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PG AND RESEARCH DEPARTMENT OF COMMERCE

CORPORATE ACCOUNTING I

Issue of equity shares
Company

Introduction

A company represents the third stage in the evolution of forms of business organizations- the first two being sole proprietorship and partnership firms. As distinct from these two, a company enjoys a separate legal status. Companies in our country are governed by the provisions of the companies Act, 1956.

Meaning

A company is an association of individuals formed for the purpose of some business or profit, with a capital, divisible into transferable shares. A company has an existence of its own. It is a juridical person and in law, exists like an individual.
Example: A company can be formed for the purposes such as charity, research, advancement of knowledge etc.

Definition

Section 3(1) (i) of the companies Act, 1956, defines a company as a company formed and registered under this Act or an already existing company. An existing company means a company formed and registered under any of the previous companies Act.

Features of a company

Voluntary association of persons: a company is a voluntary association of persons, i.e., it can neither compel a person to become its member nor to give up its membership. It is the personal choice of people and their objective to make profits which leads them to become members of a company.

Separate legal entity: Company can hold, purchase and sell properties, can open bank account in its name and can enter into contract. It is independent of members and its existence is not directed by the coming in and going out of its members.

Common seal: Being an artificial person it can act only through natural persons called directors and its distinct existence is evidenced by a common seal.

Perpetual succession: It is because of its peculiar status of a separate legal entity. Its continuity is not affected by the changes in the membership.

Limited liability: the liability of the members of a company is generally limited to the extent of the unpaid value of the shares held by them.

Kinds of companies

I) From the point of view of formation:
Statutory companies: A company formed by a special act passed either by the central or state Legislature is called Statutory Company. Such companies are governed by their respective Acts and are not required to have any Memorandum or Articles of Association.

Government companies: a company of which not less than 51% of the paid up share capital is held by the Central government or by the State government or by any two or more of them together shall be a government company.

Foreign companies: A company which is incorporated outside India but which has a place of business in India is termed as a foreign company.

Registered companies: Companies formed by registration under the companies act, 1956 is known as registered companies.

II) From the point of view of Liability:

Companies limited by shares: A company is said to be limited by shares when it has a share capital and the liability of its members is limited to the extent unpaid on the shares held by them.

Companies limited by guarantee: These are companies in which a member is liable to pay a certain sum of money mentioned in the memorandum as payable in the liquidation of the company.

Unlimited companies: Companies in which the liability of the members is unlimited. These companies are nothing but big partnerships.

III) From the point of view of investment:

Private Companies: A private company is a company which, by its articles,
Can make no invitation to the public for its shares or debentures,
Cannot have more than 50 members excluding persons who are employees of the company and
Restricts the right to transfer shares, where the company has a share capital.

Public companies: A public company means a company which:
Has a minimum paid up capital of Rs.5 lakhs or such higher paid up capital as may be prescribed;
Is not a private company.

FORMATION OF A COMPANY

Formation of a company involves 3 important stages. Namely- promotion, incorporation and commencement of business.

Promotion: A company may be formed for carrying on a new business or for absorbing an existing business concern or for amalgamating two or more business concern. The person involved in forming a company is called promoter.

Incorporation: A group of seven persons in the case of a public company and two persons in the case of a private company may by subscribing their names to a Memorandum of Association, form an incorporated company.

Commencement of business: A private company can commence business immediately after it has been duly incorporated and given the certificate of incorporation. It requires no certificate of commencement.
But a public company cannot commence business immediately after it is formed. It can commence the business only after obtaining the certificate of commencement from the Register.

PROSPECTUS

According to section 2(36), a prospectus is any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in or debentures of a body corporate.

SHARE CAPITAL
Every trading concern is expected to have a capital of a company is known as share capital.

The following are the main divisions of the share capital.

Authorized or Registered or Nominal capital: The capital mentioned in the capital clause of the Memorandum as the capital with which the company is registered is known as the Authorized capital.

Issued Capital: It is that part of the registered capital which is actually issued for subscription.

Subscribed Capital: It is that part of the registered capital which has been taken up or agreed to be taken up by the purchasers of shares of the company.

Called-up Capital: It is that portion of the subscribed capital with regard to which call have been made.

Reserve Capital: A limited company may by special resolution determine that portion of an uncalled share capital shall not be called up except in the event of and for the purpose of the company being wound up. This portion of share capital is called reserve capital.

Paid up capital: It represents that portion of the subscribed capital with regard to which the company has received all money from the shareholders.

SHARES

The capital of the company is divided into different units with definite value and the units are called shares. Holders of these shares are called shareholders.

There are two types of shares

- Preference shares
- Equity shares

Preference shares

Preference shares are those shares on which there is preferential right as
To dividend during the lifetime of the company and
To repayment of capital on the winding up.

Cumulative preference shares: If in any year, the company does not earn adequate profit, dividends on preference shares may not be paid for that year. In case of cumulative preference shares such unpaid dividend is treated as arrears. The arrears will accumulate and they will be payable out of the profits of the subsequent years.
Non- cumulative preference shares: If in any year the company does not earn adequate profit, the holders of non-cumulative preference get no dividend or get only a partial dividend. The unpaid dividend will not be carried forward to subsequent years.
Participating preference shares: In addition to the fixed rate of dividend, these kinds of shareholders have a right to participate in the surplus of profits which remains after payment to equity share holders.
Non-participating preference shares: The holders of this kind of shares have no right either to participate in the surplus of profits or the assets which remain after payment to equity shareholders.
Redeemable preference shares: The preference shares which can be redeemed (repaid) after a specified period or at the discretion of the company are called redeemable preference shares.

Equity shares

Equity shares are those shares which are not preference shares. These shares are also called *ordinary shares* .The holders of such shares are entitled to a dividend or share in the property after the preference shareholders are paid.
Explain the term “sweat equity shares”
The expression “sweat equity shares” means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called. All the limitations, restrictions and provisions relating to equity shares shall be applicable to such sweat equity shares.

ISSUE OF SHARES

Give brief explanation about the terms of Issue of shares

The terms and conditions of the issue of shares are stated in the prospectus. Shares may be issued either at par or at a premium or at a discount. When shares are issued at their face value, they are said to be issued at par, for example, when shares of Rs. 10 each (face value) are issued for Rs. 10 only (at par).

When shares are issued above their face value, they are said **to** be issued at a premium, for example, when shares of Rs. 10 (face value) are issued at Rs. 12, that is, at a premium of Rs.2.

When shares are issued below their face value, they are said to be issued at a discount, for example, when shares of Rs.10 (face value) are issued at Rs.9, that is, at a discount of Re. 1.

The issue price of shares may be received in one installment or in different installments. The different installments may be paid on application, allotment or in different calls. The amount received along with application is called the application money; the amount which becomes due on an allotment is called allotment money. Balance of the amount may be received in different installments by the company depending upon the need for the funds. They are called as first call and second call.

Application for Shares

Whenever a public company issues shares, advertisements appear in the leading newspapers about the issue. Those who are interested in purchasing the shares on the basis of the information given in the advertisement may get an application form along with a copy of the prospectus.

If the person is satisfied with the information available in the prospectus, he fills the application and remits the application money along with the filled-in application to any one of the banks (branches) mentioned in the advertisement. The bankers will send the application money to the company along with a list of applicants. The application money should be at least 5% of the face value of the shares applied for.

Allotment of Shares

The applications for shares by the members of the public are to be regarded as proposals sent by them **which** the company, through its directors, may accept (fully or partially) or reject.

All the applicants are to be informed about the allotment or non-allotment of shares by letters of allotment or of **regret** sent by the company. A letter of allotment must be stamped, as required by Indian Stamp Act.

A public company cannot allot shares unless:

1. The minimum subscription stated in the prospectus has been received.
2. A prospectus or a statement in lieu of the prospectus has been filed with the Registrar before making the first allotment.
3. The application money received is at least *5%* of the face value of the shares and the amount has been deposited in a scheduled bank.
4. There are no restrictions on the right of a private company to allot its shares.

Calls on Shares

The company may demand that portion of the uncalled capital, if any; from the members wholly or partly by making calls.

If **a company** adopts table A as its Articles of Association the following are to be noted:

(i) The Board may, from time to time, make calls upon the members in respect of any money unpaid on their shares (whether on account of the nominal value of the shares or by way of premium) and not by the conditions of allotment thereof made payable at fixed times, provided that no call shall exceed 1/4 of the nominal value of the share or be payable at less, than one month from the date fixed for the payment of the preceding call.

(ii) Each member shall, subject to receiving at least fourteen days notice specifying the time or times and place of payment, pay to the company, at the time or times and place so specified, the amount called on his shares.

(iii) A call may be revoked or postponed at the discretion of the Board.

Journal Entries for Issue of Shares

On receipt of application money, the journal entry will be as follows:

Bank A/c Dr.
To Share Application A/c
(Being the application money received)

Transfer application amount to the share capital:

Share Application A/c Dr.
To Share Capital A/c
(Being the application money transferred to the Share Capital Account)

On rejection of allotment:

Share Application A/c Dr.
To Bank A/c
(Being rejection of application)

For the amount due on allotment:

Share Allotment A/c Dr.
To Share Capital A/c
(Being the allotment money due on shares)

On receipt of allotment money:

Bank A/c Dr.
To Share Allotment A/c
(Being the allotment money received)

When the first call is due and called:

Share First Call A/c Dr.
To Share Capital A/c
(Being the first call money due)

On receipt of first call money:

Bank A/c Dr.
To Share First Call A/c
(Being the first call money received)

On making final call:

Share final Call A/c Dr.
To Share Capital A/c
(Being the final call money due)

On receipt of final call money:

Bank A/c Dr.
To Share final Call A/c
(Being the final call money received)

Issue of Shares at Premium

A company may issue shares at a premium, i.e., at a value higher than its face value. Premium so received shall be credited to a separate account called Share Premium Account.

Share premium received is a capital profit and can be used for the following stipulated purposes stated in Section 78 of the Companies Act, 1956:

(i) For the issue of fully-paid bonus shares to the members of the company.
(ii) For writing off the preliminary expenses of the **company.**
(iii) For writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company.

The amount of share premium is to be kept with the same sanctity as the share capital. If the premium money is utilized for any purposes other than mentioned above, it will be treated as reduction in share capital which is not permitted unless the provisions of Section 100 of the Companies Act are followed.

Share Premium Account must be shown separately in the Liabilities side of the Balance **Sheet** under the head 'Reserves and Surplus', so long as it has not been used.

The share premium is usually payable with the installment due on allotment. However, premium may be collected wholly or partly with application money, allotment money or calls money.

Journal Entries

(a) If the application amount includes share premium, the following entries are passed:

Bank A/c Dr.
To Share Application A/c
(Being the application money received)

Share Application A/c Dr.
To Share Capital A/c
To Share Premium A/c
(Being the application money transferred to the

Share Capital and Share Premium Account)

(b) If the share premium is received along with the allotment money, the following entries are **passed:**

Share Allotment A/c **Dr.**
To Share Capital A/c
To Share Premium A/c
(Being the allotment money and share premium due on shares)

Bank A/c Dr.
To Share Allotment A/c
(Being the allotment money along with share premium received)

Issue of Shares at a Discount

A company can issue shares at a discount, i.e., at a value less than the face value subject to the following conditions provided under Section 79:

(i) The shares are of a class which has already been issued.
(ii) The issue of the shares at a discount is authorized by a resolution passed by the company in its general meeting and sanctioned by the Company Law Board.
(iii) The resolution specifies the maximum rate of discount which should not exceed 10 % of nominal value of shares or such higher percentage as the Company Law Board may permit.
(iv) One year must have been elapsed since the date on which the company was entitled to commence business.

