders A/c (With the amount of excess capital)

(Being the conversion of shares of Rs..... per share

on.....shares to shares of Rs. .....each and transfer of the reduced amount to the Shareholders account)

(b) To record Payment to Shareholders

Sundry Shareholders Account	Dr.
To Bank Account	
(Being the repayment of excess capital made to Shareholders.)	

(c) To transfer to General Reserve :

Profit and Loss Account	Dr.
To General Reserve Account	
(Being the transfer of the amount equal to the amount of refund made from Profit and Loss Account to General Reserve Account)	

(ii) *When denomination of Shares is not changed i.e. Reduction by way of refund without change in the face value:*

(a) To record the transfer of the returnable amount:

Share Capital Account	Dr.	Returnable Amount)
To Sundry Shareholders Account		(Returnable Amount)
(Being the transfer of the returnable amount to the Shareholders account @ Rs.....per share on.....shares.)		

(b) To record Payment to Shareholders

Sundry Shareholders Account	Dr.
To Bank Account	
(Being the repayment of excess capital made to Shareholders.)	

(c) To transfer to General Reserve:

Profit and Loss Account	Dr.
To General Reserve Account	
(Being the transfer of the amount equal to the amount of refund made from Profit and Loss Account to General Reserve Account)	



Example 6

Sontoshi Ltd. has a capital of Rs. 2,00,000 divided into 20,000 equity shares of Rs. 10 each fully paid up. The

company decided on 1.4.2009 to convert the shares into Rs. 8 per share paid up and return Rs. 2 per share to equity shareholders.

Pass necessary journal entries in the books of the company assuming all legal formalities have been observed.

Solution :

In the Books of Santoshi Ltd.

Journal Entries

Date	Particulars	L F	Dr. Rs.	Cr. Rs.
2009-01-04	Equity Share Capital A/c (Rs. 10) Dr.		2,00,000	
	To Equity Share Capital A/c (Rs. 8)			1,60,000
	To Equity Shareholders A/c (Rs. 2)			40,000
	(Being the conversion of Rs. 10 equity shares into Rs. 8 fully paid equity shares and refunded Rs. 2 per equity share on 20,000 equity shares as per shareholders resolution No..... dated..... and sanctioned by the National Company Law Tribunal)			

Date	Particulars	L F	Dr. Rs.	Cr. Rs.
2009 01-04	Equity Shareholders A/c Dr.		40,000	
	To Bank A/c			40,000
	(Being the repayment of excess capital @ Rs. 2 per share on 20,000 equity shares made to equity shareholders.)			



Example 7

Honda Ltd has a capital of Rs. 2,00,000 divided into 20,000 equity shares of Rs. 10 each fully paid up. The company decided on 1.4.2009 to return Rs. 2 per share to equity shareholders and make the shares Rs. 8 called and paid up.

Pass necessary journal entries in the books of the company assuming all legal formalities have been observed.

Solution :

In the given problem, shares of Rs. 10 are not converted into shares of Rs. 8. Rs. 10 fully paid up shares are made Rs. 8 called up and paid up, the shares remain at the nominal value of Rs. 10 each.

In the Books of Honda Ltd.

Journal Entries

Date	Particulars	L F	Dr. Rs.	Cr. Rs.
2009-01-04	Equity Share Capital A/c Dr. To Equity Shareholders A/c (Being the amount refundable @ Rs. 2 per equity share on 20,000 equity shares as per shareholders resolution No..... dated..... and sanctioned by the National Company Law Tribunal)		40,000	40,000

Date	Particulars	L F	Dr. Rs.	Cr. Rs.
2009-01-04	Equity Shareholders A/c Dr. To Bank A/c (Being the refund of excess capital made to Shareholders @ Rs. 2 per share on 20,000 equity shares made to equity shareholders.)		40,000	40,000

(3) Journal entries for Cancellation of any paid up capital which is lost or is unrepresented by any available assets i.e. Reduction in Capital:

In case of heavy losses incurred over the years, the capital base and the financial strength of company may become weak. In such cases it becomes necessary for such a company to undertake some financial reconstruction measures. Such financial reconstruction measures are given effect through schemes of capital reduction. Generally, shareholders have to bear the loss. If the loss is heavy, then creditors and debentures holders are also required to bear a portion of such financial loss.

This is the third way through which internal reconstruction of a company can be carried out, the accounting entries of which are shown below. For this a 'Capital Reduction Account', which is also called ''Reconstruction'' account or ''Re-organisation'' account, is opened. In examination problems where there are no specific directions, you may use

any of the terms viz. 'Capital Reduction Account' or 'Reorganisation Account' or 'Reconstruction Account'.

Journal Entries for giving effect to the Capital Reduction Scheme:

(i) When denomination of Shares is not reduced; only paid up value is reduced -

Share Capital Account	Dr.	*(with the amount of Reduction)*
To Capital Reduction Account		

(ii) When denomination of Shares is reduced -

Share Capital Account (Old Denomination)	Dr.	*(Old Capital)*
To Share Capital Account (New Denomination)		*(New capital)*
To Capital Reduction Account		*(with the amount of Reduction)*

(iii) If Balance of any reserve (if any) transferred to Capital Reduction a/c:

Capital Reserve Account	Dr.
General Reserve Account	Dr.
(Any other) Reserve Account	Dr.
To Capital Reduction Account	

(iv) For Sacrifice made by Debentureholders, if any;

Debentures Account	Dr.
To Capital Reduction Account	

(v) For Sacrifice made by Creditors, if any:

Creditors Account	Dr.
To Capital Reduction Account	

(vi) For recording any Increase in the value of Assets (on Revaluation):

(Particular) Asset Account	Dr.	*(Amount of Increase)*
To Capital Reduction Account		

(vii) For recording decrease in the value of liability:

(Particular) Liability Account	Dr.	*(Amount of Decrease)*
To Capital Reduction Account		

(viii) For making any Provision for Contingent Liability:

Capital Reduction Account	Dr.
To Provision for Contingencies Account	

(ix) Capital Reduction Account is used for writing off various accumulated losses, fictitious assets and loss on assets and liabilities and the journal

entry is-

Capital Reduction Account		Dr.
	To Profit and Loss Account	
	To Preliminary Expenses Account	
	To Discount on Issue of Shares/Debentures Account	
	To Goodwill Account	
	To Patents Account	
	To Trade Mark Account	
	To Provision for Doubtful Debt (if created)	
	To (Respective) Asset Account	
To Capital Reserve Account		



LET US KNOW

The amount to be written off cannot exceed the amount credited to Capital Reduction Account. But if there is any reserve in the liabilities side of the balance sheet, the same may be utilised in writing off accumulated losses and fictitious assets. **After writing off various assets, if any balance is left in the Capital Reduction Account, the same will be transferred to Capital Reserve Account.**

- The words **"And Reduced"** should be added to the name of the company, if the National Company Law Tribunal (NCLT) so directs.
- The amount written off in respect of fixed assets under a scheme of reconstruction must be shown in the Balance sheet for five years after the date of reduction.
- After completion of the accounting process the Capital Reduction Account should not show any balance.

