Centre for Distance & Online Education
(CDOE)

BACHELOR OF COMMERCE

BCOM 301

CORPORATE ACCOUNTING

Guru Jambheshwar University of Science &
Technology, Hisar – 125001

Contents

Subject: Corporate Accounting	
Course Code: BCOM- 301	**Author:** Dr. Sanjeev Kumar Garg
Lesson No.: 1	**Vetter:** Prof. Suresh Kumar Mittal
Valuation of Goodwill	

Structure

1.0 Learning Objectives

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

- Understand the meaning of Goodwill.
- Know the features & factors affecting Goodwill.
- Know the need for valuing Goodwill.
- Understand the methods of valuing Goodwill.

1.1 Introduction

Goodwill is an intangible but not fictitious asset which means it has some realisable value. From the accountants' point of view goodwill, in the sense of attracting customers, has little significance unless it has a saleable value. Therefore, goodwill may be said to be an element arising from the reputation, connection, or other advantages possessed by a business which enables it to earn greater profits. In considering the return normally to be expected, regard must be given to the nature of the business, the risks involved, fair management and any other relevant circumstances. There are many circumstances such as for disposing off business, admission of partner, retire and death of partner, merger of companies, takeover of companies where need arises for valuation of goodwill. In this chapter it is discussed about goodwill and methods of valuation of goodwill.

1.1.1 Meaning & Definition of Goodwill

A firms' reputation of generally assessed by goodwill earned by the firm during its tenure. The goodwill has been defined by many, but no one has given a crystal clear definition. "Goodwill" is generally used in business world to access the value of a firm. It an intangible, invaluable asset. A business, which has earned a good reputation during its tenure, gets credit of "Goodwill". The people are started trusting in the products or services of that firm. It is a common notion that if a firm is a profitable one it is valued high and in turn attracts goodwill. Now we can say that the reputation of a firm coupled with its going profitability represents "Goodwill". But goodwill can be realised and quantified in money's worth when the firm is disposed of.

Definitions:

- *As per Lord Lindley,* "The term goodwill is generally used to denote the benefit arising from connections and reputation".

- *As per Lord Lindley,* "Goodwill is nothing more than the probability that the old customers will resort to the old place".
- *As per Investopedia;* "Goodwill is an intangible asset that arises as a result of the acquisition of one company by another for a premium value. The value of a company's brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary represent goodwill. Goodwill is considered an intangible asset because it is not a physical asset like buildings or equipment. The goodwill account can be found in the assets portion of a company's balance sheet".
- *As per Wikipedia;* "Goodwill is a special type of intangible assets that represents that portion of the entire business value that cannot be attributed to other income producing business assets, tangible or intangible".

Thus goodwill is an intangible asset associated with the purchase of one company by another. The value of a company's brand name, solid customer base, good customer relations, good employee relations, and any patents or proprietary technology represent some examples of goodwill.

1.1.2 Characteristics of Goodwill

- **It is an intangible asset:** Goodwill is an intangible asset. It is non-visible but it is not a fictitious asset.
- **Valuable only where entire business sold:** It cannot be separated from the business and therefore cannot be sold like other identifiable and separable assets, without disposing off the business as a whole.
- **It cannot be built by amount invested or cost incurred:**The value of goodwill has no relation to the amount invested or cost incurred in order to build it.
- **Valuation of goodwill is subjective:** Valuation of goodwill is subjective and is highly dependent on the judgment of the valuer.
- **It is subject to fluctuation:** Goodwill is subject to fluctuations. The value of goodwill may fluctuate widely according to internal and external factors of business.

1.1.3 Factors affecting the Value of Goodwill

The goodwill possessed by a firm may be due to the following:

Profitability: The profitability of company is past and expected profit in future will affects value of Goodwill. Profitability is the most important factor in valuation of Goodwill. The main emphasis is on future profits of the concern. Whether concern will able to increase in its profit in future. Since the profit earned in past provides a base for the concern's future profit. The process of assessment, whether a concern will maintain its profits in the future is otherwise called "Future Maintenance Profit". Following factors are to be considered, while estimating the "Future Maintenance Profit";

- All normal working expenses should be included;
- Any appreciation in the fixed assets should be excluded;
- Any appreciation in the value of Current Assets should be included;
- Provision for taxes should be included;
- Income from non-trading assets should not be taken into account;
- Transfer to General Reserve should be excluded;
- Dividend to Preference Shareholders should be excluded;
- Non –recurring expenses should be included;
- Average profits of past years should be considered.

Normal rate of return: Every person investing his/her/its funds in companies needs a fair return; this is referred as "Rate of Earnings". The rate of return is dependant on the nature of industry and other factors such as bank rate, risk, type of management, etc., it consists of following elements;

- Return at Zero Risk Level; in this case the risk to the investor is nil or zero, the concern in which it has invested, do not has any risk in its activities. But at the same time the return will be lower than expected. Such as investment in Government securities, Bonds, NSCs etc.
- Premium for business risk; it refers to risky investment. If a concern faces more risk in its business transactions, then the rate of return or earning will be high. The profit will vary in proportion to risk covered in the industry. The more is risk, higher is the Premium.
- Premium for financial risk; it refers to risk connected with the Capital Structure. A concern having higher debt/equity ratio is considered more risky. There are other factors that affects the Rate of Returns are;

- The bank rate;
- Period of investment;
- Risk (due to nature of business or capital structure);
- Economic and Political Scenario, etc.

Capital Employed to earn profit: The quantum of profits earned with respect to the capital used is an important basis for valuation of goodwill. The Capital Employed represents Fixed Assets + Net Working Capital. This represents Equity Holders fund plus long terms borrowings. Following items to be included in determining Capital Employed;

- All Fixed Assets Less Depreciation written off;
- Trade Investments;
- All Current Assets

Following items should be excluded;

- Long term liabilities;
- All Current Liabilities;
- Intangible Assets including Goodwill;
- Non Trading Assets;
- Fictitious Assets

Generally "Average Capital Employed" is used instead of "Capital Employed. Since profit earning is a continuous process during the year.

- The yield from business as expected by the investors;
- Size, location and reputation of the company's products.
- The longevity of existence of business concern;
- Market share of products of entity;
- The edge of concern over its competitions in the market;
- Relationship between management and staffs;
- Brand position and efforts taken to establish brand of the concern;
- Technical innovation, modern technology, patents, etc,;

- Tax Planning;
- Relationship with Government, Local Bodies;
- There are some other factors affecting the value of Goodwill.
- The possession of favourable contracts, complete or partial monopoly, etc.
- The personal reputation of the promoters.
- The possession of efficient and contented employees.
- The possession of trade marks, patents or a well-known business name.
- The continuance of advertising campaigns.
- Quality of the firm’s product and development of the business with changing conditions
- Nature of the industry, its history and the risks to which it is subject to.
- Prospects of the industry in the future.
- The company’s history, its past performance and its record of past profits and dividends.
- The basis of valuation of asset of the company and their value.
- The nature of management and the chance for its continuance.
- Capital structure.
- The number of shareholders.
- Yield on shares of companies engaged in the same industry, which are listed in the Stock Exchanges.

1.1.4 Need for Valuation of Goodwill

Generally goodwill may be valued at the time of disposal of business of the firm. But in many cases the goodwill may be valued to find out value of the firm. In case of proprietorship business it will be valued at the time of disposal of business, in case of firm it may be calculated at the time of addition, resignation and disposal of firm. Now in case of companies the need for valuation of goodwill arises in the following circumstances;

Business enterprise valuation: The identification and quantification of goodwill is one procedure of the asset-based approach to business valuation. An asset-based approach is often used in the valuation of an industrial or commercial company or professional service business. Such business valuations are routinely performed for taxation, ownership transition, financing, bankruptcy, corporate governance, litigation, and other purposes.

Economic damage analyses: When a business has suffered a breach of contract or a tort (such as an infringement, breach of a fiduciary duty, or interference with business opportunity), one measure of the damages suffered is the reduction in the value of the entity's goodwill due to the wrongful action. This analysis may encompass the comparative valuation of the entity's goodwill before and after the breach of contract or tort. This before and after method is also useful for quantifying the economic effects of a prolonged labour strike, a natural disaster, or a similar phenomenon.

Business or professional practice merger: When two businesses merge, the equity of the merged entity typically is to be allocated to the merger partners. One common way to allocate equity in the merged entity is in proportion to the relative value of the assets contributed, including the contributed goodwill.

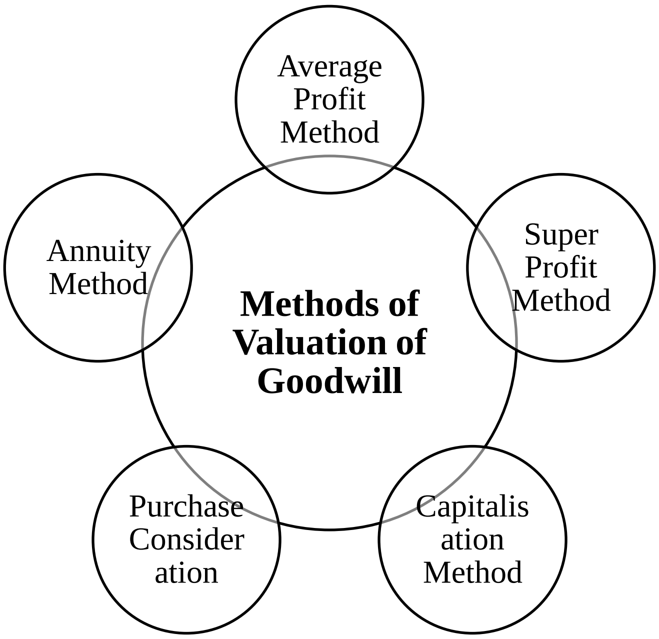
Following are also some situations when valuation of goodwill required:

- When business is to be disposed of.
- When someone is to be admitted as a partner.
- When a partner retires or dies.
- When there is a change in the profit sharing ratio of partners.
- When the business or when the company is to be sold to another company or when the company is to be amalgamated with another company;
- In case of takeover of one company by another or sold of business of one company;
- In case of a company wants to exercise controlling interest in other company;
- In case of company's management has been taken over by Government and some other events in which valuation of Goodwill held.
- When, stock exchange quotations not being available, shares have to be valued for taxation purposes, gift tax, etc.;
- When a large block of shares, so as to enable the holder to exercise control over the company concerned, has to be bought or sold; and
- When the company has previously written off goodwill and wants its write back.

1.2 Methods of Valuing Goodwill

Following are the methods of valuing Goodwill;

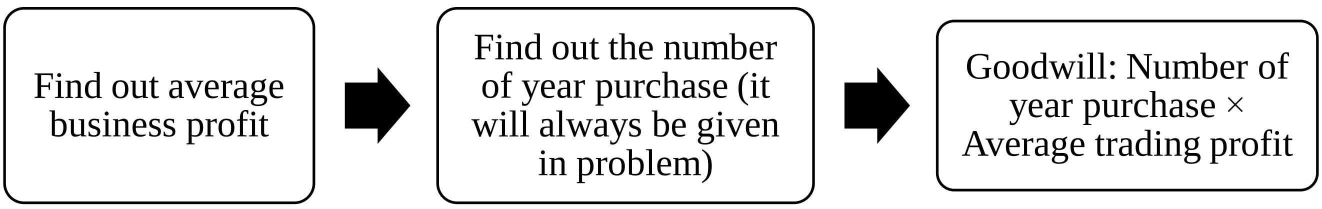
- Average Profits Method;
- Super Profits Method;
- Capitalization Method;
- Purchase Consideration Method
- Annuity Method



1.2.1 Average Profits Method

This very simple and widely followed method of calculating goodwill. In this method goodwill is generally valued on the basis of a certain number of years' purchase of the average business profits of the past few years.

Steps for Calculation of Goodwill on the basis of average profit method



Calculation of average profits: While calculating average profits for the purposes of valuation of goodwill, certain adjustments are made. Some of the adjustments are as follows:

Past profits must be adjusted in the light of following future expectations:
Add: • Abnormal Loss • Income expected in future • Stoppage of future expenses
Less: • Abnormal Gains / Profits • Income from Investments • Non-operating Income • Operating Expenses expected to be incurred in future • Stoppage of future earnings
Adjustment: • *Managerial Remuneration:* It can be added of can be deducted on the basis of managerial remuneration paid in future. If it is estimated to be paid in future is in excess, it should be deducted. If estimated to be paid in future is less, it should be added. • *Income Tax:* Average profits should be calculated after deducting tax at current rates.

Notes: If past profits are in increasing trend, then calculate Average Profit by weighted average method or otherwise simple average method.

Calculation of Weighted Average Profit: If profits are continuously increasing weighted average profit is calculated for valuing goodwill. For this higher weightage is given to the recent year of profits and lower to the far year's profit e.g. profit of 2019-20 could be similar to the profits of 2018-19 as compared to 2013-14 profits. Thereafter profits are multiplied by their weight, then after totalling the whole amount and divide by total weight.

Year	Profit₹	Weight	Products₹
2013-14	1,00,000	1	1,00,000
2014-15	1,40,000	2	2,80,000
2015-16	2,00,000	3	6,00,000
2017-18	2,50,000	4	10,00,000
2018-19	3,00,000	5	15,00,000
Total		**15**	**34,80,000**

Weighted Average Profit = ₹ 34,80,000/15 = ₹ 2,32,000

<u>Illustration 1:</u>

Mr. X purchased a business on 1st April 2019. It was agreed to value goodwill at three years purchase of average normal profits of last 4 years. The Profits are as follows:

Year Ended	Profits
• 31st March 2016	₹ 1,90,000
• 31st March 2017	₹ 2,60,000
• 31st March 2018	₹2,75,000
• 31st March 2019	₹ 3,20,000

- During the year ended 31March2016, an asset was sold at a profit of ₹30,000
- During the year ended 31March2017, firm had incurred an abnormal loss of ₹40,000
- Profit of 2018 include ₹ 45,000 speculative profit.
- Firm earned abnormal gain of ₹20,000 during the year ended 31, March 2019.
- During the year ended 31 March 2019, a plantgot destroyed in accident &₹50,000 was written off as loss in Profit & Loss Account.

<u>Solution:</u>

Calculation of Normal Profit:

Year Ended	Profit (+ -) Adjustment ₹	Normal Profit ₹
31Mar.2016	₹1,90,000 - (₹30,000) Profit on sale of Asset	1,60,000
31Mar.2017	₹2,60,000 + (₹40,000) Abnormal loss	3,00,000
31Mar.2018	₹2,75,000 - (₹45,000) speculative profit	2,30,000
31Mar.2019	₹3,20,000 – (₹20,000) Abnormal gain + (₹50,000) Abnormal loss (Loss on sale of asset)	3,50,000
Total Normal Profit		**10,40,000**
Total no. of years 4		

Average Profit=Total Normal Profit / Total No. of years =₹10,40,000/4 = ₹ 2,60,000

Goodwill = Average Profit × No. of Years of Purchase

=₹2,60,000× 4 = ₹10,40,000

Illustration: 2

Mr. X purchased a business on 1st April 2019 carried by A. It was agreed to value goodwill at three years purchase of weighted average profits of last 3 years. The Profits are as follows:

Year Ended	Profits
2015 – 16	₹60,000
2016 – 17	₹ 63,000
2017 – 18	₹90,000

2018 – 19 ₹85,000

The appropriate weights to be used are: 2015-16:-1; 2016-17:-2; 2017-18:-3; 2018-19:-4. Other information are as follows:

- During the year 2015-16, closing stock overvalued by ₹10,000
- In December 2017, firm had incurred speculation profit of ₹8,000
- To cover management cost an annual charge of ₹5,000 should be made for the purpose of goodwill valuation.

Solution:

Calculation of Weighted Average Normal Profit:

Year Ended	Profit (+ -) Adjustment ₹	Profits ₹	Weights	Product ₹
2015 – 16	₹ 60,000 – ` 10,000 (overvaluation of closing stock) – ₹ 5,000 (Charge for management cost)	45,000	1	45,000
2016 – 17	₹ 63,000 – ₹ 5,000 (Charge for management cost)	58,000	2	1,16,000
2017 – 18	₹ 90,000 – ₹ 8,000 (Speculation Profits) – ₹ 5,000 (Charge for management cost)	77,000	3	2,31,000
2018 – 19	₹ 85,000 – ₹ 5,000 (Charge for management cost)	80,000	4	3,20,000
Total Normal Profit			**10**	**7,12,000**

Weighted Average Profit= ₹7,12,000 / 10 = ₹71,200

Goodwill = Weighted Average Profit × No. of Years of Purchase

=₹71,200× 3 = ₹ 2,13,600

1.2.2 Super Profits Method

The future maintainable profits of the firm are compared with the normal profits for the firm. Normal earnings of a business can be judged only in the light of normal rate of earning and the capital employed in the business. Hence, this method of valuing goodwill would require the following information:

(i) A normal rate of return for representative firms in the industry.
(ii) The fair value of capital employed.

The normal rate of earning is that rate of return which investors in general expect on their investments in the particular type of industry. Normal rate of return depends upon the risk attached to the investment, bank rate, market, need, inflation and the period of investment.

Find out Normal Profit = Capital Employed × (Normal Rate of Return /100)

→ **Super Profit =** Actual or Average profit – Normal Profit

→ **Goodwill =** Super Profit × No. of years' of purchase

Goodwill = Super Profit x Discounting Factor

Calculation of Capital Employed: Calculation of capital employed is one of the most important factors in valuation of goodwill. While calculating capital employed following points should be considered on the basis of balance sheet items:

Calculation of Capital Employed
Add All fixed and current assets at current market price: ***Note:*** • Fictitious assets such as Share issue expenses, discount of issue of debentures, advertisement expenditure, underwriting commission should not be included. • Investment is the amount invested outside the business and in the nature of non-trading

assets, therefore should not be include in assets. • Goodwill showing in balance sheet should also be excluded.
Deduct: • Liabilities due to outside parties such as Debentures, Creditors, Bills Payable, Bank Overdraft, Provision for taxation etc.
Thus Net Capital Employed = All Fixed Assets + Current Assets – Outside Liabilities

Calculation of Average Capital Employed: Average Capital Employed fairly represent the capital employed throughout the year. Average capital employed is calculated with the following formula:

- Average Capital Employed = (Capital Employed in the beginning + Capital Employed at the end) /2
- If capital employed in the beginning of the year in not given in the question, then with the help of following formula average capital employed can be calculated:

Average Capital Employed = (Capital Employed at the end – ½ of current year's profit)

Illustration: 3

The average net profits expected of a firm is future are ₹65,000 per years and capital invested in the business by the firm is ₹3,50,000. The rate ofinterest expected from capital invested in this class of business is 12%. The remuneration of the partners is estimated to be ₹ 5,000 for the year. Calculate thevalue of goodwill on the basis of four years purchase of super profit.

Solution:

Average Profit (Adjusted) = Average net Profit – Partner's Remuneration

=₹65,000 – ₹5,000 = ₹ 60,000

Normal Profit $=\frac{\text{Capital employed} \times \text{Normal Rate of Return}}{100}=\frac{3,50,000 \times 12}{100}$ =₹42,000

Super Profit = Average profit – Normal Profit= ₹60,000 – ₹42,000=₹18,000

Goodwill = Super Profit × No. of years purchase

Goodwill = ₹18,000× 4= ₹72,000

Illustration: 4

From the following particulars of ABC Limited you are required to calculate goodwill by 5 years purchase of super profits:

BALANCE SHEET

as at 31st March, 2019

Particulars		₹	₹
I EQUITY AND LIABILITIES:			
Shareholder's Fund			
Equity Share Capital		5,00,000	
Preference Share Capital		2,00,000	
Reserve and Surplus:			
Reserve	3,00,000		
Workmen Compensation Fund	50,000	3,50,000	10,50,000
Non-Current Liabilities			
10% Debentures			1,20,000
Current Liabilities			
Bills Payable			80,000
Total			**12,50,000**
II ASSETS:			
Non-Current Assets			
Land and Building		4,00,000	
Less: Depreciation		40,000	3,60,000

Plant& Machinery	2,50,000	
Less: Depreciation	37,500	2,12,500
Goodwill		60,000
Investment in Govt. Securities		2,00,000
Investment for Plant Replacement		50,000
Current Assets		3,50,000
Current/Non-Current Assets		
Discount on Issue of Debentures		17,500
Total		**12,50,000**

Assume normal rate of return on Average Capital Employed is 10%. Current year profit is ₹ 1,80,000. Taxation rate is 50%.

Solution:

Calculation of Net Capital Employed:		
Land and Building	3,60,000	
Plant & Machinery	2,12,500	
Investment for Plant Replacement	50,000	
Current Assets	3,50,000	9,72,500
Less:		
10% Debentures	1,20,000	
Bills Payables	80,000	2,00,000
Capital Employed		7,72,500
Less: ½ of the Current Years Profit Rs. 90,000*		45,000
Average Capital Employed		**7,27,500**

- Profit ₹1,80,000 – ₹90,000 (50% Tax) = ₹ 90,000 (PAT)
- Normal Profit = 10% of ₹ 7,27,500 (Average Capital Employed) = ₹72,750
- Super Profit = Actual Profit after Tax – Normal Profits
- = ₹90,000 – ₹72.750 = ₹ 17,250
- Calculation of Goodwill :- ₹17,250 × 5 = ₹ 86,250

1.2.3 Capitalisation Method

Goodwill can be calculated by two ways with the help of capitalisation methods. These are as follows:

- Capitalisation of Average Profits Method
- Capitalisation of Super Profits Method

Capitalisation of Average Profits Method: In this method the value of Goodwill is determined by deducting the Actual Capital Employed in the business from the Capitalised Value of Average Profits on the basis of Normal Rate of Return.

- Step-I Average Profits are ascertained on the basis of Past Few Years' Performance.
- Step-II Average Profits calculated in Step-I, are to be Capitalised on the basis of Normal Rate of Return as follows;
  [Total Value of Business = Average Profits × Normal Rate of return]
- Step-III Actual Capital Employed (Net Assets) is calculated by deducting Outside Liabilities from the Total Assets (Excluding Goodwill) as
  [Capital Employed= Total Assets (Excluding Goodwill) – Outside Liabilities]
- Step-IV Goodwill= Actual Capital Employed-Average Value of Business [Step III-Step]

For example: if average profits of a business is ₹ 60,000, actual capital employed is ₹ 5,00,000 in the business. Normal rate of return earned by other firms in the same type of business in 10%, the goodwill as per capitalisation of average profits will be calculated as follows:

Capitalised value of profits = (Average Profit × 100) / Normal Rate of Profits

= (₹ 60,000 × 100) / 10 = ₹ 6,00,000

Goodwill = Capitalised Profit – Actual Capital Employed

= ₹ 6,00,000 – ₹ 5,00,000

= ₹ 1,00,000

Capitalization of Super Profits: This method tries to find out the amount of capital needed for earning the super profit.

- Step-I Capital Employed in the business is calculated as follows
  Capital Employed= Total Assets – Outside Liabilities.
- Step-II required profit on Capital Employed is calculated as follows
  Required Profit = Capital Employed × Required Rate of Return
- Step-III Average Profits for last few years is to be calculated
- Step-IV Super Profit= Required Profits – Average Profits [Step II – StepIII]
- Step-V Goodwill = Super Profits × Required Rate of Return

Illustration: 5

From the following figures calculate goodwill as per Capitalisation method:-

- Actual Average Profits ₹1,20,000.
- Normal Rate of Return for the same business is 12%.
- Average Capital Employed is ₹7,50,000.

Solution:

- Capitalisation of Average Profits Method:

  Goodwill = Capitalised Profit – Actual Capital Employed

  Capitalised value of average profits = (Average Profit × 100) / Normal Rate of Profits

  = (₹ 1,20,000 × 100) / 12 = ₹ 10,00,000

Goodwill = ₹ 10,00,000 – ₹ 7,50,000= ₹ 2,50,000

- Capitalisation of Super Profits Method:

Goodwill = (Super Profit × 100) / Normal Rate of Profits

Calculation of Super Profit: = Actual Average Profit – Normal Profit

= ₹1,20,000 – 12% of ₹7,50,000

= ₹1,00,000 – ₹ 9,00,00

Super Profit = ₹30,000

Goodwill = (₹30,000 × 100) / 12% = ₹ 2,50,000

Illustration: 6

From the following figures in Balance Sheet of ABC Limited as at 31st March 2020:-

Particulars	₹	₹
I EQUITY AND LIABILITIES:		
Shareholder's Fund		
Equity Share Capital (50,000 shares of 10 each)		5,00,000
Profit & Loss Balance		40,000
Non-Current Liabilities:		
Current Liabilities		
Bank Overdraft		3,11,600
Trade Payable		4,68,400
Provision for Taxation		71,000
Total		**13,91,000**
II ASSETS:		

Non-Current Assets		
Land and Building		4,00,000
Plant & Machinery		3,00,000
Goodwill		80,000
Current Assets		5,75,000
Current/Non-Current Assets		
Discount on Issue of Debentures		36,000
Total		**13,91,000**

Profit before tax (50%) of last three years are: 2017-18 ₹ 1,20,000; 2018-19 ₹ 1,00,000; 2019-20 ₹ 1,52,000. Other information's are as follows:

Present Value of Plant &Machinery is ₹2,30,000.

Average dividend paid by the company during last three years is 10% which is reasonable expected return on capital invested in the business.

Calculate the value of goodwill according to capitalisation method.

Solution:

Step 1: Calculation of Average Profit:-

Total Profit for 3 years (₹1,20,000 + 1,00,000 + 1,52,000)	3,72,000
Less: 50% Income Tax	1,86,000
Profit After Tax	1,86,000
Average Profit = 1,86,000 / 3	62,000

Step 2: Calculation of Average Capital Employed:

Land and Building (present value) Plant Current Assets		4,60,000 3,00,000 5,75,000
		13,35,000
Less: Current Liabilities: Bank Overdraft Trade Payables Provision for Taxation	 3,11,600 4,68,400 71,000	 8,51,000
Capital Employed		4,84,000
Less: ½ of Current year profit after tax (76,000)		38,000
Average Capital Employed		4,46,000

Step 3: Calculation of Goodwill:-

Goodwill = Capitalised Profits – Average Capital Employed

Capitalised Profit = (Average Profit × 100) / Normal Rate of Profit

= (₹ 62,000 × 100) / 10 = ₹ 6,20,000

Goodwill = ₹ 6,20,000 – ₹ 4,46,000 = ₹ 1,74,000

1.2.4 Purchase Consideration Method

Goodwill as per this method is the excess amount of purchase consideration over the net assets of the business.

Goodwill = Purchase Consideration – Net Assets (Assets – Outside Liabilities)

For example, if the assets of a business amount to ₹50,00,000, its liabilities are ₹20,00,000, and business is purchased for ₹ 42,00,000; the amount of goodwill will be:

Goodwill = ₹ 42,00,000 (Purchase Consideration) – ₹ 30,00,000 Net Assets (₹ 50,00,000 Assets – ₹ 20,00,000 Outside Liabilities) = ₹ 12,00,000

1.2.5 Annuity Method

Goodwill, in this case, is the discounted value of the total amount calculated as per purchase method. The idea behind super profits methods is that the amount paid for goodwill will be recouped during the coming few years. But in this case, there is a heavy loss of interest. Hence, properly speaking what should be paid now is only the annuity value of super profits paid annually at the proper rate of interest. Tables show that the present value of ₹ 0.282012 annuity for 4 years @ 5 % is Re. 1.

Formula: Goodwill = Super Profit × Present Value Factor

Goodwill is calculated as follows;

- Step-I Future Super Profits has to be calculated.
- Step-II Rate of Return has to be fixed.
- Step-III Present Value Factor has to be calculated by using Annuity Table.
- Step-IV Present Value Factor has to be multiplied by Super Profit Calculated in Step-I.
- Step-V Average Sum Total of Product of the Present Value Factor and Super Profits of the Goodwill.

For example if super profit is ₹ 4,000 and goodwill is calculated on the basis of 4 years super profit then as per annuity method the value of goodwill will be:

= ₹ 4,000 × 1/0.282012 = ₹14,184

Illustration:7

M/s XY is a partnership firm with X and Y as its partners. They now decide to admit Z in the firm and hence need to value goodwill. Capital employed is ₹ 5,00,000 at the end of the 4th year. The normal rate of return is 15%. Assume the interest rate is equal to the Normal Rate of Return. Calculate Goodwill using Annuity Method. Their profits for the last 4 years are:

Year	Profits
1	₹ 1,00,000
2	₹ 1,20,000
3	₹ 1,50,000
4	₹ 2,00,000

Solution:

- Average Profit = Total profits / No. of years = ₹ 5,70,000/4 = ₹ 1,42,500
- Normal Profit = Capital employed × (Normal Rate of Return/100) = ₹ 5,00,000 × (15/100) = ₹ 75,000.
- Super Profit = Average Profit – Normal Profit = ₹ 1,42,500 – ₹ 75,000 = ₹ 67,500

Goodwill = Super Profit × Discounting factor = ₹ 67,500 × 2.855 = ₹ 1,92,713

1.3 Check Your Progress

1. Goodwill is termed as:

a) An intangible asset
b) A fixed asset
c) Realisable
d) All of the above

2. Super profit is:

a) Excess of average profit over normal profit

b) Extra profit earned

c) Average profit earned by similar companies

d) None of the above

3. Normal Rate of Return depends on:

a) Rate of Interest

b) Rate of Risk

c) Both (a) and (b)

d) None of the above

4. While calculating capital employed,

a) Tangible trading assets should be considered

b) Intangible assets should be considered

c) Fictitious assets should be considered

d) None of the above

5: Under capitalisation of super profit method, Goodwill is equal to:

a) Capitalised value of super profit at NRR

b) Capitalised value of maintained profit

c) Both (a) and (b)

d) None of the above

6. Any non-trading income included in the profit should be:

a) Eliminated

b) Added

c) Ignored

d) None of the above

1.4 Summary

Goodwill may be described as the aggregate of those intangible attributes of a business which contribute to its superior earning capacity over a normal return on investment. It may arise from such attributes of a business as good reception, a favourable location, the ability and skill of its employees and management, nature of its products, etc. Goodwill is an intangible asset. The real value is indeterminable for a non-purchased goodwill and based on arbitrary measurement. Financial advisers are often asked to value these different types of goodwill for transaction, taxation, financial accounting, litigation, and other purposes. This chapter describes meaning, need and the various factors which have impact on valuation of goodwill. There are various methods of valuation of goodwill is often based on the customs of the trade and generally calculated as number of year's purchase of average profits or super-profits.

1.5 Keywords

Goodwill: Goodwill in accounting is an intangible asset that arises when a buyer acquires an entire existing business.

1. **Super Profit:** Super profit is the excess of average profits over normal profits.
2. **Capital Employed**: Capital employed refers to the value of all the assets used by a company to generate earnings
3. **Intangible Assets:** An intangible asset is a long-term financial value to a business but not have material object.
4. **Fictitious Assets:** Fictitious Assets are not assets these are those expenses which are unclaimed and treated as an asset in the balance sheet.
5. **Annuity:** An annuity is a series of payments made at equal intervals.

1.6 Self-Assessment Test

Short Answer Questions:

1. Define Goodwill.
2. Need for valuation of goodwill.
3. Explain the super profit method of valuing goodwill.
4. Explain capitalisation of average profits method valuing goodwill.
5. Write short note on:
    - Capital Employed
    - Average Profit Method
    - Super profit method of valuing goodwill

Long Answer Questions:

1. What do you mean by Goodwill? What are the situations where calculation of goodwill is needed?
2. Explain the factors affecting the valuation of goodwill. Discuss the methods which are used for goodwill valuation.
3. Explain the term Goodwill. What are the factors having impact on calculation of Goodwill?
4. What is Goodwill? Explain the various method of calculating Goodwill.
5. Explain super profit method of valuing Goodwill with the help of example.

Numerical Questions:

1. Ram and sons earn an average profit of ₹ 60,000 with a capital of ₹ 4,00,000. The normal rate of return is 10%. Using capitalization of super profits method calculate the value the goodwill of the firm.

   (Answer ₹ 2,00,000).

2. The average net profits expected of ABC firm is future are ₹ 68,000 per years and capital invested in the business by the firm is ₹ 3,50,000. The rate of interest expected from capital invested in this class of business is 12%. The remuneration of the partners is estimated to be ₹ 8,000 for the year. Calculate the value of goodwill on the basis of four years purchase of super profit.

   (Answer ₹ 72,000).

3. Ram and Mohan are partners in a retail business. Balances in Capital & Current Accounts as on 31st March 2019 were:
   - Capital Account showing Ram ₹ 4,00,000 (Cr) ; Mohan ₹ 4,80,000 (Cr).
   - Current Account showing Ram ₹ 1,00,000 (Cr); Mohan ₹ 20,000 (Dr).

   The firm earned an average profit of ₹ 1,10,000. If the normal rate of return is 10%, find the value of goodwill.

   (Answer ₹ 1,40,000).

4. Average Profit of the firm is ₹ 1,50,000. Total tangible assets in the firm are ₹ 13,00,000& outside liabilities are ₹ 8,00,000. In the same type of business, the normal rate of return is 20%. Calculate the value of goodwill of the firm by Capitalization of Super Profit method.

   (Answer ₹ 2,50,000).

5. From the following figures calculate goodwill as per Capitalisation method:-
    - Actual Average Profits ₹ 2,40,000.
    - Normal Rate of Return for the same business is 12%.
    - Average Capital Employed is ₹ 15,00,000.

(Answer ₹ 5,00,000).

6. M/s XY is a partnership firm with X and Y as its partners. They now decide to admit Z in the firm and hence need to value goodwill. Capital employed is ₹ 5,00,000 at the end of the 4th year. The normal rate of return is 15%. Assume the interest rate is equal to the Normal Rate of Return. Calculate Goodwill using Annuity Method. Their profits for the last 4 years are:

Year	Profits
1	₹ 1,00,000
2	₹ 1,20,000
3	₹ 1,50,000
4	₹ 2,00,000

(Answer ₹ 1,99,850)

1.7 Answers to check your progress

1(d), 2 (a), 3(c), 4 (a), 5(a), 6 (a)

1.8 References/ Suggested Readings

- Gupta, Nirmal. Corporate Accounting, SahityaBhawan, Agra
- Jain, S.P. and K.L. Narang. Corporate Accounting, Kalyani Publishers, New Delhi.
- Maheshwari, S.N. and S. K. Maheshwari. Corporate Accounting, Vikas Publishing House, New Delhi.
- Monga, J.R. Fundamentals of Corporate Accounting, Mayur Paper Backs, New Delhi.
- Naseem Ahmed, Corporate Accounting, ANE Books Pvt. Ltd. New Delhi.
- Sehgal, Ashok and Deepak Sehgal. Corporate Accounting, Taxman Publication, New Delhi.
- Shukla, M.C., T.S. Grewal, and S.C. Gupta. Advanced Accounts, S. Chand & Co., New Delhi.

Subject: Corporate Accounting	
Course Code: BCOM- 301	**Author:** Dr. Sanjeev Kumar Garg
Lesson No.: 2	**Vetter:** Prof. Suresh Kumar Mittal
Valuation of Shares	

Structure

2.0 Learning Objectives

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

- Know the meaning of valuation of Shares
- Understand the purpose of valuing Shares

- Know the factors that affect valuation of Shares
- Know the various methods of valuing Shares

2.1 Introduction

In the cases of shares quoted in the recognised Stock Exchanges, the prices quoted in the Stock Exchanges are generally taken as the basis of valuation of those shares. However, the Stock Exchange prices are determined generally on the demand-supply position of the shares and on business cycle. The Stock Exchange may be linked to a scientific recording instrument which registers not its own actions and options but the actions and options of private institutional investors all over the country/world. These actions and options are the result of fear, guesswork, intelligent or otherwise, good or bad investment policy and many other considerations. The quotations what result definitely do not represent valuation of a company by reference to its assets and it’s earning potential.

Valuation of share is the most complex of the accounting problems, although various tax laws have made specific provisions for the valuation of share and have laid down the exact procedure to be followed.

2.1.1 Need or Purpose of Valuation of Shares

The need for valuation of shares may be felt by any company in the following circumstances:

- When shares are received as gift, it is necessary to valuation of shares for the purpose of assessing tax on the gift.
- For assessment of Wealth Tax, Estate Duty etc.
- Amalgamations, absorptions, internal reconstruction schemes.
- For purchase and sale of private companies and other unquoted shares.
- For converting one class of shares to another class.
- Advancing loans on the security of shares.
- Compensating the shareholders on acquisition of shares by the Government under a scheme of nationalisation.
- Acquisition of interest of dissenting shareholder under the reconstruction scheme.
- For the valuation of shares held by a trust or an investing company.

2.1.2 Factors affecting valuation of Shares

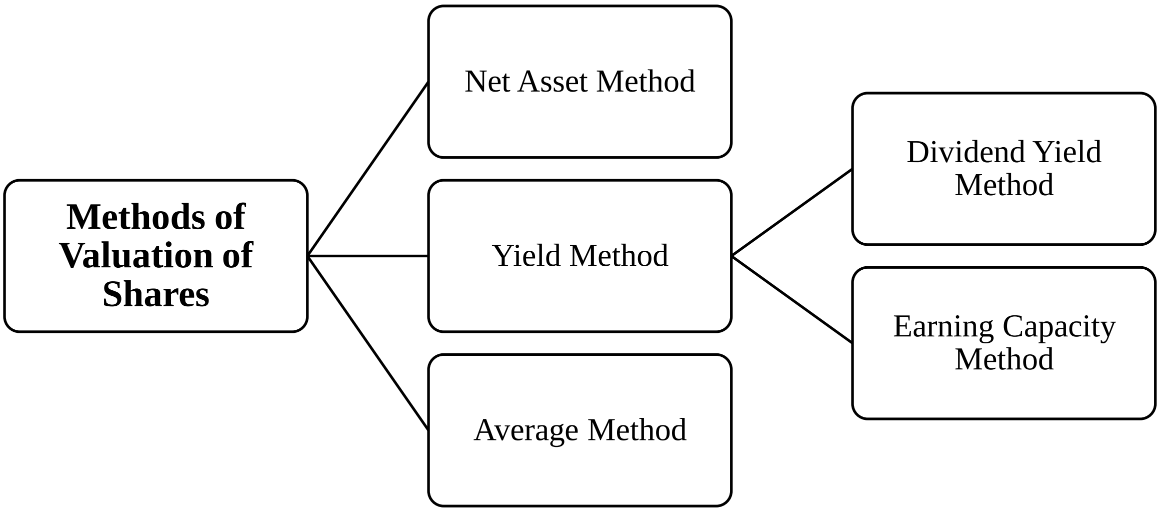
The value of share of a company depends on so many factors such as:

- **Earning capacity of the company:** In this regard average profit earned by company in past, lowest and highest profit earned in past, average rate of return on capital employed, profit after tax and preference dividends, and events that affect the profits are considered.
- **Dividend Policy of the company:** Payment of dividend plays an important role in the valuation of share, where an investors hold bulk of shares in a position to influence the rate of dividend. Therefore, distributable profits play an important role in the valuation of shares.
- **Financial Ratios:** A company having better financial ratios such as Current Ratio, Debt-Equity ratio, ROE is always favoured by the investors.
- **Nature of Business:** Nature of company's business affects the value of shares a lot. If company is doing a business having better future growth, have positive impact on value of share of the company.
- Record of efficiency, integrity and honesty of Board of Directors and other managerial personnel of the company.
- Quality of top and middle management of the company and their professional competence.
- Record of performance of the company in financial terms.
- Economic policies of the Government.
- Demand and supply of shares.
- Rate of dividend paid.
- Yield of other related shares in the Stock Exchange, etc.
- Net worth of the company.
- Earning capacity.
- Quoted price of the shares in the stock market.
- Profits made over a number of years.
- Extent of competition
- Future prospects of the company.
- Dividend paid on the shares over a number of years.

- Prospects of growth, enhanced earning per share.
- Availability of reserves and future prospects of the company.
- Realisable value of the net assets of the company.
- Current and deferred liabilities for the company.

2.2 Methods of Valuing Shares

Certain methods have come to be recognised for valuation of shares of a company, these are:



- Net Assets Method
- Dividend Yield Method
- Earning Yield Method
- Average Method.

2.2.1 Net Assets Method

This method is also called as Assets Backing Method, Real Value Method, Balance Sheet Method or Break-up Value Method. Under this method, the net assets of the company including goodwill and non-trading assets are divided by the number of shares issued to arrive at the value of each share.If the market value of the assets is available, the same is to be considered and in the absence of such information, the book values of the assets shall be taken as the market value.

$$\text{Value of Share} = \frac{\text{Net Assets}}{\text{Number of Equity Shares}}$$

First Method:-

Assets at Market Value:-			D
Goodwill, Land and Building, Plant and Machinery, Inventory, Sundry Debtors, Bills Receivables etc.			---------
Less:	Outstanding Liabilities:-		
	Debentures	--------	
	Trade Payables	--------	
	Other Liabilities	--------	
Less:	Preference Share Capital		--------
	Value of Net Assets available for Equity Shareholders		---------

Second Method:-

	Equity Share Capital		
	Reserve & Surplus	--------	
	Accumulated Profits	--------	
	Profit on revaluation of assets	--------	
Less:	Accumulated Losses		--------
	Preliminary Expenses		
	Value of Net Assets available for Equity		--------

Shareholders

Points to Note:

- While arriving at the net assets, the fictitious assets such as preliminary expenses, the debit balance in the Profit and Loss A/c should not be considered.
- The liabilities payable to the third parties and to the preference shareholders is to be deducted from the total asset to arrive at the net assets.
- The funds relating to equity shareholders such as General Reserve, Profit and Loss Account, Balance of Debenture Redemption Fund, Dividend Equalisation Reserve, Contingency Reserve, etc. should not be deducted.

Steps

- Under this method, value of the net assets of the company is to be determined first.
- Thereafter, the net assets are to be divided by the number of shares in order to rind out the value of each share.

However, these following points should be carefully followed while calculating Net Assets or the Funds available for Equity Shareholders:

- Ascertain the total market value of fixed assets and current assets;
- Compute the value of goodwill (as per the required method);
- Ascertain the total market value of non-trading assets (like investment) which are to be added;
- All fictitious assets (e.g. Preliminary Expenses, Discount on issue of Shares/Debentures, Debit-Balance of P&L A/c etc.) must be excluded;
- Deduct the total amount of Current Liabilities, Amount of Debentures with arrear interest," if any, Preference Share Capital with arrear dividend, if any.
- The balance left is called the Net Assets or Funds Available for Equity Shareholders.

Applicability of this method:

- The permanent investors determine the value of shares under this method at the time of purchasing the shares;

- The method is particularly applicable when the shares are valued at the time of Amalgamation, Absorption and Liquidation of companies; and
- This method is also applicable when shares are acquired for control motives.
- Provisions of various tax laws (wealth tax rules) provide for this method valuing the shares.

Disadvantages of Net Asset Method:

- This method applicable in case of liquidation of company. Since company is treated as a going concern and where there is no possibility of its liquidation in the near future, this method is far from reality.
- This method does not take into consideration the profit of the company.
- Due to personal bias it is difficult to calculate market value of assets.
- This method ignore various factors such as financial ratios, nature of business, management of company, future prospect of the company which have impact on value of shares.

Illustration 1:

From the following Balance Sheet of XYZ Ltd. you are asked to-ascertain the value of each Equity Share of the company:

Particulars		₹
I. EQUITY AND LIABILITES :		
Shareholder's Fund :		
Equity Share Capital (40,000 Shares of Rs. 10 each)		4,00,000
General Reserve		2,90,000
Profit & Loss Balance		64,000
Non-Current Liabilities		
Employee's Provident Fund		30,000
Current Liabilities		
Trade Payables		1,72,000

Workmen Saving Account		56,000
Short term provision : Taxation Provision		24,000
TOTAL		10,36,000
II. ASSETS :		
Non-Current Assets :		
Land and Building		4,20,000
Plant and Machinery		1,40,000
Goodwill		80,000
Investment (Market Value Rs. 60,000)		40,000
Current Assets :		
Inventory		1,20,000
Bills Receivables		1,60,000
Cash at Bank		60,000
Current/ Non-Current Assets		
Share Issue Expenses		16,000
TOTAL		10,36,000

Land and Building have been valued at Rs. 6,00,000 and Plant and Machinery is Rs. 1,20,000. From bills receivables Rs.10,000 was bad. Goodwill was taken Rs. 1,40,000.

Solution:

	Rs
Land and Building	6,00,000
Plant and Machinery	1,20,000
Goodwill	1,40,000

Investment		60,000
Inventory		1,20,000
Bills Receivables (Rs. 1,60,000 – Rs. 10,000)		1,50,000
Cash at Bank		60,000
(A)		**12,50,000**
Less:	Liabilities:	
	Employee's Provident Fund	30,000
	Trade Payables	1,72,000
	Workmen Saving Account	56,000
	Taxation Provision	24,000
(B)		**2,82,000**
Net Assets (A – B)		**9,68,000**

$$\text{Value of Share} = \frac{\text{Net Assets}}{\text{Number of Equity Shares}}$$

$$\text{Value of Share} = \frac{9,68,000}{40,000 \text{ Shares}} = ₹\ 24.20 \text{ per Share}$$

Different class of equity share in Balance Sheet: In such case unit value of capital should be obtained by dividing the amount of net assets by the total paid up equity capital.

- Unit value of Capital = Total amount of net assets / Total paid up equity capital
- Thereafter = Paid up value × unit value of Capital =Value of equity share

Illustration 2:

X Ltd. presented the following Balance Sheet as on 31st March 2019. Ascertain the value of shares on the basis of following information:

Particulars		₹	₹
I. EQUITY AND LIABILITES :			
Shareholder's Fund :			
Equity Share Capital			
(i) 20,000 Equity Shares of Rs. 10 each fully paid		2,00,000	
(ii) 40,000 Equity Shares of Rs. 7 each fully paid		2,80,000	
(iii) 80,000 Equity Shares of Rs. 5 each fully paid		4,00,000	
Reserve and Surplus:			
General Reserve			
Debenture Redemption Fund	2,50,000		
Profit & Loss Balance	50,000		
Non-Current Liabilities	50,000	3,50,000	12,30,000
10% Debentures			
Current Liabilities			
Bills Payable			
			2,00,000
			90,000
TOTAL			15,20,000
II. ASSETS :			
Non-Current Assets :			
Fixed Assets		12,00,000	
Less: Depreciation Fund		1,80,000	10,20,000
Current Assets			4,68,000
Current/ Non-Current Assets			

Share Issue Expenses Discount on Debentures		22,000 10,000
TOTAL		15,20,000

Assets are worth their book values. Interest on debentures is outstanding for six months.

Solution:

Calculation of Net Assets :			
Fixed Assets		10,20,000	
Current Assets		4,68,000	14,88,000
Less: Liabilities			
10% Debentures		2,00,000	
Bills Payables		90,000	
Debentures interest		10,000	3,00,000
Net Assets			**11,88,000**

Total Equity Capital (paid up):

2,00,000 + 2,80,000 + 4,00,000 = ₹ 8,80,000

Unit Value of Capital =₹ 11,88,000 / 8,80,000 = ₹ 1.35

- Value of ₹ 10 paid share = ₹ 10 × 1.35 = ₹13.50
- Value of ₹ 7 paid share =₹ 7 × 1.35 = ₹ 9.45
- Value of ₹ 5 paid share = ₹× 5 1.35 =₹ 6.75

When Preference Shares are also appearing in Balance Sheet: According to the Companies Act, the preference shares have a right to receive their capital and arrears of dividend in preference to the equity shares. As such, the capital and dividend of preference shares must be deducted from net assets in ascertaining the value of an equity share.

Illustration 3:

Particulars		₹
II. EQUITY AND LIABILITES :		
Shareholder's Fund :		
Equity Share Capital (40,000 Shares of ₹ 10 each)		4,00,000
Preference Share Capital		
(2,000, 10% Preference Shares of ₹ 100 each)		2,00,000
General Reserve		2,90,000
Profit & Loss Balance		64,000
Non-Current Liabilities		
Employee's Provident Fund		30,000
Current Liabilities		
Trade Payables		1,72,000
Workmen Saving Account		56,000
Shor term provision : Taxation Provision		24,000
TOTAL		12,36,000
III. ASSETS :		
Non-Current Assets :		
Land and Building		5,20,000
Plant and Machinery		2,40,000
Goodwill		80,000
Investment (Market Value Rs. 60,000)		40,000
Current Assets :		
Inventory		1,20,000

Bills Receivables		1,60,000
Cash at Bank		60,000
Current/ Non-Current Assets		
Share Issue Expenses		16,000
TOTAL		12,36,000

Preference dividends are in arrears for the last two years. Land and Building have been valued at Rs 6,00,000 and Plant and Machinery is Rs. 1,20,000. From bills receivables Rs.10,000 was bad. Goodwill was taken Rs. 1,40,000.

Solution:

		Rs.
Land and Building		6,00,000
Plant and Machinery		1,20,000
Goodwill		1,40,000
Investment		60,000
Inventory		1,20,000
Bills Receivables (Rs. 1,60,000 – Rs. 10,000)		1,50,000
Cash at Bank		60,000
(A)		**12,50,000**
Less:	Liabilities:	
	Employee’s Provident Fund	30,000
	Trade Payables	1,72,000
	Workmen Saving Account	56,000
	Taxation Provision	24,000

(B)		**2,82,000**
Net Assets (A – B)		**9,68,000**
Less: Preference Share Capital	2,00,000	
Preference Share Dividend	40,000	**2,40,000**
		7,28,000

$$\text{Value of Share} = \frac{\text{Net Assets}}{\text{Number of Equity Shares}}$$

$$\text{Value of Share} = \frac{7{,}28{,}000}{40{,}000 \text{ Shares}} = ₹\ 18.20 \text{ per Share}$$

Different conditions of Preference Shares

- If preference share have priority as to the payment of capital only
- If preference share have priority as to the payment of capital dividend only
- If preference share have priority as to the payment of both capital and dividend
- If preference share have no priority of capital and dividend

In above illustration:

• **If preference share have priority as to the payment of both capital and dividend**		
Net Assets		**9,68,000**
Less: Preference Share Capital	2,00,000	
Preference Share Dividend	40,000	**2,40,000**
		7,28,000
Value of Share = $\frac{7{,}28{,}000}{40{,}000 \text{ Shares}}$ = ₹ 18.20 per Share		
• **If preference share have priority as to the payment of capital only**		

Net Assets	**9,68,000**
Less: Preference Share Capital	**2,00,000**
	7,68,000
Value of Share = $\frac{7,68,000}{40,000 \text{ Shares}}$ = ₹ 19.20 per Share	
• **If preference share have priority as to the payment of capital dividend only**	
Net Assets	**9,68,000**
Less: Preference Share Dividend	**40,000**
	9,28,000
Value of Share = $\frac{9,28,000}{40,000 \text{ Shares}}$ = ₹ 23.20 per Share	
• **If preference share have no priority of capital and dividend**	
Net Assets	**9,68,000**
Value of Share = $\frac{9,68,000}{40,000 \text{ Shares}}$ = ₹ 24.20 per Share	

Thus, the ratio of exchange is 5,000 shares of X Ltd. for 10,000 shares of Y Ltd. i.e., the ratio is 1 : 2 or 1 share of X Ltd. is equal to 2 shares of Y Ltd.

2.2.2 Dividend Yield Method

Under the dividend yield method, the emphasis goes to the yield that an investor expects from his investment. The yield, here we mean, is the possible return that an investor gets out of his holdings—dividend, bonus shares, right issue. If the return is more, the price of the share is also more. Under this method the valuation of shares is obtained by comparing the expected rate of return with normal rate of return. The formula is:

$$\text{Value of Share} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Paid up value of Share}$$

For instance, if paid up value of a share is ₹100 and expected rate of return is 9% while normal rate of return is 6%, then the value of shares will be:

$$(9/6) \times 100 = ₹150$$

Yield is the effective rate of return on investments which is invested by the investors. It is always expressed in terms of percentage. Since the valuation of shares is made on the basis of Yield, it is called Yield-Basis Method. For example, an investor purchases one share of ₹ 100 (face value and paid-up value) at ₹ 150 from a Stock Exchange on which he receives a return (dividend) @ 20%.

For calculating value of share under dividend yield method following two elements should be ascertained:

Ascertained Expected Rate of Dividend: For this amount available for distribution among equity shareholders is calculated by following way:

Profit of the Company		----------
Less: • Income Tax • Transfer to Reserve • Transfer to debenture sinking fund • Preference Share dividends	……… ……… ……… ………	----------
Profit available for distribution among equity shareholders		----------

This amount is divided by the paid up equity capital to ascertain expected rate of dividend:

Expected Rate of Dividend

$$= \frac{\text{Profit available for distribution among equity shareholders}}{\textit{Paid up equity capital}} \times 100$$

Ascertained Normal Rate of Dividend: Normal rate of dividend is no need for calculation as is already stated in the question.

Limitations of Dividend Yield Method:

Following are some limitations of dividend yield method:

- This method gives too much weightage to the dividend factor. If a company earns huge profits but not giving dividend the value of share according to this method will be nil.
- Similarly, financially weak company paying high dividend this method will give a higher value to the share of company.
- If this method is used for valuing share, value can be manipulated by increasing or decreasing the rate of dividend by the directors.
- This method not consider assets of the company.
- This method ignore various other factor having impact on value of share such as Govt. policy, future prospects of the company.
- In practice it is very difficult to expected and normal rate of dividend.

Applicability of Dividend Yield Method:

- This method is suitable for those investors who wished to hold the shares for short term and the objective is to get dividends.
- Where rate of dividend does not change frequently and dividend declared related with profits.
- When company is regularly paying dividends and having no past losses.
- When company has no plan for liquidation in near future.
- When information related to expected dividend is readily available.

<u>Illustration 4:</u>

ABC Limited declares dividend at 20% on its equity shares of ₹10 each, ₹8 paid up. If normal rate of dividend in the market is 8%, what shall be the value of a share on the basis of dividend yield method?

Solution:

$$\text{Value of Share} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Paid up value per share}$$

It is assumed that ABC Limited will declare 20% dividend in the future.

$$\text{Value of Share} = \frac{20}{8} \times 8 = ₹\ 20$$

Illustration 5:

From the following information of a company, calculate the value of equity share.

- Equity Share Capital (issued) — 80,000 shares of ₹10 each
- Paid up Equity share capital — ₹8 per share
- 12% Preference Share Capital — 30,000 shares of ₹10 each fully paid
- Transfer to General Reserve — ₹18,000
- Rate of Tax — 40%
- Expected Profit before tax — ₹4,00,000
- Normal Rate of Dividend — 16%

Solution:

Step 1:- Calculation of profit available for the equity shareholders:

Profit of the Company	4,00,000
Less: Income Tax	1,60,000
Profit after Tax	2,40,000
Less: Transfer to Reserve	18,000
	2,22,000

Less: Preference Share dividends	30,000
Profit available for distribution among equity shareholders	1,92,000

Step 2:- Calculation of Expected Rate of Dividend:--

$$\text{Expected Rate} = \frac{\text{Profit Available to E.S.H.}}{\text{Total paid up Equity Capital}} \times 100$$

$$= \frac{1,92,000}{6,40,000} \times 100 = 30\%$$

Step 2:- Calculation of Value of share:--

$$\text{Value of Share} = \frac{30}{16} \times 8 = ₹\ 15$$

2.2.3 Earning Yield Method

The main drawback of dividend yield method was that valuation of share depends on actual dividend declared by a company and also ignores the earning capacity of the business. Sometimes better managed companies retained their earned and distributed in later in form of bonus shares, so it is appropriate to value the share on the basis of company's earnings rather than dividend. Therefore in earning capacity method rate of earning of company is compared with normal rate of return prevailing in the similar industry. The formula is:

$$\text{Value of Share} = \frac{\text{Rate of Earnings}}{\text{Normal Rate of Return}} \times \text{Paid up value per share}$$

For calculating the value of share with earning capacity method you have to ascertain following two elements:

Rate of Earnings: Estimated future earnings are expressed as a percentage of capital employed for the company. The formula is:

$$\text{Rate of Earnings} = \frac{\text{Profit Earned}}{\text{Capital Employed}} \times 100$$

Estimated future earning: It is calculated by making certain adjustments in the past profits:-

Past profits must be adjusted in the light of following future expectations:
<u>Add:</u> • Abnormal Loss • Income expected in future • Stoppage of future expenses
<u>Less:</u> • Abnormal Gains / Profits • Income from Investments • Non-operating Income • Operating Expenses expected to be incurred in future • Stoppage of future earnings
<u>Adjustment:</u> • *Managerial Remuneration:* It can be added of can be deducted on the basis of managerial remuneration paid in future. If it is estimated to be paid in future is in excess, it should be deducted. If estimated to be paid in future is less, it should be added. • *Income Tax:* Average profits should be calculated after deducting tax at current rates.

Notes: If past profits are in increasing trend, then calculate Average Profit by weighted average method or otherwise simple average method.

Calculation of Weighted Average Profit: If profits are continuously increasing weighted average profit is calculated for valuing goodwill. For this higher weightage is given to the recent year of profits and lower to the far year's profit e.g. profit of 2019-20 could be similar to the profits of 2018-19 as compared to 2013-14 profits. Thereafter profits are multiplied by their weight, then after totalling the whole amount and divide by total weight.

Year	Profit₹	Weight	Products₹
2013-14	1,00,000	1	1,00,000
2014-15	1,40,000	2	2,80,000

2015-16	2,00,000	3	6,00,000
2017-18	2,50,000	4	10,00,000
2018-19	3,00,000	5	15,00,000
Total		**15**	**34,80,000**

Weighted Average Profit = 34,80,000/15 = ₹ 2,32,000

While calculating future maintainable profits following factors must be taken in to consideration:

- Change in management of company
- Change in economic conditions
- Change in structure of company
- Change in government policy
- Change in demand of product of company

Capital Employed: While calculating capital employed following points should be considered on the basis of balance sheet items:

Calculation of Capital Employed
Add All fixed and current assets at current market price: ***Note:*** • Fictitious assets such as Share issue expenses, discount of issue of debentures, advertisement expenditure, underwriting commission should not be included. • Investment is the amount invested outside the business and in the nature of non-trading assets, therefore should not be include in assets.
Deduct: • Current Liabilities such as Creditors, Bills Payable, Bank Overdraft, Outstanding expenses, Provision for taxation etc.
Capital Employed = All Fixed Assets – Current Liabilities

Note: Profit should be figure before debenture interest and preference dividend. If these are already deducted from profit then same must be added back.

Illustration: 6

Calculate the value of share on the basis of following information in Balance Sheet.

Particulars	₹
I. **EQUITY AND LIABILITIES:**	
Shareholders' Fund:	
1,00,000 Equity Shares of ₹10 each	10,00,000
Reserve and Surplus	3,00,000
Non-Current Labilities	
8% Debentures	2,50,000
Current Liabilities	2,00,000
Total	17,50,000
II. **ASSETS**	
Current/Non-Current Assets:	
Sundry Assets (including goodwill)	17,50,000
Total	17,50,000

Market value of the assets ₹16,00,000. Company earns profit of ₹5,50,000 per annum after interest on debentures but before tax. Normal rate of return in such type of company is 10%. Assume income tax rate is 40%.

Solution:

Capital Employed = Sundry Asset as per market value – Current Liabilities

= 16,00,000 – 2,00,000 = ₹14,00,000

Profit after Tax = 5,50,000 – 40% of 5,50,000 = 5,50,000 – 2,20,000 = ₹ 3,30,000

PAT + Interest on Debenture = 3,30,000 + 20,000 = ₹ 3,50,000

Rate of Earning = $\frac{\text{Profit Earned}}{\text{Capital Employed}} \times 100$

$= \frac{3,50,000}{14,00,000} \times 100 = 25\%$

Value of Share = $\frac{25}{10} \times 10$ = ₹ 25 per share

Illustration: 7

Calculate the value of share based on earning capacity method from the following information in Balance Sheet.