The entry for the issue is:

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

Discount on the issue of shares will be written off from the Profit and Loss Account over a number of years. In general the period is **5** years.

On writing off discount
P&L A/c Dr.
To discount on issue of shares A/c

Issue of shares for consideration other than cash

In some cases, shares are issued to persons who sell some asset to the company or to the promoters for their services. When shares are issued to vendors the entry will be:

(i) Sundry assets A/c Dr.
To vendor

(ii) Vendor Dr.
To share capital A/c
To share premium A/c
(Being the issue of ...shares of Rs… each at Rs… Per share to vendor in lieu of cash)

When shares are issued to promoter (for their remuneration) the entry will be:
Goodwill A/c Dr.
To share capital A/c

The companies Act requires that the balance sheet of a company should give particulars separately regarding shares issued for consideration other than cash such as to vendors or promoters.

FORFEITURE AND REISSUE

If a shareholder fails to pay the allotment money and/or calls made on him, his shares are liable to be forfeited. Forfeiture of shares brings about compulsory termination of membership and takes away the shares from a member by way of penalty for non-payment of allotment and/or call money. The Companies Act does not contain any specific provision regarding forfeiture of shares. However, the following conditions must be satisfied in order to ensure that the forfeiture of shares is valid:

(I) The power to forfeit shares must be expressly given by the Articles of Association of the company.
(II) There should be a default by the shareholder to pay allotment money/a valid call.
(III) The procedure given in the Articles must be followed.
(IV) A notice of demand, requiring the shareholder to pay allotment money/calls within the specified period specifying the amount also must be given.
(V) The board of directors must pass a resolution for forfeiture of shares.

The effect of forfeiture of shares is that the defaulting shareholder loses all his rights in the shares and ceases to be a member. The name of the shareholder is removed from the Register of Members and the amount already paid by him is forfeited. He is not entitled in future to dividends and to the rights of membership.

Forfeited shares account is to be shown in the balance sheet by way of addition to the paid up capital on the liabilities side until the concerned shares arc reissued.

The entries for forfeiture are:

Share Capital A/c Dr.
(Number of shares forfeited multiplied by the amount called up per share)
To Various calls
Or
Calls in arrears
} (the amount that remains unpaid)

To Share Forfeited A/c

Forfeiture of shares issued at par. The journal entry will be as follows:

Share capital A/c (with the amount called up) Dr.

To unpaid calls A/c (with the amount received)
To Forfeited shares A/c (with the amount received)

Forfeiture of shares issued at premium

The amount of share premium had not been received but it was credited to “securities Premium Account”, when the amount became due.

The journal entry for forfeiture will be:

Share capital A/c (with the amount called up) Dr.
Securities premium a/c (with the amount of premium called) Dr.
To unpaid calls A/c
To Forfeiture shares A/c

The amount of share premium has either been received or even if not received, the company has given credit to the securities premium account only with the amount of premium received.

The journal entry will be

Share capital A/c Dr.
(With the amount called up on account of share capital)
To unpaid calls
(with unpaid amount excluding share premium)
To Forfeiture shares A/c
(with the amount received)

Forfeiture of shares issued at discount

The journal entry will be:

Share capital A/c Dr.
To unpaid call a/c
To forfeited shares a/c
To discount on issue of shares A/c

Reissue of Forfeited Shares

On forfeiture, the shareholder ceases to be a holder of the forfeited shares and the company becomes entitled to it. The company may dispose of the forfeited shares as permitted by the law and by the Articles of the company. The forfeited shares can be reissued by the directors even at a discount provided the discount on reissue does not exceed the amount forfeited per share. The discount (loss on reissue) thus allowed has to be debited to the Share forfeited account.

The entry is:

Cash/Bank A/c	Dr.	(Actual amount received)
Share Forfeited A/c	Dr.	(Discount allowed)
To Share Capital A/c		(Amount credited as paid up)

After the reissue, any balance in the Share Forfeited Account has to be transferred to the Capital Reserve Account proportionate to the extent of the shares reissued. Any balance in the Share Forfeited Account will be carried forward and will be used for meeting the discount loss on the issue of the remaining shares.

What is Capital Reserve?

Capital reserve is that which is not available for paying dividends through the profit and loss account. It is generally created out of capital profits, such as profits prior to incorporation, profit on sale of a fixed asset above the original cost or on revaluation; profit on reissue of forfeited shares etc.

Share premium is also capital reserve, but it is to be shown separately in the balance sheet and kept intact. Profit transferred to Capital Redemption Reserve Account, out of divisible profits becomes capital profit on such transfer but this must also be shown separately in the balance sheet and kept intact.

Capital profits, unless they are to be kept intact, are used to write off the capital loss and are not available for distribution among the shareholders as dividend. However, many capital profits such as profit

on sale of fixed assets realized in cash, share premium, capital redemption reserve, etc., can be utilized for issue of fully paid bonus shares. Realized profit on sale of fixed assets is available for dividend, legally, if

i. This course is permitted by the articles, and
ii. This profit remains on a fair revaluation of all assets and liabilities.

Give a detail note about surrender of shares

Surrender of shares means the return of shares voluntarily by the shareholder to the company for cancellation. In this case the shareholder voluntarily abandons the shares in favor of the company.

A company can accept surrender of shares only when it is authorized by its Articles. Moreover, surrender of shares can be accepted only under any of the following two circumstances.

When shares are surrendered in exchange of a new issue of the same nominal value. There would be no reduction of share capital in such a case.

Journal entry for such a surrender of shares will be as follows:

Share capital A/c (old) Dr.
To share capital A/c (new)

What do you mean by the term "STOCK INVEST"

In order to mitigate the harassment caused to the investors because of non-receipt/delay in refund of share application money or allotment letter from the concerned company, an instrument called "STOCKINVEST" has been introduced by the government.

This instrument is an additional facility available to an intending investor in case he so opts. It is essentially a combination of a letter of authority and guaranteed cheque and as good as cash. The instrument is available with leading banks of the country in various denominations as per the stock investment scheme.

CALLS IN ADVANCE

A company may, if authorized by its Articles, accept calls in advance from its shareholders. Table *A g*ives such a power and also provides for payment of interest at a rate not exceeding 6% per annum. The amount received in advance as payment of calls will be credited to a "Calls in Advance Account." The amount so received will be adjusted towards the payment of calls as and when they become due.

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

Share… call A/c Dr.
To Share capital A/c
(With the amount due on…call on all shares
including those on which call has been received in advance)

Bank A/c Dr.
(with the amount actually received)
Calls in advance A/c Dr.
(with the amount of the call received in advance)
To …call A/c

CALLS IN ARREARS

A shareholder may not pay the call when it becomes due. The company may provide in its articles for charging interest from the defaulting shareholder. Table A permits charging of interest on calls in arrears at 5% per annum. The journal entries in respect of calls in arrears are as follows:

When a call becomes due:

Share.... call A/c Dr.
To Share capital A/c

When money in response to calls is received

Bank A/c Dr.
To Share call A/c
(with the amount actually received excluding the amount of a call in arrear)

At the end of the accounting year, the amount outstanding on account of a call will be transferred to 'Calls in Arrears A/c'.

Calls in arrears A/c Dr.
To Share…call A/c

In case a shareholder makes payment of a "call in arrear' with interest, the entry will be:

Bank A/c Dr.
To Share... call A/c / Calls in arrears A/c
To interest A/c

PROBLEMS:

Issue of Shares at par

1. A Limited company issued 10,000 equity shares of Rs. 10 each, payable Re 1on application, Rs 2 on allotment, Rs 3 on first call and Rs 4 on final call. All shares were subscribed and amounts duly received. Pass entries in the books of the company.

2. On 10 January 2002, a company offers 8,000 shares of Rs 10 each. Applications are received for full 8,000 shares. Money is payable as follows:

On application Rs 3 per share
On allotment Rs 2 per share
On 1st call Rs 3 per share
On final call Rs 2 per share

The shares were duly allotted calls made and money realized. You are required to pass necessary entries.

3. A Limited company issued 10,000 equity shares of Rs. 10 each, payable as under:
Rs 2 on application, Rs 5 on allotment, Rs 3 on final call all the money due on shares were received. Show the journal entries in the books the company.

Issue of Shares at Premium

4. Bharath Limited issued 10,000 shares of Rs. 10 each to the public for subscription at Rs. 12 per share. Money is payable as follows:

Rs 3 on application
Rs 4 on allotment (including Re 1 as premium)
Rs 5 on call (including Re 1 as premium)

The shares were duly allotted call made and money realized. You are required to pass necessary journal entries and show how the items will appear in the company's balance sheet.

Issue of Shares at discount

5. A limited invited applications for 15,000 equity shares of Rs 10 each at a discount of 10% payable as follows:
On application Rs 3
On allotment Rs 3
First &final call Rs 3
Applications received were for 15,000 shares and all these were accepted all money due was received. Pass necessary JE of the company.

Issue of shares for consideration other than cash

6. Raja Ltd. was incorporated with a share capital of Rs. 10, 00,000 in Rs.10 shares. The company purchased plant and machinery from Hindustan & Co for Rs 3, 00,000 payable in fully paid shares of the company. The directors also decided to allot 1,500 shares credited as fully paid to the promoters for their services. The rest of the shares were issued for cash and were taken up by the public and fully paid for. Give journal entries and show the balance sheet.

Under Subscription

7. Sridhar Ltd issued 20,000 equity shares of Rs 10 each payable as- Rs 3 on application, Rs 4 on allotment, Rs 3 on final call.

The public applied for 15, 000 shares which were allotted. All the money due on shares was received. Show the journal entries in the books of the company.

Forfeiture and re-issue, over-subscription, calls in advance, calls in arrears-comprehensive problems

8. A Limited Company issued 10,000 equity shares of Rs 10 each payable as under:
The public applied for 8000 shares which were allotted. All the money due on shares was received except the final call on 100 shares. These shares were forfeited and reissued at Rs 8 per share. Show the journal entries in the books of the company.

9. A company offers 10,000 shares to the public. The amount payable is Rs 3 on application, Rs 2 on allotment, Rs 3 on 1st call and Rs 2 on final call.
Applications are received for 15,000 shares. The directors make the allotment as follows:
i. No allotment to applicants to applicants for 3,000 shares.
ii. Rest allotted on a pro rata basis.

All calls were duly made and paid except

- A, a holder of 100 shares paid the 2 calls with allotment.
- B. a holder of 200 shares fails to pay the 1st and the 2nd calls.
- C, a holder of 100 shares fails to pay the 2nd call.

Pass the necessary JE to record the above transactions in the company's books and show how the share capital will appear in the company's balance sheet.