Example 8

Balance Sheet of Barpeta Ltd. as on 31st March, 2009

Liabilities	Rs.	Assets	Rs.
80,000 Equity Shares of Rs. 10 each	8,00,000	Goodwill	2,00,000
5000 8% Pref Shares of Rs. 100 each	5,00,000	Other Fixed Assets	9,00,000
4,000,9% Debentures of Rs.100 each	4,00,000	Current Assets	7,00,000
Sundry Creditors	3,00,000	P/L Account	2,00,000
	20,00,000		**20,00,000**

Following scheme of reconstruction has been passed and approved by the court on 1.4.2009:

(i) The equity shares are to be reduced to shares of Rs. 6 each fully paid 8% Preference shares are to be reduced to 10% Preference shares of Rs. 80 each fully paid. Number of shares to remain the same.

(ii) 9% debentures are to be reduced to 10% debentures of Rs. 80 each fully paid.

(iii) The amount so available will used to write off Loss and goodwill first, and there after fixed assets to the extent possible.

You are required to give journal entries and Balance Sheet in the books of Barpeta Ltd.

Solution:

Amount of sacrifice and utilisation

Sacrifice

1. Equity Shares: 80,000 x Rs. 4.00 = 3,20,000
2. Preference Shares: 5,000 x Rs. 20.00 = 1,00,000
3. Debentures 4,000 x Rs. 20.00 = 80,000

5,00,000

Utilization

1. Writing off of Loss	2,00,000	
2. Writing off of Goodwill		2,00,000
3. Writing off of Fixed Assets	1,00,000	
		5,00,000

Journal Entries:

Date	particulars	LF	Dr. Rs.	Cr. Rs.
1.4.09	Equity Share Capital A/c (Rs.10) Dr. To Share Capital A/c(Rs.6) To Capital Reduction Account (Being 80,000 equity shares of Rs. 10 each fully paid reduced to equity shares of Rs. 6 each fully paid and the balance transferred to Capital reduction account as per special resolution No…. dated …. And confirmed by the NCLT vide order No. ….)		8,00,000	 4,80,000 3,20,000

Date	particulars	LF	Dr. Rs.	Cr. Rs.
1.4.09	8% Pref Share Capital A/c (Rs.100) Dr. To 10% Pref Share Capital A/c (Rs.80) To Capital Reduction A/c (Being 5, 000 8% Preference shares of Rs. 100 each fully paid reduced to 10 % Preference shares of Rs. 80 each fully paid and the balance transferred to Capital Reduction Account as per special resolution No…. dated …. and confirmed by the NCLT vide order No. ….)		5,00,000	 4,00,000 1,00,000

Date	particulars	LF	Dr. Rs.	Cr. Rs.
1.4.09	9% Debenture A/c (Rs.100) Dr. To 10% Debenture A/c (Rs.80) To Capital Reduction A/c (Being 4,000 9% Debenture of Rs. 100 each fully paid reduced to 10% Debenture of Rs. 80 each fully paid and the balance transferred to Capital reduction account as per special resolution No…. dated …. And confirmed by the NCLT vide order No. ….)		4,00,,000	 3,20,000 80,000

Date	Particulars	L F	Dr. Rs.	Cr. Rs.
1.4.2009	Capital Reduction A/c Dr. To Profit & loss A/c To Goodwill A/c To Fixed Assets a/c (Being the amount of Capital reduction a/c used for writing off loss, Goodwill and fixed assts as per the scheme of reconstruction dated……)		5,00,,000	 2,00,000 2,00,000 1,00,000

Balance Sheet of Barpeta Ltd. as on 1st April, 2009 (and Reduced)

Liabilities	Rs.	Assets	Rs.
80,000 Equity Shares of Rs. 6 each	4,80,000	Fixed Assets	8,00,000
5000 8% Pref Shares of Rs. 80 each	4,00,000	Current Assets	7,00,000
4,000,9% Debentures of Rs.80 each	3,20,000		
Sundry Creditors	3,00,000		
	15,00,000		**15,00,000**



12.6 LET US SUM UP

In this unit we have discussed the following-

- A company may be reconstructed in the event of acute financial problems.
- A company may be reconstructed in two ways-
  - External reconstruction, where a company is wound up and a new company is formed;
  - Internal reconstruction, where some changes are made in the capital structure of the company without liquidating the company.
- Internal reconstruction of a company becomes necessary in various situations like, to change the face value of the shares of the company, to write off accumulated losses etc.
- Internal reconstruction of a company can be carried out in two ways-
  - Alteration of share capital; and

- Reduction in share capital.

- Accounting entries on alteration of share capital and reduction in share capital.



12.7 FURTHER READING

1) Dam B B and Gautam H. C.(2008). Corporate Accounting : For B.Com Part II (new course) of Gauhati University. Guwahati, Capital Publishing Company

2) S.N. Maheshwari & S.K. Maheshwari (2009). Corporate accounting. Noida, Vikar Publishing House Pvt. Ltd.

3) Sinyal R.S. (2010). Corporate accounting. New Delhi, V.K. (India) Enterprise.

4) Goyal V.K. & Goyal R. (2012). Corporate accounting. New Delhi, PHI Learning Pvt. Ltd.



12.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The term 'External Reconstruction' means the winding up of an existing company and registering itself into a new one after a rearrangement of its financial position. On the other hand, "Internal Reconstruction" means a recourse undertaken to make necessary changes in the capital structure of a company without liquidating the existing company.

Ans to Q No 2: The following are the three situations generally responsible for the internal reconstruction of a company:

(i) When the capital structure of a company is complex and it is required to make it simple.

(ii) When there are huge accumulated losses and it is required to write off these losses to depict a better position of the company.

(iii) When a part of the capital is not represented by available tangible assets.

Ans to Q No 3: The options available to a company for the reduction of capital are: A company may

(1) extinguish or reduce the liability on any of its shares in respect of share capital not paid- up;

(2) cancel any paid-up share capital which is lost or is unrepresented by any available assets;

(3) pay off any paid-up share capital which is in excess of what is required by the company.



12.9 MODEL QUESTIONS

Q 1: What is 'internal reconstruction' in the context of a company?

Q 2: Is it necessary to change the capital structure of a company taking recourse to Internal Reconstruction ? Justify your answer.

Q 3: Mention the different forms of internal reconstruction.

Q 4: Do you think that Reduction of Share Capital is necessary in internal reconstruction of a company? Give reasons.

Q 5: What are the situations that call for internal reconstruction of a company?

Q 6: What is meant by 'Consolidation of Shares' and 'Sub-division of shares' in the context of internal reconstruction of a company?

Q 7: Mention any three method of Reduction in Share Capital.

Q 8: On 16.5.2009 Gauhati Ltd. passed a resolution consolidating 60,000 fully paid equity shares of Rs. 10 each into 6,000 fully paid equity shares of Rs. 100 each.

Show entry for consolidation of shares.

Q 9: B. H. Industries Ltd. has share capital of Rs.10,00,000 divided into 10,000 equity shares of Rs. 100 each. On 30.4.2009 the company passed a resolution converting the shares into stock.

Show necessary journal entry in the books of the company.

Q 10: Fairtrade Ltd. passed a resolution in the general meeting held on 30th April, 2009 to convert its 1, 00,000 equity shares of Rs. 10 each

fully paid up into equity stock of Rs. 10,00,000.

Pass necessary journal entry and show how the items would appear in the Balance Sheet as on 30th April, 2009.