Particulars		₹
III. **EQUITY AND LIABILITIES:**		
Shareholders' Fund:		
80,000 Equity Shares of ₹ 10 each		8,00,000
Preference Share Capital		
(1,500, 10% Preference Shares of 100each)		1,50,000
Reserve and Surplus		
General Reserve		1,00,000
Profit & Loss Balance (Opening)		80,000
Profit for 2019 (before taxation)		5,50,000
Non-Current Labilities		
Current Liabilities		
Trade Payable		80,000
Total		17,60,000

IV. **ASSETS**		
Non-Current Assets:		
Building		4,50,000
Furniture		1,10,000
5% Govt. Securities (Face value 3,00,000)		3,60,000
Current Assets		
Inventory at Market value		4,00,000
Bills Receivable		2,40,000
Cash and Bank Balance		1,90,000
Current/Non-Current Assets:		
Share Issue Expenses		10,000
Total		17,60,000

Other information's are:

- Building are net worth ₹4,00,000
- Similar companies earning capacity is 15% in same industry.
- Profits for the past three years have shown an increase of ₹40,000 annually.
- Assume income tax rate is 40%.

Solution:

Calculation of Net Capital Employed:	₹
Building	4,00,000
Furniture	1,10,000
Inventory	4,00,000
Bills Receivables	2,40,000

Cash and Bank Balance	1,90,000
	13,40,000
Less: Bills Payable	80,000
Net Capital Employed	12,60,000

Calculation of Average Profit:

Step 1: Calculation of Actual Profit

- Profit in 2019 ₹5,50,000
- Profit in 2018 ₹5,10,000
- Profit in 2017 ₹4,70,000

Since profit is rising continuously, we have to calculate weightage average:

Year	Profit₹	Weight	Product₹
2017	4,70,000	1	4,70,000
2018	5,10,000	2	10,20,000
2019	5,50,000	3	16,50,000
		6	31,40,000

Average Profit = ₹31.40,000 / 6 = ₹5,23,333

Average Profit	5,23,333
Less: Interest on Govt. Security	15,000
	5,08,333
Less: Taxation (40%)	2,03,333
	3,05,000

Rate of Earning = $\frac{\text{Profit Earned}}{\text{Capital Employed}} \times 100$

$= \frac{3{,}05{,}000}{12{,}60{,}000} \times 100 = 24.21\%$

Value of Share = $\frac{24.21}{15} \times 10$ = ₹ 16.14 per share

2.2.4 Average Method

None of method discussed earlier give a true and fair value of the share due to much difference in the value of share calculated by different method. Therefore, it is suggested that valuation may be done by any two methods and be averaged to find out value of share. This average value is considered Fair Value of the share.

<u>Illustration: 8</u>

From the following information in Balance Sheet calculate the fair value of share.

Particulars		₹
I. **EQUITY AND LIABILITIES:**		
Shareholders' Fund:		
20,000 Equity Shares of ₹ 100 each		20,00,000
Reserve and Surplus		5,00,000
Non-Current Labilities		
12% Debentures		20,00,000
Current Liabilities		
Other Liabilities		5,00,000
Total		50,00,000
II. **ASSETS**		

Non-Current Assets:		
Building		24,00,000
Furniture		3,00,000
Plant & Machinery		7,00,000
Goodwill		4,00,000
Current Assets		
Inventory at Market value		7,00,000
Bills Receivable		3,00,000
Cash and Bank Balance		1,60,000
Current/Non-Current Assets:		
Share Issue Expenses		40,000
Total		50,00,000

Other information's are:

- Market value of Building is₹ 28,00,000, Furniture is ₹1,92,000, Plant & Machinery is ₹ 4,48,000; Goodwill is valued at₹ 6,00,000.
- Profit of the company after interest on debenture but before tax is ₹ 13,00,000.
- Similar companies earning capacity is 10% in same industry.
- Assume income tax rate is 50%.

Solution:

- Value of Share on the basis of Net Asset Method

Calculation of Net Capital Employed:		₹
Building		28,00,000
Furniture		1,92,000

Plant & Machinery		4,48,000
Goodwill		6,00,000
Inventory		7,00,000
Bills Receivables		3,00,000
Cash and Bank Balance		1,60,000
		52,00,000
Less:		
12% Debentures	20,00,000	
Other Liabilities	5,00,000	25,00,000
Net Capital Employed		**27,00,000**

Value of Share = $\frac{27,00,000}{20,000}$ = ₹ 135 per share

- <u>Value of Share on the basis of Earning Capacity Method</u>

Profit after interest but before tax	13,00,000
Less: Income Tax (50%)	6,50,000
Profit after interest and tax	6,50,000
Add: Interest on Debentures	2,40,000
Profit before interest and after tax	8,90,000

Net Capital Employed = Total Assets – Other Liabilities

= 52,00,000 – 5,00,000 = 47,00,000

Rate of Earning = $\frac{\text{Profit Earned}}{\text{Capital Employed}} \times 100$

$= \frac{8,90,000}{47,00,000} \times 100 = 18.936\%$

Value of Share = $\frac{18.936}{10} \times 100$ = ₹ 189.36 per share

- Fair Value of Share (Average Value):

$= \frac{135+189.36}{2}$ = ₹ 162.18 per share

2.3 Check Your Progress

1. Shares are to be valued on ______________.
   a) Mergers
   b) Sale of shares
   c) Gift tax
   d) All of the above

2. Net asset value is also called as.
   a) Asset backing value
   b) Intrinsic value
   c) Liquidation value
   d) (a), (b) and (c)

3. Net asset value method is based on the assumption that the company is _____________.
   a) A going concern
   b) Going to be liquidated
   c) Both (a) and (b)
   d) None of the above

4. Value of a partly paid equity share is equal to .
   a. Value of fully paid share – calls unpaid per share
   b. Calls in arrears per share
   c. Paid-up value per share
   d. None of the above

5: Under capitalisation of super profit method, Goodwill is equal to.
   a. Capitalised value of super profit at NRR

b. Capitalised value of maintained profit
c. Both (a) and (b)
d. None of the above

6.Any non-trading income included in the profit should be .

a. Eliminated
b. Added
c. Ignored
d. None of the above

2.4 Summary

Valuation of shares is the process of knowing the value of company’s shares. Share valuation is done based on quantitative techniques and share value will vary depending on the market demand and supply. The share price of the listed companies which are traded publicly can be known easily. But private companies whose shares are not publicly traded, valuation of shares is really important and challenging. There are some of the instances where valuation of shares is important such as when you are about to sell your business and you wanted to know your business value, when you approach bank for a loan based on shares as a security, merger, acquisition, reconstruction, amalgamation etc. valuation of shares is very important. Sometimes, even publicly traded shares have to be valued because the market quotation may not show the true picture or large blocks of shares are under transfer etc. There are four methods for valuing the shares mentioned in this chapter. On the basis of these methods shares of the companies are valued.

2.5 Keywords

- **Share:** is one of the equal parts into which a company's capital is divided, entitling the holder to a proportion of the profits.
- **Asset:** An asset is a resource with economic value that an individual, corporation, or country owns or controls with the expectation that it will provide a future benefit.
- **Capital Employed:** Capital employed refers to the value of all the assets used by a company to generate earnings.
- **Intangible Assets:** An intangible asset is a long-term financial value to a business but not have material object.

- **Fictitious Assets:** Fictitious Assets are not assets these are those expenses which are unclaimed and treated as an asset in the balance sheet.
- **Dividend:** a sum of money paid regularly (typically annually) by a company to its shareholders out of its profits.
- **Profit**: Profit, also called net income, is the amount of earnings that exceed expenses for the period.

2.6 Self-Assessment Test

Short Answer Questions:

1. Need for valuation of shares.
2. Discuss the factors affecting valuation of share.
3. Explain the net asset method of valuing share.
4. Explain yield method valuing share.
5. Write short note on capital employed.

Long Answer Questions:

1. In what situations calculation of shares is needed? Explain the factors affecting the valuation of shares.
2. Discuss the various methods which are used for share valuation.
3. Explain the net asset method of valuing share with the help of example.
4. Explain yield method of valuing share with the help of example.
5. What are conditions where dividend yield method is suitable for the valuation of share? Explain with the help of example.
6. Explain the concept of Net Capital Employed.

Numerical Questions:

1. For the purpose of valuing the shares of the company, the assets were revalued as: Goodwill ₹ 50,000; Land and Building at cost plus 50%, Plant and Machinery ₹ 1,00,000; Investments at book values; Stock ₹ 80,000 and Debtors at book value, less 10%.

(Answer ₹16.50).

2. The paid up share capital of a company consists of 2,000, 5% preference shares of 100 each and 40,000 equity share of 10 each. Preference shareholder are also addition to a fixed dividend of 5% entitled to participate in the profit upto 4% after payment of a dividend of 10% on the equity shares.

The annual average profits of the company is 1,00,000 after providing for depreciation and taxation and it is considered necessary to transfer 6,000 per annum to reserve fund. The normal rate of dividend expected on preference share is 8% and on equity share is 10%.

Find out the value of preference share and equity share on the basis of dividend yield method.

(Answer:Value of Prefernce Share ₹ 112.50; Value of Equity Share ₹ 19.00).

3. From the following information in Balance Sheet calculate the value of share.

Particulars		₹
I. **EQUITY AND LIABILITIES:**		
Shareholders' Fund:		
60,000 Equity Shares of ₹ 10 each		6,00,000
Reserve and Surplus		1,40,000
Non-Current Labilities		
10% Debentures		1,50,000
Current Liabilities		1,10,000
Total		10,00,000
II. **ASSETS**		
Current / Non-Current Assets:		
Sundry Assets (including goodwill)		10,00,000
Total		10,00,000

Other information's are:

- Market value of half of the assets is 20% higher.
- Profit of the company after interest on debenture but before tax is ₹ 3,66,000.
- Similar companies earning capacity is 12% in same industry.
- Assume income tax rate is 50%.

(Answer ₹16.67 per share).

4. Calculate the value of share based on earning capacity method from the following information in Balance Sheet.

Particulars		₹
V. **EQUITY AND LIABILITIES:**		
Shareholders' Fund:		
40,000 Equity Shares of ₹ 10 each		4,00,000
Preference Share Capital		
(1,000, 8% Preference Shares of 100each)		1,00,000
Reserve and Surplus		1,50,000
Profit & Loss Balance (Opening)		80,000
Profit for 2019 (before taxation)		4,30,000
Non-Current Labilities		
Current Liabilities		
Trade Payable		48,000
Total		12,08,000
VI. **ASSETS**		
Non-Current Assets:		
Building		70,000
Furniture		3,000
4% Govt. Securities (Face value 4,00,000)		3,35,000
Current Assets		

Inventory at Market value		4,50,000
Bills Receivable (3,00,000 – 20,000 provision)		2,80,000
Cash and Bank Balance		60,000
Current/Non-Current Assets:		
Share Issue Expenses		10,000
Total		12,08,000

Other information's are:

- Building are net worth ₹3,50,000
- Similar companies earning capacity is 15% in same industry.
- Profits for the past three years have shown an increase of ₹50,000 annually.
- Assume income tax rate is 50%.

(Answer ₹115.87 per share).

5. Balance Sheet of XYZ Limited as at 31st March 2019 is as follows:

Particulars		₹
VII. **EQUITY AND LIABILITIES:**		
Shareholders' Fund:		
1,50,000 Equity Shares of ₹ 10 each		15,00,000
Reserve and Surplus		1,43,000
Current Liabilities		
Trade Payable		80,000
Outstanding Expenses		5,600
Provision for taxation		2,40,000
Total		19,68,600
VIII. **ASSETS**		
Non-Current Assets:		

Fixed Asset at cost		
Less: Depreciation	22,00,000	
Investment: 8% Government Securities	6,70,000	15,30,000
Current Assets		1,50,000
Current/Non-Current Assets:		
Share Issue Expenses		
		18,600
Total		19,68,600

Other information's are:

- Provision for taxation for current year is 60% of net profit.
- Return on capital employed for is 12% in same industry.

(Value of Share is ₹8.78).

2.7 Answers to check your progress

1(d), 2 (d), 3(c), 4 (a), 5(a), 6 (a)

2.8 References/ Suggested Readings

- Gupta, Nirmal. Corporate Accounting, Sahitya Bhawan, Agra
- Jain, S.P. and K.L. Narang. Corporate Accounting, Kalyani Publishers, New Delhi.
- Maheshwari, S.N. and S. K. Maheshwari. Corporate Accounting, Vikas Publishing House, New Delhi.
- Monga, J.R. Fundamentals of Corporate Accounting, Mayur Paper Backs, New Delhi.
- Naseem Ahmed, Corporate Accounting, ANE Books Pvt. Ltd. New Delhi.
- Sehgal, Ashok and Deepak Sehgal. Corporate Accounting, Taxman Publication, New Delhi.
- Shukla, M.C., T.S. Grewal, and S.C. Gupta. Advanced Accounts, S. Chand & Co., New Delhi.

Subject: Corporate Accounting	
Course Code:**BCOM-301**	Author: **Prof. Suresh K. Mittal**
Lesson No:**3**	
Issue of Shares, Forfeiture and Re-issue of Shares	

STRUCTURE:

3.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning and types of shares.

- Understand the accounting treatment of issue of shares.
- Know the meaning and reasons of forfeiture of shares.
- Know the accounting treatment of re-issue of shares.

3.1 Introduction

Company form of business organisation came into existence due to the limitations of sole proprietorship and partnership form of business organisation namely limited capital, unlimited liability and other managerial problems. A company is an entity incorporated by a group of persons through the process of law for doing a business. According to Prof. Haney, "A Company is an artificial person created by law, having separate entity with a perpetual succession and a common seal". The existence of a company is not affected by the insolvency or death of a member and the company have a separate existence from its shareholders. There may be different types of companies like unlimited company, company limited by guarantee and company limited by shares. The company limited by shares may be further divided into private company, public company and one Person Company. A company can raise funds throughout the world by issuing shares.

3.2 Meaning and Types of Shares

The total capital of the company is divided into small parts. Each part is called "Share". For example, the total capital of a company is ₹10,00,000 which is divided into 1,00,000 parts of ₹10 each, the each part of ₹ 10 will be called a share. The shares of a company are movable property which is transferable as per the provision of Articles of Association of the Company. Under section 13 of the Companies Act, 2013, a company may issue two types of shares i.e. preference shares and equity shares.

Preference Shares: Preference Shares are those shares which carry the following two preferences:

- Right to receive the dividend before the dividend paid on equity shares.
- In case of winding up of the company, preference shares have a right to return the capital before equity shares.

There may be some more rights such as the right to participate in excess profits or the right to receive premium of the time of redemption. There may be different types of preference shares namely cumulative preference shares, Non-cumulative preference shares, participating preference shares, Non-participating preference shares, Redeemable Preference Shares, Irredeemable Preference Shares etc.

Equity Shares: Equity Shares are the most commonly issued class of shares which carry highest risk and reward. In case of equity shares, the dividends are paid only when profit are left after the dividend paid on equity shares. At the time of winding up of company, the amount of equity share is returned after the payment of preference shares. The owners of the equity shares are called equity shareholders. Equity Shareholders have voting rights and control the management of the company. There is no fix rate of dividend on equity shares which means if there is no profits or insufficient profits in a particular year, the equity share holders will not receive any dividend. The equity shareholder will get higher return in the year company earns more profits.

The following is the process for the issue of shares to public:

- To Issue Prospectus: Prospectus is an invitation to purchase shares of the company to the public. At describes the profitability and financial position of the company. Prospectus contains the information like Name and Registered office of the Company, Name and Address of the Directors, consent from SEBI, objectives and risks of the issue, opening and closing date of issue, details of Merchant bankers which involved in the issue.
- To Receive Applications: After going through the prospectus, the prospective investors applies for the shares in the company on a prescribed from along with application money. Application money should not be less than 25% of the issue price of share and be deposited in a scheduled bank.
- To Make Allotment of Shares: After the last date of receiving the share applications, the Banks send all the applications to the Company. The Company will issue share certificate for eligible number of shares if the company gets the minimum subscription which is 90% of the issue size as per SEBI rules.
- To Make Calls: The amounts demanded by the company after the application money and allotment money are called calls. In the case when the whole amount of share is not paid on application and allotment, the unpaid amount of the share may be called in one or more instalments. Each instalment in named on First call, Second call and Final call etc.

3.3 Accounting Treatment of Issue of Shares

A company can issue shares for different considerations i.e. for cash, purchasing any assets, promoters etc. issue of shares for cash means shares are issued by a company against payment received. These shares may be issued at par or at premium but the issue of shares at a discount is not allowed by the Companies Act, 2013. Issue may be payable in the following manner:

- In lump sum along with the application or
- In instalments i.e. partly on application, partly on allotment and balance on calls.

Entries on Receiving Applications:

(1) The application money must be deposited by the Company in a 'Scheduled Bank'. The following entry is made by the Company on receiving the applications:

Bank A/c Dr.

To Share Application A/c

(Application money received on ………. Shares at the rate of ₹……… per share)

(2) Application money is a part of the share capital of the Company, and as such, when the directors allot the shares, the share application money is transferred to Share Capital Account. For this the following journal entry is passed:

I. Share Application A/c Dr.

To Share Capital A/c

(Application money on allotted shares transferred to Share Capital A/c)

II. Sometimes, the directors do not allot any shares to some of the applicants. The application money of such applicants is returned to them. The entry will be:

Share Application A/c Dr.

To Bank A/c

(Application money returned on un-allotted shares)

Entries on Allotment:

(3) Those applicants who are allotted shares are sent letters of allotment in which the number of shares allotted and the amount due on allotment is mentioned. As soon as the allotment letters are issued, the allotment money becomes due and becomes a part of Share Capital. The entry required is:

Share Allotment A/c Dr.

To Share Capital A/c

(Amount due on allotment on …… shares at the rate of ₹……. per, share)

(4) On receipt of Allotment Money:

Bank A/c Dr.

To Share Allotment A/c

(Amount received on allotment on ……. shares at the rate of ₹…. per share)

Entries on First Call:

(5) When Shareholders are informed to pay the First Call:

Share First Call A/c Dr.

To Share Capital A/c

(First call due on ………. shares at the rate of ₹ ………. per share)

(6) On receipt of First Call Money:

Bank A/c

To Share First Call A/c

(First call money received on …….. shares at the rate of ₹……. per share)

Entries on Second Call:

(7) When shareholders are informed to pay the Second Call:

Share Second Call A/c Dr.

To Share Capital A/c

(Second Call due on …….. shares at the rate of ₹………. per share)

(8) On receipt of Second Call Money:

Bank A/c Dr.

To Share Second Call A/c

(Second Call money received on …….shares at the rate of ₹……. per share)

Similarly, entries for other calls may be prepared.

Issue of Shares at Par

Shares are issued at par when they are issued at a price equal to the face value. For example, if a share of ₹ 10 is issued at ₹ 10, it is said that the share has been issued at par.

Example:

X Ltd. Invited applications for 30,000 shares of ₹ 10 each. Payments were to be made as follows - ₹ 3 on Application, ₹ 3 on Allotment; ₹ 2 on First Call and ₹ 2 on Final call.

All the shares were applied. You are required to prepare Journal Entries, Ledger Accounts and show the Share Capital in the Balance Sheet of the company assuming that all sums due on Allotment and Calls have been received. Share issue expenses amounted to ₹ 8,000. 4,000 fully paid shares were also issued to Promoters for their services.

Solution:

Journal Entries

Date	Particulars	L.F.	Dr.(₹)	Cr. (₹)
			(₹)	(₹)
	Bank A/c Dr. To Equity Share Application A/c (Money received on application for 30,000 shares @ ₹3 per share)		90,000	90,000
	Equity Share Application A/c Dr. To Equity Share Capital A/c (Transfer of application money to Share Capital A/c)		90,000	90,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Allotment money due on 30,000 shares @ ₹3 per share)		90,000	90,000
	Bank A/c Dr. To Equity Share Allotment A/c (Allotment money received)		90,000	90,000

	Equity Share First Call A/c Dr. To Equity Share Capital A/c (First call due on 30,000 shares @ ₹2 per share)		60,000	 60,000
	Bank A/c Dr. To Equity Share First Call A/c (Allotment received on first call)		60,000	 60,000
	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Final call due on 30,000 shares @ ₹2 per share)		60,000	 60,000
	Bank A/c Dr. To Equity Share Final Call A/c (Allotment received on final call)		60,000	 60,000
	Share Issue Expenses A/c Dr. To Bank A/c (Expenses incurred on issue of shares)		8,000	 8,000
	Incorporation Costs A/c Dr. To Equity Share First Call A/c (Fully paid shares issued to promoters for their services)		40,000	 40,000

Ledger Accounts

Dr. Bank Account Cr.

Particulars	₹	Particulars	₹
To Equity Share Application A/c To Equity Share Allotment A/c To Equity Share First Call A/c To Equity Share Final Call A/c	90,000 90,000 60,000 60,000	By Share Issue Expenses A/c By Balance c/d	8,000 2,92,000

	3,00,000		3,00,000

Dr. Equity Share Application Account Cr.

Particulars	₹	Particulars	₹
To Equity Share Capital A/c	90,000	By Bank A/c	90,000
	90,000		90,000

Dr. Equity Share Allotment Account Cr.

Particulars	₹	Particulars	₹
To Equity Share Capital A/c	90,000	By Bank A/c	90,000
	90,000		90,000

Dr. Equity Share First Call Account Cr.

Particulars	₹	Particulars	₹
To Equity Share Capital A/c	60,000	By Bank A/c	60,000
	60,000		60,000

Dr. Equity Share Final Call Account Cr.

Particulars	₹	Particulars	₹
To Equity Share Capital A/c	60,000	By Bank A/c	60,000
	60,000		60,000

Dr. Equity Share Capital Account Cr.

Particulars	₹	Particulars	₹
To Balance c/d	3,40,000	By Equity Share Application A/c	90,000
		By Equity Share Allotment A/c	90,000
		By Equity Share First Call A/c	60,000
		By Equity Share Final Call A/c	60,000
		By Incorporation Costs A/c	40.000
	3,40,000		3,40,000

Dr. Share Issue Expenses Account Cr.

Particulars	₹	Particulars	₹
To Bank A/c	8,000	By Balance c/d	8,000
	8,000		8,000

Dr. Incorporation Costs Account Cr.

Particulars	₹	Particulars	₹
To Equity Share Capital A/c	40,000	By Balance c/d	40,000
	40,000		40,000

Extract of Balance Sheet of Pawan Ltd. as at ………………..

Particulars	Note No.	Current year	Previous year
I. Equity And Liabilities:		₹	₹
Shareholder's Funds:			
(a) Share Capital	1	3,40,000	

Notes to Accounts:

	₹	₹
(1) Share Capital		
Authorised:		
………….. Shares of ₹…………… each	………..	
Issued, subscribed and fully paid-capital:		
34,000 Equity Shares of ₹ 10 each		
(of the above shares, 4,000 shares are allotted as fully paid-up		
Pursuant to contracts without payments being received in cash)	3,40,000	

Issues of Shares at Premium

When a Company issues a share at a price which is above its face value, it is said to be issued at premium. For example, if a share of the face value of ₹ 10 is issued at ₹ 12, ₹ 2 will be the premium on the share. There is no legal restriction on issue of shares at a premium.The premium on issue of shares is a Capital profit and not a revenue profit and as such, must be credited to a separate account called 'Securities Premium Reserve Account'. It must be shown separately in the Balance Sheet on the equity & liabilities side under the head 'Reserves and Surplus'.

Under Section 52 (2) of the Companies Act, 2013, the amount of securities premium reserve may be used only for the following purposes:

- In writing the preliminary expenses of the Company;
- For writing off the expenses, commission or discount allowed on issue of shares or debentures of the Company;
- For issuing fully paid bonus shares to the shareholders of the Company;
- For providing for the premium payable on redemption of redeemable preference shares or debentures of the Company.
- For Buy back of its own shares and other securities as per Section 68.

Accounting Entries for the Amount of Securities Premium:

The amount of securities premium may be charged by the Company on application or on allotment or even with the calls. Following entries will be passed, if the amount or premium is received alongwith application money:

I. Bank A/c Dr.

To Share Application A/c

(Application money received including premium)

II. Share Application A/c Dr.

To Share Capital A/c

To Securities Premium Reserve A/c

(Application money transferred to Share Capital A/c and Securities)

Premium Reserve A/c)

If the amount of securities premium is received alongwith allotment money, the following entries will be passed:

I. Share Allotment A/c Dr.

To Share Capital A/c

To Securities Premium Reserve A/c

(Allotment money due, including securities premium)

II. When allotment money is received: Dr.

Bank A/c

To Share Allotment A/c

(Application money received, including securities premium)

Use of Cash Book

A cash Book is prepared to record cash transactions. If it is asked to prepare a Cash Book in the question, entries for cash transactions must be recorded in the Cash Book and those transactions which are not related with Cash are recorded in journal.

Example:

A limited company offered for subscription 10,000 Equity Shares of ₹ 10 each at a premium of ₹ 2 per share and 5,000, 10% Preference Shares of ₹ 10 each at par.

The amount on equity shares was payable as thus:

On Application	₹ 3 per share
On Allotment	₹5 per share (including a premium)
On First Call	₹ 4 per share

The amount of preference shares was payable as follows:

On Application	₹ 3 per share
On Allotment	₹4 per share
On First Call	₹ 3 per share

All the shares were fully subscribed, called-up and paid.

Record these transactions in the journal and cash book of the company.

Solution:

Books of A Ltd.

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Application A/c	Dr.		30,000	
	10% Preference Share Application A/c	Dr.		15,000	
	To Equity Share Capital A/c				30,000
	To 10% Preference Share Capital A/c				15,000
	(Transfer of application money)				
	Equity Share Allotment A/c	Dr.		50,000	
	10% Preference Share Allotment A/c	Dr.		20,000	
	To Equity Share Capital A/c				30,000
	To Securities Premium Reserve A/c				20,000
	To 10% Preference Share Capital A/c				20,000
	(Amount due on allotment)				
	Equity Share First & Final Call A/c	Dr.		40,000	
	10% Preference Share First & Final Call A/c	Dr.		15,000	
	To Equity Share Capital A/c				40,000
	To 10% Preference Share Capital A/c				15,000
	(Amount due on first and final call)				

Dr. Cash Book (Bank Column) Cr.

Particulars	₹	Particulars	₹
To Equity Share Application A/c	30,000	By Balance c/d	1,70,000
To 10% Preference Share Application A/c	15,000		
To Equity Share Allotment A/c	50,000		
To 10% Preference Share Allotment A/c	20,000		

To Equity Share First & Final Call A/c	40,000		
To 10% Preference Share First & Final Call A/c	15,000		
	1,70,000		1,70,000

Issues of Shares at Discount

When a share is issued at a price which is less than its face value, it is said that it has been issued at a discount. For example, if a share of the nominal value of ₹ 100 is issued at ₹ 95, it is said to have been issued at a discount of 5%.

As per Section 53 of the Companies Act, 2013, Companies would no longer be permitted to issue shares at a discount. The only shares that could be issued at a discount are sweat equity wherein shares are issued to employees or directors in lieu of their services under Section 54 of 2013 Act.

3.3.1 Over subscription and Under-Subscription of Shares

Sometimes, number of shares applied for by the public is less than the number of shares offered by the Company. Such as issue is said to be under-subscribed. In such a case the accounting entries are made on the basis of the number of shares applied for.

Over-Subscription of Shares

Shares issued by well managed and financially strong Companies often get over-subscribed. Shares are said to be over-subscribed when the number of shares applied for is more than the number of shares offered to the public for subscription. 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. It means that smaller numbers of shares are allotted to each applicant according to the number of shares applied by them.

Example:

X Limited issued ₹ 10, 00,000 new capital divided into ₹ 100 shares at a premium of ₹ 20 per share, payable as under:

On Application ₹ 10 per share

On Allotment ₹ 40 per share (including premium of ₹ 10 per share)

On First and Final Call Balance

Over-payments on application were to be applied towards sums due on allotment and first and final call. Where no allotment was made, money was to be refunded in full.

The issue was oversubscribed to the extent of 13,000 shares. Applicants for 12,000 shares were allotted only 2,000 shares and applicants for 3,000 shares were sent letters of regret and application money was returned to them. All the money due was duly received.

Give Journal Entries to record the above transactions (including cash transactions) in the books of the company.

Solution:

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr.		2,30,000	
	To Share Application A/c (23,000 × ₹ 10)			2,30,000
	(Application money received for 10,000 + 13,000 = 23,000 shares @ ₹ 10 per share)			
	Share Application A/c Dr.		2,30,000	
	To Share Capital A/c (10,000 × ₹ 10)			1,00,000
	To Share Allotment A/c (2,000 × ₹ 40)			80,000
	To Calls in Advance A/c (₹1,00,000 – ₹ 80,000)(1)			20,000
	To Bank A/c (3,000 × ₹ 10)			30,000
	(Application money adjusted)			
	Share Allotment A/c Dr.		4,00,000	
	To Share Capital A/c			3,00,000
	To Securities Premium Reserve A/c			1,00,000
	(Allotment money due on 10,000 shares)			
	Bank A/c Dr.		3,20,000	
	To Share Allotment A/c			3,20,000
	(Allotment money received)			
	Share First and Final Call A/c Dr.		7,00,000	
	To Share Capital A/c			6,00,000

	To Securities Premium Reserve A/c(2) (First and final call due on 10,000 shares including the remaining premium of ₹ 10)			1,00,000
	Bank A/c Dr. Cash in Advance A/c Dr. To Share First and Final Call A/c (Call money received)		6,80,000 20,000	7,00,000

Working Notes:

(1) Applicants for 12,000 shares have been allotted 2,000 shares.

Hence excess application money received on 10,000 shares @ ₹10 per share 1,00,000

Less: Amount adjusted on Allotment on 2,000 shares @ ₹ 40 per share 80,000

Balance 20,000

This amount of ₹ 20,000 will be transferred to Calls in Advance A/c, as it will be adjusted on future calls.

(2) Out of premium of ₹ 20, ₹ 10 are due on allotment.

Remaining ₹ 10 will be assumed to be due on first and final call.

3.3.2 Calls-In-Arrears and Calls-in-Advance

If a shareholder does not pay the call amount due on allotment or on any calls according to the terms, the amount not so received is called Calls-in-Arrears. The unpaid or arrear amount on account of allotment or calls may or may not be transferred to Calls-in-Arrears Account.

Interest on Calls-in-Arrears

The company if authorised by its Articles of Association may charge interest at the specified rate on Calls-in-Arrears from the due date to the date of payment. In case, the Articles of Association of the Company is silent, Table F of the Companies Act, 2013 shall apply which provides for interest on Calls-in-Arrears @ 10% p.a. However, the Directors have the right to waive the interest on Calls-in-Arrears.

Accounting Treatment of Calls-in-Arrears

There are two methods of accounting of Calls-in-Arrears:

(i) Without Opening Calls-in-Arrears Account

Under this method, amount received from the shareholders is credited to the relevant call account and various call accounts will show debit balance equal to the total unpaid amount of calls. On a subsequent date, when the amount of Calls-in-Arrears is received, Bank Account is debited and relevant Call Account is credited. Suppose, if first call money @ ₹ 2 per share on 10,000 shares is called but out of this, first call money on 9,500 shares is received, entries will be passed as follows:

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Shares First Call A/c Dr. To Share Capital A/c (Being the first call money due on 10,000 shares @ ₹ 2 per share)		20,000	 20,000
	Bank A/c Dr. To Share First Call A/c (Being the first call money received only on 9,500 shares)		19,000	 19,000

Dr. Shares First Call Account Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
	To Share Capital A/c		20,000		By Bank A/c		19,000
					By Balance c/d (calls–in-Arrears)		1,000
			20,000				20,000

The above balance of Shares First Call Account shows that there is Calls-in-Arrears.

(ii) By Opening Calls-in-Arrears Account

Under this method, unpaid amount is transferred to Calls-in-Arrears Account. As a result, Shares Allotment Account and Shares Call Accounts will not show any balance. The Calls-in-Arrears Account will show a debit balance equal to the total unpaid amount on allotment and calls. Later, on receipt of arrear amount, it is credited to the Calls-in-Arrears Account.

In the above example, if Calls-in-Arrears Account is opened, then first two entries will be the same and the third entry will be passed as follows:

Calls-in-Arrears A/c	….Dr.	₹ 1,000	
To Shares First Call A/c			₹ 1,000

In place of second and third entry, a combined entry may also be passed as follows:

Bank A/c	….Dr.	₹ 19,000	
Calls-in-Arrears A/c	….Dr.	₹ 1,000	
To Shares First Call A/c			₹ 20,000

Disclosure in the Balance Sheet

Calls-in-Arrears Account is shown in the Note to Accounts on 'Share Capital' to the Balance Sheet as a deduction from the amount of 'Subscribed but not fully paid-up' under 'Subscribed Capital'.

Example:

A Ltd. company had an authorised capital of ₹ 12,50,000 divided into 12,500 shares of ₹ 100 each. The company issued 10,000 shares payable at ₹ 20 on application, ₹ 30 on allotment, ₹ 30 on first call and ₹ 20 on second and final call. All the shares were subscribed by the public. The Directors made allotment and the money was duly received except the second and final call on 500 shares, which is transferred to Calls-in-Arrears Account. Pass Journal entries, prepare Share Capital Account and show how share capital will appear in the Balance Sheet.

Solution:

In the Books of A Ltd.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c (10,000 × ₹ 20) Dr. To Share Application A/c (Being the application money received for 10,000 shares @ ₹20 per share)		2,00,000	 2,00,000
	Share Application A/c Dr. To Share Capital A/c (Being the application money transferred to Share Capital A/c)		2,00,000	 2,00,000

	Share Allotment A/c (10,000 × ₹ 30) Dr. To Share Capital A/c (Being the allotment money due)		3,00,000	 3,00,000
	Bank A/c Dr. To Share Allotment A/c (Being the allotment money received on 10,000 shares)		3,00,000	 3,00,000
	Share First Call A/c (10,000 × ₹ 30) Dr. To Share Capital A/c (Being the First call money received)		3,00,000	 3,00,000
	Bank A/c Dr. To Share First Call A/c (Being the first call money received)		3,00,000	 3,00,000
	Share Second and Final Call A/c (10,000 × ₹ 20) Dr. To Share Capital A/c (Being the second and final call due)		2,00,000	 2,00,000
	Bank A/c (9,500 × ₹ 20) Dr. Calls-in-Arrears A/c (500 × ₹ 20) To Shares Second and Final Call A/c (Being the shares second and final call money received on 9,500 shares)		1,90,000 10,000	 2,00,000

Dr. Share Capital Account Cr.

Particulars	₹	Particulars	₹
To Balance c/d	10,00,000	By Share Application A/c	2,00,000
		By Share Allotment A/c	3,00,000
		By Share First Call A/c	3,00,000
		By Share Second and Final Call A/c	2,00,000
	10,00,000		10,00,000

Balance Sheet (Extract)

as at …..

Particulars	Note No.	₹
I. Equity and Liabilities		
Shareholder's Funds		
Share Capital	1	9,90,000

Note to Accounts

1. Share Capital		
Authorised Capital		
12,500 Equity Shares of ₹100 each		12,50,000
Issued Capital		
10,000 Equity Shares of ₹100 each		10,00,000
Subscribed Capital		
Subscribed and fully paid-up		
9,500 Equity Shares of ₹ 100 each\		9,50,000
Subscribed but not fully paid-up		
500 Equity Shares of ₹ 100 each	50,000	
Less: Calls-in-Arrears (500 × ₹ 20)	10,000	40,000
		9,90,000

Oversubscription and Calls-in-Arrears

In the case of oversubscription, *pro rata* allotment may be made to all or some of the applicants. It means the applicants to whom *pro rata* allotment is made have paid excess application money. The excess application money may be adjusted towards Allotment Money and Securities Premium, if shares are issued at premium. Adjustment is made first towards Share Capital and thereafter, towards Securities Premium.

The balance may be carried forward and adjusted against calls, if the question specifies.

Example:

X Ltd. issued 50,000 Equity Shares of ₹10 each at a premium of ₹ 2 per share payable as follows:

₹ 3 on application, ₹ 4 on allotment (including premium), ₹ 2 on first call and ₹ 3 on final call.

Applications were received for 65,000 Equity Shares. Applications for 40,000 Equity Shares were accepted in full; 10,000 Equity Shares were allotted to applicants of 20,000 Equity Shares and applications for 5,000 Equity Shares were rejected. The amounts due were duly received except the first call on 1,000 Equity Shares and final call on 1,500 Equity Shares.

Pass entries in the Cash Book and Journal of the Company. Also, show Share Capital in the Balance Sheet.

Solution:

In the Books of X. Ltd.

Cash Book (Bank Column only)

Date	Particulars	₹	Date	Particulars	₹
	To Shares Application A/c	1,95,000		By Shares Application A/c	15,000
	(₹ 3 on 65,000 shares)			(₹ 3 on 5,000 shares refunded)	
	To Shares Allotment A/c	1,70,000			5,93,500
	(₹ 2,00,000 – ₹ 30,000)			By Balance c/d	
	To Share First Call A/c	98,000			
	(₹ 10,000 – ₹ 2,000)				
	To Shares Second and Final Call A/c	1,45,500			
	(₹ 1,50,000 – ₹ 4,500)	6,08,500			6,08,500

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Share Application A/c ...Dr.		1,50,000	
	To Share Capital A/c			1,50,000
	(Being the application money on 50,000 shares			

	transferred to Share Capital Account)			
	Share Application A/c [(20,000 × ₹3) – (10,000 × ₹ 3)] …Dr. To Share Allotment A/c (10,000 × ₹ 10) (Being the surplus application money on partially accepted applications transferred to Shares Allotment Account)		30,000	1,00,000 80,000 20,000 30,000
	Share Allotment A/c ...Dr. To Share Capital A/c To Securities Premium Reserve A/c (Being the amount due on allotment: ₹ 2 on 50,000 shares for Capital and ₹ 2 on 50,000 shares for premium)		2,00,000	1,00,000 1,00,000
	Shares First Call A/c ...Dr. To Share Capital A/c (Being the amount due on first call @ ₹ 2 per share on 50,000 shares)		1,00,000	1,00,000
	Share Second and Final Call A/c ...Dr. To Share Capital A/c (Being the amount due on second and final call @ ₹ 3 per share on 50,000 shares)		1,50,000	1,50,000

It is advised that the Ledger Account be prepared and observe how Share Capital is shown in the Balance Sheet:

Balance Sheet as at….

Particulars	Note No.	₹
I. Equity And Liabilities:		
Shareholder's Funds:		
Share Capital	1	4,93,500

Notes to Accounts:

1. Share Capital	₹
Authorised Capital	

….. Equity Shares of ₹10 each		…
Issued Capital		
50,000 Equity Shares of ₹10 each		5,00,000
Subscribed Capital		
Subscribed and fully paid-up		
48,500 Equity Shares of ₹ 10 each		4,85,000
Subscribed but not fully paid-up		
1,500 Equity Shares of ₹ 10 each	15,000	
Less: Calls-in-Arrears [(1,000 × ₹ 2) + (1,500× ₹ 3)]	6,500	8,500
		4,93,500

Note: Securities Premium Reserve Account, being capital profit, will be shown on the Equity and Liabilities part of Balance Sheet under the head 'Reserves and Surplus'.

Calls-in-Advance

A company may, if its Articles of Association allows, accept the amount against the call or calls not yet made. The amount so received in advance is called Calls-in-Advance. As discussed earlier, it may also happen in case of partial or pro rata allotment of shares when the company retains excess amount received on application of shares beyond the allotment money.

Disclosure in the Balance Sheet

The amount received that is not yet due is a liability of the company. It is shown in the Equity and Liabilities part of the Balance Sheet under the head Current Liabilities and sub-head Other Current Liabilities. The Journal entry passed to record Calls-in-Advance is:

Bank A/c …. Dr. (With the amount of calls money received in advance)

To Calls-in Advance A/c

It is adjusted when the respective call is made due. The entry is:

Calls-in-Advance A/c …. Dr.

To (Say) Shares First Call A/c

Interest on Calls-in-Advance

Interest on Calls-in-Advance is paid if the Articles so provides. But if the Articles of Association is silent, provisions of Table F of the Companies Act, 2013 apply and the company is liable to pay interest on Calls-in-Advance @ 12% p.a.

Example:

On Ist January, 2016 the first call of ₹ 3 per share became due on 1,00,000 equity shares issued by X Ltd. Karan a holder of 500 shares did not pay the first call money. Arjun a shareholder holding 1,000 shares paid the second and final call of ₹ 5 per share along with the first call.

Pass the necessary Journal entry for the amount received by opening 'Calls-in-Arrears' and 'Calls-in-Advance' Account in the books of the company.

Solution:

Journal of X Ltd.

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2016				
Jan.1	Bank A/c [(99,500 × ₹3) + (1,000 × ₹ 5)] ...Dr.		3,03,500	
	Calls-in-Arrears A/c (500 × ₹ 3) ...Dr.		1,500	
	To Equity Shares First Call A/c			3,00,000
	To Calls-in-Advance A/c (1,000 × ₹ 5)			5,000
	(Being the first call money received except on 500 shares and received second and final call in advance on 1,000 shares)			
	Share Application A/c [(20,000 × ₹3) – (10,000 × ₹ 3)] …Dr.		30,000	
				1,00,000
	To Share Allotment A/c (10,000 × ₹ 10)			80,000
	(Being the surplus application money on partially accepted applications transferred to Shares Allotment Account)			20,000
				30,000
	Share Allotment A/c ...Dr.		2,00,000	
	To Share Capital A/c			1,00,000
	To Securities Premium Reserve A/c			1,00,000
	(Being the amount due on allotment: ₹ 2 on 50,000			

	shares for Capital and ₹ 2 on 50,000 shares for premium)			
	Shares First Call A/c ...Dr. To Share Capital A/c (Being the amount due on first call @ ₹ 2 per share on 50,000 shares)		1,00,000	1,00,000
	Share Second and Final Call A/c ...Dr. To Share Capital A/c (Being the amount due on second and final call @ ₹ 3 per share on 50,000 shares)		1,50,000	1,50,000

3.3.3 Issue of Shares for Consideration Other than Cash

A company may issue shares for consideration other than cash such as against purchase of an asset or purchase of business or services taken, etc. Purchase of an asset and issue of shares are two separate transactions. Thus, entry is to be passed for each transaction.

The Journal entries passed are:

I. (a) On Purchase of Assets

Sundry Assets A/cs (individually)…. Dr. [with the amount of purchase price]

To Vendor's A/c …. Dr. [with purchase consideration]

(b) On Purchase of Business

Sundry Assets A/cs …. Dr. [Agreed value of assets]

Goodwill A/c* …. Dr.

To Sundry Liabilities A/c [Agreed value of liabilities]

To Vendor's A/c [with purchase consideration]

To Capital Reserve A/c**

Note: Purchase consideration is the amount paid by purchasing company in consideration for purchase of assets/business from other enterprise. It may be given in the question, otherwise it will be equal to net assets, i.e., sundry assets minus sundry liabilities.

*If purchase consideration given is more than net assets, then difference is debited to Goodwill Account. It is a case of Purchased Goodwill hence, will be recorded in the books.

**If purchase consideration given is less than net assets, then the difference is credited to Capital Reserve. Either Goodwill or Capital Reserve will appear at a time.

II. On Issue of Shares

(a) If Shares are issued to vendor at par:

Vendor's A/cs …. Dr. [with the nominal value of share allotted]

To Share Capital A/c

(b) If shares are issued to vendor at a premium:

Vendor's A/c …. Dr. [With the purchase price]

To Share Capital A/c [With the nominal value of shares allotted]

To Securities Premium Reserve A/c [with the amount of premium]

Note: Before passing the journal entry we should calculate the number of shares to be issued against purchase consideration as follows:

$$\text{Number of Shares to be Issued} = \frac{\text{Purchase Consideration}}{\text{Issue Price of Share}}$$

Issue of Shares to Promoters

Sometimes, companies issue shares to promoters for their services rendered to the company. From the accounting point of view, it is 'incorporation costs' or 'formation expenses'. Hence, the amount is debited to 'Incorporation Expense Account' or 'Formation Expenses Account'. The entries passed are:

Incorporation Expenses or Formation Expenses A/c ….Dr.

To Promoters A/c

(Being the amount due to promoters)

Promoters A/c …. Dr.

To Share Capital A/c

(Being issue of ….shares of ₹….. each as fully paid to the promoters)

Issue of Shares to Underwriters

Underwriting means a contract by which a person, known as underwriter, agrees usually for commission to take the shares not subscribed by public. The company may issue shares to the underwriters, instead of paying the commission in cash.

The Journal entries in this case will be:

Underwriting Commission A/c ….Dr.

To Underwriters' A/c

(Being the underwriting commission due)

Underwriters' A/c …. Dr.

To Share Capital A/c

(Being the….shares of ₹….. each issued to the underwriters)

Disclosure in the Balance Sheet of Shares Issued for Consideration other than Cash

Shares issued for consideration other than cash are disclosed, i.e., shown in the Balance Sheet under Subscribed Capital (either as Subscribed and fully paid-up or Subscribed but not fully paid-up, as the case is) in the Note to Accounts on 'Share Capital'.

Example: ABC Ltd. issued 1, 00,000 fully paid Equity Shares of ₹10 each towards consideration for purchase of machinery. It is shown in the Note to Accounts on Share Capital as follows:

Note to Accounts

Share Capital	
Authorised Capital	
……… Equity Shares of ₹10 each	…
Issued Capital	
……… Equity Shares of ₹10 each	…
Subscribed Capital	
Subscribed and fully paid-up	
5,00,000 Equity Shares of ₹ 10 each	
(Out of the above, 1,00,000 Equity Shares have been issued pursuant to a contract for consideration other than cash)	50,00,000

Example:

X Ltd. Purchased the business of Ram Bros. for ₹ 1,80,000 payable in fully paid Equity Shares of ₹ 10 each. What entries will be passed in the books of X Ltd. if the issue is: (i) at par and (ii) at a premium of 20%?

Solution: **Journal of X Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Share Assets A/c ...Dr. To Ram Bros. (Being the purchase of business from Ram Bros.)		1,80,000	 1,80,000
(i)	When shares are issued at par: Ram Bros. ... Dr. To Equity Share Capital A/c (Being the issue of 18,000 shares of ₹10 each at par to the Vendor) (WN 1)		 1,80,000	 1,80,000
(ii)	When Shares are issued at a premium: Ram Bros. ...Dr. To Equity Share Capital A/c To Securities Premium Reserve A/c (Being the issue of 15,000 shares of ₹ 10 each at a premium of 20%) (WN 2)		 1,80,000	 1,50,000 30,000

Working Notes: Number of Equity Shares to be issued = $\frac{\text{Purchase Consideration}}{\text{Issue Price of a Share}}$

1. No. of Equity Shares = $\frac{₹\ 1,80,000}{₹\ 10}$ = 18,000 shares

2. No. of Equity Shares = $\frac{₹\ 1,80,000}{₹\ 12}$ = 15,000 shares

Example:

Rajan Ltd. purchased a running business from Vikas Ltd. for a sum of ₹ 2,50,000 payable as ₹ 2,20,000 in fully paid equity shares of ₹ 10 each and balance by a bank draft. The assets and liabilities consisted of the following:

Plant and Machinery ₹ 90,000; Building ₹ 90,000; Sundry Debtors ₹ 30,000; Stock ₹ 50,000; Cash ₹ 20,000; Sundry Creditors ₹ 20,000.

Journalise the above transactions.

Solution: **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Plant and Machinery A/c ...Dr.		90,000	
	Building A/c ...Dr.		90,000	
	Sundry Debtors A/c ...Dr.		30,000	
	Stock A/c ...Dr.		50,000	
	Cash A/c ...Dr.		20,000	
	To Sundry Creditors A/c			20,000
	To Vikas Ltd.			2,50,000
	To Capital Reserve A/c (Balancing Figure)			10,000
	(Being the running business of Vikas Ltd. purchased)			
	Vikas Ltd. ... Dr.		2,50,000	
	To Equity Share Capital A/c			2,20,000
	To Bank A/c			30,000
	(Being the consideration paid of Vikas Ltd. by issue of 22,000 Equity Shares of ₹10 each and balance by bank draft)			

Example:

X Ltd. issued 2,500 shares of ₹ 10 each credited as fully paid to the promoters for the services rendered to incorporate the company and also issued 2,000 shares of
₹ 10 each credited as fully paid to the underwriters for their underwriting services. Journalise these transactions.

Solution: **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Incorporation Expenses A/c ...Dr. To Promoters' A/c (Being the amount due to promoters)		25,000	 25,000
	Promoters' A/c ...Dr. To Share Capital A/c (Being the issue of 2,500 shares of ₹10 each to promoters)		25,000	 25,000
	Underwriting Commission A/c ...Dr. To Underwriters'A/c (Being the underwriting commission due)		20,000	 20,000
	Underwriters' A/c ...Dr. To Share Capital A/c (Being the issue of 2,000 shares of ₹ 10 each at par to underwriters)		20,000	 20,000

Example:

Pass necessary Journal entries for the following transactions in the books of XYZ Ltd.

(i) Purchased furniture for ₹ 2,50,000 from M/s. Furniture Mart. The payment of M/s. Furniture Mart was made by issuing equity shares of ₹ 10 each at a premium of 25%.

(ii) Purchased a running business from Aman Ltd. for a sum of ₹ 1,50,000. The payment of ₹ 12,00,000 was made by issue of fully paid equity shares of ₹ 10 each and balance by a bank draft. The assets and liabilities consisted of the following:
Plant ₹ 3,50,000; Stock ₹ 4,50,000; Land and Building ₹ 6,00,000; Sundry Creditors ₹ 1,00,000.

Solution: **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)	Furniture A/c ...Dr. To M/s. Furniture Mart (Being the furniture purchased from M/s. Furniture Mart)		2,50,000	 2,50,000
	M/s. Furniture Mart ... Dr.		2,50,000	

	To Equity Share Capital A/c To Securities Premium Reserve A/c (Being the consideration paid of issue of Equity Shares of ₹10 each at a premium of 25%, i.e. ₹ 2,50,000 + ₹ 12.50 = 20,000 shares)			2,00,000 50,000
(ii)	Plant A/c ...Dr. Stock A/c ...Dr. Land and Building A/c ...Dr. Goodwill A/c (Balancing Figure) ...Dr. To Sundry Creditors A/c To Aman Ltd. (Being the running business of Aman Ltd. purchased for ₹ 15,00,000)		3,50,000 4,50,000 6,00,000 2,00,000	 1,00,000 15,00,000
	Aman Ltd. ... Dr. To Equity Share Capital A/c To Bank A/c (Being the consideration paid of issue of fully paid ₹12,00,000; Equity shares of ₹ 10 each and balance by bank draft)		15,00,000	 12,00,000 3,00,000

3.4 Forfeiture and Re-Issue of Shares

Forfeiture of shares means cancelling the shares for non-payment of calls due. But, shares can be forfeited only if the Articles of Association of the company allows forfeiture. If any shareholder does not pay the amount of call, the company may exercise the power of forfeit the shares held by him on which amount of call is not paid. The company before forfeiture, must first give clear 14 days' notice to the defaulting shareholder that unless due is paid the amount along with interest, if any, by the specified date, the shares shall be forfeited. If the shareholder still does not pay, the company may forfeit the shares by passing an appropriate resolution.

On forfeiture, the shares are cancelled and to that extent Share Capital is reduced. The amount received by the company is not refunded. Journal entry for forfeiting the shares is passed.

Disclosure in the Balance Sheet

Till the time forfeited shares are reissued, balance of the Forfeited Share Account is added to paid-up capital under Subscribed Capital in the Note to Accounts on 'Share Capital', being part of Shareholders' Funds shown under Equity and Liabilities part of the Balance Sheet.

3.4.1 Accounting Treatment of Forfeiture of Shares

Forfeited shares may have been issued at par or at premium. Accounting entry for forfeiture will vary according to the situation.

Forfeiture of Shares Issued at Par

In this case,

(i) Share Capital Account is debited with the amount called-up up to the date of forfeiture on share forfeited;

(ii) Share Allotment Account and/or Shares Call Account is credited with amount called-up on forfeited shares but not paid by the shareholders. If Calls-in-Arrears Account is maintained, Calls-in-Arrears Account is credited; and

(iii) Forfeited Shares Account is credited by the amount received on the shares forfeited.

The entry for forfeiture of shares is:

Share Capital A/c …. Dr. [Number of Shares Forfeited × Called-up Value per share]

To Forfeited Shares A/c [With amount received on forfeited shares]

To Share Allotment A/c [With the amount due but not paid on allotment]

To Shares Call A/c [With the amount due but not paid on call]

If "Calls-in-Arrears Account" is maintained, "Calls-in-Arrears Account" is credited instead of "Shares Allotment A/c" and "Shares Call/Calls A/c".

(1) Forfeiture of shares which were issued at Par: On forfeiture of shares the Share Capital is reduced and as such, 'Share Capital A/c' is debited for the amount which has been called so far on the forfeited shares; Unpaid Call accounts are credited in order to cancel their debit standing in the books. The amount already paid by the defaulting shareholder is Credited to 'Share Forfeiture A/c'.

The Journal Entry is :

Share Capital A/c Dr. (Number of Shares forfeited × Called up

Value per share)

To Share Allotment A/c	(Amount not received on Allotment)
To Share Call A/c	(Amount not received on Calls)
To Share Forfeiture A/c	(Amount received on Application, Allotment and Calls so far)

(Forfeiture of Shares issued at Par)

Note: In case 'Calls in Arrears' account is maintained by a company, "Calls in Arrears A/c' would be credited in the above entry instead of 'Share Allotment' and 'Share Call' Accounts.

Example: Gopal was holding 100 shares of ₹ 10 each of a Company on which he had paid ₹ 3 on application and ₹ 2 on allotment, but could not pay ₹ 2 on first call. If the shares of Gopal are forfeited by the Directors, the entry for the forfeiture of shares will be:

Share Capital A/c	Dr.	700	
To Share First Call A/c			200
To Share Forfeiture A/c			500

(100 shares forfeited for non-payment of first call of ₹ 2)

(2) Forfeiture of Shares which were issued at Premium:

This may be discussed under two heads:

(I) When forfeiture takes place after the premium is received: According to Section 52 of Companies Act 2013, if premium has been fully collected, it cannot be cancelled even if that share is forfeited later on. As such, 'Securities Premium Reserve A/c' will not be debited in the entry for forfeiture in this case.

(II) When forfeiture takes place before the premium is received: When a share is forfeited on which the premium has become due but has not been received either wholly or partially, the 'Securities Premium Reserve A/c' must be debited with the full amount of premium in the entry for forfeiture. The entry in this case will be:

Share Capital A/c	Dr.	(Amount called up so far, excluding premium)
Securities Premium Reserve A/c	Dr.	(If the premium has not been received)

To Share Allotment A/c	(Amount not received on Allotment, including premium)
To Share Call A/c	(Amount not received on Calls)
To Share Forfeiture A/c	(Amount received on Application and Call so far)

(Forfeiture of shares issued at Premium)

Example: X Ltd. issued 100 shares of ₹ 10 each to Gopal at a premium of ₹ 4 per share. Only ₹ 3.50 per share have been received on these shares on Application. Gopal has not paid ₹ 6.50 on Allotment (including premium), ₹ 2 on First Call and ₹2 on Final Call.

Entry for the forfeiture of above shares will be:

Share Capital A/c	Dr.	1,000	
Securities Premium Reserve A/c	Dr.	400	
To Share Allotment A/c			650
To Share First Call A/c			200
To Share Final Call A/c			200
To Share Forfeiture A/c			350

(Forfeiture of 100 shares)

Note: In the above case the amount of premium was due on allotment. Gopal could not pay the amount due on allotment and as such he could not pay the amount of premium also. Hence, the 'Securities Premium Reserve A/c' will be debited in the entry for forfeiture.

Example: If, in the above Example No. 2, it is assumed that Gopal had paid the amount of Application and Allotment as well, and only calls are not received from him, the entry for the forfeiture of shares will be as under:

Share Capital A/c	Dr.	1,000	
To Share First Call A/c			200
To Share Final Call A/c			200
To Share Forfeiture A/c			600

3.4.2 Accounting Treatment of Re-issue of Forfeited Shares

If any shareholder fails to pay the amount due on allotment or on any call within the specified period, the Directors may cancel his shares. This is called Forfeiture of Shares.It may be noted that the shares can be forfeited only if the Articles of Association of the Company allow them to be forfeited. In order to make the forfeiture valid, it is essential to follow the rules laid down in the Articles. If no rules are given in Articles, the provision of Table F of Schedule I of the Company Act, 2013 regarding forfeiture apply.

After the forfeiture, the name of the shareholder is removed from the Register of Members. The amount already paid by him belongs to the Company and is not returned to him. Directors have the authority to reissue the forfeited shares on such terms as they think fit. That is to say that they are at liberty to reissue the forfeited shares at par, at premium or at discount. However, if the shares are re-issued at a discount the amount of the discount cannot exceed the amount previously received on these shares.

For example, if a share of ₹ 10, on which ₹ 3 has already been received, is forfeited and reissued, minimum ₹ 7 must be collected on its reissue. It means that maximum of ₹ 3 can be allowed as discount on the reissue of such shares.

Following entries are passed on the reissue of forfeited shares:

I. If the Forfeited Shares are reissued at par:

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

II. If the Forfeited Shares are reissued at Premium:

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

III. If the Forfeited Shares are reissued at Discount:

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

After the reissue of forfeited shares, the credit balance left in the Share Forfeiture A/c is a 'Capital Gain' to the Company and must be transferred to 'Capital Reserve A/c'. The journal entry for such Transfer will be:

Share Forfeiture A/c Dr.

To Capital Reserve A/c

(Transfer of Share Forfeiture A/c to Capital Reserve A/c)

It should be clearly understood that if all the forfeited shares are not re-issued, only that proportion of share forfeiture account which belongs to the re-issued shares should only be transferred to Capital Reserve Account.

Example

X Ltd. was registered with an authorised Capital of ₹ 5,00,000 divided into shares of ₹ 10 each. It purchased a Building from Y for ₹ 2,00,000 and issued fully paid shares to Y for purchase consideration. It invited applications for the balance 30,000 shares payable as under :- ₹ 3 per share on Application; ₹ 3per share on Allotment; ₹ 2 per share on First Call; and ₹ 2 on Final Call.

Ashok, who had been allotted 500 shares failed to pay both the Calls. His shares were forfeited and re-issued at ₹ 9 per share to Hari, as fully paid up. Make necessary entries in the Journal of the company.