10. Pallav Hotels Limited offered 1, 00,000 equity shares of nominal value of Rs 10 each for public subscription at Rs 12.
The amount payable on the shares were on application Rs 4.50; on allotment (including premium) Rs 4.50; on first and final call Rs 3.00.
The actual subscription was only for 90,000 shares. All money payable by share holders was received except from Sudhakar who had taken 1,000 shares but failed to pay the final call. His shares were forfeited and reissued to Prabhakar at Rs 6 each.
Show J.E in the books of the company in respect of the above (including each transaction).

11. A Limited., whose authorized share capital is 10,000 in Rs 10 shares, issued the whole of its capital to the public at a premium of Re 1 per share, payable as follows; on application and allotment Rs 6 per share (including premium), first call of Re 1 per share.

The application and allotment money was received in full but members holding 1,000 shares failed to pay the call of Re 1 per share and in consequence the shares were forfeited. At a later date and before further calls were made, 500 of these shares were reissued as fully paid for a consideration of Rs 8 per share.

Write up ledger accounts and the balance sheet.

12. Rakesh Limited issued 10,000 shares of Rs 10 each at Rs 11 per share. Share money was payable as follows: On application Rs 2 per share; on allotment Rs 5 per share; on call Rs 4 per share.

The offer was oversubscribed by 5,000 shares and the applicants were allotted shares on a pro rata basis. Surplus application money was adjusted for further share dues. All shares were fully called up and money was received except on 300 shares of Rahim who didn't pay allotment and call money. These shares were forfeited. Give cash book and J.E.

13. A Limited invited applications for 10,000 equity shares of Rs 100 each at a discount of 6% payable as follows:

On application Rs 25; on allotment Rs 34; on first and final call Rs 35.

The applications received were for 9,000 shares and all of these were accepted. All monies due were received except the first and final call on 100 shares which were forfeited. 50 shares were re-issued at Rs 90 as fully paid. Assuming that all requirements of the law were complied with Pass entries in the cash book and the journal of the company.

14. A company offers 10,000 shares of Rs 10 each to the public for subscription. The money is payable as follows-

Rs 2 on application, Rs 3 on allotment and Rs 5 on first and final call.

The company receives application for 12,000 shares. Applicants for 9,000 shares pay the application money in cash. While the rest pay that money through stock invests. The shares are allotted on the pro rata basis. All allot tees pay the allotment and final call moneys on due dates. Pass the necessary journal entries.

(UNIT I COMPLETED)

What do you mean by Preference shares?

Preference shares are those shares on which there is preferential right as

a) To dividend during the lifetime of the company and

b) To repayment of capital on the winding up.

The preference share holders are eligible to get dividend on a fixed percentage. The percentage is decided at the time of issue of the share capital. (Eg.) 15% preference shares may be the form in which the preference shares are issued. In this kind of issue, the preference shareholders are eligible to get dividend @ 15% for their holdings. But they will be paid only when the company earned profit.

Give a brief note on kinds of preference shares?

The following are the different types of preference shares:

1. Cumulative preference shares and non Cumulative preference shares
2. Participating preference shares and non Participating preference shares
3. Redeemable preference shares and Irredeemable preference shares
4. Convertible preference shares and non Convertible preference shares

- **Cumulative preference shares:** If in any year, the company does not earn adequate profit, dividends on preference shares may not be paid for that year. In case of cumulative preference shares such unpaid dividend is treated as arrears. The arrears will accumulate and they will be payable out of the profits of the subsequent years.

- **Non- cumulative preference shares:** If in any year the company does not earn adequate profit, the holders of non-cumulative preference get no dividend or get only a partial dividend. The unpaid dividend will not be carried forward to subsequent years.

- **Participating preference shares:** In addition to the fixed rate of dividend, these kinds of shareholders have a right to participate in the surplus of profits which remains after payment to equity share holders.

- **Non-participating preference shares:** The holders of this kind of shares have no right either to participate in the surplus of profits or the assets which remain after payment to equity shareholders.

- **Redeemable preference shares:** The preference shares which can be redeemed (repaid) after a specified period or at the discretion of the company are called redeemable preference shares.

- **Irredeemable preference shares:** The preference shares which could not be redeemed in a specific period of time is called irredeemable preference shares.
- **Convertible preference shares:** convertible preference shares are those shares which can be converted into equity shares after certain period of time. Conversion may either be a portion of the preference shares or entire value of the preference shares.
- **Non-Convertible preference shares:** Non convertible preference shares are those preference shares which cannot be converted into equity shares.

List out the provisions regarding Redemption of Preference Shares

A company can issue redeemable preference shares and such issue should be permitted by the Articles of Association of the company as per Section 80 of the Companies Act 1956.

The following procedure should be adopted for the redemption of preference shares.

(1) Partly paid shares should be converted into fully paid up preference shares, before the redemption. No partly paid up shares should be redeemed.
(2) The preference shares can be redeemed either out of the profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of the redemption.
(3) The premium, if any, payable on redemption must be provided either out of the accumulated profits of the company or out of the company's Share Premium Account, before the shares are redeemed.
(4) When shares are redeemed out of profits available for dividend, an amount equal to the nominal value of the shares so redeemed should be transferred from the profits to a reserve called Capital Redemption Reserve Account.
(5) The Capital Redemption Reserve Account may be applied by the company, in paying up unissued shares of the company to-be issued to members of the company as fully paid bonus shares.
(6) The redemption of preference shares by a company shall not be taken as reducing the amount of its authorized share capital.
(7) A company has redeemed or is about to redeem any preference shares, it shall have power to issue up to the nominal amount of the shares redeemed or to be redeemed as if those shares had never been issued.
(8) If new shares are issued for the purpose of redemption, it will not be treated as increase of capital.

Journal Entries for Redemption of Preference Shares

When fresh issue of shares if any, for the purpose of redemption.

Bank A/c Dr
    To Share capital A/c
(Being issue of shares for the purpose of redemption of preference shares)
[If the shares are issued at par, or at a discount appropriate entry has to be passed.]

When the shares are redeemed at premium:

Share premium A/c Dr
Profit & Loss A/c Dr
    To Premium on redemption
(Being the share premium account and the balance from Profit and Loss Account utilized for the provision for Premium on Redemption Account)

For creating Capital Redemption Reserve Account for the redemption of preference shares:

Profit and Loss A/c Dr
General Reserve A/c Dr
    To Capital Redemption Reserve A/c
(Being the capital redemption reserve amount credited out of divisible profit)

[Amount to be transferred to capital redemption reserve A/c]

Redeemable Pref. shares – Face Value(less)	Fresh issue of shares -Face Value= if issued at par or at a premium or	=	Amount to be transferred to capital redemption reserve A/c

if the shares are issued at
a discount, actual amount received

For transferring the Preference Share Capital to Preference shareholders Account

If redeemed at par.

Redeemable Preference Share Capital A/c Dr
To Redeemable Preference Shareholders A/c
(Being the transfer of capital to preference shareholders account)

If redeemed at premium.

Redeemable Preference share capital A/c Dr
Premium on redemption A/c Dr
To redeemable preference share holders A/c
(Being the transfer of capital to preference share holders account)

For the payment to redeemable preference shareholders

Redeemable preference shareholders A/c Dr
To Bank A/c
(Being the payment to redeemable preference shareholders)

Bring out the equation for determining the fresh issue of shares

When the fresh issue of shares is not given in the problem, but states that the minimum possible issue is to be made to carry out the redemption, the minimum issue can be arrived at by applying the following equation subject to the condition that the premium on redemption exceeds or is equal to the available premium plus any premium to be received on fresh issue of shares.

Use of equation for determining the fresh issue

Redeemable Preference shares + Premium on Redemption = **Premium in the Balance Sheet** + **Divisible Profit in the Balance Sheet** + **Fresh issue (say X)** + **Premium on Fresh issue**

Differentiate between capital profit and revenue profit

Capital profit is a profit made on the sale of a fixed asset or a profit earned on getting capital for the business. For example, if the shares having an original cost of Rs 4,000 are sold for Rs 5,000, the profit of Rs 1,000 thus made is capital profit. Similarly, premium received on the issue of shares and debentures is capital profit. Capital profit should not be transferred to the profit and loss account but should be **transferred to capital Reserve** which would appear as a liability in the balance sheet.

Whereas, Revenue profit is a profit made by trading e. g., profit on sale of goods, income from investments, discount received, commission earned, rent received, interest earned etc.. such profits are taken to profit and loss account.

<u>BONUS SHARES</u>

What do you mean by Bonus Shares?

It is quite natural that every prudent company likes to create a reserve out of its profits for the purpose of future expansion as well as for declaring dividend in the lean periods. The company at its choice

may pay bonus to the shareholders in cash. But, the bonus paid in the form of cash may affect the company's working capital position.

In order to avoid the outflow of cash from the business and at the same time to satisfy the shareholders, the company may resort to issuing bonus shares to the existing equity shareholders by adopting the guidelines given by the Government.

What are the circumstances to issue Bonus shares?

Bonus shares may be issued in the following circumstances:

(i) When the company has large accumulated reserves, whether capital or revenue and it wants to capitalize these reserves for making it a permanent capital of the company.
(ii) When the company, though has reserves, is not in a position to pay cash bonus because it may disturb the cash position.
(iii) When the value of fixed assets far exceeds the value of capital, to make the capital to show a value on par with the value of the assets.
(iv) When higher rates of dividend payment is not advisable because shareholders may demand at least the same rate or even more in the future which the company may not be in a position to pay.
(v) When the market value for exceeds the face value of shares, to make the value on par with each other.

Give a brief note on "Provisions relating to issue of Bonus Shares"

According to Section 205(3), 78(2) (a) and 80(5) of the Companies Act, the following reserves in be utilized for the issue of Bonus Shares.

i. Capital Redemption Reserve Account
ii. Share Premium Account
iii. Credit balance of the Profit and Loss Account
iv. General Reserve
v. Capital Profit (like profit on purchase of business, or profit on sale of fixed assets and profit prior to incorporation)
vi. Balance in the Debenture Redemption Reserve Account
vii. Any other reserves arising out of profits.

Substantiate the reserves that should not be utilized for the issue of bonus shares.

The following reserves should not be utilized for the issue of bonus shares.

- Share premium due to issue of shares on account of amalgamation or holding;
- Capital Reserve due to revaluation of assets
- Debenture Redemption Reserve Account balance before the redemption of debentures;
- Surplus due to the change in the method of charging depreciation;
- Development Rebate Reserve and Investment Allowances Reserve before the expiry of 8 years of creation.

For issuing Bonus shares, first of all the partly paid up shares should be converted into fully paid up shares. All the reserves which are eligible for the issue of bonus shares except Capital Redemption reserve and Share Premium Account can be utilized for the conversion of partly paid shares into fully paid up shares.