Q 11: Greenland Ltd. passed a resolution in the general meeting held on 30th April, 2009 to convert its equity stock of Rs. 10,00,000 into 1,00,000 equity shares of Rs. 10 each fully paid up.

Pass necessary journal entry and show the items in the Balance Sheet as on 30th April, 2009.

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UNIT 13: ACCOUNTS OF HOLDING COMPANIES

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Meaning of 'Holding Companies', and 'Subsidiary Companies'

13.4 Types of Holding Companies and Subsidiary Companies

13.5 Meaning of Consolidated Financial Statements

13.6 Advantages of Consolidated Financial Statements

13.7 Legal Requirements on Consolidation

13.8 Meaning of Minority Interest

13.9 Calculation of Minority Interest

13.10 Let Us Sum Up

13.11 Further Reading

13.12 Answers To Check Your Progress

13.13 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- explain the meaning of 'Holding Companies'
- explain the meaning of 'Subsidiary Companies'
- list out the types of Holding Companies
- focus the advantages and disadvantages of Holding Companies
- explain the meaning of Minority Interest
- calculate of Minority Interest
- elaborate the meaning and need of Consolidated Financial Statements
- describe the legal requirements on Consolidation.

13.2 INTRODUCTION

Now-a-day, no company is self-dependent for supply of raw materials, components etc. A business house is dependent on other business houses.

With the expansion of the size, in order to assure uninterrupted supply of inputs, the management of the company tries to acquire more and more control on such firms supplying raw materials and components and also on agencies engaged in marketing the output.

In Unit 11 we have discussed about 'amalgamation of companies' where two or more companies amalgamate and become one company. A few important objectives of amalgamation are: **to reduce cost, to gain financially, to achieve growth and to diversify the activities.** These objectives can also be achieved without resorting to amalgamation or by promoting new company. For the purpose of expansion of business operations, it is essential to have some sort of strong control on uninterrupted supply of raw materials; components etc which is possible by acquiring controlling interest over such business houses. The company acquiring the controlling interest in another company is called the Holding Company and the company in which the controlling interest is acquired is called Subsidiary Company.

In this unit we will cover the meaning of Holding Companies and Subsidiary companies, types of Holding Companies, advantages and disadvantages of Holding Companies, meaning and calculation of Minority Interest, meaning and need of Consolidated Financial Statements and legal requirements on consolidation

13.3 MEANING OF 'HOLDING COMPANY' AND 'SUBSIDIARY COMPANY'

The term 'holding company' has been defined under the Companies Act, 2013. Section 2(46) of the Companies Act states that, “holding company” in relation to one or more other companies, means a company of which such companies are subsidiary companies. It may be defined as one, which has one or more subsidiary companies and enjoys control over them. Legally a holding company and its subsidiaires are distinct and seprate entities.

According to Section 2(87) of the Companies Act, 2013, a company is a subsidiary of another if and only if -

(a) that other company controls the composition of its Board of Directors; or

(b) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies.

(c) the company is a subsidiary of any company which is that other company's subsidiary".

It may be explained in this way: *A holding company is a company which controls another company known as subsidiary company by owning its all or majority of the shares carrying voting rights or controlling the composition of its board of directors.*

For example Company Y is a subsidiary of Company X and Company Z is a subsidiary of Company Y. Company Z is a subsidiary of Company X. If Company AB is a subsidiary of Company Z, Company AB will also be subsidiary of Company Y and consequently also of Company X.

As per Indian Accounting Standard 21 (AS 21) on Consolidated Financial Statements **a subsidiary company** is an enterprise that is controlled by another enterprise known as the **parent company** and a parent company is an enterprise that has one or more subsidiaries.

The company acquiring the controlling interest in another company is called the Holding Company and the company in which the controlling interest is acquired is called Subsidiary Company.



CHECK YOUR PROGRESS

Q 1: Define Holding Company and Subsidiary Company.

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13.4 TYPES OF HOLDING COMPANIES AND SUBSIDIARY COMPANIES

A holding company may acquire more than fifty percent of the equity shares of subsidiary company or may acquire all the shares of subsidiary

company. From this point of view there may be two types of Holding Company. These are:

(i) Holding company which acquires all the equity shares of subsidiary company; or,

(ii) Holding company which acquires majority of the equity shares of the subsidiary company.

Types of Subsidiary companies :

From the above, it is clear that there are two types of subsidiary companies :

(i) Wholly owned subsidiary company; and

(ii) Partly owned subsidiary company.

(i) Wholly owned subsidiary company

Where all the shares of the subsidiary company are held i.e. owned by the holding company, such subsidiary company is termed as wholly owned subsidiary company. In such a case, all the shares of the subsidiary company are purchased by the holding company.

(II) Partly owned subsidiary company

Where majority of the shares of the subsidiary are held i.e. owned by the holding company, such a subsidiary is known as partly owned subsidiary company. In such a case, some of the shares of the subsidiary are owned by persons (shareholders) other than the holding company. The interest of such shareholders other than the interest of the holding company is termed as "Minority Interest".

Above distinctions are required to be kept in mind because the principle of consolidation of final accounts will vary depending on whether the subsidiary is a fully owned subsidiary or a partly owned subsidiary.



CHECK YOUR PROGRESS

Q 2: Define 'Wholly owned subsidiary company'; and' Partly owned subsidiary company'.

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13.5 MEANING OF CONSOLIDATED FINANCIAL STATEMENTS

Financial statements in the context of holding company means Balance sheets and Profit and Loss Accounts of both the holding company and its subsidiary. Therefore, consolidation of financial statements means consolidation of Balance Sheets and Profit and Loss Accounts of both holding company and its subsidiary.

Consolidation of Balance Sheet implies preparation of a single Balance Sheet by aggregating all items of assets and liabilities, appearing in the respective Balance Sheets of both the holding company and its subsidiary company.

Consolidation of Profit and Loss Accounts imply preparation of a single Profit and Loss Account by aggregating all items of incomes and expenses, etc., appearing in the respective Profit and Loss Accounts of both the holding company and its subsidiary company.

These consolidated financial statements are intended to present financial information about a holding company and its subsidiary(ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results of the group achieved with its resources. The various outside parties concerned with the holding company and its subsidiaries may also be interested in the consolidated final accounts.

13.6 ADVANTAGES OF CONSOLIDATED FINANCIAL STATEMENTS

Users of the financial statements of a parent company (holding company) are usually concerned with the financial position and results of operations of not only the enterprise itself but also of the group as a whole. For this purpose, consolidated financial statements are prepared and presented by a parent (holding company). The following are the advantages of Consolidated Financial Statements (CFS):

(i) CFS provides financial information about a parent and its subsidiary(ies) as a single economic entity;

(ii) CFS shows the economic resources controlled by the group;

(iii) CFS shows the obligations of the group; and

(iv) CFS shows the results the group achieved with its resources.

(v) CFS meets the information need of the investors for taking investment decisions.

13.7 LEGAL REQUIREMENTS ON CONSOLIDATION

A holding company must attach the following documents with its balance sheet in respect of each of its subsidiary (ies):

(i) a copy of the balance sheet of the subsidiary;

(ii) a copy of its profit and loss account;

(iii) a copy of the report of its Board of Directors;

(iv) a copy of the report of its auditors;

(v) a statement showing:

(a) the extent of the holding company's interest in the subsidiary at the end of the financial year of the subsidiary company;

(b) the profits (after deduction of losses of the subsidiary) so far as they concern the holding company separately for the current financial year and for previous financial years and separately for profits already dealt with in the books of the holding company and not so dealt with.