Solution: **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Buildings A/c Dr. To Vendors (Y) (Assets purchased)		2,00,000	 2,00,000
	Vendors (Y) Dr. To Share Capital A/c (Purchase consideration discharged by shares)		2,00,000	 2,00,000
	Bank A/c Dr. To Share Application A/c (Amount received on application)		90,000	 90,000
	Share Application A/c Dr. To Share Capital A/c		90,000	 90,000

	(Amount of share application transferred to share capital a/c)			
	Share Allotment A/c Dr. To Share Capital A/c (Allotment due)		90,000	 90,000
	Bank A/c Dr. To Share Allotment A/c (Amount received on allotment)		90,000	 90,000
	Share First Call A/c Dr. To Share Capital A/c (Amount due on first call)		60,000	 60,000
	Bank A/c Dr. To Share First Call A/c (Amount received on first call on 29,500 shares @ ₹ 2 per share)		59,000	 59,000
	Share Final Call A/c Dr. To Share Capital A/c (Amount due on Final call)		60,000	 60,000
	Bank A/c Dr. To Share Final Call A/c (Amount received on final call on 29,500 shares @ ₹ 2 per share)		59,000	 59,000
	Share Capital A/c Dr. To Share First Call A/c To Share Final Call A/c To Share Forfeiture A/c (500 shares of Ashok forfeited for non-payment of First Call and Final Call)		5,000	 1,000 1,000 3,000
	Bank A/c Dr. Share Forfeiture A/c Dr. To Share Capital A/c (Re-issue of 500 shares @ ₹ 9 per share)		4,500 500	 5,000

	Share Forfeiture A/c Dr.		2,500	
	To Capital Reserve A/c			2,500
	(Balance left in Share Forfeiture A/c ₹ 3,000 – ₹ 500 = ₹ 2,500 transferred to Capital Reserve A/c)			

Balance Sheet of Pawan Ltd.

as at …………

Particulars	Note No.	Current Year	Previous Year
I. EQUITY AND LIABILITIES		₹	₹
Shareholders' funds:			
(a) Share capital	1	5,00,000	
(b) Reserves and surplus:	2	2,500	
		5,02,500	
II. ASSETS			
Non-current assets:			
Fixed Assets:			
(i) Tangible Assets			
Current Assets:	3	2,00,000	
Cash and cash equivalents			
	4	3,02,500	
		5,02,500	

Notes to Accounts:		
I. Share Capital	₹	
Authorised, Issued, Subscribed and fully paid Capital:		
20,000 Shares of ₹ 10 each allotted as fully paid		
for a consideration other than cash		
30,000 Shares of ₹ 10 each fully paid up	2,00,000	
	3,00,000	
	5,00,000	
2. Reserve and Surplus:		

Capital Reserve	2,500	
3. Tangible Assets:		
Building	2,00,000	
4. Cash and Cash Equivalents:		
Cast at Bank	3,02,500	

Example:

XYZ Ltd. invited application for 20,000 shares of ₹ 10 each payable as under: ₹ 3 per share on application; ₹ 3 per share on Allotment; ₹ 2 per share on First Call; and ₹ 2 per share on Final Call.

Final Call was not made by the company. An applicant who had been allotted 100 shares failed to pay Allotment and First Call money due from him. His shares were forfeited after the First call and were immediately re-issued at ₹ 8.50 per share. Make necessary entries in the Journal of the company.

Solution: **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To Share Application A/c (Amount received on applications)		60,000	 60,000
	Share Application A/c Dr. To Share Capital A/c (Amount of Share application transferred to Share Capital A/c)		60,000	 60,000
	Share Allotment A/c Dr. To Share Capital A/c (Allotment due)		60,000	 60,000
	Bank A/c Dr. To Share Allotment A/c (Amount received on allotment on 19,900 shares @ ₹ 3 per share)		59,700	 59,700

	Share First Call A/c Dr. To Share Capital A/c (First call due)		40,000	40,000
	Bank A/c Dr. To Share First Call A/c (First call received on 19,900 shares @ ₹ 2 per share)		39,800	39,800
	Share Capital A/c[1] Dr. To Share Allotment A/c To Share First Call A/c To Share Forfeiture A/c (100 shares forfeited for non-payment of allotment & first call)		800	300 200 300
	Bank A/c Dr. To Share Capital A/c To Securities Premium Reserve A/c (Re-issue of 100 forfeited shares @ ₹ 8.50 per share)		850	800 50
	Share Forfeiture A/c Dr. To Capital Reserve A/c (Transfer of Share Forfeiture A/c to Capital Reserve A/c)		300	300

Balance Sheet of XYZ Ltd.

as at …………

Particulars	Note No.	Current Year	Previous Year
I. EQUITY AND LIABILITIES		₹	₹
Shareholders' funds:			
(a) Share capital	1	1,60,000	
(b) Reserves and surplus:	2	350	
		1,60,350	
II. ASSETS			

Current assets: Cash and cash equivalents	3	1,60,350	

Hint: (I) Final Call of ₹ 2 per share has not been made in the question, as such only ₹ 8 have been called up. Therefore, Share Capital A/c will be debited only from ₹ 8 per share at the time of forfeiture of shares.

Notes to Accounts:		
I. Share Capital	₹	
Issued, Share Capital:		
20,000 Shares of ₹10 each	2,00,000	
Subscribed but not fully paid Capital:		
20,000 Shares of ₹ 10 each, ₹ 8 per share called up		
	1,60,000	
2. Reserve and Surplus:		
Capital Reserve		
Securities Premium Reserve A/c	300	
	50	
3. Cash and Cash Equivalents:	350	
Cash at Bank		
	1,60,350	

Example:

ABC Ltd. invited applications for issuing 10,000 Equity Shares of ₹ 10 each. The amount was payable as follows:

On Application	₹ 1
On Allotment	₹ 2
On First Call	₹ 3
On Second and Final Call	Balance

The issue was fully subscribed. Ram to whom 100 shares were allotted, failed to pay the allotment money and his shares were forfeited immediately after allotment. Shyam to whom 150 shares were allotted, failed to pay the first call. His shares were also forfeited after the first call. Afterwards the second and final call was made. Mohan to whom 50 shares were allotted failed to pay the second and final call. His shares were also forfeited. All the forfeited shares were re-issued at ₹ 9 per share fully paid up. Pass necessary journal entries in the books of Dinesh Ltd.

Solution: **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To Equity Share Application A/c (Application money received)		10,000	 10,000
	Equity Share Application A/c Dr. To Equity Share Capital A/c (Application money transferred to Share Capital A/c)		10,000	 10,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Allotment money due on 10,000 shares)		20,000	 20,000
	Bank A/c Dr. To Equity Share Allotment A/c (Allotment money received except on 100 shares)		19,800	 19,800
	Equity Share Capital A/c (100 × ₹ 3) Dr. To Equity Share Allotment A/c (100 × ₹ 2) To Forfeited Share A/c (100 × ₹ 1) (100 shares forfeited for non-payment of allotment money)		300	 200 100
	Equity Share First Call A/c Dr. To Equity Share First Call A/c (First call money received except on 150 shares)		29,700	 29,700
	Bank A/c Dr. To Equity Share First Call A/c (First call money received except on 150 shares)		29,250	 29,250

	Equity Share Capital A/c (150 × ₹ 6) Dr. To Equity Share First Call A/c (150 × ₹ 3) To Forfeited Shares A/c (150 × ₹ 3) (150 shares forfeited due to non-payment of first call money)		900	 450 450
	Equity Share Second & Final Call A/c Dr. To Equity Share Capital A/c (Second & Final Call money due on 9,750 shares @ ₹ 4 per share)		39,000	 39,000
	Bank A/c Dr. To Equity Share Second & Final Call A/c (Final call money received except on 50 shares)		38,800	 38,800
	Equity Share Capital A/c (50 × ₹ 10) Dr. To Equity Share Second & Final Call A/c (50 × ₹ 4) To Forfeited Shares A/c (50 × ₹ 6) (50 shares forfeited due to non-payment of second call)		500	 200 300
	Bank A/c (300 × ₹ 9) Dr. Forfeited Shares A/c (300 × ₹ 1) To Equity Shares Capital A/c (All 300 shares re-issued at ₹ 9 per share fully paid up)		2,700 300	 3,000
	Forfeited Shares A/c(1) Dr. To Capital Reserve A/c (Profit transferred to Capital Reserve A/c)		550	 550

Note (1) Profit on 100 Shares of Ram	100
Profit on 150 Shares of Shyam	450
Profit on 50 Shares of Mohan	300
	850
Less: Loss on Re-issue	300
Transferred to Capital Reserve	550

3.5 Check Your Progress

A. State whether the following statements are True or False

1. A Public Limited Company can issue shares only against cash.
2. A Company can issue equity shares at a discount up to only 10%.
3. There is no maxim limit of premium on equity shares.
4. A Company can charge interest on calls-in- arrear if the Articles of Association permit.

B. Fill in the blanks

1. Liability of a shareholder is limited to____________ of the shares allotted to him.
2. After the reissue of shares, the credit balance left in Share Forfeiture Account is transferred to_______________.
3. The shares can be forfeited only if ______ of the company allows.

3.6 Summary

The total capital of the company is divided into small parts. Each part is called "Share". Under Section 13 of the Companies Act, 2013, a company may issue two types of shares i.e. preference Shares and equity Shares. Preference Shares are those shares which carry the following two preferences i.e. Right to receive the dividend before the dividend paid on equity shares and In case of winding up of the company, preference shares have a right to return the capital before equity shares. Sometimes, number of shares applied for by the public is less than the number of shares offered by the Company which is called under subscription. Issue is said to be over-subscribed when the number of shares applied for is more than the number of shares offered to the public for subscription. If any shareholder fails to pay the amount due on allotment or on any call within the specified period, the Directors may cancel his shares. This is called Forfeiture of Shares.The shares can be forfeited only if the Articles of Association of the Company allow them to be forfeited. In order to make the forfeiture valid, it is essential to follow the rules laid down in the Articles. If no rules are given in Articles, the provision of Table F of Schedule I of the Company Act, 2013 regarding forfeiture apply.After the forfeiture, the name of the shareholder is removed from the Register of Members. The amount already paid by him belongs to the Company and is not returned to him.

3.7 Keywords

Equity Shares: The most commonly issued class of shares which carry highest risk and reward.

Preference Shares: Those shares which carry the right to receive the dividend and capital before equity shares.

Over-Subscription of Shares: When the number of shares applied for is more than the number of shares offered.

Calls-in Arrears: The amount not received on any calls according to the terms.

Forfeiture of Shares: Cancelling the shares for non-payment of calls as per the schedule.

3.8 Self-Assessment Test

1. What do you mean by shares? Discuss the types and features of equity shares in detail.
2. Elaborate the accounting treatment of issue of shares with hypothetical figures.
3. What do you mean by Call in arrears and calls in advance? Discuss the accounting treatment of the same.
4. What do you mean by Forfeiture of Shares? Why the company forfeit the shares.
5. Elaborate the accounting treatment of forfeiture of shares and re-issue the forfeited shares.

3.9 Answers to Check Your Progress

Check Your Progress A

1. False
2. False
3. True
4. True

Check Your Progress B

1. Paid-up Value
2. General Reserve
3. Articles of Association

3.10 References/Suggested Readings

- R. Narayanaswamy, “Financial Accounting”, Prentice Hall of India, New Delhi.
- ArulaNandam M.A. & Raman K.S.,**Advanced Accountancy**, Himalaya Publishing House, Delhi.
- Gupta R.L. and RadhaSwamyM.,**Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
- Shukla M.C. &Grewal S.,**Advanced Accounts,** S. Chand &Company Ltd, New Delhi.
- Study material of Institute of Chartered Accountant of India (ICAI), New Delhi.

Subject: Corporate Accounting	
Course Code: **BCOM 301**	Author: **Prof. Suresh K. Mittal**
Lesson No:**4**	
Issue of Debentures	

STRUCTURE:

4.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning, feature and types of debentures.
- Understand the accounting treatment of issue of debentures.
- Know the issue of debentures for the consideration of cash, other than cash and as a collateral security.
- Understand the accounting treatment of interest on debentures.

4.1 Introduction

Broadly all sources of funds can be classified into short-term funds and long-term funds. Short-term funds are those finds which have maturity period of one year or loss than one year and used for financing working capital. Sources of short-term funds includes trade credit, bank overdraft, cash credit, commercial paper etc. Long-term funds are those sources of funds which have maturity period of three years or more than three years. Long term sources of funds include ordinary sources, preference shares, term loans and debentures etc.

4.2 Meaning, Featuresand Types of Debentures

A debenture is a long-term promissory note for raising long term funds. The company promises to pay interest and principal on debentures as stipulated. Thus a debenture is a written acknowledgement of a debt taken by the company. Debentures are issued in the form of certificate under the seal of the company. According to Section 2 (30) of the Companies Act 2013, “Debenture includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not.” The persons to whom debentures are issued are called “Debenture holders” and considered as lenders to the company. Bond is much similar to that of debenture but the main difference between debenture and bond is with respect to the rate of interest. Debentures are generally issued with fix rate of interest whereas bonds can be issued without predetermined rate of interest the example deep discount bonds and zero coupon bonds. Bonds are issued by semi-government and non-government organisation now but earlier bonds were issued by the government only.

Features of Debentures:

- Debenture is issued by a company which is a written acknowledgement of debt taken by a company.
- Debentures are issued under the common seal of a company.

- Debentures are issued for a specific period of time.
- The interest rate on a debenture is fixed which is called contractual rate of interest or coupon rate. Payment of interest is made on half yearly basis whether the company makes a profit or not.
- Debentures are generally secured by a charge on the assets of the company. The debenture holder can move the court and realise money by getting the assets of the company sold if the company is unable to repay the debentures as per the terms of the issue.
- Funds raised through issue of debentures are of long term nature which is considered loan capital.
- No company is allowed to issue debentures having a maturity period of more than 10 years but in case of a company engaged in infrastructure projects this period is up to 30 years as per Companies Act 2013.

Distinction Between a Share and a Debenture

S.No.	Basis of Distinction	Share	Debenture
1.	Capital v/s Loan	A Share is a part of the Capital of the Company,so, the shareholders are the owners of the company.	A debenture is a part of the loan, the debenture holder are the creditors of the company.
2.	Dividend vs Interest	A shareholder gets dividend from the Company.	A debentureholder gets interest from the Company.
3.	Fluctuating or Fixed rate of dividend or interest	Dividend is paid only when there are profit and rate of dividend may fluctuate from year to year.	The rate of interest is fixed and it must be paid irrespective of the Company making a profit or incurring a loss.
4.	Voluntary or compulsory redemption	It is at the option of the Company to return the amount of shares by buying back its own shares.	The amount of debentures must be returned according to the terms of the issue.
5.	Priority of repayment	In the case of winding up, the	In the case of winding up, the

		payment of share capital is made after the repayment of debentures.	payment of debentures is made before the payment of share capital.
6.	Unsecured or Secured	A share is always unsecured. Hence, they bear more risk.	Debentures are usually secured on the assets of the Company. Hence, they bear little risk.
7.	Restriction on issue at discount	Under Section 53 of the Companies Act 2013, shares cannot be issued at discount except sweat equity shares.	There are no restrictions on the issue of debentures at discount.
8.	Voting rights	Share confers right to participate in and vote at Company's meetings.	A holder of debenture neither possesses any voting right in the Company's meeting.

4.3 Accounting Treatment of Issue of Debentures

The procedure for the issue of debentures is very much similar to that of the issue of shares. A prospectus is issued in which terms and conditions of the issue of debentures are given. Applications on the prescribed form are deposited with the Company's bankers along with application money. Full amount of debentures may be called by the Company on application itself or the amount may be called in instalments, as in the case of shares. If the amount of debenture is called in instalments, some amount may be called on application, some amount on allotment and the balance may be called in one or more calls. As per Section 39 of the Companies Act, 2013, condition of Minimum Subscription applies on every type of securities including debentures.

Debentures may be issued either at par, or at a premium or at a discount. There are not restrictions on the issue of debentures at discount, whereas shares cannot be issued at discount. The rate of discount is also to be decided by the directors.

Journal entries on issue of debentures are also the same as in the case of issue of shares. The only difference is that 'Debenture A/c' will be opened in place of 'Share Capital A/c'. It is usual to prefix the rate of interest to the debentures. Thus, if the rate of interest is 10%, the name given will be "10% Debentures".

4.3.1 Issue of Debenture for cash

Following entries will be passed on the issue of debentures (assuming that the debentures carry 10% interest)

1. On receipt of application money:

   Bank A/c Dr.

   To 10% Debenture Application A/c

   (Application money received)

2. On Transfer of application money to Debenture Account :

   10% Debenture Application A/c Dr.

   To 10% Debenture A/c

   (Application money transferred)

3. On refund of money on totally rejected applications:

   10% Debenture Application A/c Dr.

   To Bank A/c

   (Application money returned on rejected application)

4. On the transfer of surplus application money on partially accepted applications:

   10% Debenture Application A/c Dr.

   To 10% Debenture Allotment A/c

   (Transfer of excess application money to allotment A/c)

5. On making allotment money due:

   10% Debenture Application A/c Dr.

   To 10% Debenture A/c

   (Allotment money due)

6. On receipt of allotment money:

Bank A/c Dr.

To 10% Debenture Allotment A/c

(Allotment money received)

7. On making the call money due:

10% Debenture First Call A/c Dr.

To 10% Debenture A/c

(First Call money due)

8. On receipt of call money:

Bank A/c Dr.

To 10% Debenture First Call A/c

(First Call money received)

If there are more than one call, separate entries for each call will be passed, like above.

Issue of Debentures at Par

Example:

ABC Ltd. issued 5,000, 12% Debentures of ₹100 each, at par, payable as follows:

On application ₹20; On Allotment ₹20; On First Call ₹30; and on Final Call ₹30.

Public applied for 6,000 debentures. Applications for 4,500 debentures were accepted in full. Application for 800 debentures were allotted 500 debentures and applications for 700 debentures were rejected. Money overpaid on applications was utilised towards allotment.

Pass journal entries assuming that all money due were duly received, except final call on 200 debentures.

Solution: **Journal of ABC Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 12% Debenture Application A/c (Application money received on 6,000 debentures @ ₹20 each)		1,20,000	1,20,000

	12% Debentures Application A/c Dr. To 12% Debenture A/c To 12% Debenture Allotment A/c To Bank A/c (Application money transferred)		1,20,000	 1,00,000 6,000 14,000
	12% Debenture Allotment A/c Dr. To 12% Debenture A/c (Application money due on 5,000 debentures @ ₹20 each)		1,00,000	 1,00,000
	Bank A/c Dr. To 12% Debenture Allotment A/c (Balance of allotment money received, i.e. ₹1,00,000 – ₹6000)		94,000	 94,000
	12% Debenture First Call A/c Dr. To 12% Debenture A/c (First Call due)		1,50,000	 1,50,000
	Bank A/c Dr. To 12% Debenture First Call A/c (First Call money received)		1,50,000	 1,50,000
	12% Debenture Second & Final Call A/c Dr. To 12% Debenture A/c (Second and Final Call due)		1,50,000	 1,50,000
	Bank A/c Dr. To 12% Debenture Second & Final Call A/c (Second & Final Call money received on 4,800 debentures @ ₹30 per Debenture)		1,44,000	 1,44,000

Example

XYZ Ltd. issued 20,000, 11% Debentures of ₹100 each, payable as follows:

₹25 on application; ₹35 on allotment and ₹40 on first and final call.

All the debentures were applied A, the holder of 500 debentures paid the entire amount on his holding on allotment and B, the holder of 100 debentures failed to pay the allotment and final call. Pass entries.

Solution: **Journal of XYZ Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 11% Debenture Application A/c (Application money received on 20,000 debentures @ ₹25 each)		5,00,000	 5,00,000
	11% Debentures Application A/c Dr. To 11% Debenture A/c (Application money transferred)		5,00,000	 5,00,000
	11% Debenture Allotment A/c Dr. To 11% Debenture A/c (Allotment due)		7,00,000	 7,00,000
	Bank A/c Dr. To 11% Debenture Allotment A/c To Calls in Advance A/c (Allotment received on 19,900 debentures @ ₹35 per debenture; plus call received in advance on 500 debentures @ ₹40 per debenture)		7,16,500	 6,96,500 20,000
	11% Debenture First & Final Call A/c Dr. To 11% Debenture A/c (First and final call due on 20,000 debentures @ ₹40 per debenture)		8,00,000	 8,00,000
	Bank A/c Dr. Calls in Advance A/c To 11% Debenture First & Final Call A/c (First & Final Call money received on 19,900 debentures @ ₹40 per debenture; Calls in advance on 500 debentures of A previously received now adjusted)		7,76,000 20,000	 7,96,000

Example

XYZ Ltd. issued 10,000, 10% Debentures of Rs.100 each, payable as follows:

₹10 on application; ₹20 on allotment, ₹30 on first call and ₹40 on second and final call.

Arun, who holds 500 debentures failed to pay the amount due on allotment. He, however, pays this amount with the first call money. Dinesh, who holds 800 debentures paid all the calls in advance on allotment. Pass entries.

Solution: **Journal of XYZ Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
1.	Bank A/c Dr. To 10% Debenture Application A/c (Application money received on 10,000 debentures @ ₹10 per debenture)		1,00,000	 1,00,000
2.	10% Debentures Application A/c Dr. To 10% Debenture A/c (Application money transferred)		1,00,000	 1,00,000
3.	10% Debenture Allotment A/c Dr. To 10% Debenture A/c (Allotment due)		2,00,000	 2,00,000
4.	Bank A/c Dr. To 10% Debenture Allotment A/c To Calls in Advance A/c (Allotment money received on 9,500 debentures @ ₹20 per debenture; plus call received in advance on 800 debentures @ ₹70 per debenture)		2,46,000	 1,90,000 56,000
5.	10% Debenture First Call A/c Dr. To 10% Debenture A/c (First call due on 10,000 debentures @ ₹30 each)		3,00,000	 3,00,000
6. (i)	Bank A/c Dr. Calls in Advance A/c To 10% Debenture First Call A/c (First call money received after adjusting the advance of first call @ ₹30 per debenture on 800 debentures of Dinesh)		2,76,000 24,000	 3,00,000
(ii)	Bank A/c Dr. To 10% Debenture Allotment A/c		10,000	 10,000

	(Receipt of arrears of allotment in respect of 500 debentures)			
7.	10% Debenture Second & Final Call A/c Dr. To 10% Debenture A/c (Second and final call due on 10,000 debentures @ ₹40 per debenture)		4,00,000	 4,00,000
8.	Bank A/c Dr. Calls in Advance A/c To 10% Debenture Second & Final Call A/c (Second call money received after adjusting the advance of Second call @ ₹40 per debenture on 800 debentures of Dinesh)		3,68,000 32,000	 4,00,000

Issue of Debentures at Premium

When the debentures are issued at more than their face value, they are said to have been issued at premium. For example, if a debenture of ₹100 is issued at ₹110, ₹10 is the premium, which is a gain to the Company. This premium should not be treated as a revenue profit as it is not an income arising from the normal course of business operations. It is a capital profit and should, therefore, be used in writing off the capital losses, such as discount on issue of shares and debentures, premium on redemption of debentures, preliminary expenses, goodwill, patents etc.

As stated earlier, the name of 'Share Premium A/c' has been changed to 'Securities Premium Reserve A/c'. Since the Debentures are also securities, Debentures Premium should also be credited to 'Securities Premium Reserve A/c'.

"Securities Premium Reserve A/c" is shown on the equity and liabilities side of the balance sheet under the head "Reserves and Surplus".

Example:

ABC Chemical Ltd. of Mumbai issued 1,00,00,000, 10% Debentures of ₹100 each at a premium of 10% payable as ₹40 on application and ₹70 on allotment. Debentures are redeemable on March 31, 2010. Record necessary entries to record issue of debentures assuming that the issue is fully subscribed and all the money due is received.

Solution: **Journal of ABC Chemical Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 10% Debenture Application A/c (Application money received)		40,00,00,000	 40,00,00,000
	10% Debentures Application A/c Dr. To 10% Debenture A/c (Application money transferred to 10% Debentures account consequent upon allotment)		40,00,00,000	 40,00,00,000
	10% Debenture Allotment A/c Dr. To 10% Debenture A/c To Securities Premium Reserve A/c (Allotment due)		70,00,00,000	 60,00,00,000 10,00,00,000
	Bank A/c Dr. To 10% Debenture Allotment A/c (Allotment money received)		70,00,00,000	 70,00,00,000

Example:

XYZ Products Ltd. offered 2,00,000, 8% Debentures of ₹500 each at a premium of 10% payable as ₹200 on application (including premium) and balance on allotment, redeemable at par after 8 years. But applications are received for 3,00,000 debentures and the allotment is made on pro-rata basis. All the money due on application and allotment is received. Record necessary entries regarding issue of debentures.

Solution: **Journal of XYZ Products Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 8% Debenture Application A/c (Application money received on 3,00,000 debentures @ ₹200 each)		6,00,00,000	 6,00,00,000
	8% Debentures Application A/c Dr. To 8% Debenture A/c To Securities Premium Reserve A/c		6,00,00,000	 3,00,00,000 1,00,00,000

	To 8% Debenture Allotment A/c (Transfer of application money to 8% Debentures A/c and the excess money to Allotment A/c)			2,00,00,000
	8% Debenture Allotment A/c Dr. To 8% Debenture A/c (Allotment due on 2,00,000 debentures @ ₹350 each)		7,00,00,000	7,00,00,000
	Bank A/c Dr. To 8% Debenture Allotment A/c (Allotment money received)		5,00,00,000	5,00,00,000

Example:

XYZ Ltd. invited applications for issuing 7,500, 12% Debentures of ₹100 each at a premium of ₹35 per debenture. The full amount was payable on application. Application were received for 10,000 debentures. Applications for 2,500 debentures were rejected and the application money was refunded. Debentures were allotted to the remaining applicants.

Pass necessary journal entries for the above transactions in the books of Narain Ltd.

Solution: **In the Books of XYZ Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 12 % Debenture Application & Allotment A/c (Receipt of application money for 10,000 debentures)		13,50,000	13,50,000
	12% Debentures Application & Allotment A/c Dr. To 12% Debenture A/c To Securities Premium Reserve A/c To Bank A/c (Allotment of 7,500, 12% debentures of ₹100 each at a premium of ₹35 and refund of excess application money on 2,500 debentures @ ₹135 each)		13,50,000	7,50,000 2,62,500 3,37,500

Issue of Debentures at Discount

When the company issues debentures at a price which is less than their face or nominal value, the debentures are said to have been issue at a discount. There are no restrictions in the Companies Act regarding the maximum limit for discount on debentures.Discount or Loss on Issue of Debentures is a capital loss. It should be written off as early as possible but within the lifetime of the debentures. It can be written off by debiting to Securities Premium Reserve Account on Statement of Profit or Loss. Following entry is passed for writing off discount or loss on issue of debentures:

Securities Premium Reserve A/c Or, Dr.

Profit & Loss Dr.

To Discount/Loss on issue of Debentures A/c

Discount being a loss, is recorded in the books of the Company by debiting "Discount on Debentures A/c". Discount is generally recorded at the time of allotment entry.

Example:

Surya Ltd. issued 2,500, 15% Debentures of ₹100 each at a discount of 10% payable as follows:

₹25 on application; ₹25 on allotment and the balance on First Call.

Applications were received for 2,000 debentures and the allotment was made. All the moneys were duly received. Expenses on issue of debentures amounted to ₹8,000. Directors decided to write off 1/5th of "Expenses on Issue A/c" and "Discount on Debentures A/c" from statement of Profit and Loss each year.

Pass journal entries (for first year only).

Solution: **Journal of Surya Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 15% Debenture Application A/c (Application money received for 2,000 debentures @ ₹25 each)		50,000	 50,000
	15% Debentures Application A/c Dr. To 15% Debenture A/c (Application money transferred)		50,000	 50,000

	15% Debenture Allotment A/c Dr. Discount on Debentures A/c Dr. To 15% Debentures A/c (Allotment due)		50,000 20,000	 70,000
	Bank A/c Dr. To 15% Debenture Allotment A/c (Allotment received on allotment)		50,000	 50,000
	15% Debenture First and Final A/c Dr. To 15% Debentures A/c (First & Final Call due)		80,000	 80,000
	Bank A/c Dr. To 15% Debenture First & Final Call A/c (Amount received on First & Final Call)		80,000	 80,000
	Expenses on Issue A/c Dr. To Bank A/c (Expenses paid on issue of debentures)		8,000	 8,000
	Profit & Loss A/c Dr. To Discount on Debentures A/c To Expenses on Issue A/c (1/5th of 'Discount on debentures' and 1/5th of 'expenses on issue' written off)		5,600	 4,000 1,600

It should be noted that in case, the full amount of a debenture is received in one instalment, the amount should be credited to 'Debenture Application & Allotment A/c', instead of 'Debenture Application A/c'.

Example:

(i) On 15-2-2017 A Ltd. invited applications for issue of 1,00,000 9% debentures of ₹100 each at a discount of 6%, redeemable at par after 3 years. The full amount was payable on application and the debentures were issued on 15-3-2017. Pass the Journal entries for the above transactions.

(ii) R. Ltd. issued 10,000, 12% Debentures of ₹100 each at a discount of 5%. Pass Journal entries.

Solution: (i)

A Ltd.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
15-02-17	Bank A/c Dr. To 9% Debenture Application & Allotment A/c (Application money received for 1,00,000 debentures @ ₹94 each)		94,00,000	 94,00,000
15-03-17	9% Debentures Application & Allotment A/c Dr. Discount on Debentures A/c To 9% Debentures A/c (Application money transferred to Debentures A/c consequent upon allotment, issued at 6% discount)		94,00,000 6,00,000	 1,00,00,000

(ii)

R Ltd.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 12% Debenture Application & Allotment A/c (Application money received for 10,000 debentures @		9,50,000	 9,50,000

	₹95 each)			
	12% Debentures Application & Allotment A/c Dr. Discount on Debentures A/c To 12% Debentures A/c (Application money transferred to Debentures A/c consequent upon allotment, issued at 5% discount)		9,50,000 50,000	 10,00,000

4.3.2 Issue of Debentures for Consideration other than Cash

Sometimes a Company purchase some assets from the vendor and instead of paying the vendor and instead of paying the vendor in cash, the Company may decide to issue debentures to the vendor in payment of purchase consideration. Such an issue of debentures to vendors is known as issue of debentures for consideration other than cash. Debentures can be issue to vendors at par, at a premium or at a discount. Following entries will be passed for this purpose:

1. On Purchase of assets:

   Assets A/c Dr.

   To Vendor's A/c

2. I. For the issue of debentures to vendor at par:

   Vendor's A/c Dr.

   To Debentures A/c

   II. For the issue of debentures to vendor at premium:

   Vendor's A/c Dr.

   To Debentures A/c

   To Securities Premium Reserve A/c

   III. For the issue of debentures to vendor at discount:

   Vendor's A/c Dr.

   Discount on Issue of Debentures A/c

   To Debentures A/c

Example: A company purchased assets of the book value of ₹99,000 from another Co. It was agreed that the purchase consideration be paid by issuing 11% Debentures of ₹100 each. Assume that the debentures have been issued (i) at par, (ii) at a discount of 10%, and (iii) at a premium of 10%.

Give necessary journal entries in the books of purchasing company.

Solution:

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Sundry Assets A/c Dr. To Vendors' A/c (Assets purchased)		99,000	 99,000
(1)	When Debentures are issued at par: Vendors' A/c Dr. To 11% Debentures A/c (Issue of debentures at par)		 99,000	 99,000
(2)	When Debentures are issued at Discount : Vendors' A/c Dr. Discount on Issue of Debentures A/c To 11% Debentures A/c (Issue of 1,100 debentures of ₹100 each at 10% discount calculated as follows: $\frac{99,000}{90}$ = 1,100 debentures)		 99,000 11,000	 1,10,000
(3)	When Debentures are issued at Premium: Vendors' A/c Dr. To 11% Debentures A/c To Securities Premium Reserve A/c (Issue of 900 debentures of ₹100 each at 10% premium, calculated as follows: $\frac{99,000}{110}$ = 900 debentures)		 99,000	 90,000 9,000

A Company may issue different kinds of debentures which can be classified as under:

1. From Security Point of View

(i) Secured Debentures: Secured Debentures are those debentures which are secured by either a fixed charge or a floating charge on the assets of the company. A charge on the assets of the company is registered with the Registrar of Companies.

(ii) Unsecured Debentures: Unsecured Debentures are those debentures which are not secured by any charge on assets of the company.

2. From Redemption Point of view

(i) Redeemable Debentures: Redeemable Debentures are those debentures that are repayable by the company at the end of a specified period or by instalments during the existence of the company.

(ii) Irredeemable Debentures: Irredeemable Debentures are those debentures that are not repayable during the lifetime of the company and hence are repaid only when the company is liquidated.

3. From Records Point of View

(i) Registered Debentures: Registered Debentures are the debentures that are registered in the company's records in the name of the holder. Principal and interest of such debentures is payable to the registered debentureholders. The transfer of debentures in this case requires the execution of a transfer deed.

(ii) Bearer Debentures: Bearer debentures are the debentures that are not registered in the records of the company in the name of the holder. These debentures are transferable by mere delivery. Interest is paid to the person who produces coupons attached to the debenture.

4. From Priority Point of view

(i) First Debentures: The debentures which have to be repaid before the other debentures are known as first debentures.

(ii) Second Debentures: The debentures, which will be repaid after the first debentures are redeemed, are known as second debentures.

5. From the Point of view of Coupon Rate

(i) Specific Coupon Rate Debentures: These debentures are issued with a specified rate of interest, called the coupon rate. For example, 10% Debentures. The specified rate may either be fixed or floating. The floating interest rate is usually linked with the bank rate.

(ii) Zero coupon Rate Debentures (Bonds): These debentures do not carry a specific rate of interest. In order to compensate the investors such debentures are issued at a substantial discount. The difference between the face value and the issue price is the total amount of interest related to the duration of debentures.

6. From Convertibility Point of View

(i) Convertible Debentures: Convertible Debentures are the debentures that are convertible into shares. If a part of the debenture amount is convertible into Equity Shares, they are known as Partly Convertible Debentures. If full amount of debentures is convertible into Equity Shares, they are known as fully Convertible Debentures.

(ii) Non-convertible Debentures: Non-convertible Debentures are the debentures that are not convertible into shares.

Example:

Lemon tree Ltd. purchased a piece of land from JSS Ltd. and paid the consideration as follows:

(i) Issued a cheque for ₹10,00,000;

(ii) Issued a Bill of Exchange for 3 months for ₹5,00,000;

(iii) Issued 5,000; 9% Debentures of ₹100 each at par redeemable at 10% premium after 5 years.

Pass the Journal entry.

Solution: **Journal of Lemon Tree Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Land A/c …Dr.		20,00,000	
	Loss on Issue of Debentures A/c …Dr.		50,000	
	To Bank A/c			10,00,000
	To Bills Payable A/c			5,00,000
	To 9% Debentures A/c			5,00,000
	To Premium on Redemption of Debentures A/c			50,000
	(Being the land purchased and consideration paid)			

Example:

Exe Ltd. Purchased assets of ₹8,40,000 and took over liabilities of ₹80,000 of Whe Ltd. at an agreed value of ₹7,20,000. Exe Ltd. issued 10% Debentures of ₹100 each at 10% discount in full satisfaction of the price. Pass Journal entries in the books of Exe. Ltd.

Solution: **Journal of Lemon Tree Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Sundry Assets A/c …Dr. To Sundry Liabilities A/c To Capital Reserve A/c (Note 2) To Whe Ltd. (Being the purchase of business of Whe Ltd.)		8,40,000	 80,000 40,000 7,20,000
	Whe Ltd. …Dr. Discount on Issue of Debentures A/c …Dr. To 10% Debentures A/c (Being the issue of 8,000; 10% Debentures at 10% discount)		7,20,000 80,000	 8,00,000

Notes:

1. Calculation of the number of Debentures:

   ₹7,20,000/ ₹90 = 8,000 debentures of ₹100 each.

   ∴ Debentures issued are of ₹8,00,000 at a discount of 10% i.e., ₹80,000.

2. Capital Reserve = Net Assets (i.e., Sundry Assets – Sundry Liabilities) – Purchase consideration = ₹(8,40,000 – 80,000) – ₹7,20,000 = ₹40,000.

Example: (Issue of Debentures to Vendors at Discount with Part Payment in Cash).

Pass Journal entries for the following transactions:

Z Ltd. purchased plant and machinery for ₹2,00,000 payable as ₹65,000 immediately in cash/cheque and balance by issue of 6% Debentures of ₹100 each at a discount of 10%.

Solution:

Journal of Z Ltd.

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Plant and Machinery A/c …Dr. To Vendors' A/c (Being the plant and machinery purchased from Vendor)		2,00,000	 2,00,000

	Vendor's A/c ...Dr.		2,00,000	
	Discount on Issue of Debentures A/c ...Dr.		15,000	
	To Cash/Bank A/c			65,000
	To 6% Debentures A/c			1,50,000
	(Being the cash paid to Vendor ₹65,000 for balance of debentures issued at 10% discount)			

Note: Number of Debentures Issued = $\frac{Purchase\ Price - Cash\ Payment}{Issue\ Price\ of\ Debenture}$

$$\frac{₹2,00,000 - ₹65,000}{₹100 - ₹10} = \frac{₹1,35,000}{₹90} = 1,500 \text{ Debentures}$$

4.3.3 Issue of Debentures as Collateral Security

Loans taken are secured by mortgage of the assets known as prime or principal security. Security given in addition to the prime or principal security is termed or known as Collateral Security. Collateral security is realised by the lender only if the due amount cannot be recovered by realising the principal security.Debentures are issued as collateral security when the borrower is not in a position to give any other asset as a collateral security. When the loan is paid back, the debentures issued as a collateral security are returned to the company. These debentures do not carry any right till the time loan is being repaid along with due interest and the lender has not demanded the loan to be repaid. In case the company fails to repay the loan being demanded by the lender, the lender may exercise its right towards debentures being issued as collateral security.

Accounting Treatment: Debentures issued as a collateral security can be dealt with in two ways:

(i) First Method: Entry for issue of debentures as collateral security is not passed in the books of account at the time of issuing such debentures. It is disclosed under the head Secured loans in the Equity and Liabilities part of the Balance Sheet that debentures have been issued as collateral security as follows:

(a) Debentures issued as Collateral Security for Long-term Loan from Bank.

Particulars	Note No.	₹
I. EQUITY AND LIABILITIES		₹
Non-Current Liabilities		
Long-term Borrowings	1	5,00,000

Note to Accounts

I. Long-Term Borrowings	₹
Term Loan from Bank	
(Secured by issue of 6,000; 9% Debentures of ₹100 each as Collateral Security)	5,00,000

(b) Debentures Issued as Collateral Security for Short-term from Bank.

Balance Sheet as at …..

Particulars	Note No.	₹
I. EQUITY AND LIABILITIES		₹
Current Liabilities		
Short-term Borrowings	1	5,00,000

Note to Accounts

I. Short-Term Borrowings	₹
Loan from Bank	
(Secured by issue of 6,000; 9% Debentures of ₹100 each as Collateral Security)	5,00,000

(ii) Second Method: Debentures issued as collateral security are recorded in the books of account. The Journal entry passed is:

Debentures Suspense A/c …Dr.

To …% Debentures A/c

When the loan is paid to the lender, the above entry is cancelled by passing a reverse entry. In the Balance Sheet, the debentures issued as collateral security are shown separately from other debentures.

Disclosure in the Balance Sheet

Debentures issued as collateral security being for the loan of the company, debentures issued as collateral security are shown in the Note to Accounts in which the loan secured by debentures is shown.

For example, if the Bank Loan is shown as Long-term Borrowings, debentures issued as collateral security are also shown in the Note to Accounts on Long-term Borrowings. The underlying principle being to disclose the security given for the borrowings. Debentures Suspense Account is shown as a deduction from the debentures. It is shown as follows:

Balance Sheet as at …..

Particulars	Note No.	₹
I. EQUITY AND LIABILITIES		₹
Non-Current Liabilities		
Long-term Borrowings	1	5,00,000

Note to Accounts

I. Long-Term Borrowings			₹
TermLoan from Bank			5,00,000
6,000; 9% Debentures of ₹100 each as Collateral Security		6,00,000	
Less: Debentures Suspense A/c	6,00,000		
			5,00,000

Example: X Ltd. obtained loan of ₹8,00,000 from State Bank of India and issued 10,000; 9% Debentures of ₹100 each as collateral security. How will issue of debentures be shown in the Balance Sheet?

Solution:

1. First Method (When Journal Entry is not Passed):

An Extract of Balance Sheet of X Ltd.

as at…

Particulars	Note No.	₹
I. EQUITY AND LIABILITIES		₹
Non-Current Liabilities		
Long-term Borrowings	1	8,00,000

Note to Accounts

I. Long-Term Borrowings	₹
Loan from State Bank of India	8,00,000
(Secured by issue of 10,000; 9% Debentures of ₹100 each as Collateral Security)	

II. Second Method (When Journal Entry is Passed):

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Debentures Suspense A/c …Dr.		10,00,000	
	To 9% Debentures A/c			10,00,000
	(Being the issue of 10,000; 9% Debentures of ₹100 each as collateral security for a loan taken from State Bank of India)			

An Extract of Balance Sheet of X Ltd.

as at…

Particulars	Note No.	₹
I. EQUITY AND LIABILITIES		₹
Non-Current Liabilities		
Long-term Borrowings	1	8,00,000

Note to Accounts

I. Long-Term Borrowings		₹
Loan from State Bank of India		5,00,000
(10,000; 9% Debentures of ₹100 each issued as Collateral Security	1,00,000	80,000
Less: Debentures Suspense A/c	1,00,000	
		5,80,000

Non-Payment of Loan

If the company (borrower) fails to pay the loan along with interest, the lender can recover the due amount by selling primary security or by redeeming collateral security, i.e, debentures.

Accounting Treatment

No Immediate liability is created at the time of issuing the debentures as collateral security, therefore, no Journal entry is passed. The liability arises when the lender exercise his right vested in the collateral security. As and when the lender exercise this option, following Journal entries are passed:

(i) ….% Debentures A/c …Dr.
To Debentures Suspense A/c

Note: The above entry will be passed when debentures issued as collateral security are recorded in the books of account.

(ii) Loan A/c …Dr. [principal]
Outstanding Interest A/c …Dr. [Outstanding interest for the period intervening the of default on the loan to date of invoking security by the lender]
To …% Debentures A/c [Principal + Interest outstanding on loan]

Example:s

XYZ Ltd. issued 10,000 10% Debentures of ₹100 each as collateral security for a loan of ₹8,00,000 from Dena Bank. The company was unable to repay the loan on which interest payable was ₹2,00,000 as on 31st March, 2018.

Dena Bank, on 31st March, 2018, exercised the right vested in it by way of debentures being issued as collateral Security.

Pass Journal entries in the books of Zee Ltd. on 31st March, 2018.

Solution: **Journal of XYZ Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2018 March 31	10% Debentures A/c …Dr. To Debentures Suspense A/c (Being the entry for debentures issued as collateral security reversed)		10,00,000	 10,00,000
	Loan A/c …Dr. Outstanding Interest A/c To 10% Debentures A/c (Being the entry for conversion of debentures issued as collateral security into Debentures Liability)		8,00,000 2,00,000	 10,00,000

4.4 Accounting Treatment of Issue of Debentures considering the Terms and Conditions of Redemption

Debentures may be redeemed either at par or at premium, according to the terms laid down at the time of issue. After taking into account the three possibilities of issue (i.e., at par, at discount, at premium) and two possibilities of redemption (i.e., at par or at premium) a Company can issue debentures from the following six types:

1. When debentures are issued at par and are redeemable at par : For example, if a debenture of ₹100 is issued at ₹100 and is redeemable at ₹100, the following entries will be passed.

Entries for Issue			Entries for Redemption		
Bank A/c Dr. To Debenture Application	100		Debentures A/c Dr.	100	 100

& Allotment A/c		100	To Debentureholders A/c		
Debenture Application & Allotment A/c Dr. To Debentures A/c	100	100	Debentureholder A/c Dr. To Bank A/c	100	100

2. When debentures are issued at a discount and are redeemable at par : For example, if a debenture of ₹100 is issued at ₹95 and is redeemable at ₹100, the following entries will be passed.

Entries for Issue			Entries for Redemption		
Bank A/c Dr. To Debenture Application & Allotment A/c	95	95	Debentures A/c Dr. To Debentureholders A/c	100	100
Debenture Application & Allotment A/c Dr. Discount on Issue of Debentures A/c Dr. To Debentures A/c	95 5	100	Debentureholder A/c Dr. To Bank A/c	100	100

'Discount on issue' is a capital loss and will be written off during the life time of the debentures. But till then it will be shown as 'Unamortized Expenses' on the Assets side of the Balance Sheet.

3. When debentures are issued at a premium and are redeemable at par : For example, if a debenture of ₹100 is issued at ₹105 and is redeemable at ₹100, the following entries will be passed.

Entries for Issue			Entries for Redemption		
Bank A/c Dr. To Debenture Application & Allotment A/c	105	105	Debentures A/c Dr. To Debentureholders A/c	100	100
Debenture Application & Allotment A/c Dr.	105		Debentureholder A/c Dr. To Bank A/c	100	100

To Debentures A/c To Securities Premium Reserve A/c		100 5			

Securities Premium Reserve A/c has a credit balance and is a capital profit, to be shown on the equity and liabilities side under the head, "Reserves and Surplus".

4. When debentures are issued at par and are redeemable at a premium: Sometimes the debentures are issued with the specific condition that the Company will pay a premium at the time of their redemption. Although, such premium will be paid at the time of actual redemption, but as it is a known loss, the Company records such loss at the time of issue by debiting an account called, "Loss on issue of debentures A/c". It is done in keeping with the convention of conservatism.

For example, if a debentures of ₹100 is issued at ₹100 and is redeemable at ₹105, the following entries will be passed:

Entries for Issue			Entries for Redemption		
Bank A/c Dr. To Debenture Application & Allotment A/c	100	100	Debentures A/c Dr. Premium or Redemption of Debentures A/c Dr. To Debentureholders A/c	100 5	105
Debenture Application & Allotment A/c Dr. Loss on Issue of Debentures A/c Dr. To Debentures A/c To Premium on Redemption of Debentures A/c	100 5	100 5	Debentureholder A/c Dr. To Bank A/c	105	105

'Loss on issue of debentures A/c' is a loss on account of promise to pay debentures at premium at the time of their redemption. This is a capital loss and is written off from Security Premium Reserve or from Statement of Profit & Loss gradually every year during the lifetime of the debentures. The entry for writing off will be:

Profit and Loss A/c Dr.

To Loss on Issue of Debentures A/c

The balance of 'Loss on issue of Debentures A/c' is shown as 'Unamortized Expenses' on the Asset side of the Balance Sheet.

'Premium on Redemption of Debentures A/c' is a Personal Account and shows a credit balance. It is a liability on the part of the Company and appears under the head: 'Non-Current Liabilities' under sub-head 'Other Long term Liabilities' on the equity and liability side of the balance sheet each year, until the debentures are repaid. At the time of redemption of debentures, this account is debited and closed off.

5. When debentures are issued at a discount and are redeemable at a premium: For example if a debentures of ₹100 is issued at ₹98 and is redeemable at ₹105, the following entries will be passed:

Entries for Issue			Entries for Redemption		
Bank A/c Dr. To Debenture Application & Allotment A/c	98	 98	Debentures A/c Dr. Premium or Redemption of Debentures A/c Dr. To Debentureholders A/c	100 5	 105
Debenture Application & Allotment A/c Dr. Loss on Issue of Debentures A/c Dr. To Debentures A/c To Premium on Redemption of Debentures A/c	 98 7	 100 5	Debentureholder A/c Dr. To Bank A/c	105	 105

Both, the amount of discount allowed ₹2 and premium on redemption ₹5 are capital losses and therefore, grouped together and debited to 'Loss on issue' as ₹7.

6. When debentures are issued at premium and are redeemable at a premium: For example if a debentures of ₹100 is issued at ₹106 and is redeemable at ₹110, the following entries will be passed:

Entries for Issue			Entries for Redemption		
Bank A/c Dr. To Debenture Application & Allotment A/c	106	 106	Debentures A/c Dr. Premium or Redemption of Debentures A/c Dr. To Debentureholders A/c	100 10	 110
Debenture Application & Allotment A/c Dr. Loss on Issue of Debentures A/c Dr. To Debentures A/c To Securities Premium Reserve A/c To Premium on Redemption of Debentures A/c	 106 10	 100 6 10	Debentureholder A/c Dr. To Bank A/c	110	 110

On the equity & liabilities side, securities premium reserve will be shown under the head "Reserves and Surplus" and Premium on Redemption will be shown under the head "Non-Current Liabilities" under the sub-head 'Other Long-term Liabilities'.

Example:

Give Journal entries for the issue of debentures in the following conditions.

I. Issued 2,000, 12% debentures of ₹100 each at par, redeemable also at par.

II. Issued 2,000, 12% debentures of ₹100 each at a discount of 2%, redeemable also at par.

III. Issued 2,000, 12% debentures of ₹100 each at a premium of 5%, redeemable also at par.

IV. Issued 2,000, 12% debentures of ₹100 each at par but redeemable at 5% premium.

V. Issued 2,000, 12% debentures of ₹100 each at a discount of 2%, redeemable at a premium of 5%.

VI. Issued 2,000, 12% debentures of ₹100 each at a premium of 5%, redeemable at a premium of 10%.

Solution:I **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 12% Debentures Application & Allotment A/c (Application money received)		2,00,000	 2,00,000
	12% Debenture Application & Allotment A/c Dr. To 12% Debentures A/c (Transfer of application money to Debentures Account, issued at par)		2,00,000	 2,00,000

II **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 12% Debentures Application & Allotment A/c (Application money received)		1,96,000	 1,96,000
	12% Debenture Application & Allotment A/c Dr. Discount on issue of Debentures A/c Dr. To 12% Debentures A/c (Transfer of application money to Debentures Account, issued at a discount of 2%)		1,96,000 4,000	 2,00,000

III. Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr.		2,10,000	
	To 12% Debentures Application & Allotment A/c			2,10,000
	(Application money received)			
	12% Debenture Application & Allotment A/c Dr.		2,10,000	
	To 12% Debentures A/c			2,00,000
	To Securities Premium Reserve A/c			10,000
	(Transfer of application money to Debentures Account, issued at a premium of 5%)			

IV. Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr.		2,00,000	
	To 12% Debentures Application & Allotment A/c			2,00,000
	(Application money received)			
	12% Debenture Application & Allotment A/c Dr.		2,00,000	
	Loss on issue of debentures A/c		10,000	
	To 12% Debentures A/c			2,00,000
	To Premium on Redemption A/c			10,000
	(Transfer of application money to Debentures Account, issued at par, but redeemable at a premium of 5%)			

V. Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr.		1,96,000	
	To 12% Debentures Application & Allotment A/c			1,96,000

	(Application money received)			
	12% Debenture Application & Allotment A/c Dr. Loss on issue of debentures A/c To 12% Debentures A/c To Premium on Redemption A/c (Transfer of application money to Debentures Account, issued at a discount of 2% and redeemable at a premium of 5%)		1,96,000 14,000	 2,00,000 10,000

Note I: Loss on issue A/c has been debited by ₹14,000 by grouping together the discount on issue ₹4,000 and premium on redemption ₹10,000.

VI. **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To 12% Debentures Application & Allotment A/c (Application money received)		2,10,000	 2,10,000
	12% Debenture Application & Allotment A/c Dr. Loss on issue of debentures A/c To 12% Debentures A/c To Securities Premium Reserve A/c To Premium on Redemption A/c (Transfer of application money to Debentures Account, issued at a premium of 5% and redeemable at a premium of 10%)		2,10,000 20,000	 2,00,000 10,000 20,000

4.4.1 Interest on Debentures

Interest on debentures is calculated at fixed rate on its nominal value payable quarterly, half yearly or yearly as per the terms of issue. Rate of interest is prefixed to the debenture, say 9% Debentures and, therefore, is payable even if the company incur loss. Interest on debenture is a charge against profit. Interest payment may be subject to tax deducted at source (TDS).

TDS (Tax Deducted at Source)

The Company paying interest on debentures deducts income tax on interest at the prescribed rate. The amount of tax deducted is deposited with the income tax authorities.

Accounting Entries

Entries for interest on debentures and Tax Deducted at Source (TDS) are as follows:

1. When interest is due and Tax is ignored:

   Debentures' interest on interest on Debentures A/c …Dr.

   To Debentureholders' A/c

2. When interest is due and Tax is Deducted at Source (TDS):

   Debentures' interest A/c …Dr.

   To Debentureholders' A/c [with interest – TDS]

   To TDS Payable A/c

3. When interest is paid:

   Debenturesholders' A/c …Dr. [with interest – TDS]

   To Bank A/c

4. When TDS is deposited in Government Account:

   TDS Payable A/c …Dr.

   To Bank A/c

5. On transfer of interest to Statement of Profit and Loss at the end of the year:

   Profit and Loss A/c …Dr.

   To Debentures' Interest A/c

Note: Debentures' interest is shown as 'Finance Cost' in of Profit and Loss A/c.

Example:

XYZ Ltd. issued 15,000; 10% Debentures of ₹100 each on Ist April, 2017. The issue was fully subscribed. According to the terms of issue, interest is payable on half-yearly basis. Pass Journal entries for Interest on Debentures for the year ended 31st March, 2018 (Ignore TDS).

Solution: **Journal of XYZ Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2017				
Sept. 30	Debentures' Interest A/c …Dr.		75,000	
	To Debentureholders' A/c			75,000
	(Being the interest on debentures payable for the half-year ended 30th September, 2017)			
	Debentureholderes' A/c …Dr.		75,000	
	To Bank A/c			75,000
	(Being the interest paid to debentureholders)			
2018				
March 31	Debentures' Interest A/c …Dr.		75,000	
	To Debentureholders' A/c			75,000
	(Being the interest on debentures payable for the half-year ended 31st March, 2018)			
March 31	Profit and Loss A/c …Dr.		1,50,000	
	To Debentures' Interest A/c			1,50,000
	(Being the interest on debentures transferable to Profit and Loss A/c)			

Note: Entry for payment is not passed assuming that it is not yet paid and will be paid in the next year. Alternatively, if the interest is paid on 31st March, 2018, the entry will be:

March 31 Debentureholders' A/c ..Dr. ₹75,000

To Bank A/c

(Being the interest paid to the debentureholders)

Example: On Ist April, 2015, K.K. Ltd. issued 500, 9% Debentures of ₹500 each at a discount of 4% redeemable at a premium of 5% after three years.

Pass necessary Journal entries for the issue of debentures and debenture interest for the year ended 31st March, 2016 assuming that interest is payable on 30th September and 31st March and the rate of tax deducted at source is 10%. The company closes its books one 31st March every year.

Solution: **Journal of K.K. Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2015 April 1	Bank A/c (500 × ₹480) …Dr. To Debentures Application and Allotment A/c (Being the application money received for 500 debentures @ ₹480 each)		2,40,000	 2,40,000
	Debentures Application and Allotment A/c …Dr. Loss on Issue of Debentures A/c To 9% Debentures A/c To Premium on Redemption of Debentures A/c (Being the issue of 500, 9% Debentures of ₹500 each at 4% discount and redeemable at 5% premium)		2,40,000 22,500	 2,50,000 12,500
Sept. 30	Debentures' Interest A/c (₹2,50,000× 9/100 × 6/12) …Dr. To Debentureholders' A/c To TDS Payable A/c (10% of ₹11,250) (Being the interest payable on 9% Debentures for 6 months and TDS @ 10%)		11,250	 10,125 1,125
Sept. 30	Debentureholders A/c …Dr. TDS Payable A/c …Dr. To Bank A/c (Being the interest paid to debentureholders and TDS deposited)		10,125 1,125	 11,250
2016 March 31	Debentures' Interest A/c …Dr. To Debentureholders' A/c To TDS Payable A/c (Being the interest payable on 9% Debentures for 6 months and Tax deducted at source @ 10%)		11,250	 10,125 1,125
March 31	Debentureholders A/c …Dr. TDS Payable A/c …Dr.		10,125 1,125	

	To Bank A/c (Being the interest paid to debentureholders and TDS deposited)			11,250
March 31	Profit and Loss A/c ...Dr. To Debentures' Interest A/c (Being the interest on debentures transferred to Statement of Profit and Loss)		22,500	22,500

Example:

ABC Ltd. Issued 2,000, 12% Debentures of ₹100 each on 1st April, 2012. The issue was fully subscribed. According to the terms of issue, interest on the debentures is payable half-yearly on 30th September and 31st march and the tax deducted at source is 10%.

Pass necessary Journal entries related to the debenture interest for the half-yearly ending 31st March, 2013 and transfer of interest on debentures of the year to the Statement of Profit and Loss.

Solution: **Journal of ABC Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2012 Sept. 30	Debentures' Interest A/c ...Dr. To Debentureholders' A/c To TDS payable A/c (Being the interest due for 6 months and TDS deducted @ 10%)		12,000	10,800 1,200
	Debentureholders' A/c ...Dr. TDS Payable A/c ...Dr. To Bank A/c (Being the interest paid to debentureholders and TDS deposited in Government Account)		10,800 1,200	12,000
2013 March 31	Debentures' Interest A/c ...Dr. To Debentureholders' A/c To TDS Payable A/c (Being the interest due on debentures for the half-year		12,000	10,800 1,200

	ended 31st March, 2013, TDS deducted @ 10%)			
	Debentureholders' A/c ...Dr. TDS Payable A/c ...Dr. To Bank A/c (Being the interest paid and TDS deposited in the Government Account)		10,800 1,200	 12,000
	Statement of Profit and Loss (Finance Cost) ...Dr. To Debentures' Interest A/c (Being the interest on debentures transferred to Statement of Profit and Loss)		24,000	 24,000

Note: It is assumed that interest and TDS was paid on 31st March, 2013. Hence, entry for payment is made.

4.4.2 Writing off Discount or Loss on Issue of Debentures

Discount or Loss on Issue of Debentures is a capital loss for the company, which should be written off at the earliest but within the tenure of the debentures, i.e., it should be written off within the period the debentures are to be redeemed. The company thus, may write off discount or loss on issue of debentures at any time before the debentures are due for redemption. Discount or Loss on Issue of Debentures written off is a part of Finance Cost in Statement of Profit and Loss.

Discount or Loss on Issue of Debentures may be written off following any of the following options:

(i) It may be written off in the first year itself; or

(ii) It may be written off over the tenure (life) of the debentures.

(i) Discount or Loss may be written off from Capital Reserve and/or from Securities Premium Reserve and/or from Statement of Profit and Loss. Accounting entry will be as follows:

Capital Reserve A/c ...Dr. [Amount Written Off]

And/Or

Securities Premium Reserve A/c ....Dr. [Amount Written Off]

And/Or

Profit and Loss A/c ... Dr. [Amount Written Off]

To Discount or Loss on Issue of Debentures A/c

Example: On 1st April, 2017, Amro Ltd. issued 10,000, 9% Debentures of ₹100 each at a discount of 10% redeemable after 5 years. The issue price is payable along with application. The debentures were subscribed. It has a balance of ₹1,75,000 in Capital Reserve. It decided to write off discount in the year ended 31st March, 2018 from Capital Reserve.

Pass the Journal entries for issue of debentures and writing off the discount and prepare Discount on Issue of Debentures Account.

Solution: **Journal of AMRO Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2017 April 1	Bank A/c ...Dr. To Debentures Application and Allotment A/c (Being the application money received for 10,000; 9% Debentures of ₹100 each issued at ₹90)		9,00,000	 9,00,000
	Debentures Application and Allotment A/c ...Dr. Discount on Issue of Debentures A/c ...Dr. To 9% Debentures A/c (Being 10,000, 9% Debentures of ₹100 each issued at 10% discount)		9,00,000 1,00,000	 10,00,000
2018 March 31	Capital Reserve A/c ...Dr. To Discount on Issue of Debentures A/c (Being the discount on issue of debentures written off)		1,00,000	 1,00,000

Dr. Discount on Issue of Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2017 April 1	To 9% Debentures A/c	1,00,000	2018 March 31	By Capital Reserve A/c	1,00,000

Example:

On Ist May, 2017, Solar Energy Ltd. issued 10,000, 9% Debentures of ₹100 each at a discount of 10% redeemable at par after five years. All the debentures were subscribed. It has a balance of ₹60,000 in Capital Reserve and ₹1,00,000 in Securities Premium Reserve which the company decided to use for writing off the loss. It decided to write off the discount in the first year itself.