Accounting Treatment of the Issue of Bonus Shares

If the bonus is to be utilized for making partly paid shares fully-paid, the entries will be as follows:

(1) Profit and Loss A/c Dr.
General Reserve A/c Dr.
Capital Reserve A/c Dr.
To Bonus to Shareholders A/c
(Being the amount transferred for bonus payable to shareholders)

(2) Share Final Call A/c Dr.
To Share Capital A/c
(Being the amount due from the shareholders in respect of final call)

(3) Bonus to Shareholders A/c Dr.
To Share Final Call A/c
(Being the bonus to shareholders applied towards meeting the call)

If the payment of bonus is made by the issue of fully paid bonus shares, the entries will be as follows:

Capital Redemption Reserve A/c Dr.
Share Premium A/c Dr.
Capital Reserve A/c Dr.
Profit and Loss A/c Dr.
General Reserve A/c Dr.
To Bonus to Shareholders A/c
(Being the amount transferred for issue of bonus shares - depending upon the available balances in the above-said accounts).

Bonus to Shareholders A/c Dr.
To Share Capital A/c
To Share Premium A/c — If issued at a premium.
(Being the issue of bonus shares)

PROBLEMS

1) The following are extracts from the Balance Sheet of A.Ltd as on December 31, 2012:

Authorized Capital	*Rs.*
10,000 equity shares of Rs. 10 each	1,00,000
Issued and subscribed capital:	
5.000 equity shares of Rs. 10 each fully paid-up	50,000
Reserve fund	35,000
Profit and Loss A/c	10,000

A resolution was passed to issue 1,000 bonus shares of Rs. 10 each by providing Rs. 5,000 out of the P& L Account and the balance out of the Reserve Fund.Set out Journal entries to give effect to the resolution and show how they would affect the Balance Sheet.

2) X Ltd. has resolved to utilize Rs. 3,00,000 out of the General Reserve balance to declare a bonus to the shareholders by paying the final call of Rs. 3 per share on 1,00,000 equity shares of Rs. 10 each. Along with this, the Company further decided to utilize the balance of the Share Premium Account to issue fully paid-up bonus shares in the ratio of one equity share for every five equity shares held. Show Journal entries in the books of X.Ltd.

3) The Balance Sheet of A Ltd. as at 31.3.2005 is as follows :

Balance Sheet as at 31.3.2005

Liabilities	*Rs.*	*Assets*	
Authorised Share Capital : 1,50,000 Equity Shares of Rs. 10 each	15,00,000	Sundry Assets	17,00,000
Issued, Subscribed and Paid-up : 80,000 Equity Shares of Rs. 7.50 each called-up and paid-up	6,00,000		
Reserves			
Capital Redemption Reserve	1,50,000		
Plant Revaluation Reserve	20,000		
Share Premium Account	1,50,000		
Development Rebate Reserve	2,30,000		
Investment Allowance Reserve	2,50,000		
General Reserve	3,00,000		
	17,00,000		17,00,000

The company wanted to issue bonus shares to its share holders at the rate of one share for every two shares held. Necessary resolutions were passed; requisite legal requirements were complied with:
(a)You are required to give effect to the proposal by passing journal entries in the books of A Ltd.
(b)Show the amended Balance Sheet.

REDEEMABLE PREFERENCE SHARES

4) A company has 8,000 redeemable preference shares of Rs. 100 each fully paid. The company decides to redeem the shares on September 30.1998, at a premium of 7 %. The company has sufficient profits but in order to augment liquid funds the following issues are made :
(a) 3000, 6% debentures of Rs. 100 each at Rs. 106.(b) 2,000, equity shares of Rs. 100 each at Rs. 111.
The issues were fully subscribed and all the amounts were received. The redemption was duly carried out Give Journal entries.

5) Balance Sheet of X.Ltd. as on March 31,2012

1.

LIABILITIES	*Rs.*	**ASSETS**	*Rs.*
Share capital:			
Issued, subscribed and fully paid-up 10,000 ordinary shares of Rs. 100 each	10,00,000	Fixed assets Current assets	22,00,000 8,00,000
5.000 preference shares of Rs. 100 each	5,00,000		
Capital reserve	1,00,000		
Share Premium A/c	1,00,000		
General reserves	2,00,000		
Profit and Loss A/c	1,00,000		
Current liabilities	10,00,000		
	30,00,000		30,00,000

The preference shares are to be redeemed at **10%**premium. Fresh issue of equity shares is to be made to the extent required under the Companies Act for the purpose of this redemption. The shortfall in funds for the purpose of the redemption after utilizing the proceeds of the fresh issue is to be met by taking a Bank loan. Show Journal entries.

6) The following is the summarized Balance Sheet of a company as on March 31, 2011

Balance Sheet

Liabilities	Rs	assets	Rs
Issued, subscribed and paid up capital:		Sundry Assets	18,00,000
		Cash at bank	6,60,000
4,000, 8% redeemable preference shares of Rs. 100 each fully called-up and paid-up	4,00,000		
3,000, 9% redeemable preference shares of Rs. 100 each, Rs 80 paid-up	2,40,000		
1,00,000 equity shares of Rs. 10 each fully called-up and paid-up	10,00,000		
Share Premium A/c	50,000		
Revenue reserve	5,00,000		
Current liabilities	2,70,000		
	24,60,000		24,60,000

It was decided to redeem both the classes of preference shares on June 30 at a premium of 5 %. In May, 2011, the company issued for cash as many equity shares of Rs.10 each as were necessary to provide for redemption of both classes of preference shares which could not otherwise be redeemed. The issue was fully subscribed and all the moneys were received.

Give the Journal entries in the books of the company and draw up the amended Balance Sheet.

7) PP. Ltd. had an authorized share capital of Rs 10 Lakhs.

Balance Sheet of PP. Ltd. as on December 31,2012

Liabilities		*Rs.*	*Assets*		*Rs.*
Share Capital:			Fixed Assets:		
Issued and fully paid:			Plant and machinery	4,00,000	
15,000, 5% redeemable Preference shares of			Furniture	42.000	
			Vehicles	48,000	
Rs. 10 each	1,50,000			------------	4.90,000
30,000 equity shares			Investments		1,00,000
of Rs.10 each	3,00,000		Current Assets:		
	----------	4,50.000	Stock	2,10,000	
Share Premium		1,35,000	Debtors	1,10,000	
General Reserve		1,60.000	Balance at Bank	90,000	4,10,000
Profit & Loss A/c		55,000		-----------	
Sundry Creditors		2,00,000			
		10,00,000			10,00,000

Determining the fresh issue of shares

8) From the following particulars show the amount to be transferred to capital redemption reserve A/c
Fresh issue of equity shares of Rs 2,00,000 at a premium of 10%
Fresh issue of equity shares of Rs. 1,00,000 at par(or)
Fresh issue of equity shares of Rs. 1,00,000 at a premium of 10% (or)
Fresh issue of equity shares of Rs. 1,00,000 at a discount of 10%.

9) Redeemable preference shares to be redeemed Rs.20,000**.** Premium on Redemption 10%
Profit available for dividend Rs. 10,000.
Share Premium appearing in the Balance Sheet Rs. 1.000.

Fresh issue is to be made at 10% premium.
Calculate the minimum issue to be made.

10) Prosperous Ltd. Has 12% preference share capital of Rs 1 lac consisting of Rs 100 shares fully called and paid up. The company wants to redeem them at 10% premium. The ledger accounts show the following balances:

	Rs
Profit & Loss A/c	20,000
Share premium	4,000

The directors desire to make a minimum fresh issue of equity shares of Rs 10 each at 5% premium for redemption of the preference shares.
You are required to ascertain the amount of such fresh issue to be made by the directors and pass the requisite journal entries.

11) The following is the balance sheet of TOM Ltd. As at 31.03.2010

For the year ended 31.3.2011, the company made a net profit of Rs. 7,500 after providing Rs. 10,000 depreciation and writing off the miscellaneous expenditure of Rs. 10,000.

The following additional information is available with regard to company's operation:

(i) The preference dividend for the year ended 31.3.2011 was paid before 31.3.2011.
(ii) The company redeemed the preference shares at a premium of 10%.
(iii) To meet the cash requirements of redemption, the company sold a portion of the investments, so as to leave a minimum balance of Rs. 15,000 after such redemption.
(iv) Except cash and bank balances other current assets and current liabilities as on 31.3.2011 was the same as on31.3.2010.
(v) The company issued bonus shares in the ratio of one share for every equity share held as on 31.3.2011.
(vi) Investments were sold at 90% of cost on 31.3.2011.

You are required to:

(a) Prepare necessary Journal Entries to record redemptions and issue of bonus shares;
(b) Prepare the cash and bank account.
(c) Prepare the Balance Sheet as at 31st March, 2011 incorporating the above transactions.

What are the advantages and disadvantages of preference shares?

Advantages of preference shares are:

- The rate of dividend on preference share holders is fixed.
- Preference share holders have a right to receive dividend before any dividend is paid to equity share holders.
- On the winding up, they have right to return capital before the capital returned on equity shares.
- If dividend is not paid on these shares in any year, the arrear of dividend may accumulate.

Disadvantages of preference share holders are:

- Preference share holders are not entitled to participate in management.
- Preference share holders do not have any voting rights.

PROBLEMS

Redemption out of revenue reserves:

12) Symcox Ltd., issued 75,000 equity shares of Rs 10 each of Rs 10 each and 5,000 Redeemable preference shares of Rs 100 each all shares being fully called and paid up on 31-3-2002. Profit & Loss account showed undistributed profits of Rs 3,00,000 and general reserve stood at Rs 2,50,000. On 1-4-2002, the directors decided to redeem the existing preference shares at Rs 105 utilizing as much profits as would be required for the purpose.

You are required to pass necessary journal entries in the books of the company.

13) The following extract from the balance sheet of Gayathri co. ltd. As on 31st Dec 2010, is given to you.

	Rs
Share Capital:	
2,00,000 Equity shares of Rs 10 each	20,00,000
3,00,000 6% redeemable preference shares of Rs 10 each	30,00,000
Capital Reserve `	15,00,000
General Reserve	9,00,000
Profit & Loss A/c	25,50,000

The company exercises its option to redeem the preference shares on 1st Jan,2011. The company has sufficient balance. Give journal entries to record the redemption.

14) The Balance Sheet of Exchange ltd., as on 31-12-2011 was as follows:

Liabilities	Rs	Assets	Rs
Share Capital:			
50,000 Equity Shares of Rs 10 each, fully paid	5,00,000	Sundry Assets	9,20,000
		Bank Balance	6,00,000
4,000 Redeemable preference shares of Rs 100 each fully paid	4,00,000		
Profit and Loss A/c	5,20,000		
Creditors	1,00,000		
	15,20,000		15,20,000

On the above data, the preference shares were redeemed at a premium of 10%. You are required to pass journal entries and give the amended balance sheet.

Redemption out of Fresh issue

15) Modern Fibres Ltd., has part of its share capital as 5,000 Redeemable preference Shares of Rs 100 each. When the shares became due for redemption, the company decided that the whole amount will be redeemed out of a fresh issue of equal amount of equity shares of Rs 10 each
Show the journal entries in the books of the company.

16) Sterling Ltd. Have part of their share capital in 2,500 6% Redeemable preference shares of Rs 100 each. The company decided to redeem the preference shares at premium of 10%. The general reserve of the company shows a credit balance of Rs 3,00,000. The directors decide to utilize 60% of the reserve in redeeming the preference shares and the balance is to be met from the proceeds of fresh issue of sufficient number of shares of Rs 10 each. The premium is to be met from the year's profit & loss appropriation account. Give journal entries to record the above transactions.