The term "profits" refers to profits of a revenue nature and earned by the subsidiary company after the date of acquisition of shares by the holding company.

(vi) where the financial year of the subsidiary company does not coincide with the financial year of the holding company, a statement showing the following:

(a) whether and to what extent there has been a change in the holding company's interest in the subsidiary company since the close of the financial year of the subsidiary company.

(b) details of any material changes which have occurred between the end of the financial year of the subsidiary company and at the end of the financial year of the holding company in respect of

the subsidiaries fixed assets, its investment, the money lent by it and the money borrowed by it for any purpose other than that of meeting current liabilities.

13.8 MEANING OF MINORITY INTEREST

Minority interest is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary (ies), by the parent. Minority interest consists of:

(a) the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and

(b) the minority's share of movements in equity since the date the parent -subsidiary relationship came into existence.

In other words, Minority Interest means interest held by other shareholders (other than Holding company) in the net assets of the subsidiary. Their interest consists of the following:

(a) Paid up share capital held by them;

(b) Proportionate share of capital profits or losses; and

(c) Proportionate share of revenue profits

Both (a) and (b) together is the amount of equity attributable to minorities at the date on which investment in a subsidiary is made by the holding company.

Presentation of Minority Interest in the Consolidated Balance Sheet

The Accounting Standard states that the Minority Interest should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent company's shareholders.

Since the Standard (AS 21) has not stated as to under which head it is to be shown, Minority Interest is shown on the liabilities side of the consolidated Balance Sheet below the paid up share capital because the minority interest represents the interest of the minority in the equity of the subsidiary and they are also the shareholders of the subsidiary.

13.9 CALCULATION OF MINORITY INTEREST

The claim of the minority shareholders in the subsidiary is termed as 'Minority Interest'. The claim of the minority shareholders of the subsidiary company has to be ascertained to prepare consolidated balance sheet. Minority Interest is shown as a liability in the Consolidated Balance Sheet.

Minority Interest consists only of the paid up value of the shares held by them. But it may so happen that the subsidiary company may have some accumulated profits and reserves or accumulated losses. Again, there may be some profits earned by the subsidiary company subsequent to the date of acquisition of shares by the holding company. Besides, there may be some profits or losses on account of revaluation of its assets on the date of acquisition of shares by the holding company. While calculating the amount of minority interest, all these items have to be taken into account and the proportionate amount of all such profits and reserves should be added to the amount of paid up share capital held by the minority shareholders, while proportionate amount of all such losses should be deducted from the amount so ascertained in order to arrive at the net amount of minority interest.

Minority Interest

=

Paid-up value of shares held by minority shareholders

+

Proportionate amount of the company's profits and reserves

+

Proportionate amount of profits on revaluation of assets of the company

–

Proportionate amount of company's losses

–

Proportionate amount of loss on revaluation of assets of the company, if any.



13.10 LET US SUM UP

In this unit we have discussed the following aspects-

- A holding company is a company which controls another company by owning its all or majority of the shares carrying voting rights or controlling the composition of its board of directors.
- The company in which the controlling interest is acquired is called Subsidiary Company.
- Where all the shares of the subsidiary company are held by the holding company, such subsidiary company is called a wholly owned subsidiary company.
- Where majority of the shares of the subsidiary are held by the holding company, such a subsidiary is called a partly owned subsidiary company.
- Consolidation of financial statements means consolidation of Balance Sheets and Profit and Loss Accounts of both holding company and its subsidiary.
- Minority interest is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiaries by the parent company.



13.11 FURTHER READING

1) Dam B B and Gautam H. C.(2008). Corporate Accounting : For B.Com Part II (new course) of Gauhati University. Guwahati, Capital Publishing Company

2) S.N. Maheshwari & S.K. Maheshwari (2009). Corporate accounting. Noida, Vikar Publishing House Pvt. Ltd.

3) Sinyal R.S. (2010). Corporate accounting. New Delhi, V.K. (India) Enterprise.

4) Goyal V.K. & Goyal R. (2012). Corporate accounting. New Delhi, PHI Learning Pvt. Ltd.

13.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The company acquiring the controlling interest in another company is called the Holding Company and the company in which the controlling interest is acquired is called Subsidiary Company.

Ans to Q No 2: Where all the shares of the subsidiary company is held i.e. owned by the holding company, such subsidiary company is termed as wholly owned subsidiary company.

Where majority of the shares of the subsidiary are held i.e. owned by the holding company, such a subsidiary is known as partly owned subsidiary company.

13.13 MODEL QUESTIONS

Q 1: Give three situations under which an enterprise can become a holding company.

Q 2: Explain the different types of Holding Companies.

Q 3: What is Minority Interest ?

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UNIT 14: LIQUIDATION

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Meaning of Liquidation

14.4 Modes of Winding Up of a Company

14.4.1 Compulsory Winding Up

14.4.2 Voluntary Winding Up

14.5 Meaning of Contributories

14.6 Meaning of Liquidator

14.7 Preferential Payments

14.8 Let Us Sum Up

14.9 Further Reading

14.10 Answers To Check Your Progress

14.11 Model Questions

14.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- define the meaning of liquidation,
- explain the various modes of liquidation of a company,
- explain the meaning of voluntary and compulsory liquidation
- define the meaning of contributories,
- explain the meaning of liquidator,
- list out the preferential payments.

14.2 INTRODUCTION

Business organisations are formed by people. Sole trading business organisations are formed by a single person, while other forms of business organisations are formed by group of people. Sole trading and partnership business organisations are comparatively easier to start than the company form of organisations. Companies are creation of law, viz., Companies Act,

2013. Statutory provisions are there to form a company. In the same way, for liquidation or winding up of a company, there are certain provisions in the Act. In this unit we will discuss the meaning of Liquidation, modes of winding up of a company, appointment of Liquidator, meaning of Contributories and Preferential Payments.