Pass the Journal entries for issue of debentures and writing off the discount. Also prepare Discount on Issue of Debentures Account.

Solution: **Journal of Solar Energy Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2017				
May 1	Bank A/c ...Dr.		9,00,000	
	To Debentures Application and Allotment A/c			9,00,000
	(Being the application received for 10,000; 9% Debentures of ₹100 each @ ₹90 per debenture)			
	Debentures Application and Allotment A/c ...Dr.		9,00,000	
	Discount on Issue of Debentures A/c ...Dr.		1,00,000	
	To 9% Debentures A/c			10,00,000
	(Being 10,000, 9% Debentures allotted)			
2018				
March 31	Capital Reserve A/c ...Dr.		60,000	
	Securities Premium Reserve A/c ...Dr.		40,000	
	To Discount on Issue of Debentures A/c			1,00,000
	(Being the discount on issue of debentures written off)			

Dr. Discount on Issue of Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2017	To 9% Debentures A/c	1,00,000	2018	By Capital Reserve A/c	60,000

May 1		1,00,000	March 31	By Securities Premium Reserve A/c	40,000 1,00,000

Example:

Solar Power Ltd. on Ist April, 2017 issued 40,000, 8% Debentures of ₹100 each at a discount of 5% redeemable at a premium of 5% after 5 years payable along with application. The debentures were fully subscribed. It had balance of ₹1,00,000 in Capital Reserve and ₹1,00,000 in Securities Premium Reserve. It decided to write off discount in the first year.

Pass the Journal entries for issue of debentures and writing off the loss.

Solution: **Journal of Solar Power Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2017 May 1	Bank A/c …Dr. To Debentures Application and Allotment A/c (Being the application money received for 40,000; 8% Debentures of ₹100 each @ ₹95)		38,00,000	 38,00,000
	Debentures Application and Allotment A/c …Dr. Loss on Issue of Debentures A/c …Dr. To 8% Debentures A/c To Premium on Redemption of Debentures A/c (Being 40,000, 8% Debentures issued)		38,00,000 4,00,000	 40,00,000 2,00,000
2018 March 31	Capital Reserve A/c …Dr. Securities Premium Reserve A/c …Dr. Profit and Loss A/c …Dr. To Loss on Issue of Debentures A/c (Being loss written off)		1,00,000 1,00,000 2,00,000	 4,00,000

(ii) Discount or Loss may be written off over the tenure (life) of the debentures either by:

(a) Fixed Instalment Method; or

(b) Fluctuating Instalment Method.

(a) Fixed Instalment Method: Writing off amount of discount or loss in equal instalments every year.

This method is used when the debentures are redeemable on maturity, say at the end of 5 or 10 years. Total amount of discount on issue of debentures is written off equally over the period after which the debentures will be redeemed. For example, if the total discount allowed is ₹2,00,000 and the debentures are to be redeemed at the end of five years, then one-fifth of the discount will be written off annually, that is, ₹40,000 (i.e., 1/5th of 2,00,000).

Amount of Discount or Loss to be written off Annually

$$= \frac{Total\ Amount\ of\ Discount\ or\ Loss}{Number\ of\ Years\ after\ which\ Debentures\ will\ be\ Redeemed}$$

Example (Fixed Instalment Method):

A Limited Company issued 20,000 debentures of ₹100 each at a discount of 5%, redeemable at the end of 5 years.

Show the Discount on Issue of Debentures Account in the ledger for the period.

Solution:

Total amount of Discount on Issue of Debentures = ₹20,00,000 × 5/100 = ₹1,00,000.

Amount of Discount to be Written off annually.

$$= \frac{Total\ Amount\ of\ Discount}{Number\ of\ Years\ after\ which\ Debentures\ will\ be\ Redeemed}$$

$$= \frac{₹1,00,000}{5} = ₹20,000$$

Dr. Discount on Issue of Debentures Account Cr.

Year	Particulars	₹	Year	Particulars	₹
I	To Debentures A/c	1,00,000	I	By Profit and Loss A/c	20,000
				By Balance c/d	80,000
		1,00,000			1,00,000
II	To Balance b/d	80,000	II	By Profit and Loss A/c	20,000
				By Balance c/d	60,000

		80,000			80,000
III	To Balance b/d	60,000 60,000	III	By Profit and Loss A/c By Balance c/d	20,000 40,000 60,000
IV	To Balance b/d	40,000 40,000	IV	By Profit and Loss A/c By Balance c/d	20,000 20,000 40,000
V	To Balance b/d	20,000	V	By Profit and Loss A/c	20,000

(b) Fluctuating Instalment Method

This method is used when debentures are redeemed on different dates by draw of lots. The number of debentures to be redeemed may or may not be equal. Discount or loss on issue of debentures is written off in the ratio of outstanding balance of nominal value of debentures. When debentures are redeemable at different dates by annual drawings or in instalments which may or may not be equal, the discount is written off in the ratio of debentures outstanding (or in the ratio of benefit derived from debentures loan) during the various accounting years.

Example (Fluctuating Instalment Method)

ABC Ltd. Issued 9% Debentures of the nominal (face) value of ₹20,00,000 at a discount of 6%. The debentures were repayable by annual drawing of ₹4,00,000 starting from the end of first year of issue. Prepare Discount on Issue of Debentures Account.

Solution: Total amount of discount on issue of debentures is ₹1,20,000 (6% of ₹20,00,000). Since the debentures are redeemable by annual drawings, it is equitable to adopt the fluctuating method of writing off the discount. In this way, the burden of discount would be distributed in the ratio of benefit derived from debentures loan.

Calculation of Amount of Discount on Issue of Debentures to be Written off

At the end of	Debentures Outstanding	Ratio	Discount to be written off
Ist Year	₹20,00,000	S	₹1,20,000 × 5/15 = ₹40,000
2nd Year	₹16,00,000 (i.e., ₹20,00,000 – ₹4,00,000	4	₹1,20,000 × 4/15 = ₹32,000
3rd Year	₹12,00,000 (i.e., ₹16,00,000 – ₹4,00,000	3	₹1,20,000 × 3/15 = ₹24,000

4th Year	₹8,00,000 (i.e., ₹12,00,000 – ₹4,00,000	2	₹1,20,000 × 2/15 = ₹16,000
5th Year	₹4,00,000 (i.e., ₹8,00,000 – ₹4,00,000	1	₹1,20,000 × 1/15 = ₹8,000
		15	₹1,20,000

Dr. Discount on Issue of Debentures Account Cr.

Year	Particulars	₹	Year	Particulars	₹
I	To 9% Debentures A/c	1,20,000	I	By Profit and Loss A/c	40,000
				By Balance c/d	80,000
		1,20,000			1,20,000
II	To Balance b/d	80,000	II	By Profit and Loss A/c	32,000
				By Balance c/d	48,000
		80,000			80,000
III	To Balance b/d	48,000	III	By Profit and Loss A/c	24,000
				By Balance c/d	24,000
		48,000			48,000
IV	To Balance b/d	24,000	IV	By Profit and Loss A/c	16,000
				By Balance c/d	8,000
		24,000			24,000
V	To Balance b/d	8,000	V	By Profit and Loss A/c	8,000

Example (Writing off Loss equally over life of the debentures

On Ist June, 2014, XYZ Ltd. issued 50,000, 10% Debentures of ₹100 each at par redeemable after five years at a premium of 10%. It was decided to write off Loss on Issue of Debentures in five years equally beginning 31st March, 2015.

Pass the Journal entries for issue of debentures and writing off the loss and prepare Loss on Issue of Debentures Account till it is completely written off.

Solution: **Journal of XYZ Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2014 June 1	Bank A/c …Dr. To Debentures Application and Allotment A/c (Being the subscription received for 50,000, 10% Debentures of ₹100 each)		50,00,000	 50,00,000
	Debentures Application and Allotment A/c …Dr. Loss on Issue of Debentures A/c …Dr. To 10% Debentures A/c To Premium on Redemption of Debentures A/c (Being 50,000, 10% Debentures issued)		50,00,000 5,00,000	 50,00,000 5,00,000
2015 March 31	Profit and Loss A/c …Dr. To Loss on Issue of Debentures A/c (Being 1/5th of loss on issue of debentures written off)		1,00,000	 1,00,000
2016 March 31	Profit and Loss A/c …Dr. To Loss on Issue of Debentures A/c (Being 1/5th of loss on issue of debentures written off)		1,00,000	 1,00,000
2017 March 31	Profit and Loss A/c …Dr. To Loss on Issue of Debentures A/c (Being 1/5th of loss on issue of debentures written off)		1,00,000	 1,00,000
2018 March 31	Profit and Loss A/c …Dr. To Loss on Issue of Debentures A/c (Being 1/5th of loss on issue of debentures written off)		 1,00,000	 1,00,000
2019 March 31	Profit and Loss A/c…Dr. To Loss on Issue of Debentures A/c (Being 1/5th of loss on issue of debentures written off)		1,00,000	 1,00,000

Dr. Loss on Issue of Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2014 June 1	To Premium on Redemption of Debentures A/c	5,00,000 5,00,000	2015 March 31	By Profit and Loss A/c By Balance c/d	1,00,000 4,00,000 5,00,000
2015 April 1	To Balance b/d	4,00,000 4,00,000	2016 March 31	By Profit and Loss A/c By Balance c/d	1,00,000 3,00,000 4,00,000
2016 April 1	To Balance b/d	3,00,000 3,00,000	2017 March 31	ByProfit and Loss A/c By Balance c/d	1,00,000 2,00,000 3,00,000
2017 April 1	To Balance b/d	2,00,000 2,00,000	2018 March 31	By Profit and Loss A/c By Balance c/d	1,00,000 1,00,000 2,00,000
2018 April 1	To Balance b/d	1,00,000	2019 March 31	By Profit and Loss A/c	1,00,000

Example:

X Ltd. issued 20,000, 10% Debentures of ₹100 each at 8% discount redeemable at par. Debentures are redeemable by drawings method in the following manner:

Year end	Face Value (₹)
2	2,00,000
3	4,00,000
4	6,00,000
5	8,00,000

Prepare Discount on Issue of Debentures Account.

Solution:

Total amount of Discount of Issue of Debentures = ₹20,00,000 × 8/100 = ₹1,60,000. Since the debentures are redeemable at different dates, total amount of discount is written off in proportion of the amount outstanding against the debentures. The first redemption of debentures is made after two years, therefore, full amount of debentures is used for first two years. Amount used in the third year = ₹20,00,000 – ₹2,00,000 = ₹18,00,000 and, amount used in the fouth year = ₹18,00,000 – ₹4,00,000 – ₹14,00,000 and amount used in fifth year = ₹14,00,000 – ₹6,00,000 = ₹8,00,000.

Calculation of Amount of Discount on Issue of Debentures to be written off

At the end of	Debentures Outstanding	Ratio	Discount to be written off
Ist Year	₹20,00,000	10	₹1,60,000 × 10/40 = ₹40,000
2nd Year	₹20,00,000	10	₹1,60,000 × 10/40 = ₹40,000
3rd Year	₹18,00,000	9	₹1,60,000 × 9/40 = ₹36,000
4th Year	₹14,00,000	7	₹1,60,000 × 7/40 = ₹28,000
5th Year	₹8,00,000	4	₹1,60,000 × 4/40 = ₹16,000
		40	₹1,60,000

In the Books of X Ltd.

Dr. Loss on Issue of Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
Year 1 April 1	To 10% Debentures A/c	1,60,000 1,60,000	Year 1 March 31 March 31	By Profit and Loss A/c By Balance c/d	40,000 1,20,000 1,60,000
Year 2 April 1	To Balance b/d	1,20,000 1,20,000	Year 2 March 31 March 31	By Profit and Loss A/c By Balance c/d	40,000 80,000 1,20,000
Year			Year 3		

3 April 1	To Balance b/d	80,000 80,000	March 31 March 31	By Profit and Loss A/c By Balance c/d	36,000 44,000 80,000
Year 4 April 1	To Balance b/d	44,000 44,000	Year 4 March 31 March 31	By Profit and Loss A/c By Balance c/d	28,000 16,000 44,000
Year 5 April 1	To Balance b/d	16,000	Year 5 March 31 March 31	By Profit and Loss A/c	16,000

Example:

X Ltd. issued 10,000, 10% Debentures of ₹100 each at a discount of 6% on Ist July, 2015 repayable by five equal annual instalments of ₹2,00,000 each.

The company closes its accounts on 31st March, every year. Determine the amount of discount to be written off in every accounting year if the debentures are to be redeemed equally every year beginning from 30th June, 2016. Also prepare Discount on Issue of Debentures Account.

Solution: Total amount of Discount on Issue of Debentures = ₹1,00,000× 6/100=₹60,000

Calculation of Amount of Discount on Issue of Debentures to be written off

Year ended (1)	Amount Outstanding (₹) (2)	Months for which Amount used (3)	Total Amount (Product 2×3) (₹) (4)	Ratio (5)	Discount to be Written off (6)
31st March, 2016	10,00,000	9(From Ist July, 2015 to 31st March, 2016)	90,00,000	15	₹60,000 × 15/60 = ₹15,000
31st March, 2017	10,00,000 8,00,000	3(From Ist April, 2016 to 30th June, 2016)	30,00,000 72,00,000	17	₹60,000 × 17/60 = ₹17,000

		9(From Ist July, 2016 to 31st March, 2017)	1,02,00,000		
31st March, 2018	8,00,000 6,00,000	3(From IstApril, 2017 to 30th June, 2017) 9(From Ist July, 2017 to 31st March, 2018)	24,00,000 54,00,000 78,00,000	13	₹60,000 × 13/60 = ₹13,000
31st March, 2019	6,00,000 4,00,000	3(From Ist April, 2018 to 30th June, 2018) 9(From Ist July, 2018 to 31st March, 20190)	18,00,000 36,00,000 54,00,000	9	₹60,000 × 9/60 = ₹9,000
31st March, 2020	4,00,000 2,00,000	3(From Ist April, 2019 to 30th June, 2019) 9(From Ist July, 2019 to 31st March, 2020)	12,00,000 18,00,000 30,00,000	5	₹60,000 × 5/60 = ₹5,000
31st March, 2021	2,00,000	3(From Ist April, 2020 to 30th June, 2020)	6,00,000	1	₹60,000 × 1/60 = ₹1,000
			Total	60	₹60,000

Dr. Loss on Issue of Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2015 July 1	To 10% Debentures A/c	60,000 60,000	2016 March 31 March 31	By Profit and Loss A/c By Balance c/d	15,000 45,000 60,000

2016 April 1	To Balance b/d	45,000 45,000	2017 March 31 March 31	By Profit and Loss A/c By Balance c/d	17,000 28,000 45,000
2017 April 1	To Balance b/d	28,000 28,000	2018 March 31 March 31	By Profit and Loss A/c By Balance c/d	13,000 15,000 28,000
2018 April 1	To Balance b/d	15,000 15,000	2019 March 31 March 31	By Profit and Loss A/c By Balance c/d	9,000 6,000 15,000
2019 April 1	To Balance b/d	6,000 6,000	2020 March 31 March 31	By Profit and Loss A/c By Balance c/d	5,000 1,000 6,000
2020 April 1	To Balance b/d	1,000	2021 March 31 March 31	By Profit and Loss A/c	1,000

4.5 Check Your Progress

A. State whether the following statements are True or False

1. A debenture is a long-term promissory note for raising long-term funds.
2. Debentures are usually secured on the assets of the company.
3. Debentures cannot be issued at premium.
4. Debentures can be issued only for the consideration of cash only.

B. Fill in the blanks

1. Discount on issue of debentures is a _____________.
2. Securities Premium Reserve is a capital profit and to be shown under the head_____________.
3. Interest on debenture is a charge against profit and subject to________________.
4. Discount on issue of debentures is a capital loss and will be shown as ____________.

4.6 Summary

Thus a debenture is a written acknowledgement of a debt taken by the company. Debentures are issued in the form certificate under the real of the company. According to Section 2 (30) of the Companies Act 2013, “Debenture includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not.” The persons to whom debentures are issued are called “Debenture holders” and considered as lenders to the company. There may be different types of debentures namely secured and unsecured debentures, redeemable and irredeemable debentures, registered and bearer debentures, convertible and non convertible debentures etc. Debentures are issued as collateral security when the borrower is not in a position to give any other asset as a collateral security. When the loan is paid back, the debentures issued as a collateral security are returned to the company. In case the company fails to repay the loan being demanded by the lender, the lender may exercise its right towards debentures being issued as collateral security.

4.7 Keywords

Secured Debentures:The debentures which are secured by fixed or a floating charge on the assets of the company.

Collateral Security: Thesecurity in addition to the prime/principal security is known as Collateral Security.

Debenture: A document acknowledging a debt by a company.

Debenture Redemption Fund: Fund created to redeem debentures.

4.8 Answers to Check Your Progress

Check Your Progress A

1. True

2. True
3. False
4. False

Check Your Progress B

1. Capital Loss
2. Reserves & Surplus
3. Tax Deduction at Source
4. Unamortized Expenses

4.9 Self-Assessment Test

1. What do you understand by Debentures? Discuss the types and features of debentures in detail.
2. Elaborate the accounting treatment of issue of debentures with hypothetical figures.
3. What do you mean by Collateral Security? Discuss the accounting treatment of issuing of debentures as collateral security.
4. Discuss the term and accounting treatment of writing off loss on issue of debentures in detail.

4.10 Suggested/ Further Readings

- ArulaNandam M.A. & Raman K.S.,**Advanced Accountancy**, Himalaya Publishing House, Delhi.
- Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.
- Gupta R.L. and RadhaSwamyM.,**Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
- Paul S.K.R,.**Advanced Accountancy**, New Central Book Agency, Calcutta.
- Shukla M.C. &Grewal S.,**Advanced Accounts,** S. Chand &Company Ltd, New Delhi.
- Study material of Institute of Chartered Accountant of India (ICAI), New Delhi.

Subject: Corporate Accounting	
Course Code: **BCOM 301**	Author: **Prof. Suresh K. Mittal**
Lesson No:**5**	
Book Building: Concept and Process	

STRUCTURE:

5.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning, methods and characteristics of Book Building.
- Understand the advantages and disadvantages of Book Building.
- Know the historical issues through Book Building in Indian capital market.
- Understand the SEBI guidelines regarding Book Building.

5.1 Introduction

Every company requires funds for smooth running of its businesses. There are different sources of funds through which a company can raise funds namely equity shares, preference shares, bonds, term loans from financial institutions, public deposits etc. The equity share capital and preference share capital are called owners funds and fund through debentures, bonds, term loans are creditors funds. These funds can be raised by the company directly from the investors or through intermediaries. When a company raises funds directly from the investors, the most popular means to raise funds are Initial Public Offer (IPO) or Follow on Public Offer (FPO). Through IPO/FPO, the company offers its shares/securities to the public at a fixed price or a price range. When a company offers its securities at a price range, the investors decide the issue price through bidding process. This method of issuing securities provides an opportunity to the market / investors to discover the price of the securities which are offered by the company. The method of offering securities at a price range and the final price is discovered through bidding the process is called Book-Building process.

5.2 Meaning of Book Building

Book Building is a process used by the companies to raise funds from investors for efficient price discovery. Book building is a mechanism in which bids are collected from investors at various prices during the specific time period. The issue price at which securities will be issued is not known. The issue price is determined after the closure of the book building process. In this method, the market discovers the price of securities through bidding process instead of the company determine the price. But in fixed price method the company determine the issue price and investors cannot choose the price. Book Building is the most efficient mechanism by which companies price their securities and also re-commended by all the major stock exchange of the world. It is also helpful to the prospective investors to value the price of securities by submitting the bids. The price range of the securities consists of ceiling price and floor price and the final price at which securities are issued to investors is known as “Cut-off-Price”. Generally there are two methods of book building i.e. open book systems and closed book systems. In open book system, the issuers and merchant bankers are required to display the demand and bids online during the bidding period. But in case of closed book system, the display of the demand and bids is not made public during the bidding period. The following are the important point in the book building process:

- The Company / Issuer who is planning a public offer appoint lead merchant bankers as ‘Book Runners”.
- Number of securities to be issued and the price bands.
- Appointment of syndicate members with whom orders are to be placed.
- Display of bids in “Electronic Book”.
- Book normally remains open for 3-7 days.
- Bids to be entered with in price band and can be revised before the book closes.
- Evaluation of bids on the basis of the demand at different prices.
- Determination of final price by the book runners and the issuer.

5.2.1 Main Characteristics of Book Building

A public offer in which the price of an issue is discovered through the demand from the prospective investors is called “Book Built Issue”. The following are the characteristics of the Book Built Issue:

- **Price Discovery:** In book-built issue, the price of securities is determined on the basis of bids received from the investors.
- **Open Book Building:** In book-built issues, it is mandatory to have online display of the demand and bids during the bidding period.
- **Price Band:** There is a price band in book-built issues, the lowest price is called floor price and highest of the band is called ceiling / cap price. The spread between the floor and the cap of the price band cannot be more than 20%.
- **Cut-off Price:** The actual discovered issue price through bidding process is called “Cut off Price”. As per SEB’ Regulations 2009, only retail investors have an option of applying at cut-off price.

- **Minimum and Maximum Number of Days:** Book built issue shall be kept open for at least for 3 working days and maximum for 10 days.

5.2.2 Methods of Book Building

There are two methods of book building which are discussed below:

- **Open Book System:** In open book system, it is mandatory to display online the demand and bids of the securities during the bidding period. In this system, the investor can know the movement of the bids during the bidding period.
- **Closed Book System:** In this system, the books are not made public and investors have to make bids without knowing the details of bids submitted by other bidders.

5.2.3 Intermediaries involved in Book Building Process

The following parties are involved in the book-building process:

- **The Company:** All the initiatives regarding the public issue of securities are taken by the company.
- **Book Running Lead Managers:** These are the Category I merchant banker registered with SEBI.
- **Syndicate Members:** These are appointed by the book running lead managers. The syndicate members are registered with SEBI and also permitted to carry on activities as under-writers.

5.2.4 Steps Involved in Book Building Process

The following are the steps involved in book building:

1. **Issuer Company:** IPO Process initialization
    - Appoint Lead Manager as Book Runner.
    - Appoint Registrar of the Issue.
    - Appoint Syndicate Members.
2. **Lead Manager's – Pre Issue Role – Part 1**
    - Prepare draft offer prospectus document for IPO.
    - File draft offer prospectus with SEBI.
    - Road shows for the IPO.
3. **SEBI – Prospectus Review**
    - SEBI review draft offer prospectus.

- Reverts it back to Lead Manager if need clarification or changes.
- SEBI approves the draft offer prospectus, the draft offer prospectus becomes Offer Prospectus.

4. Lead Manager – Pre Issue Role – Part 2

- Submit the Offer Prospectus to Stock Exchanges, registrar of the issue and get it approved.
- Decide the issue date & issue price band with the help of Issuer Company.
- Modify Offer Prospectus with date and price band. The document is now called Red Herring Prospectus. (RHP)
- Red Herring Prospectus & IPO Application Forms are printed and posted to syndicate members; through which they are distributed to investors.

5. Investor – Bidding for the public issue

- Public Issue Open for investors bidding.
- Investors fill the application forms and place orders to the syndicate members.
- Syndicate members provide the bidding information to BSE/NSE electronically and bidding status gets updated on BSE/NSE websites.
- Syndicate members send all the physically filled forms and cheques to the registrar of the issue.
- Investor can revise the bidding by filling a form and submitting it to Syndicate member.
- Syndicate members keep updating stock exchange with the latest data.
- Public Issue Closes for investors bidding.

6. Lead Manager – Price Fixing

- Based on the bids received, lead managers evaluate the final issue price.
- Lead Managers update the Red Herring Prospectus with the final issue price and send it to SEBI and Stock Exchanges.

7. Registrar – Processing IPO Applications

- Registrar receives all application forms & cheques from Syndicate members.
- They feed applicant data & additional bidding information on computer systems.
- Send the cheques for clearance.
- Find all bogus application.
- Finalize the pattern for share allotment based on all valid bids received.

- Prepare 'Basis of Allotment'.
- Transfer shares in the dematerialized account of investors.
- Refund the remaining money

8. Lead Manager– Stock Listing

- Once all allocated shares are transferred in investorsDemat accounts. Lead Manager with the help of Stock Exchange decides Issue Listing Date.
- Finally, shares of the issuer company get listed in the Stock Market.

5.2.5 Process of Book Building

Basically, Book Building is a price discovery mechanism which is used while pricing of securities offered to the public in the new issue market. The following are the steps of book building process:

- **Appointment of Investment Banker:** The first step in book building starts with the appointment of lead investment bankers. The lead investment banker conducts due-diligence and proposes the size of the issue and price band of the securities.
- **Collection of Bids:** The bids are invited from the prospective investors along with application money. The lead investment banker can appoint sub-agents for receiving the bids from a large number of investors.
- **Price Discovery:** After receiving the bids, the process of price discovery starts. The final price chosen at which the issue is fully subscribed is called cut-off price.
- **Publicizing:** Most of the regulators and the stock exchanges in the world require companies to make public the details of biddings. It is the duty of lead investment banker to publicize the details of the bids submitted by prospective investors.
- **Allotment and Settlement:** Allotment process begins by allocating the securities to the accepted bidders and settlement process ensures that all allotment happens at the cut-off price. An investor who had bid at higher price than cut-off price their excess money is returned. The investors who had bid less than cut-off price, their total application money is refunded.

5.2.6 Advantages of Book-Building

Book Building is one of the most efficient mechanisms which help in evaluating the intrinsic value of the securities being offered to the public. The following are the advantages of Book-Building:

- Pricing of securities is determined in a more realistic way on the basis of bids received from prospective investors. Conceptually, pricing is not aexact science which may be more realistic in a range instead of fix price.
- The highest price is being discovered through Book Building process at which issue will be fully subscribed which leads to lowering the cost of capital which leads to wealth maximization of the firm.
- The price of securities is being fixed on the basis of bids received from potential investors which lead to the success of public issue.
- Book Building is very beneficial to the issuer company as the pricing of securities is more realistic which reduces the probability of issue not being fully subscribed. The failure of public issue is more costly than a failure of product.
- The issuer company reduces the advertising and other costs in Book-Building issues.
- The issue price of securities is market determined which reduces the probability that market price will fall lower than issue price.
- Transparent and efficient mobilisation of funds is possible through improved procedures.
- The process of Book Building increases investor's confidence which leads a larger investor base.
- It is possible immediate allotment and placement in Book Building process.

5.2.7 Disadvantages of Book-Building

The Book Building has the following disadvantages also:

- It is suitable only for mega issues because in small issues, the companies know the attributes and preferences of potential investors very well. The risk-return preferences and attributescannot be estimated in big issues.
- The issue company should be fundamentally and well known to the potential investors.
- It works well in efficient and matured markets which are not commonly found in real world.
- There is a possibility of price rigging on listing of securities.

5.2.8 Green Shoe Option

Green shoe option means right of allocating more securities in comparison to offered securities to the potential investors. As per SEBI guidelines, "A company desirous of availing the Green Shoe option shall, in the resolution of the general meeting authorising the public issue, seek authorization also for the possibility of allotment of further issues to the management team as the stabilising agent". The procedure of such option is given below:

- The GSO is available only in case of IPO and not for subsequent issues.
- A company which wants to take the option shall, in the resolution of the general meeting, authorize the public issue; such authorization is also for the possibility of allotment of further shares.
- A lead book runner, as stabilizing Agent, should be appointed by the company who will make an agreement with the company.
- An agreement should be made between the Stabilizing Agent and the promoters that maximum number of shares borrowed from them would be 15% of total issue size.
- The shares shall be in dematerialized from only.
- The share should be allotted on Pro rata basis to all the applicants.
- The stabilization period shall not exceed 30 days from the date when trading permission was given.
- It is the duty of the Stabilizing Agent to stabilize post-listing price of the shares.
- On expiry of the stabilization period, if the Stabilizing Agent does not buy the over-allotted shares from the market, the issuer company shall allot shares to the extent of shortfall in dematerialized form.
- The Stabilizing Agent shall remit an amount equal to the company from GSO Bank Account. The amount left, if any, shall be transferred to the Investor Protection Fund.

5.3 SEBI Guidelines regarding Book Building

An issuer company proposing to issue capital through book building shall comply with the following:

A) 75% Book Building Process

In an issue of securities to the public through a prospectus the option for 75% book building shall be available to the issuer company subject to the following:

(i) The option of book-building shall be available to all body corporate which are otherwise eligible to make an issue of capital to the public.

(ii) (a) The book-building facility shall be available as an alternative to, and to the extent of the percentage of the issue which can be reserved for firm allotment, as per these Guidelines.

(b) The issuer company shall have an option of either reserving the securities for firm allotment or issuing the securities through book-building process.

(iii) The issue of securities through book-building process shall be separately identified / indicated as 'placement portion category', in the prospectus.

(iv) (a) The securities available to the public shall be separately identified as 'net offer to the public'.

(b) The requirement of minimum 25% of the securities to be offered to the public shall also be applicable.

(v) In case the book-building option is availed of, underwriting shall be mandatory to the extent of the net offer to the public.

(vi) The draft prospectus containing all the information except the information regarding the price at which the securities are offered shall be filed with the Board.

(vii) One of the lead merchant bankers to the issue shall be nominated by the issuer company as a Book Runner and his name shall be mentioned in the prospectus.

(viii) (a) The copy of the draft prospectus filed with the Board may be circulated by the Book Runner to the institutional buyers who are eligible for firm allotment and to the intermediaries eligible to act as underwriters inviting offers for subscribing to the securities.

(b) The draft prospectus to be circulated shall indicate the price band within which the securities are being offered for subscription.

(ix) The Book Runner on receipt of the offers shall maintain a record of the names and number of securities ordered and the price at which the institutional buyer or underwriter is willing to subscribe to securities under the placement portion.

(x) The underwriters shall maintain a record of the orders received by him for subscribing to the issue out of the placement portion.

(xi) (a) The underwriters shall aggregate the offers so received for subscribing to the issue and intimate to the Book Runner the aggregate amount of the orders received by him.

(b) The institutional investor shall also forward its orders, if any, to the book runner.

(xii) On receipt of the information, the Book Runner and the issuer company shall determine the price at which the securities shall be offered to the public.

(xiii) The issue price for the placement portion and offer to the public shall be the same.

(xiv) On determination of the price of the underwriter shall enter into an underwriting agreement with the issuer indicating the number of securities as well as the price at which the underwriter shall subscribe to the securities provided that the Book Runner shall have an option of requiring the underwriters to the net offer to the public to pay in advance all monies required to be paid in respect of their underwriting commitment.

(xv) On determination of the issue price within two day, thereafter the prospectus shall be filed with the Registrar of Company.

(xvi) The issuer company shall open two different accounts for collection of application moneys, one for the private placement portion and the other for the public subscription.

(xvii) One day prior to the opening of the issue to the public, Book Runner shall collect from the institutional buyers and the underwriters the application forms along with the application moneys to the extent of the securities proposed to be allotted to them / subscribed by them.

(xviii) (a) Allotments for the private placement portion shall be made on the second day from the closure of the issue.

(b) However, to ensure that the securities allotted under placement portion and public portion are paripassu in all respects, the issuer company may have one date of allotment which shall be the deemed date of allotment for the issue of securities through book building process.

(xix) In case the Book Runner has exercised the option of requiring the underwriter to the net offer to the public to pay in advance all moneys required to be paid in respect of their underwriting commitment by the eleventh day of the closure of the issue the shares allotted as per the private placement category shall be eligible to be listed.

(xx) (a) Allotment of securities under the pubic category shall be made as per the Guidelines.

(b) Allotment of securities under the public category shall be eligible to be listed.

(xxi) (a) In case of under subscription in the net offer to the public spillover to the extent of under subscription shall be permitted from the placement portion to the net offer to the public portion subject to the condition that preference shall be given to the individual investors.

(b) In case of under subscription in the placement portion spillover shall be permitted from the net offer to the public to the placement portion.

(xxii) The issuer company may pay interest on the application moneys till the date of allotment or the deemed date of allotment provided that payment of interest is uniformly given to all the applicants.

(xxiii) (a) The Book Runner and other intermediaries associated with the book building process shall maintain records of the book building process.

(b) The Board shall have the right to inspect such records.

B) 100% BOOK BUILDING PROCESS

In an issue of securities to the public through a prospectus option for 100% Book Building shall be available to any issuer company subject to the following:

(i) Issue of capital shall be Rs.25 crores and above.

(ii) Reservation or firm allotment to the extent of percentage specified in these Guidelines shall not be made to categories other than the categories mentioned in sub-clause (iii) below.

(iii) Book Building shall be for the portion other than the promoter’s contribution and the allocation made to.

(a) Permanent employees of the issuer company and in the case of a new company the permanent employees of the promoting companies'.

(b) Shareholders of the promoting companies in the case of a new company and shareholders of group companies in the case of an existing company either on a competitive basis or on a firm allotment basis.

(iv) The issuer company shall appoint an eligible Merchant Bankers as book runners and their names shall be mentioned in the draft prospectus.

(v) The Lead Merchant Banker shall act as the Lead Book Runner and the other eligible Merchant Banker(s), so appointed by the Issuer, shall be termed as Co-Book Runner(s).

(vi) The primary responsibility of building the book shall be that of the Lead Book Runner.

(vii) The Book Runners may appoint those intermediaries who are registered with the Board and who are permitted to carry on activity as an Underwriter or as syndicate members.

(viii) The draft prospectus containing all the disclosures as laid down in Chapter VI except that of price and the number of securities to be offered to the public shall be filed by the Lead Merchant Banker with the Board provided that the total size of the issue shall be mentioned in the draft prospectus.

(ix) (a) In case of appointment of more than one Lead Merchant Banker or Book Runner for book building, the rights, obligations and responsibilities of each should be delineated.

(b) In case of an under subscription in an issue, the shortfall shall have to be made good by the Book Runners to the issue and the same shall be incorporated in the inter se allocation of responsibility given in **Schedule II**.

(x) (a) The Board within 21 days of the receipt of the draft prospectus may suggest modifications to it.

(b) The Lead Merchant Banker shall be responsible for ensuring that the modifications / final observations made by the Board are incorporated in the prospectus.

(xi) (a) The issuer company shall after receiving the final observations if any on the offer document from the Board make an advertisement in an English National daily with wide circulation, one Hindi National newspaper and a Regional language newspaper with wide circulation at the place where the registered office of the Issuer company is situated.

(b) The advertisement so issued shall contain the salient features of the final offer document as specified in Form 2A of the Companies Act circulated along with the application form.

(xii) The issuer company shall compulsorily offer an additional 10% of the issue size offered to the public through the prospectus.

(xiii) The pre-issue obligations and disclosure requirements as specified in Chapter V and VI respectively of these Guidelines shall be applicable to issue of securities through book building unless stated otherwise in this Chapter.

(xiv) The Book Runner(s) and the issuer company shall determine the issue price based on the bids received through the syndicate members.

(xv) On determination of the price, the number of securities to be offered shall be determined (issue size divided by the price which has been determined).

(xvi) Once the final price (cut-off price) is determined all those bidders whose bids have been found to be successful (i.e. at and above the final price or cut-off price) shall become entitle for allotment of securities.

(xvii) No incentive, whether in cash or kind, shall be paid to the investors who have become entitled for allotment of securities.

(xviii) On determination of the entitlement under sub-clause (xvi), the information regarding the same (i.e. the number of securities which the investor becomes entitled) shall be intimated immediately to the investors.

(xix) The final prospectus containing all disclosures as per these Guidelines including the price and the number of securities proposed to be issued shall be filed with the Registrar of Companies.

(xx) Arrangement shall be made by the issuer for collection of the applications by appointing mandatory collection centres as per these Guidelines.

(xxi) The investors who had not participated in the bidding process or have not received intimation of entitlement of securities may also make an application.

5.4 History of Book-Building in India

The Book-Building in India was introduced in the year 1995 on the basis of recommendation of committee by SEBI under the chairmanship of Y.H. Malegam. In January 2000, SEBI came out with a compendium of guidelines, circulars and instructions on Book-Building mechanism. Book building has become the preferred route of raising capitaland since 2012-13 all the issues are made through book building route except one issue in the year 2017-18.

5.5 Check Your Progress

A. State whether the following statements are True or False

1. Book Building is a process of discovering the prices of securities.
2. SEBI came out with a compendium of guidelines in January 2000.
3. There is no limit of ceiling price in Book Building.
4. The only retail investor can apply for shares at cut off price.

B. Fill in the blanks

1. IPO stands for ___________.
2. The spread between the floor price and ceiling price cannot be more than _________.
3. Lead manager of the issue should be registered with ____________.
4. Minimum number of days for which IPO should be kept open.

5.6 Summary

Book building is a mechanism in which bids are collected from investors at various prices during the specific time period. In other words, Book Building is a process used by the companies for efficient price discovery. The issue price is determined after the closure of the book building process. In this method, the market discovers the price of securities through bidding process instead of the company determine the price. The price range of the securities consists of ceiling price and floor price and the final price at which securities are issued to investors is known as "Cut-off-Price". Generally there are two methods of book building i.e. open book systems and closed book systems.

5.7 Keywords

Fixed Price Issue: A public issue in which the issuer at the outset decides the price of securities.

Floor Price: The minimum price at which bids can be made.

Book Built Issue: A public issue in which the price of securities is discovered on the basis of demand rose from prospective investors.

Oversubscription: The excess subscription amount received by the company.

Lot size: The minimum number of shares an investor can bid in an IPO.

5.8 Answers to Check Your Progress

Check Your Progress A

1. True
2. True
3. False
4. True

Check Your Progress B

1. Initial Public Offerings

2. 20%
3. SEBI
4. Three Working Days

5.9 Self-Assessment Test

1. What do you mean by Book Building? Discuss the characteristics of Book Building in detail.
2. Explain the advantages and disadvantages of Book Building in detail.
3. Elaborate the process of Book Building with a suitable example.
4. Give an overview of SEBI guidelines regarding Book Buildings.
5. Write notes on the following:
   i) Green Shoe Option
   ii) Intermediaries of Book Building

5.10 References/Suggested Readings

- ArulaNandam M.A. & Raman K.S.,**Advanced Accountancy**, Himalaya Publishing House, Delhi.
- Gupta R.L. and RadhaSwamyM.,**Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
- Paul S.K.R,.**Advanced Accountancy**, New Central Book Agency, Calcutta.
- Shukla M.C. & Grewal S.,**Advanced Accounts,** S. Chand &Company Ltd, New Delhi.
- Study material of Institute of Chartered Accountant of India (ICAI), New Delhi.

Subject: Corporate Accounting	
Course Code: **BCOM 301**	Author:**Prof. Suresh K. Mittal**
Lesson No:**6**	
Issue of Right Shares and Bonus Shares	

STRUCTURE:

6.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning of Bonus Shares and Right Shares.

- Understand the advantages and disadvantages of Issuing of Bonus and Right Shares.
- Know the SEBI guidelines regarding issue of Bonus and Right Shares.
- Know the accounting treatment of Bonus and Right Shares.

6.1 Introduction

A company requires long term funds through different sources of funds namely equity shares, preference shares, debentures, bonds, term loans from financial institutions, public deposits etc. for smooth running of the business. The total of long term funds is called capitalization and make up of capitalisation is called capital structure. In a situation when there are higher profits in the company and all the profits are not distributed as dividend among shareholders, these undistributed profits are shown in the balance sheet of the company which arise the problem of under capitalisation. To remove the problem of under capitalisation the company issue bonus shares to the shareholders'. In a situation where company requires more funds for any purpose and intends to issue new shares, the rights of the existing Shareholders may be diluted. To protect the voting rights of existing shareholders, the company offers first to subscribe new issue of shares to the existing shareholders in proportion to their existing holding of shares which is called 'Right issue of Shares'.

6.2 Issue of Right Shares: Meaning

When a company intends to issue new shares, the voting and controlling rights of the existing shareholders may be diluted, if they are not allowed to preserve them. It may happen because new shareholders may subscribe to the issued share capital. Companies Act, 2013 allows existing shareholders to preserve their position by offering those newly issued shares at the first instance to them. The existing shareholders are given a right to subscribe these shares. However, if they do not desire to subscribe these shares, they are even given the right to renounce it in favour of someone else.

In nutshell, the existing shareholders have a right to subscribe to any fresh issue of shares by the company in proportion to their existing holding for shares. They have an implicit right to renounce these rights in favour of anyone else, or even reject it completely. In other words, the existing shareholders have right of first refusal i.e., the existing shareholders enjoy a right to either sub-scribe for these shares or sell their rights or reject the offer.

A Company is planning of issuing new shares to offer, as per Section 62(1) (a) of Companies Act 2013, the shares of existing equity shareholders through a letter of offer subject to the following conditions, namely:

- The offer shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined.
- Unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person.
- After the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose of them in such manner which is not disadvantageous to the shareholders and the company.

Exception to the rights of existing equity shareholders

Section 62 recognises four situations under which the further shares are to be issued by a company, but they need not be offered to the existing shareholders. The shares can he offered, without being offered to the existing shareholders, provided the company has passed a special resolution and shares are offered to

Situation 1

To employees under a scheme of employees stock option subject to certain specific conditions.

Situation 2

To any personseither for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer.

Situation 3

Sometimes companies borrow money through debentures/loans and given their creditor an option to buy equity shares of a company. An option is a right, but not an obligation, to buy equity snares on a future date at a price agreed in advance.

Situation 4

It is a special situation where the loan has been obtained from the government and government in public interest, directs the debentures/loan to be converted into equity shares.

Financial effects of a further issue

The financial position of a business is contained in the balance sheet. Further issue of shares increase the amount of net worth aswell as the liquid resources. The amount of equity is the product of further number of shares issued multiplied by issue price. The issue price may he higher than the face value which is called issue at a premium. Companies Act does not allow issue of shares at a discount, except issue of sweat equity shares under Section 53.

Book Value of a Share

Book value of a share = Net worth (as per books)/ Number of shares

If there are 10,000 shares with book value 1,25,000. The book value of one share is (₹ 1,25,000/10,000 shares) ₹ 12.50 per share. However, the market value may differfrom the book value of shares. The market value of a company's shares represents the present value of future cash flows expected to be earned from the share in the form of dividends and capital gains from expected future share price appreciation. The market price, which exists before the rights issue istermed as Cum-right Market Price of the share. If the company decides to issue further shares it may affect the market value of the share. 'Theoretically', the value of a company's shares after a rights issue must equal the sum of market capitalisation immediate prior to rights issue and the cash inflows generated from the rights issue. Generally, the further pubic issue to the existing shareholders are offered at a discounted price from the market value to evoke positive response as well as to reward the existing shareholders.

Assume 1,000 shares are issued (making it a right issue of 1, 10; or 1 new snare for 10 existing shares held) at a price of ₹14 per share. The existing worth of tangible assets held by the business shall become 264000 (Existing net worth ₹2,50,000 + Fresh issue ₹14.000). Equity shares shall correspondingly command a valuation of ₹264,000.

The market price of the shares after further issue of shares (right issue) is termed as Ex-right Market Price of the shares, Theoretical Ex-Rights Price is a deemed value, which is attributed to a company's share immediately after a rights issue transaction occurs. This price is going to prevail after the further issue of shares is executed.

Example:

Mr. X has 100 shares of Prosperous Company before rights issue.

Current worth of holding = No. of Shares × Cum-right Market Price

= 100 × 25

= ₹ 2,500

(a) If X exercises his right, he will pay ₹14 × 10 shares = ₹140.

His total investment in the company including right is ₹2,640 (₹2,500 + ₹140).

On a per share basis, it is ₹2,640/110 shares = ₹24, which is the Ex-right Market value of the share.

(b) If X does not exercises his right to further issue, his holding's worth will decline to ₹24 × 100 shares = ₹2400. The law allows him to compensate for this dilution of shareholding by renouncing this right in favour of say, Mr.Y. X can charge fromY, in well functioning capital markets, this dilution of ₹100 by renouncing his right to acquire 10 shares. Hence Y will be charged ₹10 per share (₹ 100/10 shares), in return for a confirmed allotment of 10 shares at ₹14 each.

For every share to be offered to Y, X must have ten shares at the back. Hence his holding of 10 shares fetches him right money of ₹10 or ₹1 per share held. This is exactly equal to the difference between Cum-right and Ex-right value of the share. It is termed as the Value of Right.

In a well-functioning capital market, this mechanism works in a fair manner to all the participants.

- Y's total investment will be ₹140 (payable to Company) + ₹100 (payable to X, by way of value of right), or ₹240. He will end up holding ten shares at an average cost of ₹24, which is the Ex-right Market price of the share.
- X will have a final holding of ten shares worth ₹2400 + ₹100 by way of value of right received from Y. It matches with his cum-right holding valuation.

Right of Renunciation

Right of renunciation refers to the right of the shareholder to surrender his right to buy the securities and transfer such right to any other person. Shareholders that have received right shares have three choices of what to do with the rights. They can act on the rights and buy more shares as per the particulars of the rights issue, they can sell them in the market: or they can pass on taking advantage of their rights i.e. reject the right offer).

The renunciation of the right is valuable and can be monetised by the existing shareholders in well-functioning capital market. The monetised value available to the existing shareholders due to right issue is known as 'value of right'. If a shareholder decides to renounce all or any of the right shares in favour of his nominee, the value of right is restricted to the sale price of the re-nouncement of a right in favour of the nominee. In case the right issue offer is availed by an existing shareholder the value of right is determined as given below:

Value of right = Cum-right value of share – Ex-right value of share

Ex-right value of the shares = [Cum-right value of the existing shares + (Rights shares X Issue Price)] /Existing Number of shares – Number of right shares)

In our previous example. Ex-right value of share = (₹250,000 + (₹ 14 X 1,000 shares)] / 10,000 + 1,000 shares = ₹ 24

Value of right = ₹25– ₹ 24 = ₹ 1 per share.

The Ex-right value of the share is also known as the average price.

Example:

A company offers new shares of ₹100 each at 25% premium to existing shareholders on one for four bases. The cum-right market price of a share is ₹150. Calculate the value of a right. What should be the ex-right market price of a share?

Solution:

Ex-right value of the shares = (Cum–right value of the existing shares + Rights shares Issue Price) / (Existing Number of Shares + Rights Number of Shares)

= (₹150 × 4 Shares + ₹125 × 1 Share) / (4 +1) Shares

= ₹725 / 5 shares = ₹145 per share.

Value of right = Cum-right value of the share – Ex-right value of the share

= ₹150 – ₹145 = ₹5 per share.

Hence, any one desirous of having a confirmed allotment of one share from the company at ₹125 will have to pay ₹20 (4 shares x ₹5) to an existing shareholder holding 4 shares and willing to renounce his right to buying one share in favour of that person.

6.2.1 Advantages and Disadvantages of Right Shares

Advantages of Right Issue

- Right issue enables the existing shareholders to maintain their proportional holding in the company and retain their financial and voting rights.
- In well functioning capital markets, the right issue necessarily leads to dilution in the value of share. However, the existing shareholders are not affected by it because getting new shares at a discounted value from their cum-right value will compensate decrease in the value of shares.
- Right issue is a natural hedge against the issue expenses normally incurred by the company is relation to public issue.
- Right issue has an image enhancement effect, as public and shareholders view it positively.
- The chance of success of a right issue is better than that of a general public issue and is logistically much easier to handle.

Disadvantages of right issue

- The right issue normally leads to dilution in the market value of the shares of the company.
- The attractive price of the right issue should be objectively assessed against its true worth to ensure that you get a bargained deal.

6.2.2 Accounting Treatment of Issuing Right Shares

The accounting treatment of rights share is the same as that of issue of ordinary shares and the following journal entry will be made:

Bank A/c Dr.

To Equity Shares capital A/c

In case rights shares are being offered at a premium, the premium amount is credited to the securities premium account.

The accounting entry is usual and is

Bank A/c Dr.

To Equity Share Capital A/c

To Securities Premium A/c

Example:

A company having 100,000 shares of ₹10 each as its issued share capital, and having a market value of ₹46, issues rights shares in the ratio of 1:10 at an issue price of ₹31.

The entry at the time of subscription of right shares by existing shareholders will be

Bank A/c	Dr.	3, 10,000	
To Equity Share Capital A/c			1, 00,000
To Securities Premium A/c			29 , 10,000

6.3 Issue of Bonus Shares

"Capitalisation of profits refers to the process of converting profits or reserves into paid up capital." A company may capitalise its profits or reserves which otherwise are available for distribution as dividends among the members by issuing fully paid bonus shares to' the members.

6.3.1 Meaning of Bonus Shares

A bonus share may be defined as a free share of stock given to current shareholders in acompany, based upon the number of shares that the shareholder already owns. While theissue of bonus shares increases the total number of shares issued and owned, it does notincrease the net worth of the company. Although the total number of issued shares increases,the ratio of number of shares held by each shareholder remains constant. An issue of bonusshares is referred to as a bonus issue. No new funds are raised with a bonus issue. If the subscribed and paid up capital exceeds the authorised share capital as a result of bonus issue, a resolution shall be passed by the company at its general body meeting for increasing the authorised capital. A return of bonus issue along with a copy of resolution authorising the issue of bonus shares is also required to be filed with the Registrar of Companies.

6.3.2 Provisions of the companies Act, regarding issue of Bonus Shares

Section 63 of the Companies Act, 2013 deals with the issue of bonus shares. According to Sub-section (1) of this section, a company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—

(i) Its free reserves;

(ii) The securities premium account; or

(iii) The capital redemption reserve account:

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

Sub-section(2) of Section 63 provides that no company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (1), unless –

(a) It is authorised by its articles;

(b) It has been authorised in the general meeting of the companyon the recommendation of the Board;

(c) It has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it:

(d) It has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund) gratuity and bonus;

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

(f) It complies with such conditions as may be prescribed.

Sub-section (3) of the Section also provides that the bonus shares shall not be issued in lieuof dividend.

6.3.3 SEBI Regulations regarding issue of Bonus Shares

A listed company or a company which intends to get its securities listed is also required to follow the provisions of the Securities and Exchange Board of India Act, 1992 and the rules and regulations made there under. Some of the important regulations regarding restrictions and conditions of bonus issue are as follows:

Conditions for Bonus Issue – Reg. 92 of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

A listed company may issue bonus shares to its members if:

(a) It is authorised by its articles of association for issue of bonus shares, capitalisation of reserves, etc.

provided that if there is no such provision in the articles of association, the issuer shall pass aresolution in general body meeting making provisions in the articles of associations for capitalisation of reserves;

(b) It has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(c) It has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity and bonus:

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

Example:

Following items appear in the trial balance of ABC Ltd. (a listed company) as on 31st March, 2020:

	₹
40,000 Equity Shares of ₹10 each	4,00,000
Capital Reserve (including 30,000 being profit on sale of machinery	75,000
Capital Redemption Reserve	25,000
Securities Premium	30,000
General Reserve	1,05,000
Surplus i.e. credit balance of Profit and Loss Account	50,000

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 4 shares held and for this purpose, it decided that there should be the minimum reduction in free reserves. Pass necessary journal entries.

Solution:

Journal Entries in the books of ABC Ltd.

		Dr. ₹	Cr. ₹
Capital Reserve A/c	Dr.	30,000	
Capital Redemption Reserve A/c	Dr.	25,000	
Securities Premium A/c	Dr.	30,000	
General Reserve A/c	Dr.	15,000	

To Bonus to Shareholders A/c (Bonus issue of one share for every four shares held, by utilising various reserves as per Board's resolution dated …….)		1,00,000
Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Capitalisation of Profit)	1,00,000	 1,00,000

Note: Capital reserve amounting ₹ 30,000 realised in cash can only be used for bonus issue.

Example:

Following is the extract of the Balance Sheet of XYZ Ltd. as at 31st March, 2020.

	₹
Authorised capital:	
10,000 12% Preference Shares of ₹ 10 each	1,00,000
1,00,000 Equity Shares of ₹10 each	10,00,000
Issued and Subscribed Capital:	11,00,000
8000, 12% Preference shares of ₹10 each fully paid	
90,000 Equity Shares of ₹10 each, ₹8 paid up	80,000
Reserves and Surplus:	7,20,000
General reserve	
Revaluation reserve	1,60,000
Securities Premium	35,000
Profit and Loss Account	20,000
Secured Loan:	2,05,000
12% Debentures @ ₹100 each	
	5,00,000

On 1st April, 2020 the Company has made final call @ ₹2 each on 90,000 equity shares. The call money was received by 20th April, 2020. Thereafter the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held. Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue.

Solution

Solid Ltd.

Journal Entries

2020		Dr. (₹)	Cr. (₹)
April 1	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Final call of ₹2 per share on 90,000 equity shares due as per Board's Resolution dated…..)	1,80,000	1,80,000
April 20	Bank A/c Dr. To Equity Share Final Call A/c (Final call money on 90,000 equity shares received)	1,80,000	1,80,000
	Share Premium A/c Dr. General Reserve A/c Dr. Profit and Loss A/c Dr. To Bonus to Shareholders A/c (Bonus issue @ one share for every four shares held by utilising various reserves as per Board's Resolution dated …..)	20,000 1,60,000 45,000	2,25,000
April 20	Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Capitalisation of Profit)	2,25,000	2,25,000

Balance Sheet (Extract) as on 30th April, 2020 (after bonus issue)

	Particulars	Amount (₹)
1	Equity and Liabilities	
a	Shareholders' funds	12,05,000
b	Share Capital	1,95,000
2	Reserves and Surplus	
a	Non-current Liabilities	
	Long-term borrowings	5,00,000
	Total	19,00,000

6.3.4 Accounting Treatment of Issue of Bonus Shares:

(A) (1) On the sanction of an issue of bonus shares:

Capital Redemption Reserve Account Dr.

Securities Premium Account Dr.

General Reserve Account Dr.

Profit & Loss Account Dr.

To Bonus to Shareholders Account

(2) On issue of bonus shares

Bonus of Shareholders Account Dr.

To Share Capital Account

(B) (1) On the sanction of bonus by converting partly paid shares into fully paid shares

General Reserve Account Dr.

Profit and Loss Account Dr.

To Bonus to Shareholders Account

(2) On making the final call due

Share Final Call Account

To Share Capital Account

(3) On adjustment of final call

Bonus to Shareholders Account Dr.

To Share Final Call Account

Example:

Following items appear in the trial balance of XYZ Ltd. (a listed company) as on 31st March, 2019:

	₹
40,000 Equity Shares of ₹10 each	4,00,000
Capital Redemption Reserve	55,000
Securities Premium (collected in cash)	30,000
General Reserve	1,05,000
Surplus i.e. credit balance of Profit and Loss Account	50,000

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for even 4 shares held and for this purpose, it decided that there should be the minimum reduction in free reserves. Pass necessary journal entries.

Solution:

Journal Entries in the books of XYZ Ltd.

		Dr. ₹	**Cr.** ₹
Capital Redemption Reserve A/c	Dr.	55,000	
Securities Premium A/c	Dr.	30,000	
General Reserve A/c	Dr.	15,000	
To Bonus to Shareholders A/c			1,00,000
(Bonus issue of one share for every four shares held, by utilising various reserves as per Board's resolution dated …….)			
Bonus to Shareholders A/c	Dr.	1,00,000	
To Equity Share Capital A/c			1,00,000
(Capitalisation of Profit)			

Example 2

Following is the extract of the Balance Sheet of ABC Ltd. as at 31st March, 20X1.

	₹
Authorised capital:	
10,000 12% Preference Shares of ₹ 10 each	1,00,000
1,00,000 Equity Shares of ₹10 each	10,00,000
	11,00,000
Issued and Subscribed Capital:	
8000, 12% Preference shares of ₹10 each fully paid	80,000
90,000 Equity Shares of ₹10 each, ₹8 paid up	7,20,000
Reserves and Surplus:	
General reserve	1,60,000
Revaluation reserve	35,000
Securities Premium	20,000
Profit and Loss Account	2,05,000
Secured Loan:	
12% Debentures @ ₹100 each	5,00,000

On 1st April, 20X1 the Company has made final call @ ₹2 each on 90,000 equity shares. The call money was received by 20th April, 20X1. Thereafter the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held. Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue assuming that the company has passed necessary solution at its general body meeting for increasing the authorised capital.

Solution:

ABC Ltd.

Journal Entries

20X1			Dr. (₹)	Cr. (₹)
April 1	Equity Share Final Call A/c	Dr.	1,80,000	

	To Equity Share Capital A/c (Final call of ₹2 per share on 90,000 equity shares due as per Board's Resolution dated…..)		1,80,000
April 20	Bank A/c Dr. To Equity Share Final Call A/c (Final call money on 90,000 equity shares received)	1,80,000	1,80,000
	Share Premium A/c Dr. General Reserve A/c Dr. Profit and Loss A/c Dr. To Bonus to Shareholders A/c (Bonus issue @ one share for every four shares held by utilising various reserves as per Board's Resolution dated …..)	20,000 1,60,000 45,000	2,25,000
April 20	Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Capitalisation of Profit)	2,25,000	2,25,000

Balance Sheet (Extract) as on 30th April, 20X1 (after bonus issue)

		Particulars	Notes	Amount (₹)
		Equity and Liabilities		
1		Shareholders' funds		
	a	Share Capital	1	12,05,000
	b	Reserves and Surplus	2	1,95,000
2		Non-current Liabilities		
	a	Long-term borrowings	3	5,00,000
		Total		19,00,000

Example:

Following is the extract of the Balance Sheet of XYZ Ltd. as at 31st March, 2019

	₹

Authorised capital:	
15,000 12% Preference Shares of ₹ 10 each	1,50,000
1,50,000 Equity Shares of ₹10 each	15,00,000
	16,50,000
Issued and Subscribed Capital:	
12,000, 12% Preference shares of ₹10 each fully paid	1,20,000
1,35,000 Equity Shares of ₹10 each, ₹8 paid up	10,80,000
Reserves and Surplus:	
General reserve	1,80,000
Revaluation reserve	60,000
Securities Premium	37,500
Profit and Loss Account	3,00,000

On 1st April, 2019 the Company has made final call @ ₹2 each on 1, 35,000 equity shares. The call money was received by 20th April, 2019. Thereafter the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held.

Show necessary entries in the books of the company and prepare the extract of the balance Sheet as on 30th April, 2019 after bonus issue.

Solution:

Journal Entries in the books of XYZ Ltd.

		Dr. (₹)	Cr. (₹)
1-4-2019	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Final call of ₹2 per share on 1,35,000 equity shares due as per Board's Resolution dated…..)	2,70,000	2,70,000
20-4-2019	Bank A/c Dr. To Equity Share Final Call A/c (For Final call money on 1,35,000 equity shares received)	2,70,000	2,70,000

	Securities Premium A/c	Dr.	37,500	
	Capital Redemption Reserve A/c	Dr.	60,000	
	General Reserve A/c	Dr.	1,80,000	
	Profit and Loss A/c	Dr.	60,000	
	To Bonus to Shareholders A/c			
	(For making provision for bonus issue of one share for every four shares held)			3,37,500
	Bonus to Shareholders A/c	Dr.	3,37,500	
	To Equity Share Capital A/c			3,37,500
	(For issue of bonus shares)			

Extract of Balance Sheet as at 30th April, 2019 (after bonus issue)

	₹
Authorised capital:	
15,000 12% Preference Shares of ₹ 10 each	1,50,000
1,83,750 Equity Shares of ₹10 each (refer working note below)	18,37,500
Issued and Subscribed Capital:	
12,000, 12% Preference shares of ₹10 each fully paid	1,20,000
1,68,750 Equity Shares of ₹10 each, fully paid	16,87,500
(Out of above, 33,750 equity shares @ 10 each were issued by way of bonus)	
Reserves and Surplus:	
Profit and Loss Account	2,40,000

Working Note:

The authorised capital should be increases as per details given below:	₹	
Existing authorised Equity Share Capital	15, 00,000	
Add: Issue of bonus shares to equity shareholders	3, 37,500	
		18, 37,500

6.4 Check Your Progress

A. State whether the following statements are True or False

1. The total of long term funds is called capitalisation.
2. A company can use its profits or reserves available for distribution for issuing bonus shares to members.
3. Companies Act 2013 does not allow to preserve the position of existing shareholders by offering newly issued shares to them.
4. The existing shareholders cannot transfer their right issue in favour of other person.