17) XYZ Ltd. Had issued 20,000 equity shares of Rs 100 each fully paid and 12,000 redeemable preference shares of Rs 100 each fully paid. On 31st Dec 2007, the profit & loss A/c showed an undistributed profit of Rs 2,00,000 and the General Reserve A/c stood at Rs 5,60,000.
On 1.1.2008, the directors decided to issue 6,000 9% preference shares of Rs 100 each and to redeem the existing redeemable preference shares at Rs 110 each utilizing as less profits as possible for the purpose.
Pass necessary journal entries to record the above transactions. There was a bank balance of Rs 8,00,000 on that date.

18) The following is the Balance sheet of Harbhajan Singh Ltd. as on 30th June 2003:

Liabilities	Rs	Assets	Rs
Share Capital:		Fixed Assets	10,00,000
30,000 6% redeemable preference shares of Rs 10 each fully paid	3,00,000	Investments	2,10,000
		Current Assets:	
60,000 equity shares of Rs 10 each fully paid	6,00,000	Stock	4,40,000
		Sundry Debtors	1,60,000
Securities premium A/c	2,90,000	Cash at Bank	2,20,000
General Reserve	4,00,000		
Profit & loss A/c	2,45,000		

Sundry Creditors	1,95,000		
	20,30,000		20,30,000

The company exercised its option to redeem, on July 1 2003, the whole of the preference shares at a premium of 5%

To assist in financing the redemption, all the investments were sold, realizing Rs 1,95,000. On sep.1,2003, the company made a bonus issue of seven equity shares fully paid for six equity shares held on that date. The appropriate resolutions were passed and the above transactions were duly completed.

You are required to show the journal entries and the balance sheet of the company as it would appear after completion of the transactions.

Minimum fresh issue of shares

19) The Balance sheet of LKS Co Ltd as on 31-3-2003 was as follows:

Liabilities	**Rs**	**Assets**	**Rs**
20,000 Equity Shares of Rs 10 each fully paid up	2,00,000	Fixed Assets	2,37,500
10% Redeemable preference shares of Rs 100 each fully paid up	1,00,000	Investments	12,500
Securities Premium	4,850	Current assets	95,000
Profit & Loss A/c	60,000	Miscellaneous expenditure not yet written off	48,750
Current Liabilities	28,900		
	3,93,750		3,93,750

On the above date, it was decided to redeem the preference shares at a premium of 10%. The directors wish that only the minimum number of fresh equity shares of Rs 10 each at a premium of 5% be issued to provide for redemption of such shares as could not otherwise be redeemed. Pass necessary journal entries and also prepare the balance sheet after redemption.

(UNIT II COMPLETED)

Debentures - Theory

Introduction

A Joint Stock Company may raise funds from different sources for different purposes. Usually, long term financial needs are met by issue of shares. Medium term funds are raised by issue of debentures.

What do you mean by Debentures?

Sec. 292(1) of Companies Act deals with borrowing powers of a company which include the power to issue debentures. The Act defines debentures as "Debenture includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of a company or not".

Debentures are "creditorship securities issued by a company, usually for a fixed period, at a specified rate of interest payable periodically. The company's assets may be given as security for the debentures but such security is not mandatory.

How do you classify Debentures? Give a brief note.

Debentures may be classified in different ways as follows:

(1)On the basis of security:

Debentures may be secured or unsecured. The secured debentures usually have assets mortgaged. So, they are called mortgage debentures. The mortgage can be on specific assets or the companies assets in general. In former case, the debentures are secured by "fixed charge' and in the latter case, 'floating charge'. The unsecured debentures are called *Naked* or *Simple* debentures.

(2)On the Basis of permanence:

Debentures may redeemable or irredeemable. Redeemable debentures may have a specified future date for redemption or they may be repayable at the company's option. Irredeemable debentures have no date for redemption and for all practical purposes they may be repayable at the time of winding up of the company.

(3)On the Basis of Priority:

Debentures may be termed according to the order of their repayment. For example, 'first debentures' are repayable prior to any other debentures. 'Second debentures' are repayable after redemption of the first debentures and so on.

(4)***On the basis of convertibility:***

Debentures may be non convertible, partly convertible or fully convertible. The terms of issue of debentures may specify the manner of their conversion. Non convertible debentures are repaid in due course, as per the terms of their issue.

Partly convertible debentures (P. C. Ds) and fully convertible debentures (F. C. Ds) have specific time limits at the end of which they are converted into shares. In case of P.C.Ds., the unconvertible portion termed as 'KHOKA' is repaid in cash and the convertible portion; alone is converted into shares.

(5)On the Basis of recording:

Debentures may be *Registered debentures* or *Bearer debentures.* Registered debentures are recorded in the company's register. The holders' names, addresses, etc., are entered therein. Interest is paid and repayment is made on the basis of the register. In case of Bearer debentures no record is maintained for transfers. Coupons are attached to the debentures for the purpose of claiming interest. They can be sold and transferred by mere physical delivery.

Distinguish between 'Debenture' and 'Share'

(i) Status: A shareholder is a part owner of a company. Debenture holder is a creditor of a company.

(ii) Voting: A shareholder can vote on different matters related to the company. Debenture holder may vote on any matter relating to his rights when a meeting of debenture holders is convened.

(iii) Management: Shareholder can become a director and participate in the management of a company. He can vote in electing the directors. Debenture holders cannot participate in a company's management.

(iv) Return: Debenture holders receive interest at periodical intervals. The interest is payable irrespective of the company's profits. Shareholders may receive dividend if the board of directors recommend such dividend.

(v) ***Security:*** Usually debenture holders are given the company's assets as security for their claim. Shareholders have no security.

(vi) ***Repayment:*** Except redeemable preference shares, all other shares are repayable only at the time of liquidation of a company. Debentures are usually repayable as per the terms of issue except irredeemable debentures.

(vii)Tax advantage**:** Debenture interest is a charge against the profits and thus reduces the Company's income tax. Dividend on shares is an appropriation out of profits. Thus, dividend does not provide any tax benefit.

What are the factors to be considered in relation to redemption of debentures?

Three important aspects are to be considered in relation to redemption of debentures.

(1)Amount payable on redemption:

If redemption is carried on at the end of the specified period the amount to be repaid has to be as per the terms the time of issue. It may be at par or at premium. Similarly, if the terms of provide for periodical repayment, amount payable may be predetermined

(2) Time of redemption:

The terms of issue of debentures specify the timing of redemption.

- Redemption may be at the end of a specified period.
- Redemption may be in installments which are predetermined over an agreed number of years. The company may be permitted to repay debentures (a) By draw of lots or (b) By distinctive numbers or (c) By purchase in the open market.

Redemption may be at the option of the debenture holders, especially in case of redemption by conversion.

(3) source of funds: Debentures may be redeemed-

- Out of profits
- Out of capital
- Out of provisions made
- By conversion into shares or different class of debentures.

What are the different methods of redemption?

The different method of redemption may be broadly divided into two categories:

(1) Redemption without any provision made for the purpose and

(2) Redemption out of provision.

(1) **Redemption without Provision**

The debenture trust deed or the debenture issue terms may not provide for creating a sinking fund for redemption of the debentures. The board of directors also may not think it necessary to create such a fund. In such cases, redemption of debentures is carried out without any provision for such redemption. Redemption without provision may be in the following ways:

(a)Redemption on specified due date

(b)Redemption in installments

(c)Redemption by conversion.

(a) and (b) above can be out of profits or out of capital (a) Redemption on Specified Due Date

On specified due date, debentures are repaid, as per the terms of the issue -? at par or at premium.

(i) ***If the redemption is out of profits:*** Profits equivalent to the debentures, redeemed are transferred from profit and loss account to debenture redemption reserve account When all the debentures are redeemed the debenture redemption reserve may be closed by transferring to general reserves. Profits transferred to debenture redemption.

What are the accounting procedures for Debentures?

There are two main stages of accounting for debentures.

(A)Issue of debentures

(B)Redemption of debentures

(A) ISSUE OF DEBENTURES:

Entries for recording issue of debentures can be made on the same lines as for issue of shares. The legal restrictions relating to the issue of shares at discount or premium do not apply to the debentures. The accounting treatment for recording issue of debentures is influenced by certain aspects as explained below:

I. Consideration for issue of debentures

Consideration for issue of debentures may be cash or assets or the issue may be made as collateral security for loans.

Model Journal Entries	Rs.	Rs.
(a) Issue of debentures for cash Here, the issue price is receivable in the form of cash. It may be received immediately in one installment or it may be received in two or more stages like application, allotment and calls. ***(i) If full amount is received in one lump sum*** ***Journal* entry** Bank A/c Dr To - % Debentures A/c [Being issue of... debentures for cash at par] ***(ii)If cash is receivable in two or more stages*** *For receiving debenture application money* Bank A/c Dr To Debenture Application A/c [Being application money received on.... debenture applications] *At the time of allotment, for the application money on the allotted debentures:* Debenture Application A/c Dr To % Debentures A/c [Being *transfer of debenture* application money of allotted debentures] *For excess debenture application money* Debenture Application A/c Dr To Bank A/c (if returned) To Debenture Allotment A/c (if adjusted towards allotment) [Being return and transfer of excess application money] *For Allotment amount receivable* Debenture Allotment A/c Dr To - % Debentures A/c [Being allotment amount receivable] *For receiving allotment money* Bank A/c Dr To Debenture allotment A/c [Being allotment amount received]		

For call amount receivable Debenture Call A/c Dr To - % Debentures A/c [Being call amount receivable] *For receiving the call amount* Bank A/c Dr To Debenture call A/c [Being call amount received] **(b) Issue of debentures for consideration other than cash:** Debentures may be issued for purchase of assets or purchase of the business of vendors. In the latter case, it is called **'purchase consideration'.** *When assets are acquired* Sundry Assets Account Dr To Vendors A/c [Being purchase of assets from vendors] *When assets and liabilities are acquired* Sundry assets A/c Dr Goodwill A/c Dr To Sundry Liabilities A/c To Vendors A/c [Being assets and liabilities taken over and the purchase consideration payable, including goodwill] *When debentures are issued to the vendors* Vendors A/c Dr To % Debentures A/c [Being settlement of the vendors account by issue of debentures]		

(c) Issue of debentures as Collateral Security

Debentures may be issued as secondary security or subsidiary security in addition to the main security for a bank loan or mortgage loan. Such an issue is termed as "issue of debentures as collateral security'.

When the main security's value fluctuates, the bank can fall back on the collateral security. When the principal or interest or both are not paid in due time, the bank can recover its loan and interest not only from the main security, but also from the sale of the debentures issued as collateral security

II. Terms relating to issue price and condition of redemption of debentures

Terms of issue of debentures may relate to *the price of issue.* The issue may be made at 'par' or at ‘discount’ or at 'premium'. Terms of issue may also relate *to Condition of redemption.* Debentures may be repayable at 'par', or 'repayable at discount' or 'repayable at premium'.

The following are the journal entries for different combinations of price of issue and condition of redemption.