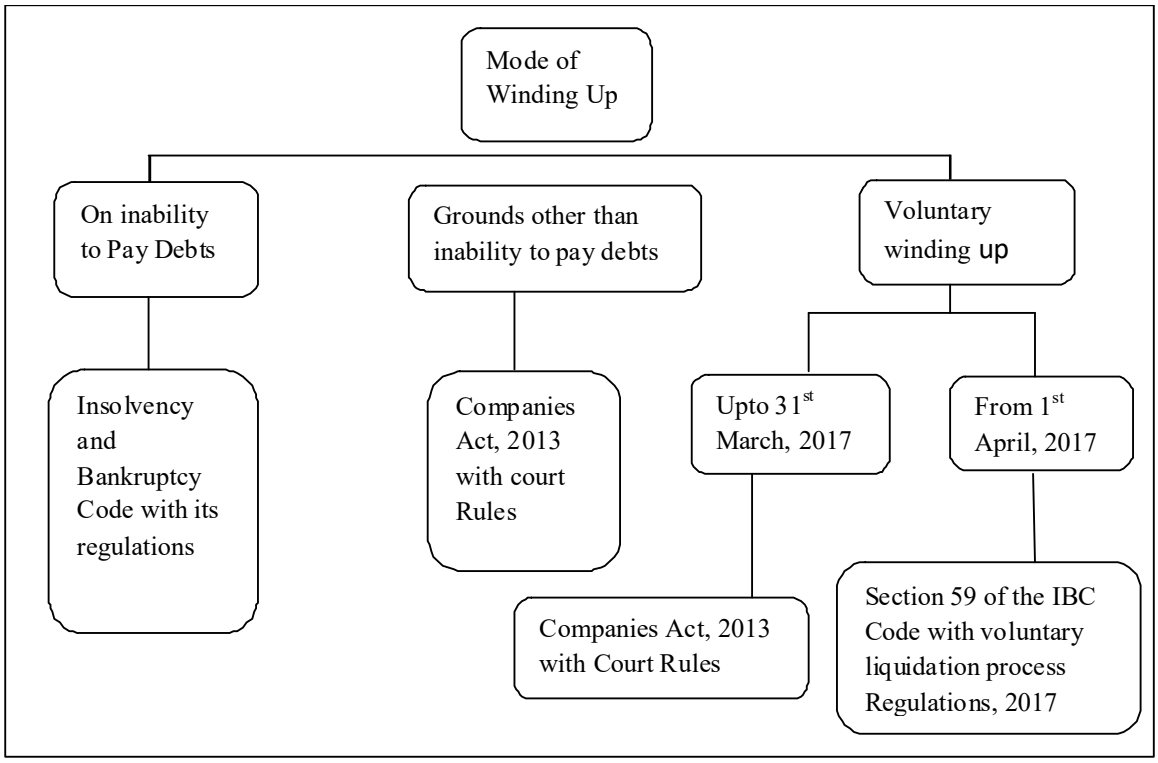
14.3 MEANING OF LIQUIDATION

A company is an artificial person which comes into existence through a process of law. Therefore its life can also be brought to an end only through the process of law. Since a company has a separate existence from its members, its life span is not affected by the life span of any of its members. One of the ways to dissolve a company is to resort to the process of winding up or liquidation. Therefore, when the process of winding up commences, the company is said to be in liquidation. When the directors or members want to liquidate the company they will have to follow the procedure stated in the company law.

Liquidation of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator, called a liquidator, is appointed and he takes control of the company, realises its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights as per the company law. The term 'Liquidation' and 'winding up' has been used synonymously.

As per Section 2(94A) of the Companies Act, 2013, "winding up" means winding up under this Act or liquidation under Insolvency and Bankruptcy Code, 2016. The procedures for Winding up of companies are provided under Chapter XX of the Companies Act, 2013 and Insolvency and Bankruptcy Code of India 2016.

14.4 MODES OF WINDING UP OF A COMPANY



A company may be wound up in any of the following two ways:

14.4.1 Compulsory Winding Up of a Company:

Section 270 of the Companies Act, 2013 provides that the provisions of Part I of Chapter XX of the Companies Act, 2013 shall apply to the winding up of a company by the Tribunal under this Act. Winding up a company by an order of the Tribunal is known as compulsory winding up. Section 271 of the Companies Act, 2013 provides that a company may, on a petition under section 272, be wound up by the Tribunal. A petition for compulsory winding up of a company may be filed in the Tribunal by any of the following persons (Sec. 272).

i. Petition by the Company - A company can file a petition to the Tribunal for its winding up when the members of the company have resolved by passing a Special Resolution to wind up the affairs of the company. Managing Director or the directors cannot file such a

petition on their own account unless they do it on behalf of the company and with the proper authority of the members in the General Meeting.

ii. Petition by the Contributories - A contributory shall be entitled to present a petition for the winding up of the company, notwithstanding that he may be the holder of fully paid-up shares or that the company may have no assets at all, or may have no surplus assets left for distribution among the holders after the satisfaction of its liabilities. It is no more required of a contributory making petition to have tangible interest in the assets of the company

iii. Petition by the Registrar - Registrar may with the previous sanction of the Central Government make petition to the Tribunal for the winding up the company only in the following cases:

(a) If the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding five consecutive financial years;

(b) If the company has acted against the interests of the sovereignty and integrity of India the security of the State friendly relations with foreign States, public order, decency or morality;

(c) If on an application made by the Registrar or any other person authorised by the Central Government by notification under this Act, the Tribunal is of the opinion that the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose or the persons concerned in the formation or management of its affairs have been guilty of fraud, misfeasance or misconduct in connection therewith and that it is proper that the company be wound up.

iv. Petition by the Central Government or a State Government- on the ground that company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality.

v. Any person authorised by the Central Government in that behalf.

14.4.2 Voluntary Winding up of a Company:

Chapter V of the Insolvency and Bankruptcy Code of India 2016 deals with the Voluntary Liquidation of Corporate Persons. Any corporate person who intends to liquidate itself voluntarily may initiate voluntary liquidation proceedings under the provisions of Section 59 of the Insolvency and Bankruptcy Code, 2016.

(1) A corporate person who intends to liquidate itself voluntarily and has not committed any default may initiate voluntary liquidation proceedings under the provisions of this Chapter.

(2) The voluntary liquidation of a corporate person under sub-section (1) shall meet such conditions and procedural requirements as may be specified by the Board.

(3) Without prejudice to sub-section (2), voluntary liquidation proceedings of a corporate person registered as a company shall meet the following conditions, namely:—

(a) a declaration from majority of the directors of the company verified by an affidavit stating that—

(i) they have made a full inquiry into the affairs of the company and they have formed an opinion that either the company has no debt or that it will be able to pay its debts in full from the proceeds of assets to be sold in the voluntary liquidation; and

(ii) the company is not being liquidated to defraud any person;

(b) the declaration under sub-clause (a) shall be accompanied with the following documents, namely:—

(i) audited financial statements and record of business operations of the company for the previous two years or for the period since its incorporation, whichever is later;

(ii) a report of the valuation of the assets of the company, if any prepared by a registered valuer;

(c) within four weeks of a declaration under sub-clause (a), there shall be—

(i) a special resolution of the members of the company in a general meeting requiring the company to be liquidated voluntarily and appointing an insolvency professional to act as the liquidator; or

(iii) a resolution of the members of the company in a general meeting requiring the company to be liquidated voluntarily as a result of expiry of the period of its duration, if any, fixed by its articles or on the occurrence of any event in respect of which the articles provide that the company shall be dissolved, as the case may be and appointing an insolvency professional to act as the liquidator: Provided that the company owes any debt to any person, creditors representing two thirds in value of the debt of the company shall approve the resolution passed under sub-clause (c) within seven days of such resolution.

(4) The company shall notify the Registrar of Companies and the Board about the resolution under subsection (3) to liquidate the company within seven days of such resolution or the subsequent approval by the creditors, as the case may be.

(5) Subject to approval of the creditors under sub-section (3), the voluntary liquidation proceedings in respect of a company shall be deemed to have commenced from the date of passing of the resolution under sub-clause (c) of sub-section (3).

(6) The provisions of sections 35 to 53 of Chapter III and Chapter VII shall apply to voluntary liquidation proceedings for corporate persons with such modifications as may be necessary.

(7) Where the affairs of the corporate person have been completely wound up, and its assets completely liquidated, the liquidator shall make an application to the Adjudicating Authority for the dissolution of such corporate person.