B. Fill in the blanks

1. The makeup of capitalisation is called ___________.
2. The company offers first to subscribe new issue of shares to the existing shareholders which is called ______________.
3. Free shares given to current shareholders in a company is known as __________.
4. ____________ refers to the right of the shareholder to surrender his right to buy the securities to any other person.

6.5 Summary

The total requirement of long term funds is called capitalization and make up of capitalisation is called capital structure. A bonus share may be defined as a free share of stock given to current shareholders in acompany, based upon the number of shares that the shareholder already owns. While theissue of bonus shares increases the total number of shares issued and owned, it does notincrease the net worth of the company. Although the total number of issued shares increases,the ratio of number of shares held by each shareholder remains constant. An issue of bonusshares is referred to as a bonus issue. No new funds are raised with a bonus issue. In a situation where company requires more funds for any purpose and intends to issue new shares, the rights of the existing Shareholders may be diluted. To protect the voting rights of existing shareholders, the company offers first to subscribe new issue of shares to the existing shareholders in proportion to their existing holding of shares which is called ‘Right issue of Shares’.

6.6 Keywords

Capitalization of Profits: The process of converting profits or reserves into paid-up capital.

Bonus Shares: Shares given in free to the existing shareholders.

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

Book Value: Value of a equity share as per accounting rules.

General Reserve: The portion of earnings appropriated by the management for a general purpose.

6.7 Self-Assessment Test

1. What do you mean by Right Issue? Explain the provisions of Companies Act regarding issue of Right Shares.
2. What are Bonus Shares? Explain the rules regarding issue of Bonus Shares.
3. Explain the accounting treatment of issue of Bonus Shares with hypothetical figures.
4. Discuss the advantages and disadvantages of issuing Right Shares.
5. Explain the term Right of Renunciation with a suitable example.

6.8 Answers to Check Your Progress

Check Your Progress A

1. True
2. True
3. False
4. False

Check Your Progress B

1. Capital Structure
2. Right Shares
3. Bonus Shares₹
4. Right of Renunciation

6.9 References/SuggestedReadings

- Arula Nandam M.A. & Raman K.S.,**Advanced Accountancy**, Himalaya Publishing House, Delhi.
- Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.
- Gupta R.L. and Radha SwamyM.,**Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
- Paul S.K.R,.**Advanced Accountancy**, New Central Book Agency, Calcutta.
- Shukla M.C. &Grewal S.,**Advanced Accounts,** S. Chand &Company Ltd, New Delhi.
- Study material of Institute of Chartered Accountant of India (ICAI), New Delhi.

Subject: Corporate Accounting	
Course Code: **BCOM 301**	Author: **Prof. Suresh K. Mittal**
Lesson No:**7**	
Redemption of Shares and Debentures	

STRUCTURE:

7.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaningand sources of finance for redemption of Debentures.
- Know the different methods of redemption of Debentures.
- Understand the accounting treatment of redemption of Debentures.
- Know the meaning and accounting treatment of redemption of Preference shares.

7.1 Introduction

There is requirement of short-term as well as long-term sources of finds for smooth running of the business. The short-term includes those funds which are required for the period less than one year, long term funds are those funds which are required for the period more than three years. The short term sources of funds are being paid during the normal course of business and such as repayment issue does not arise. In case of long-term sources of funds, there are two types of funds i.e. those do not have maturity period like equity shares second those have maturity period like debenture, long term loans, bonds etc. The maturity period means after specific period these security holders had to be paid as per the term and conditions mentioned in the prospectus.

7.2 Redemption of Debentures: Meaning and Sources of Finance

Meaning: Redemption of debentures means repayment of the due amount of debentures to the debenture holders on due date. In other words, redemption of debentures means discharging the liability on account of debentures issued by a company by repaying the due amount to the debenture holders. Generally, debentures are redeemed on due date but in some cases, the debentures can be redeemed before the due date if the terms of issue allowed. The terms and conditions of redemption of debentures are mentioned in the prospectus inviting applications for the same. Redemption of debentures may be done in instalments i.e., by draw of lots or by purchase from the open market for cancellation or by conversion into shares or new debentures. Time of redemption, amount of redemption and sources of finance for the redemption of debentures must be kept in mind at the time of redemption of debentures.

Sources of finance for the redemption of Debentures

Amount required for the redemption of debentures may be managed by the company from the following sources:

- The proceeds of fresh issue of shares and debentures
- Out of Capital
- Out of profits

Fresh issue of Shares and Debentures: When a company required funds for the redemption of debentures, the company may decide to issue new shares or debentures. The proceeds of the new issue of shares or debentures are utilized for the redemption of debentures.

Out of Capital: When profits are not set aside for the redemption of debentures it is called redemption out of capital. As per Companies Act 2013, it is not possible to redeem debentures purely out of capital.

Out of Profits: Redemption out of profits means that an amount equal to debentures issued is transferred to Debenture Redemption Reserve Account (DRR) from the profit and loss Account. The amount set aside for DRR is not available for payment of dividend and can be utilised only for redemption of debentures.

7.3 Methods and Accounting Treatment of Redemption of Debentures

The following are the methods of redemption of debentures:

- Lump-sum payment at the end of fixed period.
- Redemption of Debentures in instalments
- By the purchase of own debenture in the open market.
- By conversion into shares.

The detail of the methods of redemption of debentures along with their accounting treatment is given below:

7.3.1 Lump sum Payment at the end of Fixed Period

Under this method, all the debentures are redeemed on the redemption date specified in the terms of issue, i.e., on their maturity. The debentures may be redeemed at par or at premium. The Journal entries passed are:

For the amount due to Debenture holders on redemption:

(i) If the Debentures are Redeemable at Par:

…% Debentures A/c …Dr. [with nominal value]

To Debentureholders' A/c

(ii) If the Debentures are Redeemable at Premium:

…% Debentures A/c …Dr. [with nominal value]

Premium on Redemption of Debentures A/c …Dr. [with the amount of premium]

To Debentureholder's A/c

(iii) For payment to Debentureholders:

Debentureholders' A/c …Dr. [with the amount paid]

To Bank A/c

Premium payable on redemption is a Capital loss. At the time of allotment of debentures, premium payable on redemption is provided by debiting 'Loss on Issue of Debentures Account' and crediting Premium on Redemption of Debentures Account, i.e., a liability is recorded in the books of account following the principle of prudence.

Loss on Issue of Debentures is written off from Capital Reserve or Securities Premium Reserve or Profit and Loss A/c during the life of the debentures.

At the time of redemption, 'Premium on Redemption of Debentures Account' is debited as the liability becomes due for payment.

Debentures may be redeemed by a company:

(i) Out of capital, If the Act allows'

(ii) Out of Profits.

(i) Redemption of Debentures Out of Capital

Redemption of Debentures out of capital means that the company redeems debentures without transferring any amount to DRR out of the profits.

The Companies Act, 2013, requires every Company to transfer at least 25 per cent of the nominal (face) value of the outstanding debentures out of profits available for payment of dividend to shareholders to Debentures Redemption Reserve (DRR).

DRR is not created

(i) By the companies that are exempted from creating DRR;

(ii) On the fully convertible Debentures; and

(iii) On convertible part of partly Convertible Debentures.

When debentures are redeemed out of capital following Journal entries are passed:

(i) On Debentures becoming due for payment:

…% Debentures A/c …Dr. [with nominal value]

Premium on Redemption of Debentures A/c …Dr. [if premium is payable on redemption]

To Debenture holders' A/c [with nominal value + premium]

(ii) On payment to Debenture holders:

Debentures holders A/c …Dr. [with the amount paid]

To Bank A/c

(ii) Redemption of Debentures Out of Profit

Redemption of Debentures out of profits means that at least amount specified in Section 71(4) of the Companies Act, 2013 is transferred to Debentures Redemption Reserve out of the profit available for payment as dividend to shareholders.It means that an amount that is at least 25 per cent of the nominal (face) value of the outstanding debentures is transferred to 'Debentures Redemption Reserve Account' before the redemption of debentures begins. The company as its option, may transfer more amount to Debentures Redemption Reserve than prescribed.

In case, debentures are redeemed out of profits only, DRR is created by transferring an amount that is equal to 100 per cent of the nominal (face) value of the total outstanding debentures.

Accounting Entries

The Journal entries are passed:

(i) On transfer of amount to Debentures Redemption Reserve (DRR):

Profit and Loss A/c …Dr.

To Debentures Redemption Reserve A/c

(ii) On Investment or Depositing in Specified Securities:

Debentures Redemption Investment A/c …Dr.

To Bank A/c

(iii) On Realising Investment before Redemption of Debentures:

Bank A/c …Dr.

To Debentures Redemption Investment A/c

(iv) On the amount being due to Debentureholders on Redemption:

(a) If the Debentures are Redeemable at Par :

….. % Debentures A/c …Dr. [with nominal value]

To Debentureholders' A/c

(b) If the Debentures are Redeemable at Premium:

….. % Debentures A/c …Dr. [with nominal value]

Premium on Redemption of Debentures A/c … Dr. [with premium payable]

To Debentureholders' A/c [with nominal value + premium]

(v) On Payment to Debentureholders:

Debentureholders'A/c … Dr. [with the amount paid]

To Bank A/c

(vi) OnTransfer of amount from DRR to General Reserve:

Debentures Redemption Reserve A/c …Dr. [with the amount of DRR

To General Reserve A/c proportionate to debentures

Redeemed)

Example: (Investment or Deposit to be made for Redemption of Debentures).

X Ltd. had issued on 1st April, 2015, 20,000, 9% Debentures of ₹ 100 each redeemable by draw of lots as under:

(i) During the year ending on 31st March, 2017 – 15%

(ii) During the year ending on 31st March, 2018 – 25%

(iii) During the year ending on 31st March, 2019 – 15%

(iv) During the year ending on 31st March, 2020 – 25%

(v) During the year ending on 31st March, 2021 – 20%

What is the minimum investment or deposit that should be made by X Ltd. as per the Companies Act, 2013 before redemption of debentures and when?

Solution: Table Showing Investment or Deposit to be made by X Ltd.

Redemption during the year ending	Time of Investment	Amount of Debentures being redeemed	Minimum Investment or Deposit or DRI

(i) 31st March, 2017	On or Before 30th April, 2016	15% of ₹20,00,000 = ₹3,00,000	15% of ₹3,00,000 = ₹45,000
(ii) 31st March, 2018	On or Before 30th April, 2017	25% of ₹20,00,000 = ₹5,00,000	15% of ₹5,00,000 = ₹75,000
(iii) 31st March, 2019	On or Before 30th April, 2018	15% of ₹20,00,000 = ₹3,00,000	15% of ₹3,00,000 = ₹45,000
(iv) 31st March, 2020	On or Before 30th April, 2019	25% of ₹20,00,000 = ₹5,00,000	15% of ₹5,00,000 = ₹75,000
(v) 31st March, 2021	On or Before 30th April, 2020	20% of ₹20,00,000 = ₹4,00,000	15% of ₹4,00,000 = ₹60,000

Example: (Issue and Redemption of Debentures)

Y Ltd. Issued 50,000; 10% Debentures of ₹10 each on 1st April, 2017 redeemable at par on 30th June, 2018. The company received applications for 55,000 debentures and the allotment was made to the applicants on pro rata. The debentures were redeemed on due date. Assume that required investment was made on 1st April of the financial year in which redemption is due.

Pass Journal entries for issue and redemption of debentures, DRR and investment, ignoring interest on debentures.

Solution: **Journal of Y Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2017 April 1	Bank A/c …Dr. To Debentures Application and Allotment A/c (Being the receipt of application money)		5,50,000	 5,50,000
April 1	Debentures Application and Allotment A/c …Dr. To 10% Debenture A/c To Bank A/c (Being the debentures allotted and debentures application money adjusted)		5,50,000	 5,50,000 50,000
2018			1,25,000	

March 31	Profit and Loss A/c ..Dr. To Debentures Redemption Reserve A/c (Being the DRR created of amount equal to 25 per cent of the value of debentures)			1,25,000
April 1	Debentures Redemption Investment A/c …Dr. To Bank A/c (Being the investment made of 15% of ₹ 5,00,000, nominal (face) value of debentures to be redeemed)		75,000	75,000
June 30	Bank A/c …Dr. To Debenture Redemption Investment A/c (Being the investment realised on redemption of debentures)		75,000	75,000
June 30	10% Debentures A/c …Dr. To Debentureholders' A/c (Being the payment on redemption of debentures due to debentureholders)		5,00,000	5,00,000
June 30	Debentureholders' A/c …Dr. To Bank A/c (Being the payment due to debentureholders discharged)		5,00,000	5,00,000
June 30	Debentures Redemption Reserve A/c …Dr. To General Reserve A/c (Being the transfer of DRR to General Reserve)		75,000	75,000

Example: (Redemption of Debentures in case of Banking Company)

Bank of India Ltd. has outstanding 1,00,000; 10% Debentures of ₹10 each issued in 2005 due for redemption on 30th June, 2018. How much amount of Debentures Redemption Reserve should be created before the redemption of debentures begins and also how much amount should it invest in specified securities?

Pass Journal entries at the time of redemption of debentures.

Solution: **Journal of Bank of India Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2018				

June 30	10% Debentures A/c ...Dr. To Debenture holders' A/c (Being the amount due to debentureholders on redemption)		10,00,000	 10,00,000
	Debentures holders' A/c ...Dr. To Bank A/c (Being the amount due to debentureholders paid)		10,00,000	 10,00,000

Note: As per section 71 (4) of the Companies Act, 2013 along with Rule 18(7) (b) of Companies (Share Capital and Debentures) Rules, 2014, a banking company is not required to create Debentures Redemption Reserve and Debentures Redemption Investment. Therefore, entries for DRR and DRI are not passed.

7.3.2 Redemption of Debentures in Instalments

Under this method, the company may redeem its debentures by payment each year a part of debentures being selected by draw. The debentures may be redeemed at par or at premium according to the terms of issue. This process is called Redemption of Debentures by Draw of Lots.

DRR is created before commencing redemption of debentures and also Debentures Redemption Investment (DRI) is made under this method.

Example:

ABC Ltd. issued 2,000; 10% Debentures of ₹1,000 each at par on 1st April, 2014 redeemable in equal annual drawings by draw of lots in 2 years on 31st March, 2016 and 31st March, 2017. The company decided to transfer to Debentures Redemption Reserve amount as prescribed in law on 31st March, 2015. Investment was made in specified securities on 1st April, 2015 and 2016 respectively.

Pass Journal entries for DRR, DRI and redemption of debentures assuming the investment was realised each time the debentures were redeemed. (Ignore Interest)

Solution: **Journal of ABC Ltd.**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2015 March 31	Surplus i.e., Balance in Statement of Profit and Loss A/c ...Dr. To Debentures Redemption Reserve A/c		5,00,000	 5,00,000

	(Being 25% of nominal (face) value of the debentures outstanding transferred to DRR)			
April 1	Debentures Redemption Investment A/c (₹10,00,000 x15/100)…Dr. To Bank A/c (Being the investment equal to 15% of the amount of debentures to be redeemed during the year ended 31st March, 2016)		1,50,000	1,50,000
2016 March 31	Bank A/c ..Dr. To Debentures Redemption Investment A/c (Being the investment realised before redemption of first lot of debentures)		1,50,000	1,50,000
March 31	10% Debentures A/c …Dr. To Debentureholders' A/c (Being 1,000 debentures became due for redemption)		10,00,000	10,00,000
	Debentureholders' A/c …Dr. To Bank A/c (Being the amount paid to debentureholders)		10,00,000	10,00,000
March 31	Debentures Redemption Reserve A/c …Dr. To General Reserve A/c (Being the proportionate amount of DRR transferred to General Reserve on redemption of 1,000 debentures)		2,50,000	2,50,000
April 1	Debentures Redemption Investment A/c …Dr. To Bank A/c (Being the investment made of amount equal to 15% of ₹10,00,000)		1,50,000	1,50,000
2017 March 31	Bank A/c …Dr. To Debentures Redemption Investment A/c (Being the investment realised)		1,50,00	1,50,000
March 31	10% Debentures A/c …Dr. To Debentureholders' A/c (Being the debentures became due for redemption)		10,00,000	10,00,000

March 31	Debentureholders' A/c …Dr. To Bank A/c (Being the amount paid to debentureholders)		10,00,000	10,00,000
March 31	Debentures Redemption Reserve A/c …Dr. To General Reserve A/c (Being the amount of DRR transferred to General Reserve upon redemption of debentures)		2,50,000	2,50,000

Note: Alternatively, company may decide to transfer DRR to General Reserve when all debentures have been redeemed i.e., on 31st March, 2017.

Example:

RC Ltd. issued 15,000; 10% Debentures of ₹ 100 each at par on 1st April, 2013 redeemable at 5% premium in three years instalments by draw of lots as follows:

On 31st March, 2015 3,000 Debentures,

On 31st March, 2016 6,000 Debentures,

On 31st March, 2017 6,000 Debentures,

The company complied with the legal requirements with respect to Debentures Redemption Reserve and investment (made in Government Securities on 1st April each year).

Pass Journal entries for Issue and Redemption of Debentures. Prepare relevant Ledger Accounts in the books of the company. Ignore 'Writing off Loss on Issue of Debentures' interest paid and received.

Solution: **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2013 April 1	Bank A/c Dr. To Debentures Application and Allotment A/c (Being the debenture application received for 15,000; 10% Debentures of ₹100 each)		15,00,000	15,00,000
April 1	Debentures Application and Allotment A/c Dr. Loss on Issue of Debentures A/c Dr. To 10% Debenture A/c		15,00,000 75,000	15,00,000

	To Premium on Redemption of Debentures A/c (Being 15,000; 10% Debentures allotted at par redeemable at a premium of 5%)			75,000
2014 March 31	Profit and Loss A/cDr. To Debentures Redemption Reserve A/c (Being the DRR created for 25% of the nominal value of outstanding debentures)		3,75,000	3,75,000
April 1	Debentures Redemption Investment A/c Dr. To Bank A/c (Being the investment made in securities equal to 15% of nominal (face) value of debentures redeemable by 31st March, 2015, i.e. ₹ 3,00,000)		45,000	45,000
March 31	Bank A/c Dr. To Debenture Redemption Investment A/c (Being the investment realised)		45,000	45,000
March 31	10% Debentures A/c Dr. Premium on Redemption of Debentures A/c Dr. To Debentureholders' A/c (Being the amount due on redemption of 3,000 debentures)		3,00,000 15,000	3,15,000
	Debentureholders' A/c Dr. To Bank A/c (Being the amount due to debentureholders paid)		3,15,000	3,15,000
	Debentures Redemption Reserve A/c Dr. To General Reserve A/c (Being the amount proportionate to 3,000 debentures redeemed transferred to General Reserve from DRR)		75,000	75,000
April 1	Debentures Redemption Investment A/c Dr. To Bank A/c (Being the investment made in Securities of 15% nominal (face) value of debentures to be redeemed on 31st March, 2016 i.e., ₹6,00,000)		90,000	90,000
2016 March 31	Bank A/c Dr. To Debentures Redemption Investment A/c		90,000	90,000

	(Being the investment realised)			
March 31	10% Debentures A/c Dr. Premium on Redemption of Debentures A/c Dr. To Debentureholders' A/c (Being the amount due on redemption of 6,000 debentures)		6,00,000 30,000	 6,30,000
	Debentureholders' A/c Dr. To Bank A/c (Being the due amount paid)		6,30,000	 6,30,000
	Debentures Redemption Reserve A/c Dr. To General Reserve A/c (Being the amount proportionate to 6,000 debentures redeemed transferred to General Reserve from DRR)		1,50,000	 1,50,000
April 1	Debentures Redemption Investment A/c Dr. To Bank A/c (Being the investment made in Government Securities of 15% of debentures to be redeemed on 31st March, 2017, (i.e., ₹ 6,00,000)		90,000	 90,000
2017 March 31	Bank A/c Dr. To Debentures Redemption Investment A/c (Being the investment realised)		90,000	 90,000
March 31	10% Debentures A/c Dr. Premium on Redemption of Debentures A/c Dr. To Debentureholders' A/c (Being the amount due on redemption of 6,000 debentures)		6,00,000 30,000	 6,30,000
	Debentureholders' A/c Dr. To Bank A/c (Being the due amount paid)		6,30,000	 6,30,000
	Debentures Redemption Reserve A/c Dr. To General Reserve A/c (Being the amount proportionate to 6,000 debentures redeemed transferred to General Reserve from DRR)		1,50,000	 1,50,000

In the Books of RC Ltd.

Dr. 10% Debentures Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2014			2013		
March 31	To Balance c/d	15,00,000	April 1	By Debentures Application and Allotment A/c	15,00,000
2015			2014		
March 31	To Debentureholders' A/c	3,00,000	April 1	By Balance c/d	15,00,000
March 31	To Balance c/d	12,00,000			15,00,000
		15,00,000			
2016			2015		
March 31	To Debentureholders' A/c	6,00,000	April 1	By Balance c/d	12,00,000
March 31	To Balance c/d	6,00,000			12,00,000
		12,00,000			
2017			2016		
March 31	To Debentureholders' A/c	6,00,000	April 1	By Balance c/d	6,00,000
		6,00,000			6,00,000

Dr. Debentures Redemption Reserve Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2014			2014		
March 31	To Balance c/d	3,75,000	March 31	By Surplus i.e. Balance in Statement of Profit and Loss A/c	3,75,000
		3,75,000			3,75,000
2015			2014		
March 31	To General Reserve A/c	75,000	April 1	By Balance c/d	3,75,000
	To Balance c/d	3,00,000			
		3,75,000			3,75,000
2016			2015		
March 31	To General Reserve A/c	1,50,000	April 1	By Balance c/d	3,00,000

	To Balance c/d	1,50,000			3,00,000
		3,00,000			
2017 March 31	To General Reserve A/c	1,50,000	2016 April 1	By Balance c/d	1,50,000
		1,50,000			1,50,000

Dr. Debentures Redemption Investment Account Cr.

Date	Particulars	₹	Date	Particulars	₹
2014 April 1	To Bank A/c	45,000	2015 March 31	ByBank A/c	
		45,000			3,75,000
					3,75,000
2015 April 1	To Bank A/c	90,000	2016 March 31	ByBank A/c	90,000
		90,000			90,000
2016 April 1	To Bank A/c	90,000	2017 March 31	ByBank A/c	90,000
		90,000			90,000

7.3.3 By the Purchase of Own Debentures in the Open Market

The company can also redeem its debentures by purchase in the open market. It can be done only if the Article Association of the company so permits. By purchasing its debentures in the open market, the company is able to redeem its debentures as well as use its surplus funds. When the company purchases its own debentures in the open market, it may have to pay a higher or a lower price than the face value of its debentures. The difference between the face value of debentures and the price at which they are purchased, will be the profit or loss on their cancellation. Hence, when own debentures are purchased for cancellation, the entry should also made for such profit or loss. Thus, the journal entry will be as follows.

In case of Profit

Debentures A/c	Dr.	(Nominal value)
To Bank A/c	(price paid)	
To Profit on Redemption of Debenture A/c		

In case of loss

Debentures A/c	Dr.	(Nominal value)
Loss on Redemption of Debentures A/c	Dr.	(Loss)
To Bank A/c		(Price paid)

The profit or loss on redemption of debentures is of capital nature. Hence, if there is profit, the same should be transferred to capital reserve and if there is loss, it should be written off against capital reserve or any capital profit. The following additional entry will be made for the purpose.

In case of Profit

Profit on Redemption of Debentures A/c	Dr.
To Capital Reserve A/c	

In case of loss

Capital Reserve A/c (If available)	Dr.
Premium on Shares A/c (if available)	Dr.
To Loss on Redemption of Debentures A/c	

Payment of Interest on Debentures: When the company purchases its own debentures in the open market and cancels them, it reduces the debenture interest payable. It is because the interest in that case is payable only on the outstanding debentures. Hence, while making the entries for payment of interest, we should ensure that Debenture Interest Account is debited only in respect of the outstanding debentures and not the total debentures.

Example: A company has 1,000 12% Debentures of ₹ 100 each outstanding on January 1, 2019. The company pays interest on June 30 and December 31 every year. On March 1, 2019, it purchased 200 own debentures for immediate cancellation at ₹ 97 per debenture. Journalise the above transactions.

Solution:

Journal

		(₹)	(₹)
2019 March 1	12% Debentures A/c Dr. To Bank A/c To Profit on Red. Of Deb. A/c (Purchase of 200 debentures at ₹ 97 for immediate cancellation)	20,000	19,400 600
June 30	Debentures Interest A/c Dr. To Bank A/c (Interest on 800 debentures paid for 6 months)	4,800	4,800
Dec. 31	Debentures Interest A/c Dr. To Bank A/c (Interest on 800 debentures paid for 6 months)	4,800	4,800
Dec. 31	Profit on Redemption of Debentures A/c Dr. To Capital Reserve A/c (Profit on redemption of 200 debentures transferred)	600	600
Dec. 31	Profit & Loss A/c Dr. To Debentures Interest A/c (Interest on 800 debentures for the year transferred)	9,600	9,600

7.3.4 By Conversion into Shares

Debentures can also be redeemed by converting them into new debentures or shares. Ifit is decided to redeem the existing debentures by conversion into new debentures, the company has to follow the prescribed procedure for the purpose and give the necessary option to the debenture holders who will take their own decision. It cannot be made compulsory unless the terms of the issue had provided for such conversion. In case of debentures for which the option for such conversion has been exercised, the entry will be as follows.

Debentures (old) A/c Dr.

To Debentures (new) A/c

As for redemption by conversion into shares, it can be done only in case of convertible debentures. Non-convertible debentures cannot be converted into shares as per the latest rules. The conversion into shares may be optional or compulsory depending upon the terms at which convertible debentures had been issued. The entries for conversion of debentures into equity shares are as follows:

When shares are issued at par

Debentures A/c Dr.

To Equity Share Capital A/c

When Shares are Issued at a Premium

Debentures A/c Dr.

To Equity Share Capital A/c

To Share Premium A/c

Example:

Ajanta Ltd. issued and allotted 2,000, 12% fully Convertible Debentures of ₹200 each on January 1,2018. Interest on these debentures was payable half-yearly on June 30 and December 31 each year. 25% of the face value of each debenture is to be converted into two equity shares of 10 each at a premium of ₹15 per share on the expiry of six months after allotment and the balance into 6 equity shares of ₹10 each at a premium of ₹15 per share after 18 months of allotment.

Give Journal entries for the above in the books of the Company assuming that the conversions were duly made.

Solution:

Journal

		(₹)	(₹)
2018 Jan. 1	Bank A/c Dr. To 12% FC Debenture Application A/c (Application money @ ₹ 200 on 2,000 debentures received)	4,00,000	4,00,000
Jan. 1	DebentureApplication A/c Dr. To 12% FC Debentures A/c	4,00,000	4,00,000

	(2,000 debentures allotted as per Directors' Resolution no…… dated …….)		
June 30	Debentures Interest A/c Dr. To Bank A/c (Interest on ₹ 4,00,000 @ 12% for 6 months)	24,000	 24,000
June 30	12% FC Debentures A/c Dr. To Equity Share Capital A/c To Share Premium A/c (25% of Debentures' face value converted into 4,000 equity shares of ₹10 each at a premium of ₹15/- per share)	1,00,000	 40,000 60,000
Dec. 31	Debentures Interest A/c Dr. To Bank A/c (Interest @ 12% for 6 months on ₹ 3,00,000)	18,000	 18,000
2019 June 30	Debentures Interest A/c Dr. To Bank A/c (Interest @ 12% for 6 months on ₹ 3,00,000)	18,000	 18,000
June 30	12% FC Debentures A/c Dr. To Equity Share Capital A/c To Share Premium A/c (Conversion into 12000 shares of ₹10 each at a premium of ₹15/- per share)	3,00,000	 1,20,000 1,80,000

7.4 Redemption of Preference Shares

Redemption is a contract giving the right to redeem preference shares within or at the end of a given time period at an agreed price. These shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company. The redemption date is the maturity date, which specifies when repayment takes place and is usually printed on the preference share certificate.

Provisions of the Companies Act (Section 55)

A company limited by shares if so authorised by its Articles of Association, may issue preference shares which at the option of the company, are liable to be redeemed within a period, normally not exceeding 20 years from the date of their issue. It should be noted that:

(a) No shares can be redeemed except out of profit of the company.

(b) No such shares can be redeemed unless they are fully paid;

(c) (i) In case of such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of Companies under Section 133.

(ii) In case of other companies (not falling under (i) above), the premium, if any payable on redemption shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

(d) where any such shares are proposed to be redeemed out of the profits of the company, there shall, out of profits which would otherwise have been available for dividends.

The 'gap' created in the company's capital by the redemption of redeemable preference shares much be filled in by:

(a) The proceeds of a fresh issue of shares;

(b) The capitalisation of undistributed profits; or

(c) A combination of (a) and (b).

7.4.1 Redemption of Preference Shares by Fresh Issue of Shares

One of the methods for redemption of preference shares is to use the proceeds of a fresh issue of shares. A company can issue new shares (equity share or preference share) and the proceeds from such new shares can be used for redemption of preference shares).

Reasons for Issue of New Equity Shares:

A company may prefer issue of new equity shares for the following reasons:

(a) When the capital is needed permanently and it makes sense to issue Equity Shares in place of Redeemable Preference Shares.

(b) When the balance of profit, which would otherwise be available for dividend, is insufficient.

(c) When the liquidity position of the company is not good enough.

Advantages of redemption of preference shares by issue of fresh equity shares

Following are the advantages of redemption of preference shares by the issue of fresh equity shares:

(1) No cash outflow of money – now or later.

(2) New equity shares may be valued at a premium.

(3) Shareholders retain their equity interest.

Disadvantages of redemption of preference shares by issue of fresh equity shares

The disadvantages are:

(1) There will be dilution of future earnings;

(2) Share-holding in the company is changed.

Accounting Entries

1. When new shares are issued at par

   Bank Account Dr.

   To Share Capital Account

   (Being the issue of …… shares of ₹ …… each for the purpose of redemption of preference shares)

2. When new shares are issued at a premium

   Bank Account Dr.

   To Share Capital Account

   To Securities Premium Account

   (Being the issue of …… shares of ₹ …… each at a premium of ₹…… each for the purpose of redemption of preference shares)

3. When preference shares are redeemed at par

   Redeemable Preference Shares Capital Account Dr.

   To Preference Shareholders Account

4. When preference shares are redeemed at a premium

   Redeemable Preference Shares Capital Account Dr.

   Premium on Redemption of Preference Shares Account Dr.

   To Preference Shareholders Account

5. When payment is made to preference shareholders

   Preference Sharesholders Account Dr.

To Bank Account

6. For adjustment of premium on redemption

   Profit and Loss Account Dr.

   To Premium on Redemption of Preference Shares Account

Example:

XYZ Company Ltd. had 5,000, 8% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹10 each fully paid up at par. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

In the books of XYZ Company Ltd.

Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c To Equity Share Capital A/c (Being the issue of 50,000 Equity Shares of ₹10 each at par for the purpose of redemption of preference shares, as per Board Resolution No. ….. dated ……)	Dr.	5,00,000	5,00,000
	8% Redeemable Preference Share Capital A/c To Preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)	Dr.	5,00,00000	5,00,000
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr.	5,00,000	5,00,000

7.4.2 Redemption of Preference Shares by Capitalisation of undistributed Profits

Another method for redemption of preference shares, as per the Companies Act, is to use the distributable profits. When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by debiting the distributable profit. In other words, some of the distributable profits are kept aside to ensure that it can never be distributed to shareholders as dividend.

Advantages of redemption of Preference by capitalisation of undistributed profits:

The advantages of redemption of preference shares by capitalisation of undistributed profits are:

(1) No change in the percentage of equity share-holding of the company;

(2) Surplus funds can be used.

Disadvantages of redemption of preference shares by capitalisation of undistributed profits

The disadvantages of redemption of preference shares by capitalisation of undistributed profits is that there may be a reduction in liquidity.

Accounting Entries

1. When shares are redeemed at par

   Redeemable Preference Shares Capital Account Dr.

   To Preference Shareholders Account

   (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)

2. When shares are redeemed at a premium

   Redeemable Preference Shares Capital Account Dr.

   Premium on Redemptions of Preference Shares Account Dr.

   To Preference Shareholders Account

   (Being the amount payable on redemption transferred to Preference Shareholders Account)

3. When payment is made to preference shareholders

   Preference Shareholders Account Dr.

   To Bank Account

   (Being the payment of preference shareholders as per terms)

4. For adjustment of premium of redemption

   Profit and Loss Account Dr.

   To Premium on Redemption of Preference Shares Account

(Being the premium on redemption adjusted against profit

and Loss Account)

5. For transferring nominal amount of shares redeemed to Capital

Redemption Reserve Account

General Reserve Account Dr.

Profit and Loss Account Dr.

To Capital Redemption Reserve Account

(Being the amount transferred to Capital Redemption Reserve

Account as per the requirement of the Act)

Example:

The following are the extracts from the Balance Sheet of ABC Ltd. as on 31st December, 2017.

Share capital: 40,000 Equity Shares of ₹10 each fully paid – ₹4,00,000; 1,000 10% Redeemable preference shares of ₹100 each fully paid – ₹1,00,000

Reserve & Surplus; Capital Reserve – ₹50,000; Securities Premium – ₹50,000; General reserve – ₹75,000; Profit and Loss Account – ₹35,000

On 1st January 2019, the Board of Directors decided to redeem the preference shares at par by utilisation of reserve.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Solution:

In the books of ABC Limited

Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
2012				
Jan 1	10% Redeemable Preference Share Capital A/c	Dr.	1,00,000	
	To Preference Shareholders' A/c			1,00,000

	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr.	1,00,000	 1,00,000
	General Reserve A/c Profit & Loss A/c To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)	Dr.	75,000 25,000	 1,00,000

Note: Securities premium and capital reserve cannot be utilised for transfer to Capital Redemption Reserve.

7.4.3 Redemption of Preference Shares by Combination of Fresh Issue and Capitalisation of Undistributed Profits

A company can redeem the preference shares partly from the proceeds from new issue and partly out of profits. In order to fill in the gap between the face value of shares redeemed and the proceeds of new issue, a transfer should be made from distributable profits (Profit & Loss Account, General Reserve and other Free Reserves) to Capital Redemption Reserve Account.

Formula:

(i) Amount to be Transferred to Capital Redemption Reserve

	₹
Face value of shares redeemed	***
Less: Proceeds from new issue	***
	***

(ii) Proceeds to be collected from New Issue

	₹
Face value of shares redeemed	***
Less: Profits available for distribution as dividend	***

***

Example:

ABC Limited had, 3000, 12% Redeemable Preference Shares of ₹100 each, fully paid up. The company had to redeem these shares at a premium of 10%.

It was decided by the company to issue the following:

(i) 25,000 Equity Shares of ₹10 each at par,

(ii) 1,000 14% Debentures of ₹100 each.

The issue was fully subscribed and all amounts were received in full. The payment was duly made. The company had sufficient profits. Show Journal Entries in the books of the company.

Solution

In the books of ABC Limited

Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c To Equity Share Capital A/c (Being the issue of 25,000 equity shares of ₹ 10 each at par as per Board's resolution No….. dated ……)	Dr.	2,50,000	 2,50,000
	Bank A/c To 14% Debenture A/c (Being the issue of 1,000 Debentures of ₹ 100 each as per Board's resolution No….. dated ……)	Dr.	1,00,000	 1,00,000
	12% Redeemable Preference Share Capital A/c Premium on Redemption of Preference Shares A/c To Preference Shareholders A/c (Being the amount payable on redemption transferred to Preference Shareholders Account)	Dr. Dr.	3,00,000 30,000	 3,30,000
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr.	3,30,000	 3,30,000
	Profit & Loss A/c To Premium on Redemption of Preference Shares A/c	Dr.	30,000	 30,000

	(Being the adjustment of premium on redemption against Profits & Loss Account)			
	Profit & Loss A/c To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)	Dr.	50,000	 50,000

Working Note:

Amount to be transferred to Capital Redemption Reserve Account

Face value of shares to be redeemed	3,00,000
Less: Proceeds from new issue	(2,50,000)
Total Balance	50,000

7.5 Check Your Progress

A. State whether the following statements are True or False

1. Redemption of debentures means repayment of due amount of debentures to the debenture holders.
2. Debentures can be redeemed only out of profits.
3. Debenture Redemption Reserve is created before commencing redemption of debentures.
4. A company can purchase its debentures from the market for redemption purpose.

B. Fill in the blanks

1. Debentures can be redeemed out of capital and ______________.
2. DRR stands for__________________________.
3. Profit on redemption of debentures account is transferred to_____________________.
4. Premium payable on redemption of debentures is a _________________.

7.6 Summary

Redemption of debentures means repayment of the due amount of debentures to the debenture holders on due date. Generally, debentures are redeemed on due date but in some cases, the debentures can be redeemed before the due date if the terms of issue allowed. Redemption of debentures may be done in instalments i.e., by draw of lots or by purchase from the open market for cancellation or by conversion into shares or new debentures. Time of redemption, amount of redemption and sources of finance for the redemption of debentures must be kept in mind at the time of redemption of debentures. Amount required for the redemption of debentures may be managed by the company from the following sources:

- The proceeds of fresh issue of shares and debentures
- Out of Capital
- Out of profits

The methods of redemption of debentures may be any out of the following:

- Lump-sum payment at the end of fixed period.
- Redemption of Debentures in instalments
- By the purchase of own debenture in the open market.
- By conversion into shares.

7.7 Keywords

Redemption of Debentures: Repayment of the due amount of debentures on due date to the debenture holders.

Fully Convertible Debentures: Debentures whose full amount is convertible into equity shares of the company.

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

Maturity Date: Date when repayment takes place and generally printed on the certificates**.**

Reserve: The portion of earnings appropriated by the management for a general or specific purpose.

7.8 Self-Assessment Test

1. What do you mean by Redemption of Debentures? Explain the sources of finance for redemption of debentures.
2. Discuss the methods and accounting treatment of redemption of debentures in detail.
3. What are Preference Shares? Explain the provisions of Companies Act regarding preference shares.
4. What do you mean by redemption of preference shares? Also explain accounting treatment of redemption of preference shares.

7.9 Answers to Check Your Progress

A. Check Your Progress

1. True
2. False
3. True
4. True

B. Check Your Progress

1. Out of Profits
2. Debenture Redemption Reserve
3. Capital Reserve
4. Capital Loss

7.10 References/Suggested Readings

- Arula Nandam M.A. & Raman K.S.,**Advanced Accountancy**, Himalaya Publishing House, Delhi.
- Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.
- Gupta R.L. and RadhaSwamyM.,**Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
- Paul S.K.R,.**Advanced Accountancy**, New Central Book Agency, Calcutta.
- Shukla M.C. &Grewal S.,**Advanced Accounts,** S. Chand &Company Ltd, New Delhi.
- Study material of Institute of Chartered Accountant of India (ICAI), New Delhi.

Subject: Corporate Accounting	
Course Code: **BCOM 301**	Author: **Prof. Suresh K. Mittal**
Lesson No: **8**	
FINAL ACCOUNTS OF COMPANIES	

Structure

8.0 Learning Objectives

After going through this chapter, you should be able-

To know the meaning of financial statements.

To understand the meaning and preparation of Trading Account, Manufacturing Account, Profit and Loss Account, and Balance Sheet

To know the meaning of Adjustments and Accounting treatment of the same.

8.1 Introduction

The transactions of a business enterprise for the accounting period are first recorded in the books of original entry, then posted therefrom into the ledger and lastly tested as to their arithmetical accuracy with the help of trial balance. After the preparation of the trial balance, every businessman is interested in knowing about two more facts. They are: (i) Whether he has earned a profit or suffered a loss during the period covered by the trial balance, and (ii) Where does he stand now? In other words, what is his financial position?

For the above said purposes, the businessman prepares financial statements for his business i.e. he prepares the Trading and Profit and Loss Account and Balance Sheet at the end of the accounting period. These financial statements are popularly known as final accounts. The preparation of financial statements depends upon whether the business concern is a trading concern or manufacturing concern. If the business concern is a trading concern, it has to prepare the following accounts along with the Balance Sheet: (i) Trading Account; and (ii) Profit and Loss Account.

But, if the business concern is a manufacturing concern, it has to prepare the following accounts along with the Balance Sheet: (i) Manufacturing Account; (ii) Trading Account; and (iii) Profit and Loss Account.

Trading Account is prepared to know the gross profit or gross loss. Profit and Loss Account discloses net profit or net loss of the business. Balance sheet shows the financial position of the business on a given date. For preparing final accounts, certain accounts representing incomes or expenses are closed either by transferring to Trading Account or Profit and Loss Account. Any Account which cannot find a place in any of these two accounts goes to the Balance Sheet.

8.2 Trading account & Manufacturing account

After the preparation of trial balance, the next step is to prepare Trading Account. Trading Account is one of the financial statements which show the result of buying and selling of goods and/or services during an accounting period. The main objective of preparing the Trading Account is to ascertain gross profit or gross loss during the accounting period. Gross Profit is said to have made when the sale proceeds exceed the cost of goods sold. Conversely, when sale proceeds are less than the cost of goods sold, gross loss is incurred. For the purpose of calculating cost of goods sold, we have take into consideration opening stock, purchases, direct expenses on purchasing or manufacturing the goods and closing stock. The balance of this account i.e. gross profit or gross loss is transferred to the Profit and Loss Account. The specimen of a Trading Account is given below:

TRADING ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 2018

Particulars	**Amount ₹**	**Particulars**	**Amount ₹**
To Opening Stock		By Sales	
To Purchases		*Less* Sales Returns	
Less Purchases Returns		By Closing Stock	
To Direct Expenses:		By Gross Loss	
To Carriage Inward		transferred to	
To Wages		P & L A/c	
To Fuel, Power and Lighting			
To Expenses			
To Manufacturing Expenses			
To Coal, Water and Gas			
To Motive Power			
To Octroi			
To Import Duty			
To Custom Duty			
To Consumable Stores			
To Freight and Insurance			
To Royalty on manufactured			

To Goods To Packing charges To Gross Profit transferred to P & L A/c			

8.2.1 Important points regarding Trading Account

1. Stock

The term 'stock' includes goods lying unsold on a particular date. The stock may be of two types:

(a) Opening stock

(b) Closing stock

Opening stock refers to the closing stock of unsold goods at the end of previous accounting period which has been brought forward in the current accounting period. This is shown on the debit side of the Trading Account.

Closing stock refers to the stock of unsold goods at the end of the current accounting period. Closing stock is valued either at cost price or at market price whichever is less. Such valuation of stock is based on the principle of conservatism which lays down that the expected profit should not be taken into account but all possible losses should be duly provided for.

Closing stock is an item which is not generally available in the trial balance. If it is given in Trial Balance, it is not to be shown on the credit side of Trading Account but appears only in the Balance Sheet as an asset. But if it is given outside the trial balance, it is to be shown on the credit side of the Trading Account as well as on the asset side of the Balance Sheet.

2. Purchases

Purchases refer to those goods which have been bought for resale. It includes both cash and credit purchases of goods. The following items are shown by way of deduction from the amount of purchases:

(a) Purchases Returns or Return Outwards.

(b) Goods withdrawn by proprietor for his personal use.

(c) Goods received on consignment basis or on approval basis or on hire purchase.

(d) Goods distributed by way of free samples.

(e) Goods given as charity.

3. Direct Expenses

Direct expenses are those expenses which are directly attributable to the purchase of goods or to bring the goods in saleable condition. Some examples of direct expenses are as under:

(a) Carriage Inward: Carriage paid for bringing the goods to the godown is treated as carriage inward and it is debited to Trading Account.

(b) Freight and insurance: Freight and insurance paid for acquiring goods or making them saleable is debited to Trading Account. If it is paid for the sale of goods, then it is to be charged (debited) to Profit and Loss Account.

(c) Wages: Wages incurred in a business is direct, when it is incurred on manufacturing or merchandise or on making it saleable. Other wages are indirect wages. Only direct wages are debited to the Trading Account. Other wages are debited to the Profit and Loss Account. If it is not mentioned whether wages are direct or indirect, it should be assumed as direct and should appear in the Trading Account.

(d) Fuel, Power and Lighting Expenses: Fuel and power expenses are incurred for running the machines. Being directly related to production, these are considered as direct expenses and debited to Trading Account. Lighting expenses of factory is also charged to Trading Account, but lighting expenses of administrative office or sales office are charged to Profit and Loss Account.

(e) Octroi: When goods are purchased within municipality limits, generally octroi duty has to be paid on it. It is debited to Trading Account.

(f) Packing Charges: There are certain types of goods which cannot be sold without a container or proper packing. These form a part of the finished product. One example is ink, which cannot be sold without a bottle. These types of packing charges are debited to Trading Account. But if the goods are packed for their safe despatch to customers, i.e. packing meant for transportation or fancy packing meant for advertisement will appear in the Profit and Loss Account.

(g) Manufacturing Expenses: All expenses incurred in manufacturing the goods in the factory such in factory rent, factory insurance etc. are debited to Trading Account.

(h) Royalties: These are the payments made to a patentee, author or landlord for the right to use his patent, copyright or land. If royalty is paid on the basis of production, it is debited to Trading Account and if it is paid on the basis of sales, it is debited to Profit and Loss Account.

4. Sales

Sales include both cash and credit sales of those goods which were purchased for resale purposes. Some customers might return the goods sold to them (called sales return) which are deducted from the sales in the inner column and net amount is shown in the outer column. While ascertaining the amount of sales, the following points need attention:

(a) If a fixed asset such as furniture, machinery etc. is sold, it should not be included in sales.

(b) Goods sold on consignment or on hire purchase or on sale or return basis should be recorded separately.

(c) If goods have been sold but not yet despatched, these should not be shown under sales but are to be included in closing stock.

(d) Sales of goods on behalf of others and forward sales should also be excluded from sales.

8.2.2 Closing entries for Trading Account

The journal entries necessary to transfer opening stock, purchases, sales and returns to the Trading Account are called closing entries, as they serve to close these accounts. These are as follows:

1. For transfer of opening stock, net purchases and direct expenses to Trading A/c.

Trading A/c Dr.

To Stock (Opening) A/c

To Purchases A/c

To Direct Expenses A/c

(Being opening stock, purchases and direct expenses transferred to Trading Account)

2. For transfer of net sales and closing stock to Trading A/c

Sales A/c Dr.

Stock (Closing) A/c Dr.

To Trading A/c

(Being sales, closing stock transferred to Trading Account)

3. (a) For Gross Profit

Trading A/c Dr.

To Profit & Loss A/c

(Being gross profit transferred to Profit and Loss Account)

(b) For Gross Loss

Profit & Loss A/c Dr.

To Trading A/c

(Being gross loss transferred to Profit and Loss Account)

Illustration 1: From the following balances extracted from the books of Mr. Bansi Lal, prepare the Trading Account for the year ending 31st March, 2018.

Purchases	42,500	Wages	5,000
Mfg. expenses	1,950	Op. Stock	10,000
Sales	67,500	Sales returns	50
Carriage inwards	100	Purchases returns	200
Freight and duty	5,000		
Stores consumed	200		
Power	300		

The value of stock unsold is ₹ 12,000.

Solution

TRADING ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 2018

To Opening stock		10,000	By Sales	67,500	
To Purchases	42,500		*Less* returns	50	67,450

Less returns	200	42,300	By Closing Stock		12,000
To Manufacturing exp.		1,950			
To Carriage inwards		100			
To Freight and duty		5,000			
To Stores consumed		200			
To Power		300			
To Wages		5,000			
To Gross Profit transferred To Profit & Loss A/c		14,600			
		79,450			79,450

8.2.3 Manufacturing account

The concern which are engaged in the conversion of raw materials into finished goods, are interested to knowing the cost of production of the goods produced. The cost of the goods produced cannot be obtained from the Trading Account. So, it is desirable to prepare a Manufacturing Account prior to be preparation of the Trading account with the object of ascertaining the cost of goods produced during the accounting period.

The proforma of Manufacturing Account is given as under:

MANUFACTURING ACCOUNT

FOR THE YEAR ENDING..................

Dr. Cr.

	₹		₹
To Work-in process (Opening)		By Work-in-process (Closing)	
To Raw Materials consumed:		By Sale of Scrap	
Opening Stock		By Cost of Production of finished goods during the period transferred to the Trading Account	
Add Purchases of Raw Materials			
Less Closing Stock of Raw Materials			

To Direct or Productive Wages To Factory Overheads: Power & Fuel Repairs of Plant Depreciation on Plant Factory Rent			

The Trading Account in case of manufacturers will appear as follows:

TRADING ACCOUNT

FOR THE YEAR ENDING.............

Dr. Cr.

	₹		₹
To Opening Stock of Finished Goods		By Sales *less* Returns	
To Cost of Production of finished goods transferred from Manufacturing Account		By Closing Stock of Finished goods	
		By Gross Loss transferred to Profit and Loss A/c	
To Purchases of Finished Goods *less* Returns			
To Carriage Charges on goods purchased			
To Gross Profit transferred to Profit and Loss A/c			

The gross profit or loss shown by the Trading Account will be taken to the Profit and Loss Account which will be prepared in the usual way as explained in the following pages.

Important Points Regarding Manufacturing Account

1. Raw Materials Consumed

The cost of raw materials consumed to be included in the debit side of the Manufacturing Account shall be calculated as follows:

		₹
Opening Stock of raw materials	....	
Add Purchases of raw materials	....	....
Less Purchase return of raw materials		....
Less Closing stock of raw materials		....
Cost of raw material consumed		

2. Direct Expenses

The expenses and wages that are directly incurred in the process of manufacturing of goods are included under this head.

3. Factory Overheads

The term "overheads" includes indirect material, indirect labour and indirect expenses. Therefore, the term "factory overheads" stands for all factory indirect material, indirect labour and indirect expenses. Examples of factory overheads are: rent for the factory, depreciation of the factory machines and insurance of the factory, etc.

4. Cost of Production

Cost of production is computed by deducting from the total of the debit side of the Manufacturing Account, the total of the various items appearing on the credit side of the Manufacturing Account.

Difference between Trading Account and Manufacturing Account

	Manufacturing Account	**Trading Account**
1.	Manufacturing account is prepared to find out the cost of goods produced.	Trading Account is prepared to find out the Gross Profit/Gross Loss.
2.	The balance of the manufacturing Account is transferred to the Trading Account.	The balance of the Trading account is transferred to the Profit and Loss Account.
3.	Sale of crap is shown in the Manufacturing Account.	Sale of scrap is not shown in the Trading Account.
4.	Stocks of raw materials and work-in-progress are shown in the Manufacturing Account.	Stocks of finished goods are shown in the Trading Account.

5.	Manufacturing Account is a part of the Trading account.	Trading Account is a part of the Profit and Loss Account.

8.3 Profit and loss account & Balance sheet

Trading Account results in the gross profit/loss made by a businessman on purchasing and selling of goods. It does not take into consideration the other operating expenses incurred by him during the course of running the business. Besides this, a businessman may have other sources of income. In order to ascertain the true profit or loss which the business has made during a particular period, it is necessary that all such expenses and incomes should be considered. Profit and Loss Account considers all such expenses and incomes and gives the net profit made or net loss suffered by a business during a particular period. All the indirect revenue expenses and losses are shown on the debit side of the Profit and Loss Account, where as all indirect revenue incomes are shown on the credit side of the Profit and Loss Account.

Profit and Loss Account measures net income by matching revenues and expenses according to the accounting principles. Net income is the difference between total revenues and total expenses. In this connection, we must remember that all the expenses, for the period are to be debited to this account - whether paid or not. If it is paid in advance or outstanding, proper adjustments are to be made (Discussed later). Likewise all revenues, whether received or not are to be credited. Revenue if received in advance or accrued but not received, proper adjustment is required.

A proforma of the Profit and Loss Account showing probable items therein is as follows:

PROFIT AND LOSS A/C

FOR THE YEAR ENDED....................

	₹		₹
To Gross Loss b/d		By Gross Profit b/d	
To *Selling and Distribution Expenses*:		By *Other Income*:	
Advertisement		Discount received	
Travellers' Salaries		Commission received	
Expenses & Commission		By Non-trading Interest:	
Godown Rent		Bank Interest	
Export Expenses		Rent of property let-out	
Carriage Outwards		Dividend from shares	

Bank Charges		By *Abnormal Gains*:	
Agent's Commission		Profit on sale of machinery	
Upkeep of Motor Lorries		Profit on sale of investment	
To *Management Expenses*:		By Net Loss transferred to Capital Account	
Rent, Rates and Taxes			
Heating and Lighting			
Office Salaries			
Printing & Stationary			
Postage & Telegrams			
Telephone Charges			
Legal Charges			
Audit Fees			
Insurance			
General Expenses			
To *Depreciation and Maintenance*:			
Depreciation			
Repairs & Maintenance			
To *Financial Expenses*:			
Discount Allowed			
Interest on Loans			
Discount on Bills			
To *Abnormal Losses*:			
Loss by fire (not covered by Insurance)			
Loss on Sale of Fixed Assets			
Loss on Sale of Investments			
To Net profit transferred to Capital A/c			

8.3.1 Important points in Profit and Loss Account

1. Selling and Distribution Expenses

These expenses are incurred for promoting sales and distribution of sold goods. Example of such expenses are godown rent, carriage outwards, advertisement, cost of after sales service, selling agents commission, etc.

2. Management Expenses

These are the expenses incurred for carrying out the day-to-day administration of a business. Expenses, under this head, include office salaries, office rent and lighting, printing and stationery and telegrams, telephone charges, etc.

3. Maintenance Expenses

These expenses are incurred for maintaining the fixed assets of the administrative office in a good condition. They include repairs and renewals, etc.

4. Financial Expenses

These expenses are incurred for arranging finance necessary for running the business. These include interest on loans, discount on bills, etc.

5. Abnormal Losses

There are some abnormal losses that may occur during the accounting period. All types of abnormal losses are treated as extra ordinary expenses and debited to Profit and Loss Account. Examples are stock lost by fire and not covered by insurance, loss on sale of fixed assets, etc.

Following are the expenses not to appear in the Profit and Loss Account:

(i) Domestic and household expenses of proprietor or partners.

(ii) Drawings in the form of cash, goods by the proprietor or partners.

(iii) Personal income tax and life insurance premium paid by the firm on behalf of proprietor or partners.

6. Gross Profit

This is the balance of the Trading Account transferred to the Profit and Loss Account. If the Trading Account shows a gross loss, it will appear on the debit side.

7. Other Income

During the course of the business, other than income from the sale of goods, the business may have some other income of financial nature. The examples are discount or commission received.

8. Non-trading Income

Such incomes include interest on bank deposits, loans to employees and investment in debentures of companies. Similarly, dividend on investment in shares of companies and units of mutual funds are also known as non-trading incomes and shown in Profit and Loss Account.

9. Abnormal Gains

There may be capital gains arising during the course of the year, e.g., profit arising out of sale of a fixed asset. Such profit is shown as a separate income on the credit side of the Profit and Loss Account.

8.3.2 Closing entries for Profit and Loss Account

(i) For transfer of various expenses to Profit & Loss A/c

Profit and Loss A/c Dr.

To Various Expenses A/c

(Being various indirect expenses transferred to Profit and Loss Account)

(ii) For transfer of various incomes and gains to Profit & Loss A/c

Various Incomes & Gains A/c Dr.

To Profit & Loss A/c

(Being various incomes & gains transferred to Profit and Loss Account)

(iii) (a) For Net Profit

Profit & Loss A/c Dr.

To Capital A/c

(Being Net Profit transferred to capital)

(b) For Net Loss

Capital A/c Dr

To Profit & Loss A/c

(Being Net Loss transferred to Capital Account)

Illustration 2: From the following balances extracted at the close of year ended 31 March, 2018, prepare Profit and Loss Account as at that date:

	₹		₹
Gross Profit	51,000	Discount (Dr.)	500
Carriage Outward	2,500	Apprentice Premium (Cr.)	1,500
Salaries	5,500	Printing & Stationary	250
Rent	1,100	Rates & Taxes	350
Fire Insurance Premium	900	Travelling Expenses	200
Bad Debts	2,100	Sundry Trade Expenses	300
Commission Received	1,000	Discount allowed by Creditors	800

Solution

PROFIT & LOSS ACCOUNT OF M/S..............................

FOR THE YEAR ENDED 31ST MARCH, 2018

Dr. Cr.

Particular	**₹**	**Particular**	**₹**
To Carriage Outward	2,500	By Gross Profit b/d	51,000
To Salaries	5,500	By Apprentice Premium	1,500
To Rent	1,100	By Discount by Creditors	800
To Fire Insurance Premium	900	By Commission	1,000
To Bad Debts	2,100		
To Discount	500		
To Printing & Stationary	250		
To Rent & Taxes	350		
To Travelling Expenses	200		
To Sundry Trade Expenses	300		
To Net Profit transferred to Capital A/c	40,600		
	54,300		54,300

Distinction between Trading Account and Profit and Loss Account

	Profit and Loss Account	Trading Account
1.	Profit and Loss Account is prepared as a main account.	Trading Account is prepared as a part or section of the Profit and Loss Account.
2.	Indirect expenses are taken in Profit and Loss Account.	Direct Expenses are taken in Trading Account.
3.	Net Profit or Net Loss is ascertained from the Profit and Loss Account.	Gross Profit or Gross Loss is ascertained from Trading Account.
4.	The balance of the Profit and Loss Account i.e. Net Profit or Net Loss is transferred to proprietor's Capital Account.	The Balance of the Trading Account i.e. Gross Profit or Gross Loss is transferred to the Profit and Loss Account.
5.	Items of accounts written in the Profit and Loss Account are much more as compared to the Trading Account.	Items of account written in the Trading Account are few as compared the Profit and Loss Account.

8.3.3 Balance sheet

A Balance Sheet is a statement of financial position of a business concern at a given date. It is called a Balance Sheet because it is a sheet of balances of those ledger accounts which have not been closed till the preparation of Trading and Profit and Loss Account. After the preparation of Trading and Profit and Loss Account the balances left in the trial balance represent either personal or real accounts. In other words, they either represent assets or liabilities existing on a particular date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company.

A Balance Sheet is also described as a "Statement showing the Sources and Application of Capital". It is a statement and not an account and prepared from real and personal accounts. The left hand side of the Balance Sheet may be viewed as description of the sources from which the business has obtained the capital with which it currently operates and the right hand side as a description of the form in which that capital is invested on a specified date.

Characteristics

The characteristics of a Balance Sheet are summarised as under:

(a) A Balance Sheet is only a statement and not an account. It has no debit side or credit side. The headings of the two sides are 'Assets' and 'Liabilities'.

(b) A Balance Sheet is prepared at a particular point of time and not for a particular period. The information contained in the Balance Sheet is true only at that particular point of time at which it is prepared.

(c) A Balance Sheet is a summary of balances of those ledger accounts which have not been closed by transfer to Trading and Profit and Loss Account.

(d) A Balance Sheet shows the nature and value of assets and the nature and the amount of liabilities at a given date.