1,000 8% debentures of Rs. 100 are issued

	Rs.	Rs.
(1) When the issue is at par, repayable at par:		

Bank A/c Dr	1,00,000	
To 8% Debentures A/c		1,00,000
[Being issue of 1,000 debentures of Rs. 100 each at par, repayable at par]		
(2)When the issue is at discount of 5%, repayable at par		
Bank A/c Dr	95,000	
Discount on issue of debentures A/c Dr	5,000	
To 8% debentures A/c		1,00,000
[Being issue of 1,000 debentures of Rs. 100 each at *5%* discount, repayable at par]		
(3)When the issue is at 10% premium, repayable at par		
Bank A/c Dr	1,10,000	
To 8% Debentures A/c		1,00,000
To Securities Premium A/c		10,000
[Being issue of 1,000 debentures of Rs. 100 each, at 10% premium, repayable at par]		
(4)When the issue is at par, repayable at 10% premium		
Bank A/c Dr	1,00,000	
Loss on issue of debentures A/c Dr	10,000	
To 8% debentures A/c		1,00,000
To Premium on redemption of-debentures A/c		10,000
[Being issue of 1,000 debentures of Rs. 100 each at par, repayable at 10% premium]		
(5)When the issue is at 5% discount and repayable at 10% premium		
Bank A/c Dr		
Discount on issue of debentures A/c Dr	95,000	
Loss on issue of debentures A/c Dr	5,000	
To 8% debentures A/c	10,000	
To Premium on redemption of debentures A/c		1,00,000
[Being issue of 1,000 debentures of Rs. 100 each at 5%		10,000
discount, repayable at 10% premium]		
(6) when the issue is at 15% premium and repayable at 10% premium		
Bank A/c Dr		
Loss on issue of debentures A/c Dr		
To 8% Debentures A/c	1,15,000	
To Securities premium A/c	10,000	
To premium on redemption of debentures A/c		1,00,000
[Being issue of 1,000 debentures of Rs 100 each at 15%		15,000
premium, repayable at 10% premium]		10,000

Treatment of different items relating to debentures in Final Accounts

(1)Debentures: Debentures are usually secured. They are shown in the Balance Sheet liabilities side, under the heading 'secured loan'.

(2)Discount on issue of debentures: This is a capital loss and is shown on the assets side of the Balance sheet under the heading 'miscellaneous expenditure'. It must be written off before the debentures are redeemed.

(3)Loss on issue of debentures: This is also a capital loss and is shown on the assets side of the Balance sheet under the heading 'Miscellaneous expenditure'. It should also be written off before the debentures are redeemed.

***(4)** Expenses of issue of debentures:* Different expenses like advertising, brokerage, printing, etc., may be incurred for issue of debentures.

	Rs.	Rs.

When expenses are paid journal entry is Debenture issue expenses A/c Dr To Bank A/c [Being expenses incurred for issue of debenture] *When the expenses are written off* Profit & Loss A/c Dr To Debenture issue expenses A/c [Being issue expenses written off]		

(5) Premium on issue of debentures: This is a capital profit. It has to be shown under the heading of 'reserves and surpluses' on the liabilities side of the Balance sheet. It may be used to write off any capital expenses or losses.
(6) Premium on redemption of debentures: This is a liability, payable to the debenture holders, at the time of redemption of the debentures. It appears on the liabilities side of the Balance sheet along with debentures till the date of redemption. At that time it is closed by transferring to the debenture holders A/c.
(7) Debenture interest: interest has to be paid regularly on debentures, usually once in six months.

	Rs.	Rs.
At the time of payment, journal entry is Debenture Interest A/c Dr To Bank A/c [Being payment of debenture interest] *At the end of the financial year for transfer* Profit & Loss A/c Dr To Debenture Interest A/c [Being transfer of interest to P & L A/c]		

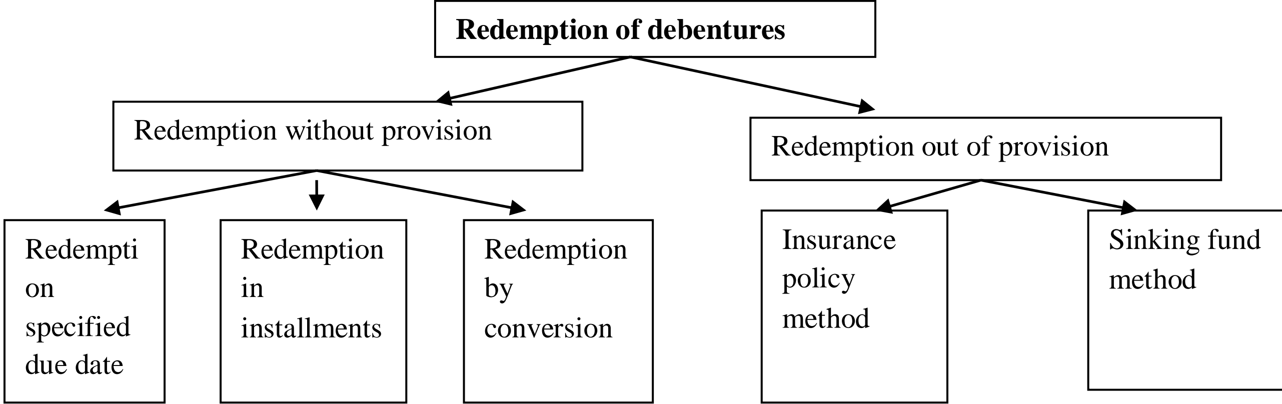
What are the different methods of redemption of debentures?
Redemption of debentures is the discharge of liability on account of debentures. The redemption must be according to the terms of issue, as specified in the debenture trust deed.

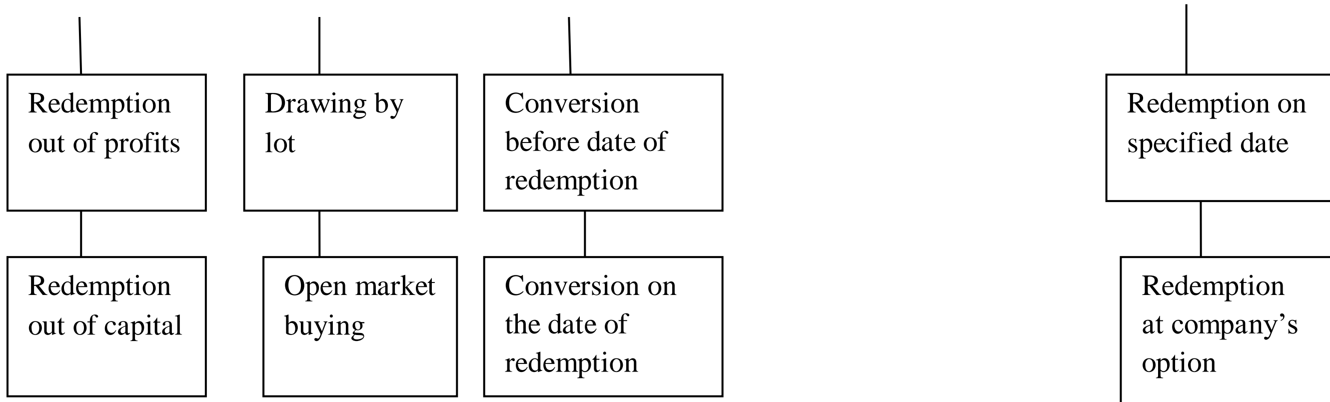
The different method of redemption may be broadly divided into two categories:
(1) Redemption without any provision made for the purpose and
(2) Redemption out of provision.

(1) Redemption without Provision

The debenture trust deed or the debenture issue terms may not provide for creating a sinking fund for redemption of the debentures. The board of directors also may not think it necessary to create such a fund. In such cases, redemption of debentures is carried out without any provision for such redemption.
Redemption without provision may be in the following ways:
(d)Redemption on specified due date
(e)Redemption in installments
(f)Redemption by conversion.
(a) and (b) above can be out of profits or out of capital.

DIFFERENT METHODS OF REDEMPTION





(a) Redemption on Specified Due Date

On specified due date, debentures are repaid, as per the terms of the issue -? at par or at premium.

(ii) ***If the redemption is out of profits:*** Profits equivalent to the debentures, redeemed are transferred from profit and loss account to debenture redemption reserve account. When all the debentures are redeemed the debenture redemption reserve may be closed by transferring to general reserves. Profits transferred to debenture redemption reserve are not used for declaration of dividend to the shareholders.

Journal entries

For repayment of debentures - % Debenture A/c Dr To Bank A/c [Being repayment of debentures as per agreement] *For transfer of profits* Profit & Loss Appropriation A/c Dr To Debenture redemption reserve A/c [Being transfer of profits consequent to the redemption of debentures] *For closing debentures redemption reserve, when all the debentures are redeemed:* Debenture redemption reserve A/c Dr To General reserve A/c [Being transfer on complete redemption of all the debentures]		

(iii)If the redemption is out of capital: When redemption is out of capital, usually, new issue of shares or debentures might have been made for this purpose. There is no need to set aside revenue profits for redeem debentures.

(b)Redemption in Installments

When debentures are issued, the terms of issue may provide for the repayment of the debentures. The following different methods can be adopted for redemption in installments.

(i) Drawings by lot (ii) Open market buying

(i) Drawings by lot: A company may agree to repay every year a predetermined amount of debentures by conducting a lot, using the distinctive numbers debentures. The debentures whose numbers are taken out in

the lot will have to be repaid by the company by giving the particular debenture holders intimation about the repayment. The redemption may be at par at or at premium, as per the terms of the debenture issue agreement.

Journal entries

For debentures repayable Debentures A/c (face value) Dr Premium on redemption (if premium is payable) To Debenture holders A/c [Being debentures repayable and premium payable thereon] *For payment of cash* Debenture holders A/c Dr To Bank A/c [Being payment to the debenture holders] Note: Debentures can be paid off directly or they can be transferred to the debenture holders and then cash is paid. The later method is generally preferable. *If redemption is out of profits* Profit & Loss Appropriation A/c Dr To Debenture redemption reserve A/c [Being transfer of profits to debenture redemption reserve on redemption of debentures]		

(iii) ***Open market buying:*** The terms of issue of debentures may permit a company to buy its own debentures in the open market and cancel, or retain or reissue them. This provides tremendous flexibility to the company.

Whenever surplus funds are available and market price of debentures is favourable, the company can buy its own debentures as an investment.

Cum-Interest and Ex-interest Quotations

When a company buys and sells its own debentures in the open market, the prices quoted may include or exclude interest accrued till that date on the debentures. If the quoted price includes interest on the debentures from the previous interest date till the date of sale, the price is known as 'cum-interest price".

If the price quoted does not include the interest from the previous interest till the date of the sale, the price is known as 'ex-interest price'.

(c)Redemption by Conversion

Redemption of debentures by conversion is possible when the debentures were originally issued as 'convertible debentures'. They may be partly convertible debentures or fully convertible debentures.

(1) ***Conversion on the date of redemption:*** When the debentures were issued, a specified redemption date is fixed and on that date the conversion takes place. Technically, instead of repaying cash, shares are given to the debenture holders. In such a case, the actual amount payable to the Debenture holders have to be converted into shares.