(8) The Adjudicating Authority shall on an application filed by the liquidator under sub-section

(7) Pass an order that the corporate debtor shall be dissolved from the date of that order and the corporate debtor shall be dissolved accordingly.

(9) A copy of an order under sub-section (8) shall within fourteen days from the date of such order, be forwarded to the authority with which the corporate person is registered.



CHECK YOUR PROGRESS

Q 1: What is meant by liquidation of a company?

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Q 2: Mention any three circumstances in which a company may be wound up by the Tribunal.

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14.5 MEANING OF CONTRIBUTORIES

The term 'contributories' has a special meaning in the context of liquidation of a company. According to Section 2(26) of the Companies Act 2013, a contributory means a person liable to contribute to the assets of the company in the event of its being wound up and includes holders of shares which are fully paid.

As soon as the winding up of company starts the members become contributory. Holder of partly paid-up share is a contributory because he is liable to pay the unpaid amount, whether called or not, on share. Although the liability of the fully paid shareholders is nil, they are also included in the list of contributories, because the liquidator prepares the list not only for the purpose of collecting money from the members liable to pay but also for distributing the balance amount remaining after winding up. Holders of fully paid shares are entitled to receive the balance amount, therefore, they are included in the list of contributories.

14.6 MEANING OF LIQUIDATOR

A Liquidator is a person who is entrusted the duty of winding up of a company. He is appointed to administer and to take control of the company. He realises the company's assets, pays its debts and finally distributes any surplus among the members in accordance with their rights as per the company law. Section 275 (1) and (2) of the Companies Act, 2013 provides that for the purposes of winding up of a company by the Tribunal, the Tribunal at the time of the passing of the order of winding up, shall appoint an Official Liquidator or a Liquidator from amongst the insolvency professionals registered under the Insolvency and Bankruptcy Code, 2016. Where a provisional liquidator is appointed by the Tribunal, the Tribunal may limit and restrict his powers by the order appointing him or it or by a subsequent order, but otherwise he shall have the same powers as a liquidator. The terms and conditions of appointment of a provisional liquidator or Company Liquidator and the fee payable to him or it shall be specified by the Tribunal on the basis of task required to be performed, experience, qualification of such liquidator and size of the company. On appointment as provisional liquidator or Company Liquidator, as the case may be, such liquidator shall file a declaration within seven days from the date of appointment in the prescribed form disclosing conflict of interest or lack of independence in respect of his appointment, if any, with the Tribunal and such obligation shall continue throughout the term of his appointment. While passing a winding up order, the Tribunal may appoint a provisional liquidator, if any, appointed under clause (c) of sub-section (1) of section 273, as the Company Liquidator for the conduct of the proceedings for the winding up of the company.

14.7 PREFERENTIAL PAYMENTS

Now let us know about the payments to be made in preferential basis in case of liquidation of a company. Section 327 of the Companies Act contains a list of preferential payments. Preferential payments are those payments which by virtue of provisions in the Act are to be paid in priority to all other debts. These are listed below in order of preference.

(i) All revenues, taxes, cesses and rates due to the Central or a State Government or to a local authority. The amount should have become due and payable within twelve months before the winding up.

(ii) All wages or salary of any employee in respect of services rendered to the company and due for a period not exceeding four months within the said twelve months before the date of winding up order.

(iii) All accrued holiday remuneration becoming payable to the employee or in case his death, to any other person in this right, on termination of his employment before of the effect of the winding up.

(iv) All amount due in respect of contributions payable during the twelve months under the Employees' State Insurance Act, 1948 or any other law.

(v) All amount due in respect of any compensation or liability for compensation under the Workmen's Compensation Act, 1923 in respect of death or disablement of any employee of the company.

(vi) All sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employees, maintained by the company.

(vii) The expenses of any investigation held in pursuance of Section 213 or 216 in so far as they are payable by the company.

After retaining sums necessary for meeting the costs and expenses of winding up, the above debts have to be discharged forthwith so far as assets are sufficient to meet them.



14.8 LET US SUM UP

In this unit we have discussed the following aspects-

- Liquidation means putting an end to the life of the company.
- The assets of the liquidated company are administered for the benefit of the members and creditors.
- A company can be compulsory wound up by the National Company Law Tribunal

- Contributory means a person who is liable to contribute to the assets of the company in the event of its being wound up and includes holders of shares which are fully paid.
- Liquidator is the person who is appointed to administer the process of liquidation of a company.
- Preferential payments mean the payments to be made in preference to all other debts according to the provisions of the Companies Act.



14.9 FURTHER READING

1) S.N. Maheshwari & S.K. Maheshwari (2018). Corporate accounting. Noida, Vikas Publishing House Pvt. Ltd.

2) Singal R.S. (2014). Corporate accounting. New Delhi, V.K. (India) Enterprise.

3) Goyal V.K. & Goyal R. (2012). Corporate accounting. New Delhi, PHI Learning Pvt. Ltd.



14.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Liquidation of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members.

Ans to Q No 2: Three circumstances in which a company may be wound up by the Tribunal are:

(i) Default in delivering the statutory report/holding statutory meeting,

(ii) Failure to commence business/carry on business and;

(iii) Acting against the interests of the sovereignty and integrity of India.



14.11 MODEL QUESTIONS

Q 1: What is meant by Liquidation of a company?

Q 2: Explain the various modes of liquidation.

Q 3: Write short note on the circumstances for voluntary liquidation of a company

Q 4: Under what circumstances the Tribunal may wound up a company?

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UNIT 15: FINAL ACCOUNTS OF JOINT STOCK COMPANIES

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

15.3 Meaning and Components of Final Accounts

15.4 Relevant Provisions of the Companies Act

15.5 Structure of Final Accounts

15.5.1 Balance sheet

15.5.2 Statement of Profit and loss Account

15.6 Let Us Sum Up

15.7 Further Reading

15.8 Answers to Check Your Progress

15.9 Model Questions

15.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- discuss the meaning and components of final accounts
- explain the relevant provisions of Companies Act for the preparation of final accounts
- discuss the various structure of Final Accounts of a company
- discuss the forms of preparing of balance sheet
- discuss some important terms which are used in the preparation of final accounts
- prepare the final accounts.

15.2 INTRODUCTION

In the Financial Accounting II of second semester, we have discussed the preparation of final accounts of sole proprietorship and partnership firms. As you are aware that every business organisation is interested to know (i) the results of its operation performed during a particular period and (ii) the

financial position on the date of close of the accounting period. These could be known through the preparation of Final Accounts. The term Final Accounts include Trading Account, Profit and Loss Account and Balance Sheet. Now-a-days, the cash flow statement is also taken as an integral part of final account of a company.

In this unit we will discuss the meaning of Final Accounts, Components of Final Accounts and how to prepare Final Accounts of Joint Stock Companies.

Let us recapitulate certain facts about final accounts-

15.3 MEANING AND COMPONENTS OF FINAL ACCOUNTS

Financial Statements are the end products of the accounting system. So these are called **Final Accounts.** Final accounts include (i) Trading and Profit and Loss A/c and (ii) Balance Sheet. Trading and profit and loss account are prepared to find out the profit or loss of a certain period. They are also called as Income Statement. The balance sheet portrays the financial position of the firm on a particular date. It is also called Position Statement. The statements i.e. Trading and P & L account and Balance Sheet are prepared to give the final results of the business; that is why they are collectively called Final Accounts. Final Accounts are prepared from the figures appearing in Trial Balance and additional information. Every company registered under The Companies Act 2013 shall prepare its balance sheet, statement of profit and loss and notes to account thereto in accordance with the manner prescribed in the revised Schedule III to the Companies Act, 2013 to harmonise the disclosure requirement with the accounting standards and to converge with new reforms.