8.3.3.1 Classification of assets and liabilities

Assets

Assets are the properties possessed by a business and the amount due to it from others. The various types of assets are:

(a) Fixed Assets

All assets that are acquired for the purpose of using them in the conduct of business operations and not for reselling to earn profit are called fixed assets. These assets are not readily convertible into cash in the normal course of business operations. Examples are land and building, furniture, machinery, etc.

(b) Current Assets

All assets which are acquired for reselling during the course of business are to be treated as current assets. Examples are cash and bank balances, inventory, accounts receivables, etc.

(c) Tangible Assets

There are definite assets which can be seen, touched and have volume such as machinery, cash, stock, etc.

(d) Intangible Assets

Those assets which cannot be seen, touched and have no volume but have value are called intangible assets. Goodwill, patents and trade marks are examples of such assets.

(e) Fictitious Assets

Fictitious assets are not assets at all since they are not represented by any tangible possession. They appear on the asset side simply because of a debit balance in a particular account not yet written off e.g. provision for discount on creditors, discount on issue of shares etc.

(f) Wasting Assets

Such assets as mines, quarries etc. that become exhausted or reduce in value by their working are called wasting assets.

(g) Contingent Assets

Contingent assets come into existence upon the happening of a certain event or the expiry of a certain time. If that event happens, the asset becomes available otherwise not, for example, sale agreement to acquire some property, hire purchase contracts etc.

In practical no reference is made to contingent assets in the Balance Sheet. At the most, they may form part of notes to the Balance Sheet.

Liabilities

A liability is an amount which a business is legally bound to pay. It is a claim by an outsider on the assets of a business. The liabilities of a business concern may be classified as:

(a) Long Term Liabilities

The liabilities or obligations of a business which are not payable within the next accounting period but will be payable within next five to ten years are known as long term liabilities. Public deposits, debentures, bank loan are the examples of long term liabilities.

(b) Current Liabilities

All short term obligations generally due and payable within one year are current liabilities. This includes trade creditors, bills payable etc.

(c) Contingent Liabilities

A contingent liability is one which is not an actual liability. They become actual on the happenings of some event which is uncertain. In other words, they would become liabilities in the future provided the contemplated event occurs. Since such a liability is not actual liability it is not shown in the Balance Sheet. Usually it is mentioned in the form of a footnote below the Balance Sheet.

8.3.3.2 Marshalling of assets and liabilities

The arrangement of assets and liabilities in a particular order is called marshalling of the Balance Sheet. Assets and liabilities can be arranged in the Balance Sheet into two ways:

(a) In order of liquidity.

(b) In order of permanence.

When assets and liabilities are arranged according to their reliability and payment preferences, such an order is called liquidity order. Such arrangement is given below in Balance Sheet (a). When the order is reversed from that what is followed in liquidity, it is called order of permanence. In other words, assets and liabilities are listed in order of permanence. This order of Balance Sheet is given below in Balance Sheet (B).

BALANCE SHEET (A)

(IN ORDER OF LIQUIDITY)

Liabilities	**₹**	**Assets**	**₹**
Bills payable		Cash in hand	
Loans		Cash at bank	
Sundry creditors		Investments	
Outstanding expenses		Sundry debtors	
Reserves		Bills receivable	
Capital		Stock-in-trade	
Add Net Profit		Loose tools	
Add Interest		Fixtures and fittings	
Less Drawings		Plant and machinery	
		Building	
		Land	

		Goodwill	

BALANCE SHEET (B)

(IN ORDER OF PERMANENCE)

Liabilities	**₹**	**Assets**	**₹**
Capital *Add* Net Profit *Add* Interest *Less* Drawings Reserves Outstanding expenses Sundry creditors Loans Bills payable		Goodwill Land Building Plant and machinery Fixtures and fittings Loose tools Stock-in-trade Bills receivable Sundry debtors Investments Cash at bank Cash in hand	

Illustration 3: The following balances are extracted from the books of Kautilya & Co. on 31st March, 2018. You are required prepare the Trading and Profit and Loss Account and a Balance Sheet as on that date.

	₹		**₹**
Stock on April, 1	500	Commission (Cr.)	200
B/R	2,250	Returns Outwards	250
Purchases	19,500	Trade Expenses	100
Wages	1,400	Office Fixtures	500
Insurance	550	Cash in Hand	250
Sundry Debtors	15,000	Cash at Bank	2,375
Carriage Inwards	400	Rent & Taxes	550
Commission (Dr.)	400	Carriage Outwards	725
Interest on Capital	350	Sales	25,000
Stationary	225	Bills Payable	1,500

Returns Inwards	650	Creditors Capital	9,825 8,950

The closing stock was valued at ₹ 12,500.

Solution

TRADING & PROFIT AND LOSS A/C OF KAUTILYA & CO.

FOR THE YEAR ENDED 31ST MARCH, 2018

Particular		**₹**	**Particular**	**₹**	**₹**
To Opening stock		500	By Sales	25,000	
To Purchases	19,500		Less returns	650	24,350
Less returns	250	19,250	By Closing Stock		12,500
To Wages		1,400			
To Carriage Inwards		400			
To Gross Profit c/d		15,300			
		36,850			36,850
To Insurance		550	By Gross Profit b/d		15,300
To Commission		400	By Commission		200
To Interest on Capital		350			
To Stationary		225			
To Trade Expenses		100			
To Rent and Taxes		550			
To Carriage Outwards		725			
To Net Profit transferred to Capital A/c		12,600			
		15,500			15,500

BALANCE SHEET OF KAUTILYA & CO

AS ON 31ST MARCH, 2018

Liabilities		**Amount (₹)**	**Assets**	**Amount (₹)**
Creditors		9,825	Cash in Hand	250
Bills Payable		1,500	Cash at Bank	2,375
Capital	8,950		Bill Receivable	2,250
Add Net Profit	12,600	21,550	Stock	12,500
			Sundry Debtors	15,000

		Office Fixtures	500
	32,875		32,875

8.4 Adjustments

While preparing Trading and Profit and Loss Account one point that must be kept in mind is that expenses and incomes for the full trading period are to be taken into consideration. For example, if an expense has been incurred but not paid during that period, liability for the unpaid amount should be created before the accounts can be said to show the profit or loss. All expenses and incomes should properly be adjusted through entries. These entries which are passed at the end of the accounting period are called adjusting entries. Some important adjustments which are to be made at the end of the accounting year are discussed in the following pages:

1. Closing Stock

This is the stock which remained unsold at the end of the accounting period. Unless it is considered while preparing the trading account, the gross profit shall not be correct. Adjusting entry for closing stock is as under:

Closing Stock Account Dr.

To Trading Account

(Being closing stock brought in to books)

Treatment in final accounts

(i) Closing stock is shown on the credit side of Trading Account.

(ii) At same value it will be shown as an asset in the Balance Sheet.

2. Outstanding Expenses

Those expenses which have become due and have not been paid at the end of the accounting year, are called outstanding expenses. For example, the businessman has paid rent only for 4 months instead of one year. This means 8 months' rent is outstanding. In order to bring this fact into books of accounts, the following adjustment entry will be passed at the end of the year:

Rent A/c Dr.

To Outstanding Rent A/c

(Being rent outstanding for 8 months)

The two fold effect of the above adjustment will be (i) the amount of outstanding rent will be added to the rent on the debit side of Profit and Loss Account, and (ii) outstanding rent will be shown on the liability side of the Balance Sheet.

3. Prepaid Expenses

There are certain expenses which have been paid in advance or paid for the future period which is not yet over or not yet expired. The benefit of such expenses is to be enjoyed during the next accounting period. Since, such expenses have already been paid, they have also recorded in the books of account of that period for which they do not relate. For example, insurance premium paid for one year ₹ 3,600 on 1st July, 2017. The final accounts are prepared on 31st March, 2018. The benefit of the insurance premium for the period from 1st April to 30th June, 2018 is yet to expire. Therefore, the insurance premium paid for the period from 1st April 2018 to 30th June, 2018, i.e. for 3 months, shall be treated as "Prepaid Insurance Premium".

The adjustment entry for prepaid expenses is as under:

Prepaid Expenses Account Dr.

To Expenses Account

(Being the adjustment entry for prepaid expenses)

The amount of prepared expenses will appear as an asset in the Balance Sheet while amount of appropriate expense account will be shown in the Profit and Loss Account by way of deduction from the said expense.

4. Accrued Income

Accrued income means income which has been earned during the current accounting year and has become due but not received by the end of the current accounting period. Examples of such income are income from investments, dividend on shares etc. The adjustment entry for accrued income is as under:

Accrued Income A/c Dr.

To Income A/c

(Being the adjustment entry for accrued income)

Treatment in final accounts

i) The amount of accrued income is added to the relevant item of income on the credit side of the Profit and Loss Account to increase the amount of income for the current year.

ii) The amount of accrued income is a debt due from a third party to the business, so it is shown on the assets side of the Balance Sheet.

5. Income Received in Advance

Income received but not earned during the current accounting year is called as income received in advance. For example, if building has been given to a tenant on ₹ 2,400 p.a. but during the year ₹ 3,000 has been received, then ₹ 600 will be income received in advance. In order to bring this into books of account, the following adjusting entry will be made at the end of the accounting year:

Rent A/c Dr. ₹ 600

To Rent Received in Advance A/c ₹ 600

The two-fold effect of this adjustment will be:

(i) It is shown on the credit side of Profit and Loss account by way of deduction from the income, and

(ii) It is shown on the liabilities side of the Balance Sheet as income received in advance.

6. Depreciation

Depreciation is the reduction in the value of fixed asset due to its use, wear and tear or obsolescence. When an asset is used for earning purposes, it is necessary that reduction due to its use, must be charged to the Profit and Loss account of that year in order to show correct profit or loss and to show the asset at its correct value in the Balance Sheet. There are various methods of charging depreciation on fixed assets. Suppose machinery for ₹ 10,000 is purchased on 1.1.2018, 20% p.a. is the rate of depreciation. Then ₹ 2,000 will be depreciation for the year 2018 and will be brought into account by passing the following adjusting entry:

Depreciation A/c Dr. ₹ 2,000

To Machinery A/c ₹ 2,000

The two-fold effect of depreciation will be:

(i) Depreciation is shown on the debit side of Profit and Loss Account, and

(ii) It is shown on the asset side of the Balance Sheet by way of deduction from the value of concerned asset.

7. Interest on Capital

The amount of capital invested by the trader in his business is just like a loan by the firm. Charging interest on capital is based on the argument that if the same amount of capital were invested in some securities elsewhere, the businessman would have received interest thereon. Such interest on capital is not actually paid to the businessman. Interest on capital is a gain to the businessman because it increases its capital, but it is a loss to the business concern.

Calculation of Interest on Capital

Interest is calculated on the opening balance of the capital at the given rate for the full accounting period. If some additional amount of capital has been brought in the business during the course of accounting period, interest on such additional amount of capital is calculated from the date of introduction to the end of the accounting period. The following adjustment entry is passed for allowing interest on capital:

Interest on Capital Account Dr.

To Capital Account

(Being the adjustment entry for interest on capital)

Treatment in final accounts

(i) Interest allowed on capital is an expense for the business and is debited to Profit and Loss Account, i.e. it is shown on the debit side of the Profit and Loss Account.

(ii) Such interest is not actually paid in cash to the businessman but added to his capital account. Hence, it is shown as an addition to capital on the liabilities side of the Balance Sheet.

8. Interest of Drawings

It interest on capital is allowed, it is but natural that interest on drawings should be charged from the proprietor, as drawings reduce capital. Suppose during an accounting year, drawings are ₹ 10,000 and interest on drawings is ₹ 500. In order to bring this into account, the following entry will be passed:

Drawings A/c Dr. ₹ 500

To Interest on Drawings A/c ₹ 500

The two-fold effect of interest on drawings will be:

(i) Interest on drawings will be shown on the credit side of Profit and Loss Account, and

(ii) Shown on the liabilities side of the Balance Sheet by way of addition to the drawings which are ultimately deducted from the capital.

9. Bad Debts

Debts which cannot be recovered or become irrecoverable are called bad debts. It is a loss for the business. Such a loss is recorded in the books by making following adjustment entry:

Bad Debts A/c Dr.

To Sundry Debtors A/c

(Being the adjustment entry for bad debts)

Treatment in final accounts

The Profit and Loss Account is debited with the amount of bad debts and in the Balance Sheet, the sundry debtors balance will be reduced by the same amount in the assets side.

10. Provisions for Doubtful Debts

In addition to the actual bad debts, a business unit may find on the last day of the accounting period that certain debts are doubtful, i.e., the amount to be received from debtors may or may not be received. The amount of doubtful debts is calculated either by carefully examining the position of each debtor individually and summing up the amount of doubtful debts from various debtors or it may be computed (as is usually done) on the basis of some percentage (say 5%) of debtors at the end of the accounting period. The percentage to be adopted is usually based upon the past experience of the business. The reasons for making provision for doubtful debts are two as discussed below:

(i) Loss caused by likely bad debts must be charged to the Profit and Loss of the period for which credit sales have been made to ascertain correct profit of the period.

(ii) For showing the true position of realisable amount of debtors in the Balance Sheet, i.e., provision for doubtful debts will be deducted from the amount of debtors to be shown in the balance sheet.

For example, sundry debtors on 31.12.2017 are ₹ 55,200. Further bad debts are ₹ 200. Provision for doubtful debts @ 5% is to be made on debtors. In order to bring the provision for doubtful debts of ₹ 2,750, i.e., 5% on ₹ 55,000 (55,200-200), the following entry will be made:

Profit and Loss A/c Dr. ₹ 2,750

To Provision for Doubtful Debts A/c ₹ 2,750

(Being Provision for Doubtful Debts provided)

It may be carefully noted that further bad debts (if any) will be first deducted from debtors and then a fixed percentage will be applied on the remaining debtors left after deducting further debts. It is so because percentage is for likely bad debts and not for bad debts which have been decided to be written off.

Treatment in final accounts

(i) The amount of provision for doubtful debts is a provision against a possible loss so it should be debited to Profit and Loss Account.

(ii) The amount of provision for doubtful debts is deducted from sundry debtors on the assets side of the Balance Sheet.

11. Provision for Discount on Debtors

It is a normal practice in business to allow discount to customers for prompt payment and it constitutes a substantial sum. Sometimes the goods are sold on credit to customers in one accounting period whereas the payment of the same is received in the next accounting period and discount is to be allowed. It is a prudent policy to charge this expenditure (discount allowed) to the period in which sales have been made, so a provision is created in the same manner, as in case of provision for doubtful debts i.e.

Profit and Loss Account Dr.

To Provision for discount on debtors account

(Being provision for discount on debtors provided)

Treatment in final accounts

(i) Provision for discount on debtors is a probable loss, so it should be shown on the debit side of Profit and Loss Account.

(ii) Amount of provision for discount on debtors is deducted from sundry debtors on the assets side of the Balance Sheet.

Note: Such provision is made on debtors after deduction of further bad debts and provision for doubtful debts because discount is allowable to debtors who intend to make the payment.

12. Reserve for Discount on Creditors

Prompt payments to creditors enable a businessman to earn discount from them. When a businessman receives cash discount regularly, he can make a provision for such discount since he is likely to receive the discount from his creditors in the following years also. The discount received being a profit, the provision for discount on creditors amounts to an addition to the profit.

Accounting treatment of Reserve for Discount on Creditors is just reverse of that in the case of Provision for Discount on Debtors. The adjustment entry for Reserve for Discount on Creditors is as follows:

Reserve for Discount on Creditors Account Dr.

To Profit and Loss Account

(Being the adjustment entry for discount on creditors)

Treatment in final accounts

i) Reserve for discount on creditors is shown on the credit side of Profit and Loss Account.

ii) In the liabilities side of the Balance Sheet, the reserve for discount on creditors is shown by way of deductions from Sundry Creditors.

13. Loss of Stock by Fire

In business, the loss of stock may occur due to fire. The position of the stock may be:

(a) all the stock is fully insured.

(b) the stock is partly insured.

(c) the stock is not insured at all.

It the stock is fully insured, the whole loss will be claimed from the insurance company. The following entry will be passed:

Insurance Co. A/c Dr.

To Trading A/c

(Being the adjustment entry for loss of goods charged from insurance Co.)

The value of goods lost by fire shall be shown on the credit side of the Trading Account and this is shown as an asset in the Balance Sheet.

If the stock is not fully insured, the loss of stock covered by insurance policy will be claimed from the insurance company and the rest of the amount will be loss for the business which is chargeable to Profit and Loss Account. In this case, the following entry will be passed:

Insurance Co. A/c Dr.

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for loss of goods)

The amount of goods lost by fire is credited to Trading Account, the amount of claim accepted by insurance company shall be treated as an asset in the Balance Sheet, while the amount of claim not accepted is a loss so it will be debited to Profit and Loss Account.

If the stock is not insured at all, the whole of the loss will be borne by the business and the adjusting entry shall be:

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for loss of goods)

The double effect of this entry will be (a) it is shown on the credit side of the Trading Account (b) it is shown on the debit side of the Profit and Loss Account.

14. Manager's Commission

Sometimes, in order to increase the profits of the business, manager is given some commission on profits of the business. It can be given at a certain percentage on the net profits but before charging such commission or on the net profits after charging such commission. In both the cases, the adjustment entry will be:

Profit and Loss A/c Dr.

To Commission Payable A/c

(Being the adjustment entry for manager's commission)

Treatment in final accounts

(i) The amount of managers' commission being a business expenditure is shown on the debit side of the Profit and Loss Account.

(ii) As the commission to manager has not been paid so far, commission payable would be shown as liability on the liability side of Balance Sheet.

Illustration 4: The following adjustments are to be made in the final accounts being made as on 31st March, 2018.

i) Closing Stock in hand ₹ 20,000.

ii) Salaries amounting to ₹ 1,000 outstanding.

iii) Depreciate Plant and Machinery @10%. The value of Plant and Machinery on 31st March, 2018 was at ₹ 40,000.

iv) Prepaid insurance ₹ 150.

v) Accrued income from investment ₹ 1,500.

You are required to pass adjustment entries.

Solution

JOURNAL

Date	**Particulars**		**L.F.**	**₹**	**₹**
2018					
Mar 31	Closing Stock A/c	Dr.		20,000	
	To Trading A/c			20,000	
	(Being the adjustment entry for closing stock)				
Mar 31	Salaries A/c	Dr.			1,000
	To Outstanding Salaries A/c				1,000

	(Being the adjustment entry for outstanding Salaries)			
Mar 31	Depreciation A/c Dr.		4,000	
	To Plant and Machinery A/c			4,000
	(Being the adjustment entry for Depreciation)			
Mar 31	Prepaid Insurance A/c Dr.		150	
	To Insurance A/c			150
	(Being the adjustment entry for prepaid insurance)			
Mar 31	Accrued Income A/c		1,500	
	To Income on Investment A/c			1,500
	(Being the adjustment entry for accrued income)			

Illustration 5: From the following Trial Balance of Mr. Garg as on 31st March, 2018, prepare Trading Account, Profit and Loss Account and Balance Sheet.

TRIAL BALANCE

Debit Balance	**₹**	**Credit Balance**	**₹**
Stock on 1st April, 2017	500	Capital	2,000
Purchases	1,500	Sales	3,500
Land and Building	2,000	Sunday Creditors	750
Bills Receivable	300	Commission	50
Wages	300	Bills payable	300
Machinery	800	Loan	600
Carriage Inward	100		
Carriage Outward	100		
Power	150		
Salaries	200		
Discount Allowed	30		
Drawings	100		
Insurance Premium	20		
Cash at Bank	500		
Cash in Hand	100		

Investments	500		
	7,200		7,200

Adjustments

1. Stock as on 31st March 2018 is valued at ₹ 200.
2. Provide depreciation @ 10% on Machinery and @ 5% on Land and Building.
3. Outstanding salaries amounted to ₹ 50.
4. Insurance premium is paid in advance to the extent of ₹ 10.
5. Allow interest on Capital @ 6% per annum.
6. Interest on loan @ 12% per annum is due for one year.

Solution

TRADING & PROFIT AND LOSS A/C

FOR THE YEAR ENDED 31ST MARCH, 2018

Particulars		**₹**	**Particulars**	**₹**
To Opening stock		500	By Sales	3,500
To Purchases		1,500	By Closing Stock	200
To Wages		300		
To Carriage Inward		100		
To Power		150		
To Gross Profit c/d		1,150		
		3,700		3,700
To Salaries	200		By Gross Profit b/d	1,150
Add Outstanding Salaries	50	250	By Commission	50
To Carriage Inward		100		
To Insurance Premium	20			
Less prepaid Ins.	10	10		
To Discount allowed		30		
To Depreciation on:				
Machinery	80			
Land and Building	100	180		
To Interest on Loan		72		

To Interest on Capital	120		
To Net Profit (Transferred to capital account)	435		
	1,200		1,200

BALANCE SHEET AS ON 31ST MARCH 2018

Liabilities		₹	**Assets**		₹
Capital	2,000		Land and Building	2,000	
Add Interest on Capital	120		Less Dep.	100	1,900
Add Net profit	438		Machinery	800	
	2,558		Less Dep.	80	720
Less Drawings Loan	100	2,458	Investments		500
	600		Closing stock		200
Add Interest O/S	72	672	Bills Receivable		300
Sundry Creditors		750	Cash at Bank		500
Bills payable		300	Cash in Hand		100
Outstanding Salaries		50	Prepaid Insurance		10
		4,230			4,230

8.5 Check Your Progress

A. State whether the following statements are True or False

1. Balance sheet shows the financial position of the business on a given date.
2. The main objective of preparing the Trading Account is to ascertain net profit or gross loss during the accounting period.
3. Closing stock refers to the stock of unsold goods at the end of the current accounting period.
4. Overhead includes direct material, indirect labour and indirect expenses.

B. Fill in the blanks

1. Profit and Loss Account measures net income by matching revenues and expenses according to the____________.

2. All types of abnormal losses are treated as extra ordinary expenses and debited to________.
3. A _________ is a statement of financial position of a business concern at a given date.
4. A contingent liability is one which is not an _____ liability.
5. Accrued income means income which has been earned during the current ________ and has become due but not received by the end of the current accounting period.

8.6 Summary

Every businessman is interested in knowing about two facts i.e. whether he has earned a profit or suffered losses and what is his financial position. To fulfill above said purposes, the businessman prepares financial statements for his business i.e. Trading A/c, Profit and Loss Account and Balance Sheet. Trading Account shows the result of buying and selling of goods/services during an accounting period. Profit and Loss Account considers all the indirect revenue expenses and losses and all indirect revenue incomes. If indirect revenue income exceeds indirect expenses and cases, it is called net loss. Balance Sheet is a statement of financial position of a business concern at a given date. The left hand side of the balance sheet shows the liabilities and right hand the assets of the business.

8.7 Keywords

Outstanding Expenses: An expense which has been incurred in an accounting period but for which no enforceable claim has became in that period.

Prepaid Expenses: These are expenses which has not incurred but paid in advance.

Assets: Tangible objects or intangible rights owned by an enterprise.

Bad debt: Debts owed to enterprises which are considered to be irrecoverable.

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

Provision: An amount retained by way of providing for any known liability which cannot be determined with substantial accuracy.

Reserve: The portion of earnings appropriated by the management for a general or specific purpose.

8.8 Self assessment Test

1. Distinguish between Trading Account and Profit and Loss Account. Give a specimen of Trading and Profit and Loss Account with imaginary figures.
2. What is a Balance Sheet? What do you understand by Marshalling used in the balance Sheet? Illustrate the different forms of marshalling.
3. What are closing entries? Give the closing entries which are passed at the end of the accounting period.
4. What are adjustment entries? Why are these necessary for preparing final account.
5. Prepare a Trading Account of a businessman for the year ending 31st December, 2018 from the following data:

	₹
Stock on 1.1.2018	2,40,000
Cash purchases for the year	2,08,000
Credit purchases for the year	4, 00,000
Cash sales for the year	3,50,000
Credit sales for the year	6,00,000
Purchases returns during the year	8,000
Sales returns during the year	10,000
Direct expenses incurred:	
Freight	10,000
Carriage	2,000
Import Duty	8,000
Clearing Charges	12,000
Cost of goods distributed as free samples during the year	5,000
Goods withdrawn by the trader for personal use	2,000
Stock damaged by fire during the year	13,000

The cost of unsold stock on 31st December, 2018 was ₹ 1,20,000 but its market value was ₹ 1,50,000.

6. The following Trading and Profit and Loss Account has been prepared by a junior accountant of a firm. Criticise it and redraft it correctly.

TRADING & PROFIT AND LOSS A/C

FOR THE YEAR ENDED 31ST MARCH, 2018

Particulars	**₹**	**Particulars**	**₹**
To Opening stock of raw material	7,352	By Closing stock of raw material	9,368
To Purchases	63,681	By Sales	1,70,852
To Sundry creditors	25,375	By Sundry debtors	40,659
To Carriage inwards	2,654	By Gross loss c/d	8,182
To Carriage outwards	394		
To Salaries	24,370		
To Wages	51,963		
To Rent, Rates & Taxes	3,981		
To Repairs to factory	35,68		
To Insurance	13,923		
	2,29,061		2,29,061

PROFIT & LOSS ACCOUNT

Particulars	**₹**	**Particulars**	**₹**
To Gross loss b/d	8,182	By Bank overdraft	17,681
To Interest on loans	6,180	By Interest on bank overdraft	123
To Dividend from investments	9,375	By net loss transferred to Balance Sheet	39,691
To Furniture purchases	17,681		
To Telephone charges	985		
To Electric charges	2,756		
To Depreciation- Plant &	663		

machinery To Charges general	11,673		
	57,495		57,495

7. Prepare Manufacturing, Trading and Profit & Loss Account for the year ended 31st December, 2018 and Balance Sheet as at that date of Shri S. Singh, manufacturer, from the following Trial Balance and information.

Particular	₹	Particular	₹
Advertising	1,660	Salaries Office	7,380
Bad Debts	1,210	Stock 1.1.2018	
Bank Charges	240	Raw Materials	10,460
Drawings	16,000	Finished Goods	14,760
Factory Power	7,228	Work in Progress	3,340
Furniture	1,800	Wages Factory	41,400
General Expenses: Factory	410	Debtors	21,120
Office	692	Cash in Hand	350
Insurance	1,804	Cash at Bank	7,852
Light and Heat	964	Credit Balances:	
Plant & Machinery (1.1.2018)	30,000	Bad Debts Provision	2,000
Plant & Mach. bought on 30.6.2017	4,000	Capital	70,000
Purchases	67,336	Current Account	3,246
Packing & Transport	2,170	Discount	824
Rent & Rates	2,972	Sales	1,58,348
Repairs to Plant	1,570	Creditors	12,300

Stock on 31st December, 2018 were: (a) Raw Materials ₹ 7,120; Work in Progress ₹ 3,480; Finished Goods ₹ 19,300 and Packing Materials ₹ 250. The Liabilities to be provided for: (b) Factory Power ₹ 1,124 ; (c) Rent and Rates ₹ 772; (d) Light and Heat ₹ 320; (e) General Expenses-Factory ₹ 50, Office ₹ 80. Insurance Prepaid ₹ 340. Provide Depreciation at 10% p.a.

on plant & machinery and 5% p.a. on furniture. Increase the Bad Debts Provision by ₹ 1,000. Five-Sixth of Rent and Rates, Light & Heat and Insurance are to be allotted to the Factory and one-sixth to the Office.

8. Following is the Trial Balance of Mr. Naresh for the year ended 31st March, 2017:

Particular	**Dr.**	**Cr.**
	₹	₹
Capital	-	3,50,000
Stock on 1st April, 2018	30,000	-
Sales	-	2,00,000
Carriage	4,000	-
Freight and Customs Duty	6,000	-
Purchases	1,90,000	-
Salaries	15,000	-
Income Tax	10,000	-
Sundry Debtors and Sundry Creditors	24,000	14,000
Cash at Bank	20,200	-
Cash in Hand	5,000	-
Furniture	1,800	-
Life Insurance premium	5,000	-
Sales Tax	5,000	-
Building	1,80,000	-
Drawings	68,000	-
Office Expenses	2,000	-
Discount Received	-	2,000
	5,66,000	5,66,000

Prepare Trading and Profit and Loss Account for the period ending 31st March, 2018 and a Balance Sheet as on that date after taking following information into consideration.

1. Closing stock ₹ 80,200 (including stationery stocks ₹ 200).
2. Office expenses include stationery purchased ₹ 800.
3. Sundry Debtors include ₹ 3,000 receivable from Reeta and Sundry Creditors include ₹ 1,000 payable to Reeta.
4. A sum of ₹ 5,000 has been received from a debtor as deposit which has been credited to his account.
5. ₹ 500 was written off as bad debts in previous year and this amount has been received during the current year and has been credited to Debtors Account.
6. Some employees are residing in the premises of business due to their nature of service, the rent of such portion is ₹ 1,000 per month.
7. Salaries include a sum of ₹ 500 which is advance salary.
8. On 1st April, 2017 books contain such furniture of ₹ 600 which was sold for ₹ 290 on 30th Sept., 2017 and in exchange of it a new furniture of ₹ 520 was acquired, its net invoice of ₹ 230 was recorded in purchase books.
9. Depreciate Buildings @ 5% p.a. and Furniture @ 10% p.a.
10. Goods worth ₹ 2,000 were in transit on the last day of the accounting year.

8.9 Answers To Check Your Progress

Check Your Progress A

1. True
2. False
3. True
4. False

Check Your Progress B

1. Accounting principles
2. Profit and Loss Account
3. Balance Sheet

4. Actual
5. Accounting year

8.10 References/suggested readings

1. Anthony N. Robert, "Accounting Principles", AITBS Publishers, New Delhi.
2. Aggarwal, M.P., "Analysis of Financial Statements", National Publishing House, New Delhi.
3. Ashok Banerjee, "Financial Accounting", Excel Book, New Delhi.
4. R. Narayanaswamy, "Financial Accounting", Prentice Hall of India, New Delhi.

Subject: Corporate Accounting	
Course Code: **BCOM 301**	Author: **Dr. Sushil Kumar**
Lesson No: **09**	Vetter: **Prof. M.C. Garg**
Updated By: **Prof. Suresh Kumar Mittal**	

INTERNAL RECONSTRUCTION

STRUCTURE:

9.0 Learning Objectives

After going through this lesson, the learners will be able to:

- Know the meaning and the need for reconstruction of companies.
- Understand various schemes of internal reconstruction.
- Understand the accounting treatment of various schemes of internal reconstruction.

9.1 Introduction

A company might have suffered huge losses in the past or might have the problem of over capitalization or might have over valued its fixed assets because of inadequate provision for depreciation. Such a company faces the threat of going onto liquidation either voluntarily or because of a petition by any of its creditors or debenture holders. In these situation companies have following three options:

a)Liquidate the company (Liquidation)

b)Reconstruct Externally (External Reconstruction) and

c) Reconstruct internally (Internal Reconstruction)

9.2 Meaning of Internal Reconstruction

Internal Reconstruction is an arrangement made by companies whereby the claims of shareholders, debenture holders, creditors and other liabilities are altered/reduced, so that the accumulated losses are written off, assets are valued at its fair value and the balance sheet shows the true and fair view of the financial position.

9.3 Schemes of Internal Reconstruction

A company can reconstruct its internal affairs in the following ways:

i. Reduction of Share Capital and other Liabilities
ii. Re-organization or Alteration of Share Capital
iii. Variation of shareholders rights
iv. Compromise / Arrangement
v. Surrender of shares

9.3.1 Reduction of Share Capital and other Liabilities

Reduction of share capital is an arrangement under which the capital of the shareholders and sometimes even the claims of the creditors and debenture holders are reduced. The amount made available by way of capital reduction is utilized in writing off the fictitious assets, accumulated losses, and the overvalued portion of the other assets.

A corporate sector unit can reduce its paid-up capital if

(a) It is authorized by its articles

(b) A special resolution is passed and

(c) A sanction of the court is obtained

Methods of Reduction in Capital

Following are the methods of reductions of capital:

1. **Reduction in paid up value only**

Here the nominal value of shares remains same only paid up is reduced.

Example I: The shareholders may agree to reduce the paid up value of ₹.100 into paid up value of ₹.10 by making a sacrifice of ₹. 90 per share. For this transaction the following journal entry will executed:

Sr. No	*Particular*	*Dr*	*Cr*
1	Share capital Account Dr (90X No. of shares)	90	
	To Capital Reduction Account (90X No. of shares)		90

2. **Reduction in both Nominal andPaid-up value**

In this case both the paid up capital and nominal value are reduced. If we consider the above example, then the following journal entries will be passed:

Sr. No	*Particular*	*Dr*	*Cr*
1	Share Capital Account Dr (100X No. of shares)	100	
	To Capital Reduction Account (90X No. of shares)		90
	To Share Capital A/c(10X number of shares)		10

Procedure for Reduction of Share Capital

Following is the procedure for the reduction of share capital of company:

Board Meeting

A Board Meeting shall be convened to approve the scheme of reduction of share capital and to approve the draft notice of the general meeting. Because as per Companies' Act, power to reduce share capital shall have been authorized by the article of association. In the nonexistence of such provision, the articles should first be altered.

General Meeting of Shareholders

In the case of a listed company the general meeting shall be held to pass a special resolution for reduction of share capital. Notice of the general meeting shall be issued to members and other eligible person at least 21 clear days' before the date of general meeting. It is also compulsory for a listed company to send 3 copies of the notice of the general meeting to the stock exchange. In case of a listed company, send a copy of the proceedings of the general meeting to the stock exchange to inform the stock exchange by letter or telegram regarding the reduction of share capital as decided by the Board; [Clause 22(c) of listing agreement].

Form No.23 of Companies General Forms and Rules, all along with a copy of the special resolution, shall be filed with Registrar of Companies within 30 days from the date of resolution together with the filing fee.

Court

A petition shall be filed in the court, for confirmation of the reduction of share capital in (Form No.18) of the Companies Court Rules together with the following documents:

a) Form No.19 of the Companies Court Rules;

b) Affidavit in Form No.3 of the Companies Court Rules;

c) Attested copy of articles and memorandum;

d) Attested true copy of the notice calling the meeting;

e) Attested true copy of the special resolution and minutes regarding the reduction of share capital;

f) Most recent audited Balance Sheet and Profit and loss account;

g) Required Court fee as prescribed by the rules of the concerned High Court.

The petition shall be advertised in the required Form No.5 of the Companies Court Rules at least 14 days before the date of hearing fixed by the Court in the official Gazette of the State and in leading

English and one vernacular daily newspapers circulating in the State in which the registered office of the company is situated. In case of a listed company, send three copies of the advertisement to the stock exchange.

If the proposed reduction involves either diminution of liability in respect of unpaid share capital or payment to any shareholder of any paid-up share capital, the method laid down in Rules 48 to 59 of Companies (Court) Rules, 1959 shall also be comply with by filing Form Numbers 21 to 29 of the supposed rules as under:

a) A list of creditors in Form No.21 of the Companies Court Rules duly certifiedby an affidavit in Form No.22 of the said regulations shall be filed;

b) Issue notice in Form No.23 of the Companies Court Rules to each of the creditors as per the above list through prepaid registered post;

c) The notice and the list of creditors in Form No.24 of the Companies Court Rules, shall be advertisedwithin 7 days from the date of filing, in the Official Gazette of the State in which the registered office of the company is situated;In case of a listed company, send three copies of the above advertisement to the Stock Exchange;

d) An affidavit proving despatch and publication of the notices mentioned in (b) and (c) above shall be filed with the Court in (Form25) of the Companies Court Rules;

e) A Statement signed by the company's advocate and verified by the company stating the result of the notices mentioned in (b) and (c) above accompanied by an affidavit in (Form 26) of the Companies Court Rules shall be filed within the time fixed by the Court;

f) Serve notice in Form No.27 of the Companies Court Rules in respect of creditors, doubtful by the company at least 4 clear days before the date of hearing fixed by the Court if the company contends that a person is not entitled to be entered in the list of creditors in respect of any debts or claim, whether admitted or not, or if any debt or claim, the particulars of which are so sent in, shall not be admitted by the company at its full amount, then, and in every such case, unless the company is willing to set apart and appropriate in such manner as the Judge shall direct, the full amount of such debt or claim, the company shall, if the Judge thinks fit so to direct, sent to the creditor a notice in Form No. 27, that he is required to come in and establish his title to be entered on the list, or as the case may be, to come in and prove such debts or claim or such part thereof as is not admitted by the company on the day fixed by the

Judge. Such notice Such notice shall be served not less than four clear days before the date fixed by the Judge

g) File the certification by company's advocate regarding the result of the settlement of list of creditors;

h) Advertise the notice regarding the date of hearing fixed for the petition, in (Form 29) of the Companies Court Rules in specified newspapers and within prescribed time as may be directed by the Court.

In case of a listed company, send three copies of the above advertisement to the stock exchange. On passing of the order by the High Court, reason for the reduction of capital shall be published, if so directed by the High Court.

Notice of the Court's order shall be delivered to the Registrar of Companies in Form No.21 of Companies General Rules and Forms, within 30 days of the receipt of the Court's order, after paying the requisite fee.

A certified copy of the High Court's order and minutes shall be delivered to the Registrar of Companies. The Registrar shall register the copy of the order and minutes and certify the same under his own hand writing, whereupon the reduction of capital becomes successful. [Section103].

The notice of registration shall be published in the manner directed by the High Courtin the Companies Court Rules.

In case of a listed company, send three copies of the above advertisement to the stock exchange. [Clause 31(e)of listing agreement].

Steps to Be Taken Subsequent to Reducing the Capital

Once the reduction of capital has completed, steps given below shall be taken:

a) Required alteration shall be made in all copies of memorandum and articles;

b) Surplus share capital shall be paid off;

c) Alteration in Share certificates shall be made in order to reflect the reduction in liability in respect of uncalled or unpaid capital;

d) Excess paid-up capital, shall be cancelled;

e) If so directed by the High Court, the words 'and reduce' shall be added to the company's name for the period specified in the order.

In case of a listed company, send six copies including a certified copy of the alterations to the memorandum and articles to the stock exchange.

9.3.2 Re-organization or Alteration of Share Capital

Alteration/ Re-organization of share capital refer to the arrangement of the capital of the company and include the following**:**

- Increase the share capital by making fresh issue of shares
- Decreasing the share capital by cancelling the unissued shares.
- Conversion of shares into stock and vice -versa
- Consolidation of shares of smaller amounts into shares of larger amounts
- Sub-division of shares of larger amounts into share of smaller amounts. A company can make alteration in its share capital if it is authorized by its Articles of Association.

9.3.3. Variation of Shareholders Rights

When a company has issued different types of shares with different types of rights regarding voting and right of dividend etc, such right may be changed in any manner and considered as part of internal reconstruction. For example, company may change rate of dividend on preference shares and convert cumulative preference shares into non cumulative preference shares without changing amount of share capital by passing the following journal entries.

Journal Entries

Sr. No	*Particular*	*Dr*	*Cr*
1	On change in rate of dividend (Old)% cum Preference share capital A/c Dr To (New)% cum Preference share capital A/c		
2	On conversion of Cumulative pref. shares into non cumulative --% cum Pref. Share capital a/c Dr To Non- Cum Pref. Share Capital Account		

9.3.4. Compromise or Arrangement

Compromise or arrangement is an agreement between companies and its members and outsiders when a company face financial problem. It may be agreement between company and shareholders, debenture holders or creditors etc or among all. Accounting treatment for the arrangement may be understood by the following entries:

Journal Entries

Sr. No	*Particular*	*Dr*	*Cr*
1	When equity shareholders give up right to accumulated reserves and profits Reserve A/c Dr To Reconstruction A/c		
2	Settlement with creditors in lesser amount than their actual claim Outside liabilities Dr(Amount of sacrifice) Provision A/c (made by creditor, debenture holders etc) To Reconstruction A/c		

The methods of capital reduction can be well understood with the help of illustration given below:

Example 2: The business of ATC Limited was being carried on continuously at losses. The following are the extracts from the balance sheet of the company as on 31st March, 2012:

Liabilities	**₹**	**Assets**	**₹**
30,000 Equity shares@ 10 each	3,00,000	Goodwill	50,000
2,000 8% cumulative preference shares of ₹ 100	2,00,000	Plant	3,00,000
Securities Premium	90,000	Loose tools	10,000
Unsecured loan (from director)	50,000	Debtors	2,50,000
Sundry creditors	50,000	Stock	1,50,000
Outstanding expenses (including Remuneration 20,000)	70,000	Cash	10,000
		Bank	35,000
		Preliminary expenses	5,000
		Profit and Loss A/c	2,00,000
Total	**10,10,000**	**Total**	**10,10,000**

Note:

Dividends on cumulative preference shares are in arrears for 3 years.

The following scheme of reconstruction has been agreed upon and duly approved by court:

i) Equity shares to be converted into 1, 50,000 shares of ₹ 2 each.

ii) Equity shareholders to surrender to the company 90% of their holdings.

iii) Preference shareholders agree to forego their right to arrears to dividends in consideration of which 8% preference shares are to be converted into 9% preference shares.

iv) Sundry creditors agree to reduce their claim by one fifth in consideration of their getting shares of ₹ 35,000 out of surrendered equity shares.

v) Directors agree to forego the amount due on account of unsecured loan and directors' remuneration.

vi) Surrendered shares not otherwise utilised to be cancelled.

vii) Assets to be reduced as under:

Goodwill	50,000
Plant	40,000
Tools	8,000
Sundry Debtors	15,000
Stock	20,000

viii) Any surplus after meeting the losses should be utilised in writing down the value of the plant further.

ix) Expenses of reconstruction amounted to ₹ 10,000.

x) Further 50,000 equity shares were issued to the existing members for increasing the working capital. The issue was fully subscribed and paid up.

xi) Authorised capital was suitably increased.

A member holding 100 equity shares opposed the scheme and his shares were taken over by a director on payment of ₹ 1000 as fixed by the court.

You are required to pass the journal entries for giving effect to the above arrangement and also to draw up the resultant balance sheet of the company.

Solution:

Journal Entries

Particulars	Dr (₹)	Cr (₹)
Equity Share Capital (₹ 10) A/c Dr To Equity shares capital (₹ 2) A/c (Being equity shares of ₹ 10 each converted into equity shares of ₹ 2 each converted equity shares of ₹. 2)	3,00,000	 3,00,000
Equity share capital(₹ 2) A/c Dr To Share surrendered A/c (Being 90% of equity share surrendered)	2,70,000	 2,70,000
8% cumulative preference share capital A/c Dr To 9% Cumulative preference shares A/c (Being 8% Cumulative preference shares converted into 9%)	2,00,000	 2,00,000
Shares surrendered A/c Dr To Equity shares capital (₹ 2) A/c (Being 17500 equity shares out of surrendered issued to creditors for 1/5th claim)	35,000	 35,000
Expenses of reconstruction A/c Dr To Cash (Being expenses of reconstruction paid)	10,000	 10,000
Shares surrendered A/c Dr To Capital reduction A/c (Being cancellation of remaining surrendered shares according to the scheme of reduction)	2,35,000	 2,35,000
Unsecured Loan A/c Dr Sundry creditors A/c Dr Outstanding A/c Dr To capital reduction A/c (Being amounts sacrificed by various parties as per the reconstruction scheme transferred to capital reduction a/c)	50,000 60,000 20,000	 1,30,000
Capital reduction A/c Dr To Goodwill A/c To Loose tools A/c To Sundry debtors A/c	3,65,000	 50,000 8,000 15,000

To Stock in trade A/c To Profit and loss A/c To Preliminary expenses A/c To Expenses of reduction A/c To Plant A/c (Being expenses of reconstruction, various losses and amounts written off various assets debited to capital reduction account as per the scheme balance of the amount credited to plant)		20,000 2,00,000 5,000 10,000 57,000
Bank A/c Dr To Equity share capital (₹ 2) A/c (Being 50,000 equity shares of ₹. 2 each issued as fully paid)	1,00,000	 1,00,000

ATC Ltd (and Reduced)

Balance Sheet

as on 31 March 2020

Liabilities	***₹***	***Assets***	***₹***
Authorised: 1,50,000 equity shares @ 2 2000, 9 % preference shares2 100	 3,00,000 2,00,000	Goodwill 50,000 Less: Amount written off 50,0000	Nil
		Plant 300,000 Less: Amt written off 57,000	2,43,000
82,500 equity shares @2 per share	1,65,000	Loose tools	2,000
2000, 9% preference shares @ 100 Per share	2,00,000	Stock in trade	1,30,000
Securities premium	90,000	Sundry debtors	2,35,000
Sundry Creditors	2,40,000	Cash at Bank	1,25,000
Outstanding expenses	50,000	Cash in Hand	10,000
	7,45,000		**7,45,000**

9.3.5 Surrender of Shares

Theshareholders are made to surrender their shares. These shares are then allotted to debenture holders and creditors in order to reduce their claim. The balance surrendered shares are then cancelled. The following journal entries will be passed for surrender of shares:

Journal Entries

Sr. No	*Particular*	*Dr*	*Cr*
1	On surrender of shares Share capital A/c Dr To Share surrendered A/c		
2	On reissue of surrendered shares Share surrendered A/c Dr To Share Capital Account		
3	On cancellation of surrendered shares Share surrendered A/c Dr To Capital Reduction A/c		

Example 3: The following information relates to Disappointed Ltd. as on 31st December, 2019.

	(₹)
2000 Equity shares @100	2, 00,000
1,000 6% Debentures @100 each	1, 00,000
Interest on debentures outstanding	12,000
Trade creditors	50,000
Fixed assets	2, 00,000
Current assets	65,000
Fixed assets re-valued	96,000
Current assets re-valued	48,000

The following scheme was duly agreed and approved by the court:

1. The shares were sub divided into shares of ₹. 5 each and 90 per cent of the shares were surrendered.
2. The total claims of debentures holders were reduced to ₹. 49,000 and in consideration of this, they were also allotted shares (out of the surrendered shares) amounting to ₹. 25,000.
3. The creditors agreed to reduce their claims to ₹. 30,000, 1/3 ofwhichwas satisfied by of equity shares out of those surrendered.
4. The shares surrendered but not reissued were cancelled.

You are required to pass the necessary journal entries.

Solution:

Journal Entries

Date	*Particulars*	*Dr ₹.*	*Cr ₹.*
	Equity shares capital(₹ 100) Dr To Equity share capital(₹ 5) Being sub division of equity shares of ₹ 100 each into of ₹.5	2,00,000	 2,00,000
	Equity Share Capital A/c(₹ 5) Dr To Shares surrendered A/c Being surrender of 90 per cent of equity shares	1,80,000	 1,80,000
	6 % Debentures A/c Dr Outstanding interest on Debentures A/c Dr To Capital Reduction A/c Being reduction in the claims of debentures holders to ₹. 49,000 as per the reconstruction scheme	51,000 12,000	 63,000
	Share Surrendered A/c Dr To Equity Shares capital A/c Being allotment of equity shares of ₹. 25000	35,000	 35,000
	Sundry Creditors A/c Dr	30,000	

	To Capital Reduction A/c Being reduction of claim of creditors from ₹. 50,000 to ₹. 20,000.		30,000
	Capital Reduction A/c Dr To Profit and Loss A/c To Fixed Assets A/c To Current Assets A/c To Capital Reserve A/c Being writing down the value of different assets and the debit balance in the profit and loss account.	2,38,000	 97,000 1,04,000 17,000 20,000

9.3.6 Accounting Entries for Internal Reconstruction

The accounting entries for internal reconstruction are as follows:

Journal Entries

Sr. No.	***Particulars***	***Dr***	***Cr***
1.	For reduction of Equity Share Capital (Old) Equity Share Capital Account Dr. To (new) Equity Share Capital Account To Capital Reduction Account		
2.	For reduction of Preference Share Capital (Old) Preference Share Capital Account Dr. To (new) Preference Share Capital Account To Capital Reduction Account		
3.	For reduction of the amount due to debenture holders Debenture holders Account Dr. To Capital Reduction Account		
4.	For reduction of the amount due to Creditors Creditors Account Dr.		

	To Capital Reduction Account		
5.	For appreciation in the value of Assets Assets Account Dr. To Capital Reduction Account		
6.	For the payment of Reconstruction expenses Reconstruction Expenses Account Dr. To Bank Account		
7.	For utilization of capital reduction account in writing off accumulated losses and various fictitious assets Capital Reduction Account Dr. To Profit and Loss account (loss) To Preliminary Expenses To Discount of issue of shares or debentures account To underwriting commission account To Advertising Suspense's account To Reconstruction Expenses account To Good will account To Patents or Trade Marks account To Fixed assets account (over valued assets) To Other assets account To Capital Reserves account (if some balance is still)		

Example 4: Consider the balance sheet of ABC Ltd. as on 31st Dec 2012.

Balance Sheet

as on 31st Dec.2019

Liabilities	**₹**	***Assets***	**₹**
Equity 400000@5	20,00,000	Local works	2000000
Pref, Capital 300000@5	15,00,000	Upcountry	1000000
10% A Debentures(secured by local	100,000	Investment of work comp Fund	35000

works)			
9% B Debentures (Secured by upcountry work)		Stock	1,15,000
Workmen comp. Fund Local 25000 Upcountry 10000	35000	Debtors	50,000
Bank Overdraft	7,50,000	Preliminary Exp	12500
Creditor	2,00,000	Profit & Loss A/c	16,22,500
Total	**48,35,000**	**Total**	**48,35,000**

The following format of reconstruction was approved by all parties concerned:

1. The equity shares were reduced to 25 paisa per share.
2. The preference Share was reduced to ₹. 3.75 per share and the rate of dividend was reduced to 9%.
3. The debenture holders waived ₹. 42000 being interest due to them (included in creditors).
4. Director agreed to refund ₹. 50,000 fees which they had received. This amount was refunded by them in cash.
5. The B Debenture holders formed new company Ltd. to take over the upcountry works at ₹ 500000. The price was settled by surrender of B Debentures and allotment of 25000 equity of ₹ 10 Each as fully paid in New Co Ltd.
6. Investment was valued at ₹. 25000, stock at ₹. 25000, stock at₹ 50,000 and Debtors at ₹ 40000. There was no actual liability to upcountry works employees. The assets were to be written down as above the fictitious assets were to be wiped off. Necessaryreserves were to be retained and the balance available was to be written off the book value of local works.

Prepare the necessary journal entries and Balance sheet Reddu Ltd. after giving effect of the above scheme.

Solution:

Journal Entries

Sr.No.	*Particulars*	*Dr*	*Cr*
1.	₹. 5 Equity Share Capital Dr To ₹ 0.25 Equity capital To Capital Reduction	2000000	 1,00,000 19,00,000
2.	10% Pref. Share capital A/c Dr To ₹. 3.75, 9 % Pref Share capital A/c To Capital Reduction A/c	15,00,000	 11,25000 3,75,000
3	Sundry creditors A/c Dr To Capital Reduction A/c	42,000	 42,000
3.	Bank a/c Dr To Capital Reduction A/c	50,000	 50,000
4.	9% B Debenture a/c Dr To 9% B Debenture holders A/c	2,50,000	 2,50,000
5.	9%, B Debenture Holders A/c Dr To Upcountry Works	5,00,000	 5,00,000
6.	Investment in new Co. Dr To 9% B Debenture Holders a/c	2,50,000	 2,50,000
7.	Workmen's Compensation Fund A/c Dr To Capital Reduction A/c	10,000	 10,000
8.	Capital Reduction A/c Dr To Profit and Loss A/c To Preliminary Expenses To Upcountry Works To Investment A/c To Stock To Provisions for Doubtful Debt To Local Works	23,77,000	 16,22,500 12,500 5,00,000 10,000 65000 10,000 1,57,000

ABC Ltd (After Reconstruction)

Balance Sheet

as on 31 Dec. 2019

Liabilities	***₹***	***Assets***	***₹***
Equity 400000@0.25	1,00,000	Local works	1843000
Pref, Capital 300000@3.75	11,25,000	Investment in New Co	2,50,000
10% A Debentures(secured by local works)	100,000	Investment of work comp Fund	25000
		Stock	50,000
Workmen Comp Fund	25,000	Debtors	40,000
Bank Overdraft	7,50,000	Cash & Bank	50,000
Creditor	158000		
Total	**22,58,000**	**Total**	**22,58,000**

Note: It has been assumed that the 5,000 shares in the New Co.Ltd are worth ₹. 2, 50,000 since that figure together with that of the amount of B Debenture Makes ₹. 500,000, the value of upcountry works.

9.4 Reconstruction Process

It has already been stated that Board of Directors of a company have to submit a reconstruction or reorganisation scheme to the Court for reconstructing the capital structure of a company. The method of preparation of such scheme is as follows:

Assumptions: Reconstruction Scheme should be based on the following assumptions:

- Company will be in position to earn sufficient fund in future. Sufficient fund means that the profit will be available for payment of interest, dividend and future internal requirement for internal investment.
- Scheme will have the approval of all the parties concerned.
- Shareholders and Debenture holders are willing to provide extra funds.

Steps for Reconstruction

Some steps should be taken for drafting of a reconstruction scheme.

1. **Estimation of loss**

Estimating loss due to written off is the first step to be taken to prepare a reconstruction scheme. This loss is estimated on the basis of the company's latest financial statements. The following variables are taken into account.

i. Fictitious Assets
ii. Preliminary Expenses
iii. Intangible Assets
iv. Loss on revaluation of assets
v. Arrears of preference dividend

2. **Writing off the loss**

Having estimated the amount of loss, it will be necessary to ascertain the parties who will have to bear this loss. The various parties interested in the company are

i. equity shareholders ii) Preference shareholdersiii) Unsecured creditor
iv) Creditors secured by a floating charge v) Creditors secured by fixed charge.

3. **Compensating the parties**

In case only the equity shareholders are required to sacrifice under the reconstruction scheme, there is no need for making any provisions for compensating them since they will automatically be compensated in terms higher income in future when makes higher profit. However if preference shareholder, debenture holders and creditors are required to make sacrifice, some provision must be made for their compensation. This can be done by increasing dividend rate or interest rate.

3. **Arrears of preference dividend**

In such scheme usually arrears of preference are cancelled. While calculating sacrifice made by various parties the cancellation of divided should be considered. This may be paid in terms of deposit certificate of avoid burden of liquid resources of company.

4. **Additional working capital**

Working capital is life blood of the business and therefore, it is necessary that reconstructed company should have adequate working capital. The required fund may provide by existing shareholders and debenture holders. It can also be collected from outsiders but one thing should be take care that is loss of control of existing shareholders.

5. **Funds for fixed Assets**

Sometimes reconstruction of a company may be necessary because the company is not in position to replace or modernise its plant and machinery. In such situation, adequate provision should be made for gap of fund between bank finance available and total fund required for replacement or modernisation. The framing of reconstruction scheme can be well understood with the help of comprehensive illustration given below:

Example 5: The following is a summary of the balance sheet of a limited company as on 31st Dec. 2019.

Liabilities	**₹**	**Assets**	**₹**	**A**	**B**
5000, 6% Commutative pref shares of ₹ 10	50,000	Freehold Property	56,550	40,000	50,000
5,000 Equity shares of ₹ 10 each	50,000	Plant and Machinery	18,930	10,500	17,500
10% Debentures (Secured on free-hold property)	30,000	Motor vehicles	3,600	3,400	3,600
Bank Overdraft (Unsecured)	9,600	Stock	95,390	75,000	95,390
Trade Creditors	75,240	Trade Debtors	12,430	11,850	12,430
		Cash	460	460	460
		Profit and Loss A/c	27,480		
Total	**2,14,840**	**Total**	**2,14,840**		

Against the balance sheet values of the assets are shown the probable realisation values in the event of a complete liquidation of the company (column A) and the equivalent figures on a 'going concern' basis (Column B). On 31 December 2012, the preference share dividends is three years in arrears and in a liquidation the preference shareholders have a prior claim to these arrears and to repayment of their subscribed capital, but they have no other rights.You are consulted by A, who holds 2,000 ordinary shares, and who is satisfied that, if the finances of the company can be reorganised , it can be expected to earn profit of not less than ₹ 50000 per annum before providing for interest and taxation. Accepting A's expectation as correct, frame a scheme of reconstruction of the company which should be acceptable to all concerned. Allow for the fact that stock and debtors will continue at their present level, that trade creditors will require to be reduced to ₹ 30,000, and that for normal working the company requires cash at bank of at least ₹ 12000 instead of an overdraft.

Solution:

Thepreference shareholders of the company are entitled to repayment of capital and arrears of cumulative preference dividend in the event of company's liquidation in priority to the equity shareholders. Thus, in the event of company's liquidation, the loss of capital will have to be mainly borne by the equity shareholders. However, in the present case in the event of company's liquidation, losses will be so heavy that they will not only wipe out completely the equity shares capital but also wipe out a substantial portion of the preference share capital.

However, on a going concern basis, the preference shareholders are fully covered by the available assets. A sum of about ₹ 3 per share would be left for equity shareholders after satisfying the claims of the company continues to carry on business.

The scheme of reconstruction may be drafted on the following lines:

i) Loss to be written off on 'going concern basis'

Particulars	**₹**
Freehold property	₹ 6,550
Plant and machinery	1,430
Profit and loss A/c	27,480
Add: Estimated reconstruction expenses	2,040
Loss to be written off	37,500

ii) Preference shareholders are requested to cancel the arrears of preference dividend for last three years amounting to ₹ 9,000 in all.

iii) The entire loss of ₹ 37,500 be written off against the equity share capital. Each equity share may be reduced to ₹. 2.5 per share from ₹ 10 each for this purpose.

iv) The authorised share capital of the company be restored to its present figure of ₹ 1 lakh.

v) In order to compensate the preference dividend be increased from 6 percent to 8 percent.

vi) The following additional working capital may be raised:

Particulars	**₹**
Payment of trade creditors	45,240

Repayment of bank overdraft	9,600
Bank Balance (say)	12,660
Additional working capital	**67,500**

The present unissued share capital amounts to ₹ 37,500. It would be, therefore, necessary to increase the authorised share capital by another (say) ₹ 30,000. In order to avoid a highly geared capital structure, it will be appropriate to raise additional capital by issue of 27,000 equity shares of ₹ 2.50 each. These new shares should be offered for subscription at par to both present preference and equity shareholders in the ratio of 1:2.

vii) As a result of the above reconstruction scheme, the company's expected profit of ₹ 50,000 would be available for distribution in the following manner:

Particulars	**₹**
Interest on Debenture	3,000
Provision for taxation (at 50%)	23,500
Dividend on preference @ 8%	4000
Dividend on equity shares of ₹ 80,000	12,000
Carry forward	7,500
Company's expected profit	50,000

9.5 Check Your Progress

A. State whether the following statements are True or False

1. An arrangement in which the claims of shareholders, debenture holders and creditors are reduced is known as internal reconstruction.
2. A company can reduce its paid-up capital if it is authorised by articles of association.
3. Internal reconstruction is more beneficial than external reconstruction.
4. There is no need of special resolution for reduction of share capital.

B. Fill in the blanks

1. The companies who have suffered huge losses are threats of going into ____________.

2. Reorganisation of capital structure of company without liquidation is called ____________________.
3. Re-organization of share capital includes increasing as well as __________of capital.
4. The balance of reconstruction account is transferred to ______________.

9.6 Summary

Reconstruction is a process by which affairs of a company are reorganised by revaluation of assets, reassessment of liabilities and writing of losses already suffered by company through reduction of share capital or varying rights of shareholders. Reconstruction account is a new account opened for adjustment loss which is not represented by lost assets. If some balance in reconstruction account remains then it should be transferred to Capital Reserve Account. Schemes of internal reconstruction include reduction of share capital and other liabilities, re-organization or alteration of share capital, variation of shareholders rights, compromise / arrangement and surrender of shares.

9.7 Keywords

Dissenting shareholders: A shareholders who has not assented to the scheme of reconstruction.

External reconstruction: A reconstruction that involves liquidation of a company having bad financial position and formation of new company to purchase its business.