(2) **Conversion before redemption due date:** sometimes, option may be given to the debenture holders to convert their debentures into shares earlier than the due date for redemption. In such cases, the conversion must be only for the actual amount originally collected on the debentures.

2) Redemption of Debentures out of Provision

Redemption of debentures is a very important obligation for a company, if a specified future date is fixed for redemption of debentures, it is essential to see that sufficient cash is available on that date for such redemption.
Two methods are universally adopted to ensure liquidity for debenture redemption.
(i) Sinking fund method; (ii) Insurance policy method

(i) Sinking fund method
A sinking fund may be created for redemption of debentures. This is different from sinking fund for replacement of assets. The former is created out of revenue profits by debiting the profit and loss appropriation account and the latter is created by debiting profit and loss account.
Sinking fund for redeeming debentures is also called 'debenture redemption fund' to distinguish it from any other sinking funds.

Journal entries

(1)At the end of the first year, for making annual transfer to sinking fund: Profit & Loss Appropriation A/c Dr To Sinking fund A/c [Being annual transfer to sinking fund for redemption of debentures] *(2)For making investment:* Sinking fund investment A/c Dr To Bank A/c [Being investment made] *At the end of the second year* *(3)For receiving interest on sinking fund investment:* Bank A/c Dr To Interest on sinking fund investment A/c [Being interest received] *(4) For transferring interest to sinking fund A/c* Interest on sinking fund investment A/c Dr To Sinking fund A/c [Being transfer of interest to the fund] *(5)For annual transfer to sinking fund* Profit & Loss Appropriation A/c Dr To Sinking fund A/c [Being annual transfer made] *(6)For making investment, including the interest received* Sinking fund investment A/c Dr To Bank A/c [Being investment made] **Note: Entries 3, 4, 5 and 6 are repeated in the 3rd year, 4th year etc.** ***At the end of last year in which the debentures are to* be *redeemed: Entries 3, 4 and 5 are written just like in second year. Then the following entries are passed.***		

(7)For sale of investment Bank A/c (cash received) Dr Sinking fund A/c (for any loss on sale) Dr To Sinking fund investment A/c [Being sale of sinking fund investment at loss] *(8)For redemption of debentures* - % Debentures A/c Dr To Bank A/c [Being repayment of the debentures] *(9)For closing the sinking fund* Sinking fund A/c To General reserve A/c [Being transfer of sinking fund balance to the general reserve]		

Redemption before due date, out of sinking fund

Usually, debentures are repaid on a specified future date, when sinking fund for redemption of debentures is created. However, if the terms of issue of debentures permit, redemption of debentures in installments is possible under this method.

From the open market own debentures may be purchased and cancelled. The necessary funds are arranged by sale of the sinking fund investment. There may be profit or loss on sale of the investments.

Journal entries

For sale of investments at profit Bank A/c Dr To sinking fund investment A/c [being investments sold] Sinking fund investments A/c Dr To sinking fund A/c [being profit on sale of investments] *For redemption of debentures:* - % Debentures A/c (face value of debentures) Dr Debenture Interest A/c (interest till sale date) Dr To Bank A/c (cash paid) To Capital reserve A/c (profit on redemption) [Being redemption of debentures along with interest and profit thereon] For transfer to general reserve Sinking fund A/c Dr To General reserve [Being transfer of the face value of debentures redeemed to general reserve from sinking fund account]		

(ii) Insurance policy method

This method is an absolutely certain method of providing exact amount of cash for redemption of debentures. However, this method can be followed when debentures are to be repaid on a definite future date only.

A sinking fund insurance policy is taken to make provision for redemption of the debentures. A fixed amount of premium is paid every year, after taking an insurance policy for the specified amount required to repay the debentures. The insurance company receives the premium year after year and pays the agreed amount on the specified future date which can be used to repay the debentures. ;

Model journal entries

In the first and subsequent accounting years including the last year

(1) For the amount of premium paid Debenture redemption policy A/c Dr To Bank A/c [Being annual premium paid on the debenture redemption policy] *(2)At the end of the accounting year* Profit & Loss Appropriation A/c Dr To Debenture redemption fund A/c [Being appropriation of the premium paid] *(3)In the last year, on realising the policy* Bank A/c Dr To Debenture redemption policy A/c [Being realisation of the policy amounts] *(4)For any profit on realisation of policy* Debenture redemption policy A/c Dr To Debenture redemption fund A/c [Being transfer of profit] *(5)For redemption of the debentures* Debentures A/c Dr To Bank A/c [Being repayment of the debentures] *(6)For closing the debenture redemption fund* Debenture redemption fund A/c Dr To General reserve A/c [Being transfer of fund on the redemption of debentures]		

If interest is taken into account

The basic difference between sinking fund for redemption of debentures and insurance policy methods is that in the former, interest is received at end of each year on the investments previously made and the interest amount is reinvested; in the latter, no interest is received in cash but the insurance policy value increases year after year to show profit at the time of final realization.

PROBLEMS

__**Issue of Debentures for cash**__

1) Timex Ltd., issued 1,000 8% debentures of Rs 100 each. Give appropriate journal entries in the books of the company, if the debentures were issued as follows**:**

(a) Issued at par, redeemable at par,
(b) Issued at a discount of 5%, repayable at par.
(c) Issued at a premium of 10%, repayable at par.

(d) Issued at par, redeemable at a premium of 10%.
(e) Issued at a discount of 5%, repayable at a premium of 10%.
You are required to show how the items concerned appear in the balance sheet in each of the above cases.

Issue of Debentures for consideration other than cash

2) A company purchased building of the book value of Rs 1,98,000 from another firm. It was agreed that the purchase consideration be paid by issuing 10% debentures of Rs 100 each. Give journal entries if the debentures have been issued; (i) At par; (ii) at discount of 10%; and (iii) at a premium of 10%.

Issue of Debentures for consideration other than cash and as collateral security

3) Excel Ltd., made the following issues of debentures on 1.4.2007
- 200 10% debentures of Rs 100 each to settle a creditor who supplied a machine on credit some time ago at a price of Rs 18,000.
- 300 10% debentures of Rs 100 each for cash at a discount of 5%.
- 1,000 10% debentures of Rs 100 each to the bankers as collateral security for a loan of Rs 80,000.

All the above issues are redeemable at par.
Pass journal entries to record the above in the books of the company and show how these items are to be shown when the company's Balance sheet is prepared.

4) Hamid Pasha Ltd. Obtained an overdraft of Rs 5,00,000 from bank for which the company issued 7,000 12% debentures of Rs 100 each as collateral security. Show how the items appear in Balance sheet, if
(a) The issue of debentures need not be recorded in the books.
(b) The issue of debentures must be recorded in the books.

Issue of Debentures (conditional issue)

5) Moon Rays Ltd. Issued 50,000 8% debentures of Rs 10 each to the public at a discount of 4% to be paid Rs 4 on application and the balance on allotment.
Applications were received for 48,000 debentures. Allotment was made to all the applicants and the amount due were received promptly.
Give journal entries to record the transactions and show how they appear in the balance sheet of the company.

6) Earth movers Ltd. Issued 15,000 14% debentures of Rs 100 each for public subscription, at a premium of 10% payable as to Rs 30 on application, Rs 50 (including premium) on allotment and the balance in one call.
25,000 applications were received. 4,000 applications were rejected and debentures were allotted to the remaining applicants' pro-rata. Allotment amount was received from all the allottees one of whom paid the call amount due on his 1,000 debentures along with allotment money. The call amount was also collected on the due date.
You are required to pass necessary journal entries in the company's books.

PROBLEMS

Writing off discount on redemption of debentures:

Without provision- On specified due date

7) A company issued 15% debentures of the face value of Rs 1,20,000 at a discount of 6% on 1st April 2002. The debentures are payable by annual drawings of Rs 24,000 commencing on 31st march 2003. How would you deal with the discount on debentures?
Show the discount account in the company's ledger for the period of duration of debentures.

8) Sharma Ltd. Issued 14% debentures of the face value of 6,00,000 at a discount of 6% on 1st April 2002. The debentures are payable by annual drawings of Rs 2,00,000 commencing from the end of the 3rd

year. Show the discount on debentures account in the company's ledger for the period of duration of debentures? Assume accounts are closed on 31st march.

Without provision – In Installment

9) Breeze Ltd. Issued 5,000 debentures of Rs 100 each at a discount of 10%. You are required to calculate the discount to be written off each year if;
(a) The debentures are repayable at the end of 5 years.
(b) The debentures are to be repaid in five equal installments at the end of each year, commencing from the very first year.

10) On 1-1-2010, P Ltd. Issued 4,000 14% debentures of Rs 100 each at a discount of 10% repayable in 4 years by annual equal installments.
(a) Give journal entries on the date of issue.
(b) Show 14% debenture account, discount on debentures account till the date of redemption.

11) Rashid Ltd., has Rs 10,00,000 8% debentures outstanding on 1.1.2006. The company has been redeeming every year on January 1st Rs 1,00,000 debentures by drawings by lot, at par. Give necessary journal entries:
(a) If the redemption is out of profits
(b) If the redemption is out of capital.

Interest on debentures
Interest on debentures is charged to the profit and loss account. While paying the interest on debentures, it is the obligation of the company concerned to deduct the income tax before making payment of interest to debenture holder.
The following journal entries are passed:
(i) When interest on debenture is due;
Interest on debentures A/c Dr
To income tax A/c
To Debenture holders A/c
(ii) When net amount due is paid:
Debenture holders A/c Dr
To Bank A/c
Interest on debentures is transferred to the debit side of profit and loss account. The credit balance of income tax account is shown on the liabilities side of the balance sheet. As and when it is paid to the Government this account is debited and bank account will be credited.
Debenture interest given in trial balance
The treatment of debentures interest while preparing final accounts must be noted carefully especially when it is given less tax at a specified rate. For example, If the trial balance shows " Half year's debenture interest less tax at 42% Rs 5,800" then the profit and loss account will be debited with the gross amount Rs 10,000 (i.e., 5,800 *100/58) and Rs 4,200 (i.e., 42/100*10,000) will be shown in the balance sheet as liability under the heading income tax payable account.

12) On 1st January, 2001, a company issued Rs 20,00,000 14% debentures at 5% discount repayable in five years at par. The company reserved the right to redeem to the extent of Rs 2,00,000 in any year by purchase in the open market. The interest was payable half yearly on 30th June and 31st December and the same was duly paid.
On 31st December, 2001, the company purchased Rs 2,00,000 debentures at a cost of Rs 1,91,000. Pass necessary journal entries in the books of the company up to 31st December,2001 including closing entries on that date if the above redemption was out of profit.

13) A company on 31st December, 2000 redeemed Rs 10,000 6% debentures out of capital by drawings a lot. Similarly, the company on 31st December, 2001 redeemed Rs 15,000 6% debentures out of profits by drawing a lot. You are required to pass journal entries in the books of a company.

Open market buying method

14) On 1st January, XYZ Ltd., has Rs 1,00,000 10% debentures. In accordance with the power under the deed, the directors have the powers to acquire the debentures in the open market for immediate cancellation. The following purchases, of own debentures were made by the company

March 1, Rs 20,000 debentures at Rs 98 cum-interest

August 1, Rs 40,000 debentures at Rs 99 ex-interest

Debenture interest is payable half- yearly on 30th June and 31st Dec every year. Show journal entries for purchase and cancellation of debentures.