Components of Final Accounts

Components of Final Accounts depend on the nature of the business entity. It should be kept in mind that the final accounts are prepared after the preparation of trial balance. The nature of the business entity may be Sole proprietorship, Partnership, Joint Stock Company and so on.

Following are the components of final accounts business of a firm carrying on trading activities:

(i) Income statement which is divided into two parts:

(a) **Trading Account** which shows the gross profit or gross loss;

(b) **Profit and Loss Account** which shows the net profit or net loss; and

(ii) Balance Sheet.

If the business entity carries on manufacturing activities, a Manufacturing account is also prepared by such business entity before the preparation of Trading Account.

15.4 RELEVANT PROVISIONS OF THE COMPANIES ACT

The procedure of finalisation of accounts of companies is not different from that of other non-corporate business entities except certain statutory requirements and some items peculiar to company form of business organisation. The financial statements of companies are required to be presented by the Board of Directors at the Annual General Meeting of the company in accordance with the provisions of Section 219 Companies Act.

Section 128 to 138 of the Companies Act, 2013 deal with the legal provisions relating to preparation and presentation of final accounts by companies. Section 128 provides that proper books of accounts must be maintained following accrual basis of accounting so that such books of account give a true and fair view of the state of affairs of the company.

Schedule III deals with preparation of final accounts by companies and also deals with the form and contents of the Balance Sheet and the Profit and Loss Account.

Financial Statement is defined under Section 2 (40), to include –

- Balance Sheet,
- Profit and Loss account or Income and Expenditure account,
- Cash flow Statement,
- Statement of change in equity, if applicable,
- any explanatory notes annexed to or forming part of financial statements, giving information required to be given and allowed to be given in the form of notes.

However, the financial statement with respect to one person company, small company and dormant company, may not include the cash flow statement. Financial statements should be prepared for financial year and shall be in form as per Schedule III.



CHECK YOUR PROGRESS

Q 1: What are the relevant provisions of Companies Act, 2013 for preparation of final accounts?

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Compliance with Accounting Standards :

The Companies Act, 2013 made it mandatory on the part of the companies to comply with the applicable accounting standards recommended by the Institute of Chartered Accountants of India and as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards. In case of non-compliance, the reason and the financial effect, arising out of such non-compliance should be disclosed.

Approval and authentication of the Final Accounts:

Section 134 of the Companies Act states that the balance sheet and the profit and loss account of every company should be approved by the Board of Directors. After approval, these should be signed by the chairperson of the company or by atleast two Directors, one of whom should be the Managing Director. After approval by the Board and proper authentication, final accounts shall be submitted to the auditors for their report thereon.

15.5 STRUCTURE OF FINAL ACCOUNTS

The structure of final accounts as prescribed in Schedule III. Part I of the schedule deals with disclosure of information relating to share capital, liabilities and assets in a statement known as the Balance Sheet of the company.

Part II of the Schedule deals with the information to be disclosed in

the Profit and Loss Account of a company.

It may be mentioned here that the following companies do not prepare their final accounts as per the provisions of the Companies Act :

(i) Insurance Companies;

(ii) Banking Companies; and

(iii) Electricity Companies.

They prepare their final accounts according to their requirements as per the provisions of their respective regulating Acts.



CHECK YOUR PROGRESS

Q 2: What is the structure of final accounts as prescribed in Schedule III of the Companies Act 2013?

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Let us go through the form of balance sheet

Name of the Company

Balance Sheet

as at.....

(s in.....)

Particulars	Note No.	Figures as at the End of Current Reporting Period	Figures as at the End of Previous Reporting Period
1. EQUITY AND LIABILITIES			
(1) Shareholders' Funds			
(a) Share Capital		....	...
(b) Reserves and Surplus		...	...
(c) Money Received Against Share Warrants		...	...
(2) Share Application Money Pending Allotment			
(3) Non-current Liabilities			
(a) Long-term Borrowings		...	...
(b) Deferred Tax Liabilities (Net)		...	...
(c) Other Long-term Liabilities		...	...

(d) Long-term Provisions		....	...
(4) Current Liabilities			
(a) Short-term Borrowings		...	...
(b) Trade Payables		...	...
(c) Other Current Liabilities		...	...
(d) Short-term Provisions		...	...
Total			
II. ASSETS			
(1) Non Current Assets			
(a) Fixed Assets			
(i) Tangible Assets		...	...
(ii) Intangible Assets		...	...
(iii) Capital Work-in-progress		...	...
(iv) Intangible Assets Under Development		...	...
(b) Non-current Investments		...	...
(c) Deferred Tax Assets (Net)		...	...
(d) Long-term Loans and Advances		...	...
(e) Other Non-current Assets		...	...
(2) Current Assets		...	...
(a) Current Investments		...	...
(b) Inventories		...	...
(c) Trade Receivables			
(d) Cash and Cash Equivalents		...	...
(e) Short-term Lonas and Advances		...	...
(f) Other Current Assets		...	...
Total			



LET US KNOW

Points to be noted in preparation of a Balance Sheet

1. It applies to all Indian companies preparing financial statement.
2. It does not apply to (i) Insurance or Banking Company, (ii) Company for which a form of balance sheet or income statement is specified under any other Act.
3. Accounting standards shall prevail over Schedule III of the Companies Act, 2013.

4. Disclosure on the face of the financial statements or in the notes are essential and mandatory.
5. Terms in the revised Schedule III will carry the meaning as defined by the applicable accounting standards.
6. Balance to be maintained between excessive details that may not assist users of financial statements and not providing important information.
7. Current and non-current bifurcation of assets and liabilities is applicable.
8. Rounding off requirements is mandatory.
9. Vertical format for presentation of financial statement is prescribed.
10. Debit balance in the statement of profit and loss to be disclosed as negative figure under the head "Surplus".
11. Mandatory disclosure for share application money pending allotment.
12. 'Sundry Debtors' and 'Sundry Creditors' replaced by terms 'Trade Receivables' and 'Trade Payables'.

15.5.2 Statement of Profit and Loss

Now let us discuss about the statement of Profit and Loss of a company. The Companies Act, 2013 has prescribed any format for presentation of Profit and Loss. Therefore, the statement of Profit and Loss of a company should be prepared in such a way that it furnishes as detailed information as possible about each item of expense, income, loss or profit during a particular accounting period.

According to Companies Act, 2013 a company is mandatorily required to prepare statement of Profit and Loss and Balance Sheet.

However, on the basis of requirements as to statment of Profit and Loss as required under Part II of Schedule III of the Companies Act, a specimen of statement of Profit and Loss as given for your ready reference.

Proforma of Statement of Profit and Loss

Name of the Company .....

Statement of Profit and Loss

for the year ending .....

(s in.....)