Internal reconstruction: Reorganisation of capital structure of company without liquidation.

Revaluation Account: Nominal account for the valuation of assets and liabilities.

9.8 Answers to Check Your Progress

Check Your Progress A

1. True
2. True
3. False
4. False

Check Your Progress B

1. Liquidation
2. Internal Reconstruction
3. Decreasing
4. Capital Reserve Account

9.9 Self-Assessment Test

1. Explain various points which kept in while framing a reconstruction scheme.
2. Define the term 'Capital reduction' and explain legal process of capital reduction.
3. Define the term 'surrender of shares'. Explain accounting treatment of surrender of shares with suitable example.
4. Explain various journal entries in case of internal reconstruction with hypothetical examples.

5. The balance sheet of ABC Company Ltd. as on 31st March, 2012 was as follows.

BALANCE SHEET OF ABC COMPANY LTD.

as on 31st March, 2019

Liabilities	**₹**	**Assets**	**₹.**
10,000 Equity Shares @ 10	1,00,000	Goodwill	10,000
10,000 Preference Shares @ 10	1,00,000	Fixed Assets	90,000
		Stock	30,000
		Debtors	25,000
		P & L A/c	45,000
Total	2,00,000	Total	2,00,000

It was resolved that equity shares of ₹. 10 each be reduced to fully paid shares of ₹. 6 each and 7% preference shares of ₹ 10 each be reduced to 7-1/2 % fully paid preference shares of ₹. 7 each. It was further resolved that amount so available be used for writing off the debit balances of profit and loss account, goodwill account, and other fixed assets as much as possible. There were arrears of preference dividend for the last three years but the amount was to be cancelled. Give journal entries and draw the revised balance sheet.

6. The following is the abridged balance sheet of Hind Ltd. as on 31st March 2019.

BALANCE SHEET OF HIND LTD.

as on 31st March 2012

Liabilities	**₹**	**Assets**	**₹.**
15,000 Equity Shares @ 10	1,50,000	Goodwill	35,000
10,000 Cumulative Preference Shares @ 10	1,00,000	Net Tangible Assets	1,52,000
		Profit and Loss A/c	63,000
Total	2,50,000	Total	2,50,000

The preference dividend is in arrears for three years. The net tangible assets are estimated to the worth ₹ 1, 36,000. On the expectation that the annual profits will be ₹. 15,000 draft a scheme of reconstruction to be submitted to the directors mentioning the important matters which would require consideration and state the effect of such proposal on two classes of shareholders. Redraft the balance sheet.

9.10 References/Suggested Readings

1. Arula Nandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing House, Delhi.

2. Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.

3. Gupta R.L. and Radha Swamy M., **Advanced Accountancy**, Sultan Chand and Sons, New Delhi.

4. Paul S.K.R., **Advanced Accountancy**, New Central Book Agency, Calcutta.

5. Shukla M.C. & Grewal S., **Advanced Accounts,** S. Chand &Company Ltd, New Delhi.

6. Study material of Institute of Chartered Accountant of India (ICAI), New Delhi.

Subject: Corporate Accounting	
Course Code: BCOM 301	**Author: Dr. Sanjeev Kumar Garg**
Lesson No.: 10	**Vetter: Prof. Suresh Kumar Mittal**
Accounts of Holding Companies I: With Provisions of AS-21	

Structure

10.0 Learning Objectives

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

- Know the Meaning of Holding & Subsidiary Company
- Know the Meaning, Objectives & Scope of AS-21
- Know the Presentation of Consolidated Financial Statements
- Understand the Major Differences between AS-21 and Ind AS-110

10.1 Introduction

10.1.1 Meaning of Holding Companies

A holding company is a company or limited liability company (LLC) which has control over another company. When a company acquires all or majority of shares carrying voting rights or controls the composition of Boards of Directors (BOD), then the acquiring company is known as Holding Company. The company whose shares have been acquired is known as subsidiary company. Typically, a holding company doesn’t manufacture anything, sell any products or services, or conduct any other business operations. Rather, holding companies hold the controlling stock in other companies. Although a holding company owns the assets of other companies, it often maintains only oversight capacities. So while it may oversee the company's management decisions, it does not actively participate in running a business's day-to-day operations of these subsidiaries. A Holding Company is also sometimes called an "umbrella" or parent company.

10.1.2 Important Definitions

As per Accounting Standard-21 (AS-21) ‘Consolidated Financial Statements’ the following terms are used with the meanings specified:

- **Control**: (a) the ownership, directly or indirectly through subsidiary (ies), of more than one-half of the voting power of an enterprise; or

  (b) Control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

- **Subsidiary:** A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).

- **Parent**: A parent is an enterprise that has one or more subsidiaries.
- **Group**: A group is a parent and all its subsidiaries.
- **Consolidated financial statements**: These are the financial statements of a group presented as those of a single enterprise.
- **Equity**: It is the residual interest in the assets of an enterprise after deducting all its liabilities.
- **Minority interest**: It 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.

As per Section 2 (46) of Companies Act, 2013, a **holding company**, in relation to one or more other companies, means a company of which such companies is subsidiary companies. As per Section 2 (87) of Companies Act, 2013, a **subsidiary company** or **subsidiary**, in relation to any other company (that is to say the holding company), means a company in which the holding company:

(i) Controls the composition of the Board of Directors; or

(ii) 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:

Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.

Explanation:-for the purposes of this clause, (a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;

(b) the composition of a company‘s Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;

(c) The expression company includes anybody corporate;

(d) Layer in relation to a holding company means its subsidiary or subsidiaries.

10.1.3 Wholly Owned and Partly Owned Subsidiaries

Wholly-owned: A wholly owned subsidiary is one in which 100% of the subsidiary's shares are owned by the parent company. The parent company has complete control over the voting rights of the subsidiary.

Partly owned: A partly owned subsidiaries company is that company in which the majority of shares i.e. more than 50 % but less than 100% owned by holding company. In partly owned subsidiaries some of shareholders don't sell their shares to the holding company, these are known as 'Minority Shareholders' and their interest in assets is known as 'Minority Interest'. The parent company doesn't have complete control, but it should have a controlling interest.

10.1.4 Advantages of Holding Companies

The followings are the advantages to the holding companies:

- **Easy method**: In this method, with a small investment, a company can acquire control over other company.
- **Easy formation**: It is quite easy to form a holding company. The promoters can buy the shares in the open market. The consent of the shareholders of the subsidiary company is not required.
- **Better Image**: When holding and subsidiary company work together then their image improve in market. Further more customers will attach with the company.
- **Easy to determine of financial position of every company**: In this method every company i.e. holding company & subsidiary company has to prepare their own accounts. Hence, determination of financial position of every company becomes easy.
- **No competition**-Competition between holding and subsidiary companies can be avoided if they are in the same line of business.

- **Better decision making**: Working with staff of different company can evaluate the available alternatives with full cost benefits analysis which further increase the decision making capacity of a company.

- **Economies**: The buying and selling of the holding company and the subsidiaries can be centralized. It can enjoy the advantage of quantity discount and better credit terms because of bulk purchases. It can also get better terms from buyers in case of sales.

- **Easy to maintain separate goodwill of every company**: As every company maintains their separate accounts hence their identities are also different. With different identity it becomes easy to maintain separate goodwill of every company.

- **Risks avoided**-In case the subsidiaries undertake risky business and fail, the loss does not affect the holding company. It can sell its stakes in the subsidiary company.

- **Easy to wind up a sick subsidiary company**: if any of the subsidiary company continuously facing difficulty in reviving or running in losses, then it can be easily wind up.

10.1.5 Disadvantages of Holding Companies

The following are the disadvantages of holding companies:

- **Difficulty in ascertaining the true picture of financial statement**-All the stakeholder like shareholders of holding company, creditors and outside shareholders in subsidiary company sometimes not aware about the true financial position of the company.

- **Misuse of power**-Sometimes holding company forcefully appoints the directors and other officers into the subsidiary company and fixed their remuneration high. The financial liability of the members of a holding company is insignificant in comparison to their financial power. It may lead to irresponsibility and misuse of power.

- **Exploitation of subsidiaries**-The holding company often compels their subsidiaries to buy goods from the holding at high prices. They might be forced to sell their products to the holding company as very low prices.

- **Manipulation in Transactions**-Information about subsidiaries may be used for personal gains. For example transaction entered into books at a value either too high or too low as the suitable to holding company. Information of the financial performance of subsidiary companies may be misused to indulge in speculative activities.

- **Concentration of economic power**-There is concentration of economic power in the hands of those who manage the holding company. Such concentration of economic power is harmful to the general economic welfare.

- **Creation of secret reserves**-Secret reserves can be easily created by some directors to detriment the interest of minority shareholders.

- **Difficult to determine the true value of inventory**- As holding and subsidiary companies does so many inter-company transactions related to goods. So, high quantity of goods remains lying in these transactions. It has becomes difficult to determine the true value of inventories.

- **Fear of mismanagement**- When there are sharp minded person working into companies for their self purpose then the fear of mismanagement increases. They can ruin all the company.

10.2 AS-21 Consolidated Financial Statements

10.2.1 Applicability of AS-21 Consolidated Financial Statements

This standard must be applied when accounting for investment in subsidiaries in a separate financial statement of the parent. It is to be noted that while preparing a consolidated financial statement, other standards also stay relevant in a similar manner as for standalone statements.

10.2.2 Objectives

The objective of this standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. These statements are intended to present financial information about a parent and its subsidiary as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources.

10.2.3 This accounting standard doesn't deal with

- accounting methods for amalgamations and effects on consolidation, which includes goodwill which arises on amalgamation
- accounting for investments in JVs (joint ventures)
- accounting for investments in associates

10.2.4 Presentation of Consolidated Financial Statements

A parent company presenting its consolidated financial statements must present these statements along with its standalone financial statements. The users of financial statements of a parent company are typically concerned with and are required to be educated about, the results of operations and financial position of not only the company itself but also of that group together. This requirement is served by offering the users of financial statements –

- Standalone financial statements of a parent; and
- Consolidated financial statements that provide financial information about the business group as that of a lone enterprise without respect to the legal restrictions of the distinct legal entities

10.2.5 Scope of Consolidated Financial Statements

A parent company which presents its consolidated financial statements must consolidate all of its subsidiaries, foreign as well as domestic. Where a company doesn't have any subsidiary, however, has associates and/or joint ventures such company also needs to prepare consolidated financial statements as per Accounting Standard-23 (Accounting for Associates in Consolidated Financial Statements) and Accounting Standard-27 (Financial Reporting of Interests in Joint Ventures) respectively.

10.2.6 Exclusion of Subsidiaries

A Subsidiary must be excluded from the consolidation when:

- control is planned to be temporary since the subsidiary was taken over and was held exclusively for disposal in the near future; or
- the subsidiary is operating under severe long-standing restrictions that considerably impair the subsidiary's ability to transfer funds to its parent

In a consolidated financial statement, investments in such subsidiaries must be accounted for as per AS-13 Accounting for Investments. Reasons for which a subsidiary isn't included in the consolidation must be disclosed in such consolidated financial statements.

10.3 Consolidation Procedures

In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps should be taken:

- The cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated;
- Any excess of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognized as an asset in the consolidated financial statements;
- When the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a capital reserve in the consolidated financial statements;
- Minority interests in the net income of consolidated subsidiaries for the reporting period should be identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and

- Minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:
    - The amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and
    - The minorities' share of movements in equity since the date the parent-subsidiary relationship came in existence.

Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.

Accounting for Investments in the Subsidiaries in Separate Financial Statement of the Parent

In a parent company's separate financial statements, the investments made in subsidiaries must be accounted for as per AS 13-Accounting for Investments.

Disclosures in the Financial Statements

Following disclosures must be made w.r.t. AS-21 Consolidated Financial Statements:

- In the consolidated financial statements the list of all the subsidiaries of the parent company which includes the name, country of residence or incorporation, the share of ownership interest and, in case different, the share of voting power held
- In case the consolidation of particular subsidiary hasn't been made according to the grounds permissible in the accounting standard, reasons for which such subsidiary isn't included in the consolidation must be disclosed in such consolidated financial statements
- In the consolidated financial statements, where valid:

- Type of relationship between a parent and its subsidiary, whether direct control or indirect control through the subsidiaries
- Effect of acquisition and disposal of the subsidiaries on financial position at the date of reporting results for the reporting period and on corresponding amounts for preceding period; and
- Name of the subsidiary(s) of which reporting date(s) is different

Major Differences between AS-21 and Ind AS-110

Major Differences between AS-21 and Ind AS-110

Particulars	Ind AS-110	AS-21
Preparation of Consolidated Financial Statements	Ind AS makes preparation of Consolidated Financial Statements compulsory for the parent company.	AS-21 doesn't mandate preparation of Consolidated Financial Statements by the parent company.
Accounting for investments in subsidiaries	Ind AS provides guidance for accounting for investments in the subsidiaries, associates and jointly controlled entities in preparing separate financial statements.	AS-21 doesn't deal with the same.
Exclusion from Consolidation	Ind AS 27 doesn't give any such exemption from consolidation of financial statements.	AS-21 excludes subsidiaries from consolidation when the control is intended to be transitory or when the subsidiaries operate under severe restrictions which are of long-term nature.
Control	Ind AS defines control as the principle-based, that states that control, is power to govern the operating and financial policies of the entity for obtaining the	AS-21 requires ownership, either directly or indirectly through the subsidiary, of more than half of voting power of the enterprise; or control of composition of

	benefits from its activities.	BoD.
Share Ownership	As per Ind AS 27, the existence and effect of prospective voting rights which are presently convertible or exercisable are considered while assessing whether the company has control over such subsidiary.	As per AS 11, for considering ownership, the potential equity shares of investee held by the investor aren't taken into account.
Presentation of minority interest	According to Ind AS 27 non-controlling interests should be presented in consolidated balance sheet within the equity distinctly from parent shareholders' equity.	According to AS-21 minority interest must be showed in the consolidated balance sheet distinctly from equity and liabilities of the parent company.
Uniform Accounting Policies	Uniform Accounting Policies Ind AS 27 doesn't recognize the situation of impracticality.	AS-21 explicitly states that in case its impracticable to employ uniform accounting policies in presenting the consolidated financial statements, such fact must be disclosed along with the share of the items in a consolidated financial statement to which such different accounting policies are applied.
Accounting for Income Tax	Accounting for Income Tax Ind AS 27 doesn't deal with the same.	AS-21 offers guidance with respect to accounting for taxes on income in consolidated financial statement.
Consolidation of Special Purpose Entities (SPEs)	Ind AS 27 (Appendix A) offers guidance on consolidation SPEs (Special Purpose Entities).	AS-21 doesn't offer guidance on the consolidation of SPEs (Special Purpose Entities).
The inclusion of notes	Ind AS 27 doesn't offer any	AS-21 offers clarification

which appears in the separate financial statement	clarification with respect to this.	with respect to inclusion of notes which appears in separate financial statements of parent company and the subsidiary in consolidated financial statement.

10.4 Consolidated Financial Statements

10.4.1 Meaning of Consolidated Financial Statements

A consolidated financial statement is financial statement, which represents the financial information of holding company and its subsidiary company as a single entity. It is presented by a parent company for its subsidiary under its control. It intended to show the assets and liabilities of all the companies of a holding company. ICAI had issued Accounting Standard -21 in respect of 'Consolidated Financial Statement' which came into effect of accounting periods commencing on or after 1.4.2001. A parent company should prepare and present these financial statements in addition to its regular financial statements as per this standard.

10.4.2 Advantages of Consolidated Financial Statements

The followings are the advantages of consolidated financial statements:

1. **Information about overall profitability**: There can be some mutual indebtedness in holding and its subsidiaries. Profitability of holding and all its subsidiaries can be determined by consolidation. Here internal and external users of financial information can make their judgement about the company that they should invest or not.

2. **Easy to know the financial position of holding and its subsidiaries**: True financial position of holding and each of its subsidiaries can be determined with consolidation of financial statement.

3. **Evaluation of efficiency**: Efficiency of holding and its subsidiaries can be evaluated with the help of consolidation of financial statements. Investors can use these information to know the past trend and future trends.

4. **Easy to find the intrinsic value of shares**: intrinsic value of shares of holding company can be found by the consolidated financial statements.

5. **Easy to know minority Interest**: minority Interest of outsider shareholders of subsidiaries can be found by the consolidated financial statements.

6. **Complete Overview**-Consolidated statements allow investors, financial analysts, business owners and other interested parties to get a complete overview of the parent company. At a glance, they can view the overall health of the business and how each subsidiary impacts the parent company.

10.4.3 Disadvantages of Consolidated Financial Statements

The followings are the advantages of consolidated financial statements:

1. Confusion about true financial position of subsidiaries: After consolidation the assets and liability are shown in single entity. So here it is difficult to know the true financial position of subsidiaries of a holding company.

2. Concealment of financial information: For the growth and to reduce the risk of holding company after aggregation of financial statement of holding and its subsidiaries may conceal some important financial information from investors.

3. Chances of fraud by Holding company: Sometimes the holding company doesn't disclose the true financial position, it can mislead the users.

10.4.4 Who is Responsible for Preparation of Consolidated Financial Statements?

The management of the company is responsible for the preparation and disclosure of the financial statements to the stakeholders. In a public company, the management is an agent and the actual owner/principal is the shareholders. So it is the responsibility of the management to report the performance of the company.

10.4.5 Consolidated Balance Sheet

Format and Contents- As per Companies Act, 2013 preparation of consolidated financial statement is not compulsory, hence there is no prescribed format. Instead this, if it prepared then it should be in according with Schedule III of the Companies Act, 2013. The Performa of consolidated balance sheet is as follows:

(Consolidated balance sheet of Holding Company and its subsidiary or subsidiaries as at.........................)

Particulars	Rs.
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital (Holding company**)**	
Minority interest	
Reserves and surplus	
a. Capital Reserve **(**Holding company**)**	
Add: Capital reserve from acquisition	
Less: Goodwill	
b. Revenue Reserve **(**Holding company**)**	
c. Surplus	
Profit of Holding company	
Add: Share in revenue profits of subsidiary	
Less: Unrealised profits	
Non-Current Liabilities (Both companies)	
Current Liabilities (Both companies)	
Less: Mutual Owings	....
	....
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets	
Intangible Assets	

Goodwill (Cost of Control):	
Goodwill (Both Companies)	
Add: Goodwill from Acquisition	
Total Goodwill	
Less: Capital Reserve	
Investments:	
Investments of Holding company (Except in shares and debentures)	
Add: Investment of subsidiary company	
Current Assets (Both companies)	
Less: Mutual Owings (if any)	
Less: Unrealised profit	
	....
	....

Explanation of Key Terms:

- **Share Capital:** Share capital of both Holding as well as of its subsidiary company can be given in the balance sheets. After consolidation share capital of only holding company will be shown in consolidated balance sheet.
- **Minority interest**: In partly owned subsidiaries some of shareholders don't sell their shares to the holding company, these are known as 'Minority Shareholders' and their interest in assets is known as 'Minority Interest'. For example; A Ltd. own 75% shares of B Ltd. the remaining 25% shares will be owned by outsiders. These are minority shareholders and their interest is known as Minority Interest. Thus, minority interest is the share of outsider in the following.
  - Proportionate share in paid up share capital in subsidiary company.
  - Proportionate share in reserves (Both pre-acquisition and post-acquisition of subsidiary company).
  - Proportionate share in accumulated losses in subsidiary company.
  - Proportionate share in Cr. Balance of profit or loss (Both pre-acquisition and post-acquisition of subsidiary company) and in case of losses their interest will be reduced.

  Calculation of Minority interest:

Paid up value of shares of subsidiary company

Add: Reserves of subsidiary company as on date of consolidation

Add: Appreciation of value of fixed assets on revaluation

Less: Dr. Balance of P & L A/c

- **Reserves & Surplus:** Reserves and surplus, as the name suggests, are the accumulated profits that a company has earned and retained overtime. Retained profits are the profits that are left after paying the dividends to the shareholders.

Calculation of Reserves & surplus

Reserves and surplus

a. Capital Reserve (Holding company)

Add: Capital reserve from acquisition

Less: Goodwill

b. Revenue Reserve (Holding company)

c. Surplus

Profit of Holding company

Add: Share in revenue profits of subsidiary

Less: Unrealised profits

- **Non-current Liabilities:** Long-term loans, Debentures, Borrowings and lease obligations, bonds payable and deferred revenue etc. After consolidation non-current liabilities of both companies will be shown in consolidated balance sheet.
- **Current Liabilities:** Accounts Payables, Trade payables, Accrued expenses, Tax payables, Short-term debt, unearned revenue etc. After consolidation current liabilities of both companies will be shown in consolidated balance sheet. Mutual Owings in any will be deducted from it.

- **Fixed Assets:** Vehicles such as company trucks, Office furniture, Machinery, Land & Buildings, etc. After consolidation fixed assets of both companies will be shown in assets in consolidated balance sheet.
- **Current Assets:** Cash and cash equivalents, Accounts receivable, Companies allow, Inventory, Short-term investments, Notes receivable, Prepaid expenses (e.g., insurance premiums that have not yet expired) Marketable securities. After consolidation current assets of both companies will be shown in assets in consolidated balance sheet.
- **Goodwill/ Capital reserve:** Sometimes Holding Company acquired the shares of Subsidiary company at par. But in actual practice it may be possible that Holding company may pay for the shares of subsidiary company an amount which is either more or less than the face value of the shares. If it pays more than the face value of shares the excess amount paid is considered as payment for Goodwill or cost of control. If it pays less than the face value of shares, the difference is considered as capital profit and is shown as Capital Reserve in the consolidate balance sheet.

Calculation of Goodwill/Capital Reserve

Amount paid for shares held in Subsidiary company

Less: Paid up value of shares held in Subsidiary company

Add: Proportionate of Reserves of subsidiary company as on date of acquisition

Add: Proportionate of appreciation of value of fixed assets on revaluation

Less: Proportionate of Dr. Balance of P & L A/c

Illustration 1.

The following is the balance sheet of H Ltd. and S Ltd. As at 31 March, 2020:

Particulars	H Ltd.	S Ltd.
I. EQUITY AND LIABILITIES:	Rs.	Rs.
Shareholder's Funds:		
Share capital (Shares of Rs. 10 each, fully paid)	40,00,000	10,00,000
Reserves and surplus	12, 00,000	-

Current Liabilities		
Trade Payables	2,80,000	1,60,000
	....	....
	54,80,000	**11,60,000**
	....	....
II. ASSETS:		
Non-current Assets		
Investments: (in 100% Shares of S Ltd.)	10,00,000	-
Current/Non-current Assets	44,80,000	11,60,000
	....	....
	54,80,000	**11,60,000**
	....	....

Prepare a consolidated balance sheet as at 31st March, 2020.

Solution:

In the above example, 100% shares of S Ltd. are held by H Ltd. These represent assets of Rs. 11, 60,000 minus the liabilities of Rs. 1, 60,000. Therefore, while preparing a consolidated balance sheet of H Ltd. and S Ltd. the assets and liabilities of both companies will be added and the investments in 100% shares of S Ltd. will be cancelled against the share capital of S Ltd. The consolidated balance sheet of H Ltd. & Its subsidiary S Ltd. is as under:

Particulars	Rs.
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	40,00,000
Reserves and surplus	12,00,000
Current Liabilities :	
Trade Payables (H Ltd. & S Ltd.)	4,40,000
	....

Total	**56, 40,000**
	....
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets (H Ltd. & S Ltd.)	56,40,000
	....
Total	**56,40,000**
	....

10.5 Check Your Progress

1. Which Accounting Standard deal with Consolidated Financial Statement?

   a) AS-19
   b) AS-20
   c) AS-21
   d) AS-22

2. Holding company also known as ……?

   a. Subsidiary
   b. Holding
   c. Both of the above
   d. None of the above

3. Wholly owned subsidiary company means?

   a. in which 100% of the subsidiary’s shares are owned by the parent company
   b. in which 51% of the subsidiary’s shares are owned by the parent company
   c. in which 10% of the subsidiary’s shares are owned by the parent company
   d. None of the above

4. Which one is the disadvantage of Holding company?

   a. Difficulty in ascertaining the true picture of financial statement

b. Misuse of Power
c. Exploitation of subsidiaries
d. All of the above

5. Which of the following is the objective of AS-21?

a. lay down principles and procedures for preparation of consolidated financial statements
b. presentation of financial statements
c. Both a & b
d. None of the above

6. AS-21 doesn't deal with:

a) accounting methods for amalgamations and effects on consolidation
b) accounting for investments in JVs (joint ventures)
c) accounting for investments in associates
d) All of the above

10.6 Summary

A holding company is a company or limited liability company (LLC) which has control over another company. When a company acquires all or majority of shares carrying voting rights or controls the composition of Boards of Directors (BOD). The company whose shares have been acquired is known as subsidiary company. A wholly owned subsidiary is one in which 100% of the subsidiary's shares are owned by the parent company. A partly owned subsidiaries company is that company in which the majority of shares i.e. more than 50 % but less than 100% owned by holding company. It is to be noted that while preparing a consolidated financial statement as per AS-21, other standards also stay relevant in a similar manner as for standalone statements. The objective of AS-21 is to lay down principles and procedures for preparation and presentation of consolidated financial statements.

The users of financial statements of a parent company are typically concerned with and are required to be educated about, the results of operations and financial position of not only the company itself but also of that group together. Where a company doesn't have any subsidiary, however, has associates and/or joint ventures such company also needs to prepare consolidated financial statements as per Accounting Standard 23-Accounting for Associates in Consolidated Financial Statements and

Accounting Standard 27-Financial Reporting of Interests in joint ventures respectively. In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries (included foreign subsidiaries) should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses.

10.7 Keywords

- **Holding company**: A holding company is a company or limited liability company (LLC) which has control over all or majority of shares carrying voting rights or controls the composition of boards of directors (BOD) of another company.
- **Subsidiary company**: The Company whose shares have been acquired is known as subsidiary company.
- **Partly owned subsidiaries**: A partly owned subsidiaries company is that company in which the majority of shares i.e. more than 50 % but less than 100% owned by holding company.
- **Wholly owned subsidiary:** A wholly owned subsidiary is one in which 100% of the subsidiary's shares are owned by the parent company.
- **Financial statements**: Financial Statements are the reports that provide the detail of the entity's financial information including assets, liabilities, equities, incomes and expenses, shareholders' contribution, cash flow, and other related information during the period of time.
- **Joint ventures**: A joint venture (JV) is a business arrangement in which two or more parties agree to pool their resources for the purpose of accomplishing a specific task. This task can be a new project or any other business activity.
- **Economies**: Economies of scale are cost advantages reaped by companies when production becomes efficient. Companies can achieve economies of scale by increasing production and lowering costs.
- **Manipulations**: The action of manipulating something in a skilful, clever or unscrupulous manner by directors or secretaries of a company.

10.8 Self-Assessment Test

Short Answer Questions:

1. Wholly owned subsidiary

2. Partially owned subsidiary
3. Consolidated financial statement
4. Minority Interest

Long Answer Questions:

1. What is a Holding company? How does a Holding company can be formed?
2. What do you mean by a Holding company? Explain the advantages and disadvantages of a Holding company.
3. Write a detailed note on AS-21.
4. What do you mean by consolidated financial Statements? Differentiate between Ind AS-110 and AS-21.

Numerical Question:

The following is the balance sheet of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	₹	₹
Shareholder's Funds:		
Share capital (Shares of Rs. 10 each, fully paid)	10,00,000	2,50,000
Reserves and surplus	3, 00,000	-
Current Liabilities		
Trade Payables	70,000	40,000
	…………….	…………….
	13,70,000	**2,90,000**
	…………….	…………….
II. ASSETS:		
Non-current Assets		
Investments: (in 100% Shares of B Ltd.)	2,50,000	-
Current/Non-current Assets	11,20,000	2,90,000
	…………….	…………….
	13,70,000	**2,90,000**
	…………….	…………….

Prepare a consolidated balance sheet as at 31st March, 2020.

(Answer: Shareholder's Funds ₹13,00,000, Current Liabilities ₹1,10,000, Total Liabilities ₹14,10,000, Fixed Assets ₹14,10,000).

10.9 Answers to check your progress

1 (c), 2 (b), 3 (a), 4 (d), 5 (c), 6 (d)

10.10 References/ Suggested Readings

- Gupta, Nirmal. Corporate Accounting, Sahitya Bhawan, Agra
- Jain, S.P. and K.L. Narang. Corporate Accounting, Kalyani Publishers, New Delhi.
- Maheshwari, S.N. and S. K. Maheshwari. Corporate Accounting, Vikas Publishing House, New Delhi.
- Monga, J.R. Fundamentals of Corporate Accounting, Mayur Paper Backs, New Delhi.
- Naseem Ahmed, Corporate Accounting, ANE Books Pvt. Ltd. New Delhi.
- Sehgal, Ashok and Deepak Sehgal. Corporate Accounting, Taxman Publication, New Delhi.
- Shukla, M.C., T.S. Grewal, and S.C. Gupta. Advanced Accounts, S. Chand & Co., New Delhi.

Subject: Corporate Accounting	
Course Code: BCOM 301	**Author: Dr. Sanjeev Kumar Garg**
Lesson No.: 11	**Vetter: Prof. Suresh Kumar Mittal**
Accounts of Holding Companies II: Consolidated Balance Sheet With One Subsidiary	

Structure

11.0 Learning Objectives

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

- Define consolidated financial statements

- Know the Advantages & disadvantages of Consolidated financial statements
- Prepare the consolidated balance sheet in case of wholly owned & partially owned subsidiary
- Define interim dividend & proposed dividend
- Knowthe Pre-Acquisition and Post-Acquisition Profits/Reserves

11.1 Introduction

11.1.1 Meaning of Consolidated financial statements

A consolidated financial statement is financial statement, which represents the financial information of holding company and its subsidiary company as a single entity. It is presented by a parent company for its subsidiary under its control. It intended to show the assets and liabilities of all the companies of a holding company. ICAI had issued Accounting Standard -21 in respect of 'Consolidated Financial Statement' which came into effect of accounting periods commencing on or after 1.4.2001. A parent company should prepare and present these financial statements in addition to its regular financial statements as per this standard.

11.1.2 Consolidated Balance Sheet

Format and Contents- As per Companies Act, 2013 preparation of consolidated financial statement is not compulsory, hence there is no prescribed format. Instead this, if it prepared then it should be in according with Schedule III of the Companies Act, 2013. The Performa of consolidated balance sheet is as follows:

(Consolidated balance sheetof Holding Company and its subsidiary or subsidiaries as at.........................)

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital (Holding company**)**	
Minority interest	
Reserves and surplus	
a. Capital Reserve**(**Holding company**)**	

Add: Capital reserve from acquisition	
Less: Goodwill	
b. Revenue Reserve**(**Holding company**)**	
c. Surplus	
Profit of Holding company	
Add: Share in revenue profits of subsidiary	
Less: Unrealised profits	
Non-Current Liabilities (Both companies)	
Current Liabilities(Both companies)	
Less: Mutual Owings	....
	....
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets	
Intangible Assets	
Goodwill (Cost of Control):	
Goodwill (Both Companies)	
Add: Goodwill from Acquisition	
Total Goodwill	
Less: Capital Reserve	
Investments:	
Investments of Holding company (Except in shares and debentures)	
Add: Investment of subsidiary company	
Current Assets (Both companies)	
Less: Mutual Owings (if any)	
Less: Unrealised profit	
	....
	....

11.1.3 Preparation of Consolidated Balance Sheet in case of wholly owned subsidiary

The basic point to be remembered in the preparation of consolidated balance sheet is that the shares held by the holding company in the subsidiary company represent the shares of the holding company in the assets and liabilities of the subsidiary companies. So while preparing consolidated balance sheet, the shares owned by the holding company in subsidiary company are replaced by the net assets of the subsidiary company.

Illustration:1

The following is the balance sheet of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	₹	₹
Shareholder's Funds:		
Share capital (Shares of ₹10 each, fully paid)	10,00,000	5,00,000
Reserves and surplus	6, 00,000	-
Current Liabilities		
Trade Payables	1,40,000	80,000
	…………….	……………..
	17,40,000	**5,80,000**
	…………….	……………..
II. ASSETS:		
Non-current Assets		
Investments: (in 100% Shares of B Ltd.)	5,00,000	-
Current/Non-current Assets	12,40,000	5,80,000
	…………….	……………..
	17,40,000	**5,80,000**
	…………….	……………..

Prepare a consolidated balance sheet as at 31st March, 2020.

Solution:

In the above Illustration, 100% shares of B Ltd. are held by A Ltd. These represent assets of ₹ 5,80,000 minus the liabilities of ₹ 80,000. Therefore, while preparing a consolidated balance sheet of A Ltd. and B Ltd. the assets and liabilities of both companies will be added and the investments in 100% shares of B Ltd. will be cancelled against the share capital of B Ltd. The consolidated balance sheet of A Ltd. & Its subsidiary is as under:

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital (1,00,000 Shares of ₹10 each, fully paid)	10,00,000
Reserves and surplus	6,00,000

Current Liabilities :	
Trade Payables (A Ltd. & B Ltd.)	2,20,000
	....
Total	**18, 20,000**
	....
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets (A Ltd. & B Ltd.)	18,20,000
	....
Total	**18,20,000**
	....

11.1.4 Cost of Control/ Capital Reserve

As discussed in the above Illustration, A Ltd. acquired the shares of B Ltd. at par. But in actual practice it may be possible that A Ltd may pay for the shares of B Ltd. an amount which is either more or less than the face value of the shares. If it pays more than the face value of shares the excess amount paid is considered as payment for Goodwill or cost of control. If it pays less than the face value of shares, the difference is considered as capital profit and is shown as Capital Reserve in the consolidate balance sheet.

Illustration:2

The following is the balance sheet of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	**₹**	**₹**
Shareholder's Funds:		
Share capital (Shares of ₹ 10 each, fully paid)	20,00,000	5,00,000
Reserves and surplus	6, 00,000	-
Current Liabilities		
Trade Payables	1,40,000	80,000
	....	....
	27,40,000	**5,80,000**
	....	....
II. ASSETS:		

Non-current Assets		
Investments: (in 100% Shares of B Ltd.) (at cost)	5,20,000	-
Current/Non-current Assets	22,20,000	5,80,000
	....	....
	27,40,000	**5,80,000**
	....	....

Prepare a consolidated balance sheet as at 31st March, 2020.

Solution:

In the above Illustration,A Ltd. paid ₹ 5,20,000 for acquiring ₹5,00,000 shares of B Ltd. In this case A Ltd. has paid ₹20,000 excess which represents the amount of Goodwill/ cost of control. The consolidated balance sheet of A Ltd. & Its subsidiary is as under:

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital (2,00,000 Shares of ₹10 each, fully paid)	20,00,000
Reserves and surplus	6,00,000
Current Liabilities :	
Trade Payables (A Ltd. & B Ltd.)	2,20,000
	....
Total	**28, 20,000**
	....
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets (A Ltd. & B Ltd.)	28,00,000
Intangible Assets(**Cost of Control/Goodwill**)	20,000
	....
Total	**28,20,000**
	....

Illustration:3

The following is the balance sheet of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	₹	₹
Shareholder's Funds:		
Share capital (Shares of ₹10 each, fully paid)	20,00,000	5,00,000
Reserves and surplus	6, 00,000	-
Current Liabilities		
Trade Payables	1,40,000	80,000
	27,40,000	**5,80,000**
II. ASSETS:		
Non-current Assets		
Investments: (in 100% Shares of B Ltd.) (at cost)	4,80,000	-
Current/Non-current Assets	22,60,000	5,80,000
	27,40,000	**5,80,000**

Prepare a consolidated balance sheet as at 31st March, 2020.

Solution:

In the above Illustration,A Ltd. paid ₹ 4, 80,000 for acquiring ₹ 5, 00,000 shares of B Ltd. In this case A Ltd. has paid ₹ 20,000 less which represents the amount of Capital Reserve. The consolidated balance sheet of A Ltd. & Its Subsidiary Company is as under:

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital (2,00,000 Shares of ₹10 each, fully paid)	20,00,000
Reserves and Surplus (₹ 6,00,000+20,000)	6,20,000
Current Liabilities :	
Trade Payables (A Ltd. & B Ltd.)	2,20,000
Total	**28, 40,000**
II. ASSETS:	
Non-current Assets	

Fixed Assets:	
Tangible Assets (A Ltd. & B Ltd.)	28,40,000
	....
Total	**28,40,000**
	....

11.1.5 Preparation of Consolidated Balance Sheet in case of partly owned subsidiary

Partly owned: A partly owned subsidiaries company is that company in which the majority of shares i.e. more than 50 % but less than 100% owned by holding company. For example; A Ltd. own 75% shares of B Ltd. this is a case of partly owned subsidiary company.

Minority Interest: In partly owned subsidiaries some of shareholders don't sell their shares to the holding company, these are known as 'Minority Shareholders' and their interest in assets is known as 'Minority Interest'. For Illustration; A Ltd. own 75% shares of B Ltd. the remaining 25% shares will be owned by outsiders. These are minority shareholders and their interest is known as Minority Interest.The parent company doesn't have complete control, but it should have a controlling interest. This will be shown in consolidated balance sheet between Share capital and Reserve and surplus.

Thus, minority interest is the share of outsider in thefollowing.

- Proportionate share in paid up share capital in subsidiary company.
- Proportionate share in reserves (Both pre-acquisition and post-acquisition of subsidiary company).
- Proportionate share in accumulated losses in subsidiary company.
- Proportionate share in Cr. Balance of profit or loss (Both pre-acquisition and post-acquisition of subsidiary company) and in case of losses their interest will be reduced.

The method of consolidation in case of partly owned subsidiary company is same as of wholly owned subsidiary.

Illustration:4

The following is the balance sheet of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	₹	₹
Shareholder's Funds:		
Share capital (Shares of ₹10 each, fully paid)	20,00,000	5,00,000
Reserves and surplus	6, 00,000	-
Current Liabilities		
Trade Payables	1,40,000	80,000
	....	....
	27,40,000	**5,80,000**
	....	....
II. ASSETS:		
Non-current Assets		
Investments: (in 60% Shares of B Ltd.) (at cost)	3,00,000	-
Current/Non-current Assets	24,40,000	5,80,000
	....	....
	27,40,000	**5,80,000**
	....	....

Prepare a consolidated balance sheet as at 31st March, 2020.

Solution:

The consolidated balance sheet of A Ltd. & Its subsidiary as at 31st March, 2020 is as follow:

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	20,00,000
Reserves and Surplus	6,00,000
Minority Interest	2,00,000
Current Liabilities :	
Trade Payables (A Ltd. & B Ltd.)	2,20,000
	....
Total	**30, 20,000**
	....
II. ASSETS:	
Non-current Assets	
Fixed Assets:	

Tangible Assets (A Ltd. & B Ltd.)	30,20,000 ………………
Total	**30,20,000** ………………

Note: Minority interest is the proportion of the outsiders in the subsidiary company's share capital and reserves and surplus. Hence minority interest in this Illustration is calculated as follows:

Minority Interest= ₹5, 00,000× 40/100= ₹2, 00,000

Illustration: 5

The following is the balance sheet of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	₹	₹
Shareholder's Funds:		
Share capital (Shares of ₹10 each, fully paid)	15,00,000	6,00,000
Reserves	2,10,000	65,000
Surplus (P & L Account)	40,000	10,000
Current Liabilities	2,00,000	95,000
Trade Payables	…………….	…………….
	19,50,000 …………….	**7,70,000** …………….
II. ASSETS:		
Non-current Assets		
Investments: (100% Shares in B Ltd. Acquired on 31st March '20)	6,25,000	-
Current/Non-current Assets		
Sundry Assets	13,25,000	7,20,000
Unamortized Expenses	-	50,000
	…………….	…………….
	19,50,000 …………….	**7,70,000** …………….

Prepare a consolidated balance sheet as at 31st March, 2020.

Solution:

The consolidated balance sheet of A Ltd. & Its subsidiary as at 31st March, 2020 is as follows:

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	15,00,000
Reserves and Surplus	2,50,000
Current Liabilities :	
Trade Payables (A Ltd. & B Ltd.)	2,95,000
	....
Total	**20, 45,000**
	....
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets (A Ltd. & B Ltd.)	20,45,000
	....
Total	**20,45,000**
	....

Working Notes:

- **Calculation of Goodwill/Capital Reserve:**

Amount paid for 100% shares in B Ltd.		6, 25,000
Less: Paid up value of 100% shares in B Ltd.	(6,00,000)	
Add: 100% of Reserves of B Ltd. As on date of acquisition	65,000	
Add: 100% of Profit & Loss balance as on the date of acquisition	10,000	
Less: 100% of unamortized expenses of B Ltd. as on the date of acquisition	(50,000)	6,25,000
Goodwill or Capital Reserve		**NIL**

11.1.6 Revaluation of Fixed Assets of Subsidiary Company

Revaluation of fixed assets of subsidiary company also affects the cost of control/goodwill or Capital Reserve and the minority interest. Its affects has been discussed in the followings Illustration:

Illustration: 6

The following is the balance sheet of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	₹	₹
Shareholder's Funds:		
Share capital (Shares of ₹10 each, fully paid)	15,00,000	5,00,000
Reserves	1,50,000	75,000
Surplus (P & L Account)	-	(20,000)
Current Liabilities	2,25,000	1,60,000
Trade Payables	....	....
	18,75,000	**7,15,000**
	....	....
II. ASSETS:		
Non-current Assets		
Fixed Assets	12,00,000	6,50,000
Investments: (17,500 Shares in B Ltd. Acquired on 31st March 19)	4,25,000	
Current Assets	2,50,000	65,000
	....	....
	19,50,000	**7,70,000**
	....	....

On 31st March, 2020 the fixed assets of B Ltd. were re-valued at ₹ 6,75,000. You are required to prepare a consolidated balance sheet of A Ltd. and its Subsidiary B Ltd. as at 31st March, 2020.

Solution:

The consolidated balance sheet of A Ltd. & Its subsidiary as at 31st March, 2020 is as follows:

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	15,00,000
Reserves and Surplus	1,50,000
Minority Interest	1,74,000
Current Liabilities :	
Trade Payables (A Ltd. & B Ltd.)	3,85,000
	....
Total	**22, 09,000**
	....
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets (A Ltd. & B Ltd.)	18,75,000
Intangible Assets	19,000
Current Assets	3,15,000
	....
Total	**22,09,000**
	....

Working Notes:

(i) Total share capital of B Ltd. is ₹ 5,00,000 divided into shares of ₹ 20 each. Hence, the total number of shares = ₹ 5,00,000/20 = 25,000 of which 70% held by A Ltd. = 25,000 ×70/100= 17,500.

(ii) Calculation of Goodwill/Capital Reserve:

Amount paid for 70% shares in B Ltd.		4, 25,000
Less: Paid up value of 70% shares in B Ltd. (5,00,000 × 70/100)	(3,50,000)	
Add: 70% of Reserves of B Ltd. As on date of acquisition	52,500	
Add: 70% of appreciation of value of fixed assets on revaluation (6,75,000 – 6,50,000) × 70/100	17,500	
Less: 70% of Dr. balance of P & L A/c	(14,000)	4,06,000
Goodwill or Capital Reserve		**19,000**

(iii) Calculation of Minority interest:

Paid up value of 30% shares of B Ltd. (5,00,000 × 30/100)	1,50,000
Add: 30% of Reserves of B Ltd. As on date of Consolidation	22,500
Add: 30% of appreciation of value of fixed assets on revaluation (6,75,000 – 6,50,000) × 30/100	7,500
Less: 30% of Dr. balance of P & L A/c	(6,000)
Minority Interest	1,74,000

11.2 Pre-Acquisition and Post-Acquisition Profits/Reserves

Till now, the full amount of Reserves & P & L balances appearing in balance sheet of subsidiary were treated as capital profits and hence were taken into account for calculating the Goodwill or Capital Reserve. This was due to the assumption that the shares were acquired on the date of balance sheet of the subsidiary.

But, in actual practice date of acquisition of shares and the date of preparing the consolidated balance sheet may be different. In such case subsidiary company's reserve and profits must be split into pre-acquisition and post-acquisition on the basis of date of acquisition of share in the subsidiary. Holding company's share in pre-acquisition reserves and profits is treated as capital profit and post-acquisition reserves and profits is treated as revenue profit (loss). In such cases there is no impact on calculation of minority interest.

<u>Illustration:7</u>

The following are the balance sheets of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	**₹**	**₹**
Shareholder's Funds:		
Share capital (Shares of ₹100 each, fully paid)	25,00,000	10,00,000
General Reserves	5,50,000	2,80,000
Surplus (P & L Account)	2,00,000	90,000
Current Liabilities		
Trade Payables	2,25,000	2,00,000

	…………… **34,75,000** ……………	…………… **15,70,000** ……………
II. ASSETS:		
Non-current Assets		
Fixed Assets	22,25,000	12,00,000
Investments: (7,500 Shares in B Ltd.) (At cost)	9,50,000	-
Current Assets	3,00,000	3,45,000
Current/Non-Current Assets		
Unamortized Expenses	-	25,000
	…………… **34,75,000** ……………	…………… **15,70,000** ……………

The shares of B Ltd. were acquired by A Ltd. on 1st April, 2019, on which date the General Reserves and Statement of P & L A/c of B Ltd. showed balances of ₹ 2,20,000 and ₹ 20,000 respectively. Unamortized expenses were not written off during the year ending 31st March, 2020. You are required to prepare a consolidated balance sheet of A Ltd. and its Subsidiary B Ltd. as at 31st March, 2020.

<u>Solution:</u>

The consolidated balance sheet of A Ltd. & Its subsidiary as at 31st March, 2020.

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	25,00,000
Reserves and Surplus	8,47,500
Minority Interest	3,36,250
Current Liabilities :	
Trade Payables	4,25,000
	……………
Total	**41, 08,750**
	……………
II. ASSETS:	
Non-current Assets	
Fixed Assets:	

Tangible Assets	34,25,000
Intangible Assets	38,750
Current Assets	6,45,000
	....
Total	**41,08,750**
	....

Working Notes:

- Total share capital of B Ltd. is ₹10,00,000 divided into shares of ₹100 each. The shares of B Ltd. is ₹10,00,000/100=10,000. A Ltd. has acquired 7,500 shares of B Ltd. Hence, A Ltd. has acquired 7,500/10,000= ¾th shares of B Ltd.

- **Capital profits of subsidiary i.e. profit earned prior to acquisition of shares:**

General Reserves as on 1st April, 2019	2,20,000
Profit & Loss as on 1st April, 2019	20,000
Less: Unamortized expenses as on 1st April, 2019	(25,000)
Pre-Acquisition profit (Capital Profits)	**2,15,000**

- **Revenue profits of subsidiary i.e. profit earned after the acquisition of shares:**

General Reserves as on 31stMarch, 2020	2,80,000
Profit & Loss as on 31st March, 2020	90,000
Less: Unamortized expenses as on 31st March, 2020	(25,000)
Less: Pre-acquisition Profits	(2,15,000)
Post-Acquisition profit (Revenue Profits)	**1,30,000**

- **Calculation of Goodwill/Capital Reserve:**

Amount paid for 3/4 shares in B Ltd.		9,50,000
Less:		
• Paid up value of 3/4 shares in B Ltd. (10, 00,000 × 3/4)	7,50,000	
• ¾ of Capital Profit i.e. profits prior to acquisition (2,15,000 × ¾)	1,61,250	(9,11,250)
Goodwill or Capital Reserve		**38,750**

- **Calculation of Minority interest:**

Paid up value of 1/4th shares of B Ltd. (₹10, 00,000 × ¼)	2,50,000
Add: 1/4th of General Reserves as on 31st march 2020 : ₹ 2,80,000 × ¼	70,000
Add: 1/4th of Profit and loss as on 31st march 2020: ₹ 90,000 × ¼	22,500
Less: 1/4th of Unamortized Expenses: 25,000 × ¼	(6,000)
Minority Interest	**3,36,250**

11.2.1 Shares of subsidiary acquired during the course of the year

Holding company may not purchase the shares of the subsidiary company on the date on which subsidiary company prepare its financial statements. For Illustration, if the subsidiary company has prepared its financial statements on 31st March, 2020 and the holding company acquired shares on 31st July, 2019, not only whole of the reserves and profit and loss account balance standing on 1st April, 2019 will be the capital profits, but the profit up to the date of acquisition i.e. up to 31st July, 2019 will be treated as capital profit. In this case it is assumed that the profits during the current year have been accruing from the day to day and hence, the apportionment of profits is made on the time basis. In the above case, profits for the period ended on 31st March, 2020 will be apportioned in the ratio of 3:9.

Illustration:8

The following are the balance sheets of Sriram Ltd. and Kailash Ltd. As at 31 March, 2020:

Particulars	Sriram Ltd.	Kailash Ltd.
I. EQUITY AND LIABILITIES:	₹	₹
Shareholder's Funds:		
Share capital (Shares of ₹20 each, fully paid)	60,00,000	15,00,000
General Reserves	17,00,000	3,00,000
Surplus (P & L Account)	7,00,000	2,00,000
Current Liabilities		
Trade Payables	15,00,000	5,00,000
	....	....
	99,00,000	**25,00,000**
	....	....
II. ASSETS:		

Non-current Assets		
Fixed Assets:		
Plant & Machinery	65,00,000	12,00,000
Office Equipment's	10,00,000	6,89,000
Investments: (45,000 Shares in B Ltd.) (At cost)	11,00,000	-
Current Assets		
Inventories	7,00,000	3,00,000
Trade Receivables	3,50,000	2,00,000
Cash	2,50,000	1,00,500
Current/Non-Current Assets		
Unamortized Expenses	-	10,500
	....	....
	99,00,000	**25,00,000**
	....	....

The shares of Kailash Ltd. were acquired by Sriram Ltd. on 1st July, 2019. On 31st March, 2019Kailash Ltd. had followings balances:

General Reserves ₹2,40,000; P& L A/c ₹1,00,000

No part of Unamortized Expense was written off during the year ending 31st March, 2020. You are required to prepare a consolidated balance sheet of Sriram Ltd. and its Subsidiary Kailash Ltd. as at 31st March, 2020.

Solution:

The consolidated balance sheets of Sriram Ltd. & its subsidiary Kailash Ltd. as at 31st March, 2020 is as follows:

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	60,00,000
Reserves and Surplus	24,93,700
Minority Interest	7,95,800
Current Liabilities :	
Trade Payables	20,00,000
	___________

Total	**1, 12, 89,500**
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets	93,89,000
Current Assets	
Inventories	10,00,000
Trade Receivables	5,50,000
Cash and cash Equivalents	3,50,000
Total	**1,12,89,500**

Working Notes:

- In the books of Kailash Ltd.

Closing balance of P & L A/c as on 31st March, 2020	2,00,000
Add: Transfer to General Reserve	60,000
Less: Opening Balance of P & L A/c as on 31st March, 2019	(1,00,000)
Net Profit for the current year	1,60,000

It is assumed that the profits during the current year have been earned evenly earned.

Profit before acquisition (1,60,000 × 3/12)	40,000
Profit after acquisition (1,60,000 × 9/12)	1,20,000
Revenue profits of Kailash Ltd.	1,20,000
Sriram Ltd.'s share in revenue profits = 1,20,000 × 60%	72,000

- **Capital profits of subsidiary i.e. profit earned prior to acquisition of shares:**

General Reserves as on 1st April, 2019	2,40,000
Profit & Loss as on 1st April, 2019	1,00,000
Profits earned up to 30th June, 2019	40,000
Less: Unamortized expenses as on 1st April, 2019	(10,500)
Pre-Acquisition profit (Capital Profits)	**3,69,500**

- **Calculation of Capital Reserve:**

Amount paid for 60% shares of Kailash Ltd.		11,00,000
Less: Paid up value of 60% shares of Kailash Ltd. (15,00,000× 60%)	(9,00,000)	
Add: 60% of Capital Profit i.e. profits prior to acquisition (3,69,500 ×60%)	2,21,700	11,21,700
Capital Reserve		**21,700**

- **Calculation of Minority interest:**

Paid up value of 40% shares of Kailash Ltd. (10, 00,000 × 40%)	2,50,000
Add: 40% of General Reserves as on 31st March 2020: 3,00,000 × 40%	1,20,000
Add: 40% of Profit and loss as on 31st March 2020:2,00,000 × 40%	80,000
Less: 40% of Unamortized Expenses: 10,500 × 40%	(4,200)
Minority Interest	**7,95,800**

11.2.2 Adjustment for Unrealized Profits included in Inventory

In case,the holding and its subsidiary company trade with each other, the goods sold at a profit by one company may appear as unsold inventory in the balance sheet of another, if the entire quantity is not sold. For IllustrationB Ltd. (subsidiary company) sold goods costing ₹ 40,000 to A Ltd. (Holding company) at a profit of ₹10,000 and at the end of the year A Ltd. Has still inventory of ₹10,000 i.e. 1/5th of the total inventory. The unrealized profits included in inventory 1/5th of the ₹10,000 i.e. ₹2,000. It will not be proper to credit the profit and loss a/c with such unrealized profit. The basic accounting technique of eliminating such profit is to deduct it from the consolidated profit as well as from the aggregate inventory in the consolidated balance sheet.

Accounting Standard-21 recommends that full amount of unrealized profit should be deducted from the consolidated financial statements. It means that if there are minority shareholders in the subsidiary there is no need of adjustment for their share of unrealized profits. So here recommendations of AS-21 will be followed to solve the practical problems.

Illustration:9

The following are the balance sheets of H Ltd. and S Ltd. As at 31 March, 2020:

Particulars	H Ltd.	S Ltd.
I. EQUITY AND LIABILITIES:	**₹**	**₹**
Shareholder's Funds:		
Share capital (Equity)	8,00,000	2,00,000
General Reserves	1,50,000	70,000
Surplus (P & L Account)	90,000	55,000
Current Liabilities		
Trade Payables	1,20,000	80,000
	....	....
	11,60,000	**4,05,000**
	....	....
II. ASSETS:		
Non-current Assets		
Fixed Assets:		
Plant & Machinery	5,50,000	1,00,000
Investments: (75% Shares in S Ltd.) (At cost)	2,80,000	-
Current Assets		
Inventories	1,05,000	1,77,000
Other Current Assets	2,25,000	1,28,000
	....	....
	11,60,000	**4,05,000**
	....	....

- H Ltd. acquired the shares on 31st July, 2019.
- S Ltd. earned a profit of ₹45,000 for the year ended 31st March, 2020.
- In January, 2020 S Ltd. sold to H Ltd. goods costing ₹15,000 for ₹20,000. On 31st March, 2020 half of these goods were lying as unsold in the godown of H Ltd.

You are required to prepare a consolidated balance sheet of H Ltd. and its Subsidiary S Ltd. as at 31st March, 2020.

Solution:

The consolidated balance sheet of H Ltd. & its subsidiary S Ltd. as at 31st March, 2020.

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	8,00,000
Reserves and Surplus	2,60,000
Minority Interest	81,250
Current Liabilities :	
Trade Payables	2,00,000
Total	**13,41,250**
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets	6,50,000
Intangible Assets	58,750
Current Assets	
Inventories	2,79,500
Other Current Assets	3,53,000
Total	**13,41,250**

Working Notes:

- **Calculation of Revenue profits of S Ltd.**

		₹
Profit of 8 months from 1 Aug. 2019 to 31st March 2020		30,000
H Ltd. share in revenue profits		22,500

- **Capital profits of subsidiary company:**

General Reserves		70,000
Profit & Loss A/c	10,000	
Profits earned up to 31th July, 2019		15,000

Capital Profits **95,000**

- **Calculation of Goodwill:**

Amount paid for 75% shares of S Ltd.		2,80,000
Less: Paid up value of 75% shares of S Ltd. (₹2,00,000 × 75%)	(1,50,000)	
Add: H Ltd. Share in capital profits (₹95,000 × 75%)	(71,250)	(2,21,250)
Goodwill		**58,750**

- **Calculation of Minority interest:**

Paid up value of 25% shares of S Ltd. (₹2,00,000 × 25%)	50,000
Add: 25% of General Reserves as on 31st March 2020: (₹70,000 × 25%)	17,500
Add: 25% of Profit and loss as on 31st March 2020: (₹55,000 × 25%)	13,750
Minority Interest	**81,250**

- **Unrealized profit in respect of inventory with H Ltd.**

Total profit charged by S Ltd. =₹20,000 – ₹15,000 = ₹5,000

Since half of the goods remains unsold hence the unrealized profit=₹5,000 × 1/2= ₹2,500

11.2.3 Elimination of Inter-Company Owings

When holding and its subsidiary company trade with each other, it may result in common accounts appearing in the balance sheet of both the companies. While preparing consolidated financial statements then these common accounts will be cancelled as follows:

- **Debtors and Creditors**:-In case the holding company owes a sum to its subsidiary or vice-versa, this sum will be deducted both from the total debtors and creditors in the consolidated balance sheet.
- **Bills of Exchange**:-In case holding company draw a bill in favor its subsidiary or vice versa, this sum will be deducted both from Bills Payables and Bills Receivables. If the bill is related to third party or discounted from bank then it will be appeared in the consolidated balance sheet as a liability.

- **Loans**:-If the holding company provides a loan to its subsidiary or vice-versa, it would be appearing as asset in the balance sheet of company giving loan and as a liability in the books of company taking loan. If interest on loan is outstanding, the lender company will credit its Profit & Loss and will be debit the loan account of the borrower company with the amount of outstanding interest. Similarly the borrowings company will debit its Profit & Loss and credit the lender company's account with the amount of outstanding interest. In the consolidated balance sheet the loan amounts and interest are cancelled.
- **Current Account Balances**:-Sometimes current account appeared in asset side of one company and liability side of other company. At the time of preparing the consolidated balance sheet these two accounts are to be cancelled. Sometimes these amounts can be different in balance sheets of both companies. In this case the difference between two accounts is treated as cash-in-transit or goods-in-transit and it will be shown in assets side of the consolidated balance sheet.

Illustration:10

R Ltd. acquired 8,000 Equity Shares of S Ltd. On 1st April, 2019. The following are the Balance Sheets of two companiesas at 31 March, 2020:

Particulars	R Ltd.	S Ltd.
I. EQUITY AND LIABILITIES:	**₹**	**₹**
Shareholder's Funds:		
Equity shares of ₹100 each	20,00,000	10,00,000
General Reserves (1.4.2019)	4,00,000	2,00,000
Surplus (P & L Account)	1,00,000	60,000
Profit for the year 2019-20	2,00,000	80,000
Current Liabilities		
Sundry Creditors	1,00,000	1,00,000
Bills Payables	30,000	10,000
	....	....
	28,30,000	**14,50,000**
	....	....
II. ASSETS:		
Non-current Assets		
Fixed Assets:		

Land & Building	5,00,000	3,00,000
Plant & Machinery	5,00,000	6,00,000
Investments in Shares in S Ltd. (At cost)	10,00,000	-
Current Assets		
Inventory	1,50,000	1,00,000
Sundry Debtors	80,000	10,000
Bills Receivables	2,50,000	1,00,500
Cash and Bank Balances	5,00,000	3,20,000
	....	....
	28,30,000	**14,50,000**
	....	....

- Bills receivables of R Ltd. Include ₹10,000 accepted by S Ltd.
- Sundry Debtors of R Ltd. Include ₹50,000 due from S Ltd.
- Inventory of S Ltd. Includes goods purchased from R Ltd. For ₹ 60,000 which were invoiced by R Ltd. At a profit of 25% on cost.

Prepare a consolidated balance sheet of R Ltd. and its Subsidiary S Ltd.

Solution:

Consolidated Balance Sheet of R Ltd. & Its subsidiary S Ltd. as at 31st March, 2020.

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	20,00,000
Reserves and Surplus	7,60,000
Minority Interest	2,68,000
Current Liabilities :	
Trade Payables	1,80,000
Total	**32,08,000**
II. ASSETS:	
Non-current Assets	
Fixed Assets:	

Tangible Assets	19,00,000
Current Assets	
Inventories	2,38,000
Trade Receivables	2,50,000
Cash and cash Equivalents	8,20,000
Total	**32,08,000**

Working Notes:

- **Calculation of Revenue profits of S Ltd.** ₹

  Profit & Loss A/c as on 31st March, 2019 80,000

  R Ltd. share in revenue profits (₹80, 000 × 80%) 64,000

- **Capital profits of subsidiary company:**

  General Reserves 2, 00,000

  Profit & Loss A/c 60,000

  Capital Profits **2, 60,000**

- **Calculation of Capital Reserve:**

Amount paid for 80% shares of S Ltd.		10,00,000
Less: Paid up value of 80% shares of S Ltd. (₹10,00,000 × 80%)	(8,00,000)	
Add: R Ltd. Share in capital profits (₹2,60,000 × 80%)	(2,08,000)	10,08,000
Goodwill		**8,000**

- **Calculation of Minority interest:**

Paid up value of 20% shares of S Ltd. (₹10,00,000 × 20%)	2,00,000
Add: 20% of General Reserves: (₹2,00,000 × 20%)	40,000
Add: 20% of Profit and loss: (₹1,40,000 × 20%)	28,000
Minority Interest	**2,68,000**

- **Unrealized profit**

Value of inventory sold to S Ltd. By R Ltd. ₹60,000

This inventory is invoiced at 25% plus cost =100+25=125

So, Profit included in the total value=Rs. 60,000 × 25/125= ₹12,000

11.2.4 Debentures in subsidiary company

If the subsidiary company has issued debentures, they should be shown as a liability in the consolidated balance sheet. But, if a portion of debentures of subsidiary is held by holding company as investment, the same should be cancelled against the debentures on the liability side of the consolidated balance sheet. If there is difference in the purchase price and their paid up value, the same is adjusted while calculating cost of control or capital reserve. Only the amount held by outsiders would be shown separately on the liabilities side of the consolidated balance sheet.

11.2.5 Preference shares in subsidiary company

If the holding company holds preference shares in the subsidiary, the paid up value of such shares will be deducted from the amount paid by the holding company for acquiring such shares in the same way as in the case of equity shares. The difference between the paid up value of preference shares held and the amount paid for their acquisition will be adjusted while calculating cost of control. If a part of preference share capital is held by outsiders, the minority interest will include the paid up value of the preference shares held by outsiders plus the dividend accrued thereon up to the date of consolidation.

11.3 Dividend received from subsidiary company out of Pre-Acquisition Profits

Dividend received by the holding company from its subsidiary company out of Pre-acquisition profits is treated as capital receipt. The holding company should deduct the amount of such dividend from the cost of shares acquired in the subsidiary company.

11.3.1 Dividend received from subsidiary company out of Post-Acquisition Profits

Dividend received by the holding company from its subsidiary company out of Pre-acquisition profits is treated as revenue receipt.

11.3.2 Rectification of error relating to dividend received from subsidiary company

In the question relating to consolidation of balance sheets, it may be given that the holding company has received dividend from the subsidiary company out of pre-acquisition profits and has credited its Profit

& Loss account with the amount so received. Thus an error has been committed in as much as a capital receipt has been treated as an income.

The correct entry that should be passed:

Bank A/c Dr.

To Shares in Subsidiary company

The wrong entry that has been passed:

Bank A/c Dr.

To Statement of Profit & Loss

The Rectifying journal entry:

Statement of Profit & Loss Dr.

To Shares in Subsidiary company

The effect on the holding company's company balance sheet will be that the credit balance of Statement of Profit & Loss will be decreased and the debit balance of shares in the subsidiary company will also be decreased by the same amount. There is no effect of payment of any dividend on the calculation of minority interest since the dividend must have been paid to them also.

Illustration:11

The following are the balance sheets of H Ltd. and S Ltd. As at 31 March, 2020:

Particulars	H Ltd.	S Ltd.
I. EQUITY AND LIABILITIES:	₹	₹
Shareholder's Funds:		
Equity Share capital (Shares of ₹ 10 each, fully paid)	50,00,000	8,00,000
8% Preference share capital	-	2,00,000
General Reserves	15,00,000	1,90,000
Surplus (P & L Account) before appropriation for dividend	6,00,000	1,74,000
Non-Current Liabilities		
10% Debentures	1,00,000	-

Current Liabilities		
Trade Payables	6,50,000	3,26,000
	…………….	…………….
	78,50,000	**16,90,000**
	…………….	…………….
II. ASSETS:		
Non-current Assets		
Fixed Assets	55,00,000	12,00,000
Investments in 75% Equity Shares in S Ltd. On 1.4.2019	7,50,400	-
Investments in 75% Preference Shares in S Ltd. On 1.4.2019	42,000	-
Current Assets	15,57,600	4,90,000
(Including ₹ 40,000 Inventory purchased from H Ltd.)		
	…………….	…………….
	78,50,000	**16,90,000**
	…………….	…………….

On 1st April, 2019 S Ltd. had followings balances after appropriation of dividends:

General Reserves ₹1,10,000; P & L A/c ₹ 70,000

You are required to prepare a consolidated balance sheet as at 31st March, 2020 assuming that H Ltd. Sells goods at a profit of 33x1/3% on cost.

Solution:

The consolidated balance sheet of H Ltd. &S Ltd. as at 31st March, 2020 is as follow.

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	50,00,000
Reserves and Surplus	22,19,200
Minority Interest	4,59,800
Non-current Liabilities	
10% Debenture	1,00,000
Current Liabilities :	
Trade Payables	9,76,000

Total	**87,55,000**
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets	67,00,000
Intangible Assets	17,400
Current Assets	20,37,600
Total	**87,55,000**

Working Notes:

- **In the books of S Ltd.** Rs.

Closing balance of P & L A/c as on 31st March, 2020	1,74,000
Add: Transfer to General Reserve	80,000
Less: Opening Balance of P & L A/c as on 31st March, 2019	(70,000)
Net Profit for the current year	**1,84,000**
Revenue Profit	184,000
Less: Preference Dividend (₹ 2,00,000 × 8%)	(16,000)
Remaining Profit	**1,68,000**
H Ltd. share in profit= ₹1,68,000 × 75/100=₹1,26,000	1,26,000
H Ltd. share in Preference dividend = ₹16,000 × 20/100	3,200
H Ltd. total share in revenue profits= ₹1,26,000+3,200	**1,29,200**
Minority shareholder's share in preference dividend = ₹16,000 × 80%	12,800

Capital profits:

General Reserves as on 1st April, 2019			1, 10,000
Profit & Loss as on 1st April, 2019		70,000	
Capital Profits	**1,80,000**		

Calculation of Cost of control or Goodwill:

Amount paid for acquiring equity shares		7,50,400
Amount paid for acquiring preference shares		42,000
Less: Paid up value of 75% equity shares of S Ltd. (₹ 8,00,000× 75%) Paid up value of 20% preference shares of S Ltd. (₹ 2,00,000 × 20%) 75% of Capital Profit (₹ 1,80,000 × 75%)	 6,00,000 40,000 1,35,000	 (7,75,000)
Goodwill		**17,400**

- **Calculation of Minority interest:**

Paid up value of 25% shares of S Ltd. (8, 00,000 × 25%)	2,00,000
Add: Paid up value of 80% preference shares of S Ltd.	1,60,000
Add: Shares in preference Dividend	12,800
Add: Shares in revenue Profit	42,000
Add: Shares in Capital Profit	45,000
Minority Interest	**4,59,800**

- **Unrealized profit**

Goods costing ₹100 are sold for 133 × 1/3

This inventory is invoiced at 33 × 1/3% plus cost =100+33 × 1/3=133 × 1/3

So, Profit included in the total value=₹ 40,000 × 100/3 × 3/400= ₹10,000

11.3.3 Interim Dividend received from subsidiary company

The subsidiary company may pay interim dividend during the year. Full amount of such dividend should be added to the balance of current year's profits of the subsidiary. If the shares in subsidiary company have been acquired during the current year, such dividend should be apportioned between pre-acquisition and post-acquisition on the basis of time. Interim dividend relating to pre-acquisition period should be deducted from pre-acquisition profits and interim dividend relating to post acquisition period should be deducted from post-acquisition profits. Thereafter, holding company's share of pre-acquisition interim dividend should be deducted from its Profit & Loss balance and also from the debit balance of shares in the subsidiary company.

11.3.4 Proposed Dividend

Proposed dividend may be given in the question below the balance sheet as additional information. As per revised AS-4, it is a contingent liability since it will be payable upon being declared by the shareholders in the AGM to be held after the end of financial year. Hence no effect is to be given to proposed dividend while preparing the consolidated balance sheet.

Illustration:12

H Ltd. acquired 31,500 shares in S Ltd. for ₹5,10,000 on 1st April, 2019. The balance sheets as at 31st March, 2020 when the accounts of both the companies were prepared as under:

Particulars	H Ltd.	S Ltd.
I. EQUITY AND LIABILITIES:	**₹**	**₹**
Shareholder's Funds:		
Share capital (Shares of B ₹10 each, fully paid)	12,00,000	4,50,000
General Reserves	7,50,000	2,25,000
Surplus (P & L Account)	4,47,000	1,84,500
Current Liabilities		
Trade Payables	1,23,000	70,500
Unclaimed Dividend	-	1500
	…………….	…………….
	25,20,000	**9,31,500**
	…………….	…………….
II. ASSETS:		
Non-current Assets		
Fixed Assets:		
Plant & Machinery	9,37,500	2,70,000

Office Equipments	1,27,500	75,000
Investments: (31,500 Shares in S Ltd.) (At cost)	5,10,000	-
Current Assets		
Inventories	6,15,000	2,85,000
Trade Receivables	1,50,000	1,20,000
Bank	1,80,000	1,76,000
Current/Non-Current Assets		
Share Issue Expenses	-	5,500
	....	....
	25,20,000	**9,31,500**
	....	....

- On 1st April, 2017 S Ltd. had followings balances:

  General Reserves ₹1,20,000; P & L A/c ₹75,000

- S Ltd. declared the final dividend of 10% per annum for the year ended 31st March, 2019.
- S Ltd. declared the interim dividend @ 8% per annum for the full year on 15th February, 2020.
- Contingent liability:

  Proposed dividend by H Ltd. @ 11%: ₹1,32,000

  Proposed dividend by S Ltd. @11%: ₹49,500

H Ltd. credited the final dividend plus interim dividend to its Profit & Loss. The entire unclaimed dividend appearing in the balance sheet of S Ltd. belongs to the minority shareholders. You are required to prepare a consolidated balance sheet as at 31st March, 2020.

Solution:

The consolidated balance sheet of H Ltd. & Its subsidiary S Ltd. as at 31st March, 2020 is as follow:

Particulars	₹
I. EQUITY AND LIABILITIES:	
Shareholder's Funds:	
Share capital	12,00,000
Reserves and Surplus	13,47,150
Minority Interest	2,57,700
Current Liabilities :	
Trade Payables	1,93,500
Total	**29,98,350**
II. ASSETS:	
Non-current Assets	
Fixed Assets:	
Tangible Assets	14,10,000
Intangible Assets	62,350
Current Assets	
Inventories	9,00,000
Trade Receivables	2,70,000
Cash and cash Equivalents	3,56,000
Total	**29,98,350**

Working Notes:

- No effectis to be given to Proposed Dividend of Both Companies because it is a Contingent Liability.
- **Calculation of S Ltd. Current year Profit & Loss:**

Closing balance of P & L A/c of S Ltd.	1,84,500
Add:	
Final Dividend @10% p.a. for the year ended 31st March, 2019	45,000
Interim Dividend @ 8% p.a. for the full year	36,000
Transfer to general reserve	1,05,000
	3,70,500
Less: Opening Balance of P & L A/c of S Ltd.	(75,000)
Net Profit for the current year	2,95,500

Revenue profits of S Ltd.

Net profit for the year	2,95,500
Less: Interim Dividend	(36,000)
Profits of S Ltd.	2,59,500
H Ltd. Share= ₹2,59,500 × 70/100	1, 81,650

(i) Dividend received by H Ltd. = ₹45,000 × 70/100 = ₹ 31,500

It will be deducted from P & L A/c of H Ltd. And also from shares in S Ltd. A/c while calculating cost of control.

(ii) Capital profits:

General Reserves 1, 20,000

Add: Profit & Loss (₹ 75,000-Final Dividend ₹ 45,000) 30,000

Less: Share Issue expenses 5,500

Capital Profits 1, 44,500

(iii) Calculation of Goodwill/Capital Reserve:

Balance of shares in S Ltd. A/c after deduction of dividend received out of		
Pre-acquisition profits (₹5,10,000 – 31,500)		4,78,500
<u>Less</u>: Paid up value of 31,500 shares (₹4,50,000 × 70%) H Ltd.'s share in Capital Profit (₹1,44,500 × 70%)	 3,15,000 1,01,150	 (4,16,150)
Goodwill		**62,350**

(iv) Calculation of Minority interest:

Paid up value of 30% shares of S Ltd. (₹4,50,000 × 30%)	2,50,000
Add: 30% of General Reserves: (₹2,25,0000 × 30%)	1,20,000
Add: 30% of Profit and loss: (₹1,84,500 × 30%)	55,350
Add: Unclaimed dividend	1,500
Less: 30% of Share Issue Expenses: (₹5,500 × 30%)	(1,650)
Minority Interest	**2, 57,700**

11.4 Check Your Progress

1. What are the advantages of consolidated financial statements?

   a. Information about overall profitability
   b. Evaluation of efficiency
   c. Easy to find the intrinsic value of shares
   d. All of the above

2. What are the disadvantages of consolidated financial statements?

a. Confusion about true financial position of subsidiaries
b. Concealment of financial information
c. Chances of fraud by Holding company
d. All of the above

3. Who is responsible Preparation of Consolidated Financial Statement?

a. Management of the company
b. Govt.
c. NCLT
d. None of the above

4. Is preparation of consolidated financial statement compulsory?

a. Yes
b. No
c. May be
d. None of the above

5. If holding company pays more than the face value of shares the excess amount paid is considered as payment for:

a. Capital Reserve
b. Cost of control
c. Goodwill
d. Both b & c

6. Proposed dividend is considered as:

a. Asset
b. Liability
c. Contingent liability
d. None of the above

11.5 Summary

A consolidated financial statement is financial statement, which represents the financial information of holding company and its subsidiary company as a single entity. It is presented by a parent company for its subsidiary under its control. Preparation of consolidated financial statements are beneficial as it provide Information about overall profitability, Easy to know the financial position of holding and its subsidiaries, Evaluation of efficiency, Easy to find the intrinsic value of shares, Easy to know minority Interest, Complete Overview. Apart from advantages, it has some disadvantages like it make confusion about true financial position of subsidiaries, Concealment of financial information, Chances of fraud by Holding company.

The management of the company is responsible for the preparation and disclosure of the financial statements to the stakeholders. In a public company, the management is an agent and the actual owner/principal is the shareholders. So it is the responsibility of the management to report the performance of the company.

As per Companies Act, 2013 preparation of consolidated financial statement is not compulsory, hence there is no prescribed format. Instead this, if it prepared then it should be in according with Schedule III of the Companies Act, 2013.

11.6 Keywords

- **Proposed Dividend**: Proposed Dividend is the Dividend to be distributed among the Shareholders of the Company during a Financial Year which will be paid in the Next Year.
- **Interim Dividend:** An interim dividend is a dividend payment made before a company's annual general meeting (AGM) and the release of final financial statements.
- **Minority Interest**: A minority interest is ownership or interest of less than 50% of an enterprise.
- **Goodwill**: Goodwill is the portion of the purchase price that is higher than the sum of the net fair value of all of the assets purchased in the acquisition and the liabilities assumed in the process.
- **Pre-acquisition profits & reserves:** Profits & reserves for period that is prior to the acquisition of company.
- **Post-acquisition profits & reserves:** Profits & reserves for period that is after to the acquisition of company.

11.7 Self-Assessment Test

Short Answer Questions:

1. Proposed Dividend
2. Interim Dividend
3. Pre-acquisition and post-acquisition profits & reserves
4. Inter-company Owings

Long Answer Questions:

1. What do you mean by consolidated financial statement? Explain the accounting procedure of Pre-acquisition and post-acquisition profits & reserves.

2. With the help of imaginary figure, prepare the proforma of Balance Sheet of a Holding company &its subsidiary company.

Numerical Questions:

1. The following is the balance sheet of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	**₹**	**₹**
Shareholder's Funds:		
Share capital (Shares of ₹ 10 each, fully paid)	20,00,000	5,00,000
Reserves and surplus	6, 00,000	-
Current Liabilities		
Trade Payables	1,40,000	80,000
	....	....
	27,40,000	**5,80,000**
	....	....
II. ASSETS:		
Non-current Assets		
Investments: (in 100% Shares of B Ltd.) at cost	4,80,000	-

Current/Non-current Assets	22,60,000	5,80,000
	....	....
	27,40,000	**5,80,000**
	....	....

Prepare a consolidated balance sheet as at 31st March, 2020**.**

(Answer Capital Reserve ₹20,000, Reserve & surplus ₹26,20,000, Trade Payables ₹2,20,000, Total Liabilities ₹30,20,000, total Assets ₹30,20,000).

2. The following are the balance sheets of A Ltd. and B Ltd. As at 31 March, 2020:

Particulars	A Ltd.	B Ltd.
I. EQUITY AND LIABILITIES:	₹	₹
Shareholder's Funds:		
Share capital (Shares of ₹200 each, fully paid)	50,00,000	20,00,000
General Reserves	11,00,000	5,60,000
Surplus (P & L Account)	4,00,000	1,80,000
Current Liabilities		
Trade Payables	4,50,000	4,00,000
	....	....
	69,50,000	**31,40,000**
	....	....
II. ASSETS:		
Non-current Assets		
Fixed Assets	44,50,000	24,00,000
Investments: (7,500 Shares in B Ltd.) (At cost)	19,00,000	-
Current Assets	6,00,000	6,90,000
Current/Non-Current Assets		
Unamortized Expenses	-	50,000
	....	....
	69,50,000	**31,40,000**
	....	....

The shares of B Ltd. were acquired by A Ltd. on 1st April, 2019, on which date the General Reserves and Statement of P & L A/c of B Ltd. showed balances of ₹ 4,40,000 and ₹ 40,000 respectively.

Unamortized expenses were not written off during the year ending 31st March, 2020. You are required to prepare a consolidated balance sheet of A Ltd. and its Subsidiary B Ltd. as at 31st March, 2020.

(Answer Capital profit of B Ltd. ₹ 4,30,000, Revenue profit of B Ltd. ₹ 2,60,000, Goodwill= ₹ 77,500, Minority Interest= ₹ 6,72,500, Reserve & surplus ₹ 16,95,000, Trade Payables ₹ 8,50,000, Total Liabilities ₹ 82,17,500, Fixed Assets: Tangible Assets= ₹ 68,50,000 & Intangible Assets= ₹ 77,500).

11.8 Answers to check your progress

1(d), 2 (d), 3(a), 4 (b), 5(d), 6 (c)

11.9 References/ Suggested Readings

- Gupta, Nirmal. Corporate Accounting, Sahitya Bhawan, Agra
- Jain, S.P. and K.L. Narang. Corporate Accounting, Kalyani Publishers, New Delhi.
- Maheshwari, S.N. and S. K. Maheshwari. Corporate Accounting, Vikas Publishing House, New Delhi.
- Monga, J.R. Fundamentals of Corporate Accounting, Mayur Paper Backs, New Delhi.
- Naseem Ahmed, Corporate Accounting, ANE Books Pvt. Ltd. New Delhi.
- Sehgal, Ashok and Deepak Sehgal. Corporate Accounting, Taxman Publication, New Delhi.
- Shukla, M.C., T.S. Grewal, and S.C. Gupta. Advanced Accounts, S. Chand & Co., New Delhi.

Subject: Corporate Accounting-1	
Course Code: **BCOM 301**	Author: **Dr. Sushil Kumar**
Lesson No: **12**	Vetter: **Prof. M.C. Garg**
Updated By: **Prof. Suresh Kumar Mittal**	

AMALGAMATION OF COMPANIES

STRUCTURE:

12.0 Learning Objectives

After going through this lesson, the learners will be able to:

- Understand the concept of merger and amalgamation;

- Understandthe difference between amalgamation and external reconstruction.
- Know the methods of calculation of Purchase Consideration.
- Know the accounting treatment regarding Amalgamation of Companies.

12.1 Introduction

Corporate restructuring in termsof mergers, amalgamations, takeovers and acquisitions, has emerged as the best form of endurance and growth. The opening up of the Indian economy and the Government's decision to disinvest has made corporate restructuring more pertinent today. In the last few years, India has followed the worldwide trends in consolidation amongst companies through mergers and acquisitions. Companies are being taken over, enterprises are being hived off, and joint ventures identical to acquisitions are being made and so on. It may be reasonably stated that the quantum of mergers and acquisitions in the last few years is more than the corresponding quantum in the four and a half decades post independence. Supreme Court of India in the landmark judgement of HLL-TOMCO merger has said that "in this era of hypercompetitive capitalism and technological change, industrialists have realised that mergers/acquisitions are perhaps the best way to reach a size comparable to global companies so as to successfully compete with them. The harsh reality of globalisation has dawned that companies which cannot compete globally must sell out as an inevitable alternative".

12.2 Meaning and Definition

Amalgamation is an arrangement where two or more companies consolidate their business to structure a new firm, or become a subsidiary of any one of the company. For practical purposes, the words amalgamation and merger are used interchangeably. However, there is a minor difference. Merger involves the fusion of two or more companies into a single company where the identity of some of the enterprises gets dissolved. On the other hand, amalgamation means dissolving the entities of amalgamating companies and forming a new company having a separate legal entity.

Amalgamation

Amalgamation comes into existence when two or more than two established joint stock companies come togetherto forma large one. After amalgamation each company loses its separate legalidentity. Newlyformed company generally take over all the assets and liabilities of old companies. Main purpose of a new company is to expand business to obtain the benefits of large scale.

Merger

When a joint stock company absorbs one or more than one company is called merger. Each firm which is absorbed loses its existence. Iteliminates the competition and obtains the monopoly profit; it reduces the cost and obtains the tax advantages.

According to Section 2(1B) of the Income Tax Act, 1961, "Amalgamation in corporate sector means the unification of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a consequence of the merger, as the amalgamated company) in such a way that

- All the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of amalgamation.
- All the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of amalgamation
- Shareholders holding not less than 3/4th in value of the shares in amalgamating company or companies (other than shares held therein immediately before the amalgamation or by a nominee for the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a outcome of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of distribution of such property to the other company after the winding up of first mentioned company.

Types of Merger and Acquisition

There are many types of merger and acquisition that redefine the business world with new strategic alliances and improved corporate philosophies. From the business structure point of view, some of the most familiar and significant types of merger and acquisition are listed below:

Horizontal Merger

This kind of merger exists between two companies who compete in the same industry fragment. The two companies bond together their operations and gains potency in terms of improved performance, increased capital, and better profits. This kind of merger substantially reduces the number of competitors in the segment and gives a higher edge over competition.

Vertical Merger

It is a kind of merger in which two or more companies in the same industry but in different fields come together in business. In this form, the companies in merger choose to combine all the operations and productions under one shelter. It is like encircling all the requirements and products of a single industry fragment.

Co-Generic Merger

Co-generic merger is a kind of merger in which two or more companies in association are some way or the other related to the production processes, business market, or basic requisitetechnologies. It includes the expansion of the product line or acquiring components that are all the way required in day to day operations. This kind of merger offers immense opportunities to businesses as it opens a huge gateway to diversify around a common set of resources and strategic requirements.

Conglomerate Merger

Conglomerate merger is a kind of venture in which two or more companies belonging to different industrial sectors combine their operations. The businesses of merged companies arenot related to each other's kind of business and product line rather their operations overlap that of each other. This is just a confederation of businesses from different verticals under one flagship enterprise or firm.

Reverse Merger

A reverse merger refers to an arrangement where private company acquires a public sector company, usually a shell company, in order to obtain the status of a public company. It isalso known as a reverse takeover, it is asubstitute to the traditional initial public offering (IPO) method of floating a public company. It is an easier approach that allows private companies to change their type while avoiding the complex regulations and formalities related with an IPO. Also, the extent of ownership and control of the private stakeholders increases in the public company. It also leads to combining of resources thereby giving more liquidity to the private company.

Types of Amalgamation

Amalgamation is of two types

a) Amalgamation in the Nature of Merger
b) Amalgamation in the nature of Purchase

Amalgamation in the Nature of Merger

There are some conditions (basically 5) that must be fulfilled for amalgamation in the nature of merger:

- The transferor company must take over all the assets and all the liabilities of the transferor company.
- Assets and liabilities of the transferor company will be taken over by the transferee company at their book value.
- The transferee company must carry on the same nature of business as that of the transferor company.
- At least 90% of the equity shareholders of the transferor company must agree to become the shareholders of the transferee company.
- The transferee company must discharge the amount of purchase consideration by issuing its equity shares to the equity shareholders of the transferor company and if there is any fraction it would be paid in cash.

Amalgamation in the Nature of Purchase

If any one or more of the above mentioned condition is/are not fulfilled, the situation is called 'Amalgamation in the Nature of Purchase'.

12.3 Purchase Consideration: Meaning

Purchase consideration is the amount which is paid by the transferee company for the purchase of the business of the transferor company. In simple words, consideration for amalgamation means the aggregate of the shares and other securities issued and payment in cash or other assets by the transferee company to the shareholders of the transferor company. It should not include the amount of obligations taken over by the transferee company, for whichpayment will be made directly by this company. Payments made to debenture-holders should not be considered as part of purchase consideration. While calculating the amount of purchase consideration, special care should be given to the valuation of assets and liabilities of the transferor company. The working out of purchase consideration is very important and may be calculated in the following ways:

12.3.1 Methods of Calculation of Purchase Consideration:

Following are the methods of calculation of purchase consideration:

(i) **Lump Sum Method**: Whenthe transferee company agrees to pay a fixed sum to the transferor company,this method shall be called a lump sum payment of purchase consideration. For example, if ALtd. purchases the business of BLtd. and agrees to pay ₹. 35, 00,000 in all, it is an example of lump sum payment.

(ii) **Net Worth (or Net Assets) Method**: According to this technique, the purchase consideration is calculated by calculating the net worth of the assets taken over by the transferee company. The net worth is calculated by adding up the agreed value of assets taken over by the transferee company minus agreed value of liabilities to be assumed by the transferee company.

Example 1: A Ltd takes over the business of B Ltd at the following values:

Fixed Assets	₹. 3, 00,000
Current assets	₹. 1, 00,000
Debentures	₹. 50,000
Current Liabilities	₹. 1, 00,000

Calculate the amount of Purchase Consideration:

Solution:

Calculation of Purchase consideration has been calculated as follows:

Assets taken over	₹	₹
Fixed assets	3, 00,000	
Current assets	1, 00,000	400,000
Less Liabilities taken over		
Debenture	50,000	
Current Liabilities	1,00,000	1,50,000
Purchase Consideration		**2,50,000**

12.3.2 Methods of Accounting

1. The Pooling of Interests Method

Under the pooling of interest method, the liabilities, assets and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts. If, at the time of the amalgamation, the transferee and the transferor companies have contradictory accounting policies, a standardized set of accounting policies is adopted following the amalgamation. The special effects on the financial statements of any changes in accounting policies are reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Past Period Items and Changes in Accounting Policies.

2. The Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual liabilities and assets of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable liabilities and assets may include assets and liabilities not recorded in the financial statements of the transferor company. Where assets and liabilities are re-stated on the basis of their fair values, the computation of fair values may be influenced by the intentions of the transferee company. For example, a transferee company may have a specialised use of an asset, which is not available to other prospective buyers. The transferee company may propose to effect changes in the activities of the transferor company which necessitate the creation of specific provisions for the expected costs, e.g. deliberate employee termination and plant relocation costs.

Example 2: The following are the balance sheet of P Ltd and S Ltd as on 31st March 2020.

Liabilities	**P Ltd. (000)**	**S Ltd (000)**
Equity Share @ 10	72,000	30,000
11 % Preference Share capital @ 100 each		17,000
General Reserve	8,000	4,500
Export Profit Reserve		2,000
Profit and Loss Account	7,500	4,000
9 % Debenture @ ₹ 100		5,000
Creditors	11,500	3,500
Total	**99,000**	**66,000**

Assets		
Land and Building	25,000	
Plant and Machinery	32,500	29,000
Furniture and Fittings	5,750	9,410
Stock	21,500	17,390
Debtors	7,250	5,200
Cash at Bank	7,000	5,000
Total	**99,000**	**66,000**

P Ltd takes over S Ltd 1st April, 2020 and discharges consideration for the business as follows:

i) Issued 35 lakh fully paid equity shares of ₹ 10 each at par to the equity shareholders of S Ltd.

ii) Issued fully paid 12% preference share of ₹. 100 each to discharge the preference shareholders of S Ltd at a premium of 10%.

iii) It is agreed that the debentures of S Ltd will be converted into equal number and amount of 10% debentures of P Ltd. The statutory reserve of S Ltd is to be maintained for two more years.

You are required to show the balance sheet of P Ltd using:

a) Pooling of interest method

b) Purchase method

Solution:

a) Pooling of Interest Method

Balance Sheet of P Ltd as on 31st March 2020

Liabilities	*Amt(000)*	*Assets*	*Amt (000)*
Equity shares @ 10	1,07,000	Land and Buildings	25,000
12% Preference shares@ 100	18,700	Plant and Machinery	61,500
General Reserve	9,800	Furniture and Fittings	15,160
Export Profit Reserve	2,000	Stock	38,890

Profit and Loss Account	7,500	Debtors	12,450
10% Debenture of ₹ 100	5,000	Cash at Bank	12,000
Creditors	15,000		
Total	**1,65,000**	**Total**	**1,65,000**

Working note

P Ltd General Reserve

P Ltd General reserve	8,000		
Add: S Ltd's general reserve	4,500		
S Ltd's profit and loss A/c	4,000		**16,500**
Less: Consideration for equity shares	35,000		
Consideration for preference shares	18,700	53,700	
Less:S Ltd's share capital		(47,000)	**(6,700)**
Reserve Appearing in Bal. sheet			**9,800**

(b)Purchase Method

Balance Sheet of P Ltd as on 31st March 2020

Liabilities	*Amt(000)*	***Assets***	*Amt (000)*
Equity shares @ 10	1,07,000	Land and Buildings	25,000
12% Preference shares@ 100	18,700	Plant and Machinery	61,500
General Reserve	8,000	Furniture and Fittings	15,160
Capital Reserve	3,800	Stock	38,890
Export Profit Reserve	2,000	Debtors	12,450
Profit and Loss Account	7,500	Cash at Bank	12,000
10% Debenture of ₹ 100	5,000	AmalgamationAdj A/c	2000
Creditors	15,000		
Total	**1,67,000**	**Total**	**1,67,000**

Working Note: Calculation of capital reserve arising on amalgamation

Total assets taken over		**66,000**
Less: 10 % Debenture	5,000	
Creditors	3,500	8,500
Net Asset taken over		**57,500**
Less: Consideration to equity shareholders	35,000	
Consideration to preference share holders	18,700	53,700
Capital on amalgamation		**3,800**

12.3.3 Difference between Pooling of Interest and Purchase Methods

The table given below illustrates some differences between the consolidated financial statement of the pooling of interest method and purchase method.

Basis	**Pooling of Interest Method**	**Purchase Method**
Book Value	Typically lower than purchase method, as in this method, goodwill asset is not created.	Typically higher than pooling method.
Trend in Earnings	Higher than purchase method because income statements are combined retroactively.	Lower than the pooling method because pre-acquisition income statements are not combined.
Trend in Sales	More accurate than the purchase method, as income statements are pooled retroactively.	Distorts growth perception of the acquiring company, as much of its sales growth can be credited to the acquisition.
EPS	Higher than the purchase method, as the income statement is pooled for the entire reporting period, rather than only for the acquisition date.	Lower than the pooling method.
ROA & ROE	Higher	Lower

Example3: Consider the Balance sheet of Rama Ltd. and ShyamaLtd.as on 31st March 2020

Balance Sheet as on 31st March 2020

	Rama	**Shyama**		**Rama**	**Shyama**
Liabilities	*Amt(000)*	*Amt(000)*	***Assets***	*Amt(000)*	*Amt(000)*
Equity Share	50,00	30,00	Land	25,00	15,50
Preference Shares	22,00	17,00	Plant	32,50	17,00
Gen Reserve	5,00	2,50	Furniture	5,75	3,50
Export Res.	3,00	2,00	Investment	7,00	5,00
Investment All Res.		1,00	Stock	12,50	9,50
Profit and Loss A/c	7,50	5,00	Debtor	9,00	10,30
Debentures	5,00	3,50	Cash	7,25	5,20
Creditors	4,50	3,50			
OthersCurrent Liabilities	2,00	1,50			
Total	99,00	66,00	Total	99,00	66,00

Other information: Rama Ltd takeover Shyama Ltd on 1st April 2020 and discharges the purchase consideration as follows:

1. Issued 350,000 equity shares of ₹10 each at par to the equity shareholders of Shyama Ltd.
2. Issued 15% preference shares of ₹ 100 each to discharge preference shareholders of Shyama Ltd at 10% premium.
3. The debentures of ShyamaLtd have been converted into equal number of debentures of Rama Ltd.
4. The statutory Reserve of Shyama Ltd is to be maintained for two more years.

Show the balance sheet of Rama Ltd after amalgamation in case

1. Amalgamation in nature of merger
2. Amalgamation in nature of Purchase

Solution:

Amalgamation in Nature of Merger

Balance Sheet of Rama Ltd

Liabilities	**Amount (000)**	**Assets**	**Amount (000)**
Share capital	12,570	Fixed Assets(tangible)	9,925
Res & Surplus	1,930	Non Current Investment	1200
Long term Borrowing	850	Inventories	2200
Trade payable	800	Bill Receivable	1930
Others CL	350	Cash	1245
Total	16,500	Total	16,500

Notes of Computation

Share capital		***Amount(000)***	***Total(000)***
	Equity, 85000 @100	8500	
	Preference shares 18700, 15% pref. Share @100 22000, 14% pref. Share @100	 1870 2200	
Total			**12,570**
Reserve& Surplus			
	GR of Rama Ltd *Add*. GR of Shyama *Less:*Adj for amalgamation	500 250 (670)	 80
	Export Profit Res of Rama Ltd *Add:* Export of Shyama	300 200	 500
	Investment Allow. Res		100
	P& L of Rama Add: P&L of Shyama	750 500	 1250
Total			**1,930**
Long term Borrowings			

	Secured 8500, 35% Debentures @ 100		850
Total			**850**
	Tangible Assets		
	Land	4050	
	Plant	4950	
	Furniture	925	
Total			**9925**

2. Amalgamation in Nature of Purchase

Balance Sheet of Rama Ltd

Liabilities	*Amt (000)*	***Assets***	*Amt (000)*
Share capital	12,570	Fixed Assets(tangible)	9,925
Res & Surplus	2230	Non Current Investment Other Non -current assets	1200 300
Long term Borrowing	850	Inventories	2200
Trade payable	800	Bill Receivable	1930
Others CL	350	Cash	1245
Total	16,800	Total	16,800

Notes of Computation

Share capital		Amount(000)	Total(000)
	Equity, 85000 @100	8500	
	Preference shares 18700, 15% pref. Share @100 22000, 14% pref. Share @100	 1870 2200	
		Total	**12,570**
Reserve& Surplus			
	Capital Reserve Gen Res	380 500	

	Export Profit Investment All Surplus	500 100 750	
Total			**2,230**
Long term Borrowings			
	Secured 8500, 35% Debentures @ 100		850
Total			**850**
	Tangible Assets		
	Land	4050	
	Plant	4950	
	Furniture	925	
Total			**9925**

Working note: Capital reserve arising on Amalgamation

A. Net Assets takeover

Sundry Assets		66, 00
Less: 13% Debenture	3, 50	
Trade creditor	3, 50	
Other current liab	*150(8, 50)*	
	=====	--------
		5750
		======

B. Purchase Consideration

To Equity Shareholders ofShyama Ltd	35 00
To Preference Shares ofShyama Ltd	18 70

	5370
	=====
Capital Reserve (A-B)	380

12.3.4 Journal Entries in case of Merger and Amalgamation:

Following are the journal entries in case of merger:

(a)Journal Entries in the Books of Transferor Company: Following are the journal entries in the books of Transferor Company:

Sr. No	*Particular*	*Dr.*	*Cr.*
1.	When Assets are transferred to Realisation A/c Realisation Dr To Sundry Assets A/c (Write Individually at Book Value)		
2.	When Liabilities are transferred to Realisation A/c Sundry Liabilities A/c (Write Individually)Dr To Realisation A/c(Book Value)		
3.	When Purchase consideration becomes Due Transferee Co. A/c Dr To Realisation A/c (with amount of Purchase consideration)		
4.	When any asset sold in the market by Transferor Company Bank A/cDr To Realisation A/c (only if Amalgamation is in nature of Purchase)		
5.	When any liability is paid off by transferor company itself Realisation A/c Dr To Bank A/c only if Amalgamation is in nature of Purchase		
6.	When preference share holders are discharged at premium or Discount **At Premium** Realisation A/C Dr To Preference Share Holders A/c **At Discount** Preference Share Holders A/c Dr To Realisation A/c		

7.	For recording of Dissolution/Realisation Expenses a). When realisation Expenses are paid by the transferor company itself. Realisation A/c Dr To Bank A/c b). When realisation Expenses are paid by the transferee Company. No Entry will be passed c).When realisation expenses are paid by transferor company and they are reimbursed by the transferee company. i). Transferee Company A/c Dr To Bank A/c ii) Bank A/c Dr To Transferee Company A/c		
8.	For recording of Profit/Loss on Realisation **a). In Case of Profit** Realisation A/c Dr To Equity Share Holders A/c **b). In Case of Loss** Equity Share Holders A/c Dr To Realisation A/c		
9.	When Purchase Consideration is received Equity Share in Transferee Company A/c Dr Preference Share in Transferee Company A/c Dr Debenture in Transferee Company A/c Dr Other Securities in Transferee Company A/c Dr Cash A/c Dr To Transferee Company A/c Note: Purchase consideration can be discharged by any one or more than one or by all which are mentioned above		
10.	When preference share capital being transferred to Preference share holders account Preference Share Capital A/c Dr To Preference share holders A/c		
11.	When purchase consideration is discharged to preference share holder Preference Share holders A/c Dr To Equity Share in Transferee Co. A/c To Preference Share In Transferee Co.A/c To Debentures in Transferee Company A/c		

	To Other Securities in Transferee Co. A/c To Cash A/c		
12	When Equity Share Capital and Reserve and Surplus are Transferred to Equity Share holders A/c Equity Share Capital A/c Dr Reserve & Surplus A/c Dr To Equity Share Holders A/c		
13.	When Miscellaneous Expenditure and Profit & Loss A/c (Dr.) Balance is adjusted in Equity Share Holders A/c Equity Share Holders A/c Dr To Miscellaneous Expenditure A/c To Profit & Loss A/c		
14.	When the Amount of Purchase Consideration is discharged to Equity Share Holders A/c Equity Share Holders A/c Dr To Equity Share in Transferee Company A/c To Preference Share In Transferee Co.A/c To Debentures in Transferee Co.A/c To Other Securities in Transferee Co.A/c To Cash A/c		

(a) Journal Entries in the Books of Transferee Company: Following are journal entries in the book of transferee company:

Sr. No.	*Particulars*	Dr.	Cr.
A	**In The Nature of Merger Pooling of Interest Method:** Following are the journal entries in pooling of interest method		
1.	When Business of transferor co. is taken over Business Purchase A/c Dr To Liquidator of Transferor Co.		
2.	When Assets and Liabilities taken over are recorded Sundry Assets A/c (Individually)Dr Reserve & Surplus A/c (Bal. Fig.) Dr To Sundry Liabilities (Individually) To Business Purchase To Reserve & Surplus (Bal. Fig.) Note: Any one Bal. Fig. will become either in Dr. or Cr.		
3.	When Purchase consideration is discharged		

	Liquidator of Transferor Co. A/cDr To Equity Share Capital A/c To Securities Premium A/c To Preference Share Capital A/c To Cash A/c		
4.	When Realisation/Dissolution expenses of transferor Co. paid by transferee Co. General Res. A/c/ Profit and Loss A/c Dr To Bank A\c		
5.	When Shares are issued to General Public Bank A/c Dr To Share Appl. & Allotment A/c		
6.	When Application and Allotment Money is transferred to Share Capital A/c **At Par.** Share Appl. & Allotment A/c Dr To Share Capital A/c **At Pre.** Share Appl. & Allotment A/cDr To Share Capital A/c To Securities Premium **At Dis.** Share Appl. & Allotment A/cDr Discount of Issue of Shares Dr To Share Capital A/c		
7.	When formation expenses of transferee co. are recorded. Formation Exp. /Preliminary Exp. A/cDr To Bank A/c		
8.	When Inter Co. transaction are recorded Sundry Creditors A/c Dr To Sundry Debtors A/c or Bills Payable A/c To Bills Receivable A/c or Loan Taken A/c To Loan Given A/c		
9.	When unrealized profit is recorded Reserve & Surplus/ P&L A/c Dr To Stock A/c/Current Assets A/c Note: When there is no profit in Balance sheet then Debit the Goodwill		
10.	When Statutory Reserve of transferor Co. are transferred to transferee Co.		

	Amalgamation Adjustment A/c Dr To Statutory Reserve A/c Note: At the time of Merge Balance Sheet, Amalgamation Adjustment A/c will be shown in Miscellaneous Expenditure A/c		
B	**In The Nature of Purchase:** Following are the journal entries in case of nature of purchase		
1.	When Business of Transferor Co. is Taken Over Business Purchase A/c Dr To Liquidator of Transferor Co. A/c		
2.	When Assets and Liabilities taken over are recorded Sundry Assets A/c (Individually)Dr Reserve & Surplus A/c (Bal. Fig.) Dr To Sundry Liabilities A/c (Individually) To Business Purchase A/c To Capital Reserve A/c (Bal. Fig.) Note: 1. Any one Bal. Fig. will become either in Dr. or Cr. 2. If Purchase consideration is calculated by Net Assets Method there will no difference but if calculated by Net Payment Method difference will become either in Dr. or Cr.		
3.	When Purchase consideration is discharged Liquidator of Transferor Co. A/c Dr To Equity Share Capital A/c To Securities Premium A/c To Preference Share Capital A/c To Debentures To Other Securities A/c To Cash A/c		
4.	When Realisation/Dissolution expenses of Transferor Co. paid by Transferee Co. RealisationA/cDr To Bank A/c		
5.	When Shares are issued to General Public Bank A/cDr To Share Appl. & Allotment A/c		
6.	When Application and Allotment money is transferred to Share Capital A/c **At Par.** Share Appl. & Allotment A/c Dr To Share Capital A/c		

	At Pre. Share Appl. & Allotment A/cDr To Share Capital A/c To Securities Premium A/c **At Dis.** Share Appl. & Allotment A/cDr Discount of Issue of Shares A/c Dr To Share Capital A/c		
7.	When formation Expenses of Transferee company are recorded. Formation Exp./Preliminary Exp. A/c Dr To Bank A/c		
8.	When formation Expenses of Transferee company are recorded. Formation Exp.\Preliminary Exp. A/c Dr To Bank A/c		
9.	When Inter Company Transaction are Recorded Sundry Creditors A/c Dr To Sundry Debtors A/c or Bills Payable A/c To Bills Receivable A/c or Loan Taken A/c To Loan Given A/c		
10.	When unrealized profit is recorded Reserve & Surplus/P&L A/c Dr To Stock A/c/Current Assets A/c Note: When there is no profit in Balance sheet then Debit the Goodwill		

Example 4: A Ltd acquires B Ltd. for a consideration of ₹. 38, 00,000 to be satisfied in the form of fully paid equity shares of ₹. 10 each. The balance sheets of the two companies on 31st Dec 2019, the date of acquisition, were as follows:

BALANCE SHEET

as on 31st Dec., 2019

Liabilities	**A Ltd.**	**B Ltd.**	**Assets**	**A Ltd.**	**B Ltd.**
Equity shares	40,00,000	25,00,000	Sundry Assets	96,00,000	58,00,000
Gen. Res.	15,00,000	30,000			
Development Rebate Res.	3,00,000	1,00,000			

Export Profit Res.	6,00,000	4,00,000			
Profit & Loss A/c	12,00,000	9,00,000			
Sundry Liabilities	20,00,000	16,00,000			
Total	**96,00,000**	**58,00,000**	**Total**	**96,00,000**	**58,00,000**

You are required to pass the necessary journal entries in the books of A Ltd. (transferee company) when amalgamation is nature of (i) merger and (ii) by way of purchase.

Solution:

When amalgamation by way of merger

In such case accounting entries are passed according to “pooling of interest” method. The following entries will be in the books of A Ltd.

Journal Entries

Date	*Particulars*	*Dr.₹.*	*Cr. ₹.*
	Business Purchase A/c Dr To Liquidator of B Ltd. (Being purchase consideration due)	38,00,000	 38,00,000
	Sundry Debtors A/c Dr General Reserve A/c(bal. figure) To Sundry Liabilities A/c To Profit & Loss A/c To Export Profit Res. A/c To General Res. A/c To Development Rebate Res A/c To Business Purchase A/c (Being merger of assets and liabilities)	58,00,000 13,00,000	 16,00,000 9,00,000 4,00,000 3,00,000 1,00,000 38,00,000
	Liquidator of B Ltd. A/c Dr To Equity Share Capital A/c (Being settlement of Purchase consideration)	38,00,000	 38,00,000

When amalgamation is by way purchase

In such a case the following entries are passed as per purchase method.

Journal Entries

Date	*Particulars*	*Dr.(₹.)*	*Cr. (₹.)*
	Business Purchase A/c Dr To Liquidator of B Ltd. (Being purchase consideration due)	38,00,000	 38,00,000
	Sundry Debtors A/c Dr To Sundry Liabilities A/c To Business Purchase A/c To Capital Reserve (Being merger of assets and liabilities)	58,00,000	 16,00,000 38,00,000 4,00,000
	Liquidator of B Ltd. A/c Dr To Equity Share Capital A/c (Being settlement of Purchase consideration)	38,00,000	 38,00,000
	Amalgamation Adjustment A/c Dr To Development Rebate Res. A/c To Export Profit Reserve A/c (Being carrying forward of statutory reserve)	5,00,000	 1,00,000 4,00,000

12.4 Amalgamation and External Reconstruction

Meaning of External Reconstruction: Reconstruction refers to certain arrangements made by financially unstable companies. The reconstruction planning made by a company, to face its financial difficulties, may be internal or external. Outside reconstruction refers to closing/liquidating the company and starting again a new or a fresh. That is technically, a fresh company will be floated or formed to take over the existing company. In-house reconstruction refers to making internal adjustments for overcoming financial difficulties. **Difference between Amalgamation and External Reconstruction**

- The major differences between amalgamation and external reconstruction are as follows:External reconstruction involves liquidation of only one company, while amalgamation of companies involves liquidation of two or more companies.
- But External reconstruction does not result in any combination but amalgamation of companies' results in combination of companies.

Difference between External Reconstruction and Absorption

The main differences between external reconstruction and absorption are as follows:

- External reconstruction involves formation of a new company; however absorption of companies does not involve formation of a new company.
- Absorption of companies results in liquidation of one or more companies while external reconstruction results in liquidation of only one company.
- External reconstruction does not involve any combination,whereas absorption of companies involves combination of companies.

12.4.1 Accounting for External Reconstruction

The accounting procedure in case of external reconstruction is the same as in case of amalgamation or absorption in the nature of purchase. However, there are no different methods in this case, as in case of amalgamation or absorption, where there are of two methods i.e. in nature of merger and in the nature of purchase.

Steps in Accounting for External Reconstruction are outlined below:

Calculation of purchase consideration:

I. Ascertainment of discharge of purchase consideration

II. Closing the books of vendor company (Vendor company is the company which is being liquidated and taken over) or transferor company

III. Passing opening entries in the books of purchasing company (i.e., Transferee Company or the new company floated.

Example 5: The balance sheet of H Ltd as on 31st March, 2020was as follows:

Liabilities	*₹*	*Assets*	*₹*
50000, 12% Cumulative Preference Shares of ₹ 10 each, fully paid	5,00,000	Goodwill	4,00,000
1,50,000 Equity Shares of ₹ 10 each fully paid	15,00,000	Plant and Machinery	7,00,000
10% Debentures	3,00,000	Furniture and Future	2,00,000
Creditors	2,00,000	Patents	1,50,000
		Stock	4,90,000
		Debtors	2,55,000
		Bank	5,000
		Preliminary Expenses	8,000
		Discount on issue of Debentures	12,000
		Profit and Loss Account	2,80,000
	25,00,000		**25,00,000**

The following scheme of external reconstruction was agreed upon:

(i) A new company to be formed called J Ltd with an authorised capital of ₹. 32, 50,000 in equity shares of ₹. 10 each.

(ii) One equity shares, ₹ 5 paid up, in the new company to be allotted for each equity shares in the old company.

(iii) Two equity shares, ₹ 5 paid-up, in the new company to be allotted for each preference shares in the old company.

(iv) Arrears of preference dividends to be cancelled.

(v) Debenture holders to receive 30,000 equity shares in the new company credited as fully paid.

(vi) Creditors to be taken over by the new company.

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

(viii) The new company to take over the old company's assets except patents, subject to writing down plant and machinery by ₹. 2, 90,000 and stock by ₹ 60,000.

(ix) Patents were realised by H Ltd for ₹. 10,000.

Show important ledger accounts in the books of H Ltd and open the books of J Ltd. by means of journal entries and give the initial balance sheet of J Ltd. Expenses of H Ltd came of ₹. 10000.

Solution:

Calculation of the consideration

Particulars	*Number of shares allotted*	*Amt Credited as paid*	*Total Amt*

12 % cumulative Preference Shareholders (50,000 X 2)	1,00,000	5	5,00,000
Equity shareholders	1,50,000	5	7,50,000
Total	**2,50,000**		**12,50,000**

Books of H Ltd

Realisation Account

Particulars (Dr)	₹	*Particulars (Cr)*	₹
To Goodwill	4,00,000	By 10 % Debentures	3,00,000
To Plant and Machinery	7,00,000	By Creditors	2,00,000
To Furniture and Fixtures	2,00,000	By J Ltd (consideration)	12,50,000
To Patents	1,50,000	By Bank (sale of Patents)	10,000
To Stock	4,90,000	ByEquity shareholders A/c(loss)	4,50,000
To Debtors	2,55,000		
To Bank	5,000		
To Bank (Realisation expenses)	10,000		
Total	**22,10,000**		**22,10,000**

J Ltd Account

Particulars (Dr)	₹	*Particulars (Cr)*	₹
To Realisation Account	12,50,000	By Equity Shares in J Ltd (₹ 5 paid up)	12,50,000

Equity Shares in J Ltd (₹ 5 Paid up)

Particulars (Dr)	₹	*Particulars (Cr)*	₹
To J Ltd	12,50,000	By 12% Cumulative Preference Shareholders Account	5,00,000
		By Equity Shareholders Account	7,50,000
	12,50,000		**12,50,000**

12% Preference Shareholders Account

Particulars (Dr)	₹	*Particulars (Cr)*	₹
To Equity Shares in J Ltd	5,00,000	By 12% Cumulative Preference Share capital Account	5,00,000
	5,00,000		**5,00,000**

Cash Book (Bank Columns)

Particulars (Dr)	₹	*Particulars (Cr)*	₹
To Balance b/f	5000	By Realisation A/c (transfer)	5000
To Realisation Account (Patents)	10,000	By Realisation A/c (exp)	10,000
	15000		**15000**

Equity Shareholders Account

Particulars (Dr)	₹	*Particulars (Cr)*	₹
To Preliminary Expenses A/c To Discount on Issue of Shares A/c To Profit and Loss A/c To Realisation A/c (loss) To Equity Shares in J Ltd (₹. 5 Paid up)	8,000 12,000 2,80,000 4,50,000 7,50,000	By Equity Share Capital A/c	15,00,000
	15,00,000		**15,00,000**

Books of J Ltd

Journal

Date	*Particular*	*Dr (₹)*	*Cr (₹)*
31 March 2020	Business Purchase A/c Dr To Liquidator of H Ltd (Amount payable to liquidator of H Ltd)	12,50,000	 12,50,000
	Plant and MachineryA/c Dr Furniture and Fixture A/c Dr	4,10,000 2,00,000	

	Stock Dr	4,30,000	
	Debtors Dr	2,55,000	
	Bank Dr	5,000	
	Goodwill A/c Dr	4,50,000	
	To 10% Debenture (H Ltd) Account		3,00,000
	To Sundry Creditors		2,00,000
	To Business Purchase Account		12,50,000
	(Incorporation of assets and liabilities taken over)		
31 March 2020	Liquidator of H Ltd Dr	3,00,000	
	To Equity Share Capital Account		3,00,000
	(Allotment of 2,50,000 equity shares of ₹ 10 each, ₹ 5 paid up for consideration)		
	10%Debenture (H Ltd) Account Dr	3,00,000	
	To Equity Share Capital (fully paid) Account		3,00,000
	Bank Dr	4,50,000	
	To Equity Share Capital Account		4,50,000

Balance Sheet of J Ltd as on 31st March 2020

Liabilities	***₹***	***Assets***	***₹***
2,50,000 Equity shares @10, ₹ 5 paid up	12,50,000	Goodwill	4,50,000
75,000 equity shares of ₹ 10	7,50,000	Plant and Machinery	4,10,000
Creditors	2,00,000	Furniture and fixture	2,00,000
		Stock	4,30,000
		Debtors	2,55,000
		Cash at Bank	4,55,000

	22,00,000		**22,00,000**

12.5 Check Your Progress

A. State whether the following statements are True or False

1. Amalgamation means when two or more than two companies come together to form a large one.
2. When a company absorbs one or more than one company is called merger.
3. There are only disadvantages of mergers and amalgamation of companies.
4. A merger of one bank with another bank is called Vertical Merger.

A. Fill in the blanks

1. ____________ is a kind of merger in which two or more companies in different sectors combine their operations.
2. The amount paid by the transferee company for the purchase of the business of the transferor company is called__________________.
3. There are ______types of amalgamation.
4. External reconstruction involves______________________.

12.6 Summary

Amalgamation is an arrangement where two or more companies consolidate their business to structure a new firm, or become a subsidiary of any one of the company. For practical purposes, the words amalgamation and merger are used interchangeably. However, there is a minor difference. Merger involves the fusion of two or more companies into a single company where the identity of some of the enterprises gets dissolved. On the other hand, amalgamation means dissolving the entities of amalgamating companies and forming a new company having a separate legal entity. There are two types of amalgamation i.e.amalgamation nature of merger and amalgamation nature of purchase. There are two type of accounting method i.e. pooling of interest method and purchase method. The accounting procedure in case of external reconstruction is the same as in case of amalgamation or absorption in the nature of purchase. However, there are no different methods in this case, as in case of amalgamation or absorption, where are of two methods viz, in nature of merger and in the nature of purchase

12.7 Keywords

Amalgamation: Taking over of the business of two or more companies by a newly formed company for this purpose.

Absorption: Taking over of the business of one or more companies by an existing company.

Liabilities: Claims of outsiders against company.

Purchase Consideration: The amount paid by purchasing company to the vendor for acquiring its business.

Trade liabilities: Liabilities incurred on account of purchase of goods.

12.8 Self-Assessment Test

1. Differentiate between the terms 'amalgamation by way of merger' and 'amalgamation by way of purchase' with suitable examples.

2. State the various accounting entries to be passed in the books of vendor company in case of amalgamation.

3. Explain Pooling of Interest method with suitable example.

4. Define the term 'external reconstruction' and differentiate between amalgamation and external reconstruction**.**

5. The Following is the balance sheet of XYZ Co. Ltd. on 31st December, 2012:

BALANCE SHEET

XYZ Co. Ltd.

as on 31st December, 2012

Liabilities	***₹***	***Assets***	***₹.***
20,000 Shares@10	2,00,000	Land & building	1,20,000
Debentures	1,00,000	Plant & Machinery	1,50,000
Sundry Creditors	30,000	Work in progress	30,000
Reserve Fund	25,000	Stock	60,000
Dividend Equalization Fund	20,000	Furniture	2,500

Profit and Loss Appropriation A/c	5,100	Sundry Debtors	5,000
		Cash at Bank	12,500
		Cash in Hand	100
Total	**3,80,100**	**Total**	**3,80,100**

The Company is absorbed by ABC Ltd. on the above date. The consideration for absorption is the discharge of debentures at a premium of 5 per cent, taking over the liability in respect of the sundry creditors, and payment of ₹. 7 in cash and one share of ₹. 5 in ABC Co Ltd. at the market value of ₹.8 per share in exchange for one share in XYZ Co. Ltd. The costof liquidation of ₹. 5000 is to be met by purchasing company. Pass journal entries in the books of both companies and also prepare final accounts.

6. The Balance sheet of X Ltd. and Y Ltd. as at 31st Dec, 2012, are given below:

BALANCE SHEET OF X LTD. & Y LTD.

as at 31st Dec, 2012

Liabilities	**X Ltd.**	**Y Ltd.**	***Assets***	**X Ltd.**	**Y Ltd.**
Equity Shares @100	4,00,000	3,60,000	Premises	1,20,000	------
General Res.	75,000	------	Goodwill	-------	1,20,000
Profit & Loss A/c	38,000	---------	Sundry Debtors	80,000	1,60,000
Sundry creditors	72,000	1,20,000	Stock in trade	3,00,000	90,000
			Bank	85,000	75,000
			P & L A/c	-----	35,000
Total	**5,85,000**	**4,80,000**	**Total**	**5,85,000**	**4,80,000**

A new company XY Ltd. was formed to take over the two businesses entirely on the following understandings:

(a) X Ltd 's Premises to be revalued at ₹ 1,50,000, sundry debtors taken over at 90 percent and stock at ₹. 3,15,000.

(b) Y Ltd's Goodwill to be taken over at ₹. 1,60,000, debtors to be taken at ₹. 1,50,000 and stock at ₹. 75,000.

It was decided that the capital of XY Ltd. would consist of both preference and equity and equity share of the face value of ₹. 10 each. Preference shares would be of the order of ₹. 4, 00,000 and the balance would be in equity shares. Both companies would be issued shares of both the types in equal number, except that the surplus capital of X Ltd. would be discharged fullyin preference shares. Indicate the number of shares to be issued to each of the absorbed companies and also prepare balance sheet of XY Ltd.

12.9 Answers to Check Your Progress

Check Your Progress A

1. True
2. True
3. False
4. False

Check Your Progress B

1. Conglomerate Merger
2. Purchase Consideration
3. Two
4. Formation of a new company

12.10 References/Suggested Readings

- ArulaNandam M.A. & Raman K.S.,**Advanced Accountancy**, Himalaya Publishing House, Delhi.
- Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.
- Gupta R.L. and RadhaSwamy M.,**Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
- Paul S.K.R,.**Advanced Accountancy**, New Central Book Agency, Calcutta.
- Shukla M.C. & Grewal S.,**Advanced Accounts,** S. Chand &Company Ltd, New Delhi.
- Study material of Institute of Chartered Accountant of India (ICAI), New Delhi.

NOTES

NOTES

NOTES

NOTES

NOTES

NOTES