Particulars	Note No.	Figures For the Current Reporting Period	Figures For the Previous Reporting Period
I. Revenue from Operations		....	...
II. Other Income		...	...
III. Total Revenue (I+II)		...	...
IV. Expenses			
Cost of Materials Consumed		...	...
Purchases of Stock-in-trade		...	...
Changes in Inventories of Finished Goods		...	...
Work-in-progress and Stock-in-trade		...	...
Employees Benefits Expenses		...	...
Finance Costs		...	...
Depreciation and Amortisation Expenses			
Other Expenses		...	...
Total Expenses			
V. Profit before Exceptional and Extraordinay Items and Tax (III-IV)		...	...
VI. Exceptional Items		...	...
VII. Profit before Extraordinary Items and Tax (V-VI)		...	...
VIII. Extraordinary Items		...	...
IX. Profit before Tax (VII-VIII)		...	...
X. Tax Expenses		...	...
(1) Current Tax		...	...
(2) Deferred Tax		...	...
XI. Profit (Loss) for the Period from Continuing Operations (VII-VIII)		...	...
XII. Profit (Loss) from Discontinuing Operations		...	...
XIII. Tax Expense of Discontining Operations		...	...
XIV. Profit (Lose) from Discontinuing Operations (After tax) (XII-XIII)		...	...
XV. Profit (Loss) for the Period (XI-XIV)		...	...
XVI. Earnings per Equity Share		...	...
(1) Basic		...	...
(2) Diluted		...	...



15.6 LET US SUM UP

In this unit we have discussed the following aspects-

- Preparation of final accounts is the end function of accounting;
- The components of financial statements are income statement and position statement;
- Income statement contains trading account and profit and loss account and the position statement is called balance sheet;
- Relevant provision of the Companies Act
- As required by the schedule III of the Companies Act, the final accounts are divided as under-
  - ➢ Balance Sheet
  - ➢ Profit and Loss account
  - ➢ Interpretation and explanation of certain terminologies; and
  - ➢ Disclosure of certain details.
- Certain items which require special attention at the time of preparation of final accounts of companies.



15.7 FURTHER READINGS

1) Maheshwari, S. N. & Maheshwari, S. K (2018). Corporate accounting. New Delhi, Vikas Publishing House Pvt. Ltd.

3) Mukherjee A. & Hanif M (2017). Corporate accounting. New Delhi,Tata McGraw- Hill Publishing Company.



15.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Section 128 to 138 of the Companies Act, 2013 deal with the legal provisions relating to preparation and presentation of final accounts by companies. Section 128 provides that proper books of

accounts must be maintained following accrual basis of accounting so that such books of account give a true and fair view of the state of affairs of the company.

Schedule III deals with preparation of final accounts by companies and also deals with the form and contents of the Balance Sheet and the Profit and Loss Account.

Ans to Q No 2: The structure of final accounts as prescribed in Schedule III is divided into four parts. Part I deals with disclosure of information relating to share capital, liabilities and assets in a statement known as the Balance Sheet of the company.

Part II of the Schedule deals with the information to be disclosed in the Profit & Loss Account of a company.'



15.9 MODEL QUESTIONS

Q 1: Write the meaning of final accounts and also discuss its various components.

Q 2: Discuss the relevant provisions of Companies Act, 2013 for preparation of final accounts.

Q 3: Discuss briefly the structure of final accounts as prescribed in Schedule III of the Companies Act, 2013?

The following is the Trial Balance of Lotus Ltd. as on 31st March, 2019. Prepare a Statement of Profit and Loss for the year ended 31st March, 2019 and a Balance Sheet of the company as on that date.

Debit	Amount(Rs.)	Credit	Amount(Rs.)
Opening inventory	50,000	Sales	7,00,000
Purchases	3,50,000	Discount	6,000
Wages	1,70,000	Profit & Loss A/c	12,000
Commission	9,000	Creditors	80,000
Management expenses	1,20,000	Reserve	41,000
Trade mark	38,000	Loan from IFCI	31,000
Bonus	20,000	Shares Capital	3,50,000

Debtors	31,000	(Share of Rs. 10 each)	
Investment in Mutual Fund	50,000	Income tax refund	15,000
Machinery	1,50,000	Outstanding salary	20,000
Furniture	30,000	Bad debt recovered	10,000
Bank	2,29,000		
Bad debts	18,000		
	12,65,000		12,65,000

Adjustments :

1. Closing inventory Rs. 2,20,000
2. Provide Rs. 1,500 for the Company's Contribution to the Staff Provident Fund
3. Management expenses include Rs. 6,000 paid to the managing director as managerial remuneration.
4. Income tax to be provided for Rs. 10,000
5. Write off Rs. 2,000 from Trade Mark.

*** ***** ***



REFERENCES (For All Units of the Course)

1) Advanced Accounting 2 Corporate Accounting by Dr. A Sehgal and Dr. D Sehgal, Taxman.
2) Ahmed N. (2007). Corporate Accounting: For B. Com (Hons.) and other professional courses. New Delhi, Atlantic Publishers and Distributors (P) Ltd.
3) Corporate Accounting K R Das and others, LBS publication.
5) Grewal T. S. (2016). Introduction to accountancy. New Delhi, S. Chand & Company Ltd.
6) Goyal V.K. & Goyal R. (2018). Corporate accounting. New Delhi, PHI Learning Pvt. Ltd.
7)) Maheshwari, S. N. & Maheshwari, S. K (2017). Corporate accounting. New Delhi, Vikas Publishing House Pvt. Ltd.
8) Mukherjee A. & Hanif M (2017). Corporate accounting. New Delhi,Tata McGraw- Hill Publishing Company.
9) Theory and Practice of Accountancy by B B Dam , Sarda and others, Capital Publishing.
10) Singal R.S. (2010). Corporate accounting. New Delhi, V.K. (India) Enterprise.

Name of the Paper:
Course Code:

Centre for Internal Quality Assurance (CIQA)
Krishna Kanta Handiqui State Open University
City Office, Housefed Complex, Guwahati- 06

Learner's Feedback on Course

Dear Learner,

Regarding the course as mentioned above, we would like to know your opinions and comments so as to improve the quality of self learning materials in future. Please respond to the following statements by ticking the number you feel most reflect your opinion. After completion of the additional comments, please detach the page and send/mail the same to us at the address given below.

The Director, Centre for Internal Quality Assurance, KKHandiqui State Open University
Housefed Complex, Dispur, Guwahati- 781006
(E-mail id: ciqa@kkhsou.in)

1. Approximately how many hours did you spend for studying the units in the course?
2. Please give your opinions (by √ marks) in the following items based on your reading of the block.

Sl. No.	Statements	Strongly Agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree
I.	The SLMs of the course fulfil the learning objectives set out in the beginning of each unit					
II.	The units of the SLM could satisfy my needs or needs and expectations					
III.	The Unit writers have excellent knowledge about the course contents					
IV.	Language and contents of the units were presented at a level which I could readily understand					
V.	Ample opportunity for participation in the activities provided in the units					
VI.	Used enough illustrations (diagrams, tables etc.) for examples clarity					
VII.	Quality of contents is engaging, relevant, and up-to-date					
VIII.	The self check questions are very helpful					
IX.	The Print the model questions and the answers to check my progress have benefited me a lot					

Additional Comments: *Please feel free to provide your open comments*

1. Which aspects of the SLM, according to you, worked well?

   .....

   .....

2. What sort of changes/improvements do you feel SHOULD could implement to improve the overall quality of the SLM?

   .....

   .....

Thank you for taking the time to complete this form.