15) Krishna Ltd., which had Rs 50,00,000 10% debentures outstanding, made the following purchases in the open market for immediate cancellation:

1.4.2007 1,000 debentures of Rs 100 each at Rs 99

1.4.2007 2,000 debentures of Rs 100 each at Rs 97

You are required to give journal entries for purchase and cancellation of the debentures.

(a) If the above purchase rates are 'Ex-interest'

(b) If the above purchase rates is 'Cum-interest'. Assume that interest is payable every year on 30th June and 31st December.

16) Raja Ltd., issued on 1st April, 2002, 20,000 12% debentures of Rs 100 each redeemable at the option of the company after the second year at Rs 104 upon having two months notice to the debentureholders. The company purchased the following debentures in the open market.

(i) On 12th June, 2004 Rs 4,000 nominal value at cum-interest cost, Rs 4,025.

(ii) On 24th August, 2004 Rs 7,000 nominal value ex-interest cost, Rs 6,915.

These debentures were retained as investments till 30th September, 2005 on which date they were cancelled. Show the necessary ledger accounts as they would appear in the books of the company for 2004-05 and for 2005-06 assuming that the company closes its book of accounts every year on 31st March. Interest payable half-yearly on 30th September and 31st March. Ignore income tax.

17) On 1st April,2008, a company issued 1,000 6% debentures of Rs 1,000 each at Rs 950. Terms of issue provided that beginning with 31st March, 2011 Rs 50,000 of debentures should be redeemed either by drawings at par or by purchase in the market every year. The expenses of the issue amounted to Rs 3,000 which were written off on 31st March, 2009. The company wrote off Rs 10,000 from the discount on debentures every year. On 31st March, 2011 the debentures to be redeemed were repaid at the end of the year by drawings. On 31st March, 2012 the company purchased for cancellation 50 debentures at the ruling price of Rs 980, the expenses being Rs 100. Interest is payable yearly. Ignore income-tax.

PROBLEMS

Redemption of debentures by conversion

18) 'S' Ltd. Issued Rs 5,00,000 10% debentures of Rs 100each at a discount of 10%. The debenture holders have an option to convert them into equity shares of Rs 10 each at par after the expiry of 2 years. The due date for redemption of the debentures at par is at the end of the 10th year.

You are required to find out the number of shares a debenture holder gets and also give the necessary journal entries.

(a) If he converts his 200 debentures at the end of the second year from the date of issue;

(b) If he converts his 200 debentures at the end of tenth year, on the agreed date of the redemption.

19) New Ventures Ltd. Had to redeem its 5% debentures of Rs 10,00,000 on 31st December 2007 at a premium of 5%. The company convened a meeting of the debenture holders and offered the following options to them.

(a) 8% cumulative preference shares of Rs 50 each at 20% premium.

(b) 6% debentures of Rs 100 each at par.

(c) Full payment as per terms in cash.

Holders of Rs 3,00,000 debentures accepted option (a) those of Rs 2,00,000 opted for (b) and the others preferred (c).

Pass journal entries to record the above transactions as on 31.12.2007.

20) On 1st April, 2011, Y Ltd. Issued 800 12% Debentures of Rs 1,000 each at Rs 950 each. Debenture holders had an option to convert their holdings into 6% preference shares of Rs 100 each at a premium of Rs 25 per share. On 31st march, 2012, one year's interest had accrued on these debentures which were not paid. A holder of 50 debentures notified his intention to convert his holding into 13% preference shares.
Journalise the above transactions and draw the company's Balance sheet as at 31st march, 2012.

With or without provision

Sinking Fund Method

21) On 1st April, 2007, Metal products Ltd. Issued debentures for Rs 1,00,000 redeemable at par at the end of 5 years and it was resolved that a Sinking Fund should be formed and invested in tax-free securities.

Give journal entries for 5 years, assuming that the interest received on the investments was at the rate of 5% on cost, that the interest was received yearly and immediately invested and that the investments were realized at a loss of Rs 300 at the end of five years. Reference to the sinking fund table shows that Re. 0.180975 invested at the end of year, at 5% compound interest will produce Re 1 at the end of 5 years.

22) Samy Ltd., issued 6% debentures for Rs 12,00,000 on 1.1.2004. It was provided in the debenture trust deed that the debentures are repayable at the end of 2006 with a premium of 10%. A Sinking fund was set aside annually are to be invested in 5% Government bonds. Sinking fund tables show that 0.31720856 at 5% compound interest in 3 years will become Re 1.

You are required to write the ledger accounts for all the 3 years in the company's books calculations may be to the nearest rupee.

23) King Ltd. Had Rs 4,00,000 debenture redemption fund in its books on 31.12.2004. The fund was invested in Rs 5,00,000 (nominal value) port trust bonds. On that day, the debentures account showed a balance of Rs 15,00,000. The company sold Rs 3,00,000 nominal value investments at 84% for the purpose of redeeming Rs 2,50,000 debentures at Rs 100.5.

Show the relevant ledger accounts in the books of the company, ignore brokerage and interest.

Insurance Policy Method

24) Sudhir Ltd. Issued 15,000 10% debentures of Rs 100 each on 1.1.2005. They are repayable at the end of 3 years, at par. The company decided to take an insurance policy for the redemption of these debentures, to provide the necessary cash. The premium payable at the beginning of every year is Rs 4,11,975 and interest at 10% p.a., at compound rate is expected. The policy amount was received at the end of the third year and the debentures were duly redeemed.

Show ledger accounts in the books of the company for all the years.

25) A Limited company has made an issue of Rs 5,00,000 9% debentures on 1st April, 2006, the terms of which include that the company must take a 4 years Sinking Fund Insurance Policy for the redemption of debentures at a premium of 5%. The annual premium is Rs 1,15,000. The value of the policy increases each year by 6%.
Give the necessary ledger accounts to record the above transactions for 4 years.

26) Ramesh Ltd., has made an issue of Rs 1,00,000 5% debentures on 1.1.2003, the terms of which include that the company must provide for a sinking fund for the redemption on 31st December each year from 2005 for 3 years. The directors decide to take out an insurance policy to provide the necessary cash, the annual premium being Rs 31,410.80 on which the return is at 3% p.a. at compound interest. Show the ledger accounts.

26) Selwell Ltd., issued 50,000 14% debentures of Rs 10 each at par on 1st April 2006, repayable after three years at par on 31st March 2009.The company decided to take out an insurance policy to provide necessary cash for the redemption of the debentures.
The annual premium for the policy, payable on 1st April every year was Rs 1,57,050.
Prepare ledger accounts in the company's book.

(UNIT III COMPLETED)

UNIT: IV

Underwriting of Shares

Define Underwriting.

According to the institute of Company Secretaries of India, "Underwriting may be defined as a contract entered into by the company with persons or institutions, called underwriters, who undertake to take up the whole or a portion of such of the offered shares or debentures as may not be subscribed for by the public, in consideration of remuneration called underwriting commission".

Give a detail note on Importance of Underwriting.

The basic purpose of underwriting is to guard against the 'Damocles sword of minimum subscription', which is not less than 90% of the issue value.

- As per Sec. 69(l) of Companies Act, a company must receive the amount of minimum subscription as mentioned in the prospectus within 120days from date of opening of the issue. Otherwise, all the amounts received should be returned and the issue abandoned.
- Underwriting acts as a sort of insurance or guarantee against the danger of not receiving minimum subscription.
- Underwriting function has great economic significance. It provides assurance to a company that the-stipulated amount of a public issue will be definitely received. This enables the company to go ahead with its investment programme, without waiting for the success of the issue.

In view of the importance of the function of underwriting, several financial institutions of the Central Government have been functioning as underwriters in India. The most important of them are LD.B.I, I.F.C, I.C.I.C.I, L.I.C, U.T.I, etc.

What do you mean by underwriting commission?

The Commission is the consideration for the service rendered by the underwriters. It is paid for the risk taken by them in placing of the shares before the public.

Underwriting commission is paid at specified rates, as per the agreement, subject to limits fixed by the Companies Act.

The Commission is payable whether an underwriter was called upon to take any shares or debentures or not. It is usually paid as a percentage on the total issue price of the shares or debentures underwritten.

Differentiate between underwriters and brokers

Underwriters: An underwriter guarantees subscription for a company's shares and debentures. He has personal responsibility and potential liability. He takes financial risks.

Brokers: A broker agrees to procure subscription for the shares or debentures of a company without any commitment or responsibility or risk. A broker places a company's securities with his contacts and brings the potential customers and the company together. Brokers are eligible for remuneration from the company called 'brokerage'.

What are the different types of underwriting?

Underwriting agreements can be broadly divided into two types:

(1) Pure underwriting and

(2)Firm underwriting.

(1) **Pure underwriting:** In this type of contract, the underwriter's liability is purely contingent. He agrees to subscribe for shares or debentures of the company which are not applied for by the public. If the public subscribes for the entire issue, the underwriter has no obligation at all.

Pure underwriting can again be subdivided into two types.

(a) Complete and

(b) Partial

(a) ***Complete underwriting:*** *if the* whole of the issue of shares or debentures of a company is underwritten, without involving any 'Firm' underwriting it is termed as complete underwriting.
The issue may be fully underwritten by a single underwiter or it may be underwritten by more than one underwiter, each agreeing to take risk only to a limited extent.

*(b)****Partial underwriting:*** *If only a* part of the issue of shares or debentures of a company is underwritten, it is termed as partial underwriting. In case of partial underwriting, the company is treated as 'underwriter[1] for the remaining part of the issue.

(2) *Firm underwriting: In* this type of underwriting contract, the underwriters liability is partly definite and partly contingent. The contract signifies definite commitment to take up a specified number of shares irrespective of the number of shares subscribed by the public. The underwriter gets priority over the general public for such shares in the event of over subscription.

Give a brief note on Marked, Unmarked and Firm underwriting applications.

- **Marked underwriting applications:** These are the duly filled up applications received by a company public, bearing the 'stamp' or 'marking' of a particular underwriter, They were originally issued to the public by the underwriter or his agent. The marked applications are deemed to be received 'through the underwriters' even if they are directly submitted by the applicant to the company.
- **Unmarked underwriting applications:** These are the duly filled up applications received by the company from the public without bearing any 'Stamp' or 'marking'. They were originally issued by the company to the public directly. They are usually termed as 'direct applications'.
- *Firm underwriting applications:* The underwriters of an issue may agree to take up a specified number of shares 'firm' in addition to the shares underwritten. In such cases, the underwriters have *to fill up and* submit application forms to the company just like any other applicant, *paying* the *required application money also. Such application forms* filled by the underwriters personally are called firm underwriting applications.

How do you determine the liability of underwriters in respect of an underwriting contract.

It is necessary to determine the number of shares or debentures to be taken by the underwriters as per the underwriting contract. Based on the liability determined and the commission payable, final settlement can be made between the company and the underwriters.

(a) Complete underwriting

(1) When an entire issue is fully underwritten by a single underwriter

If the issue is fully subscribed by the public, the underwriter is free from any liability. He gets his commission without taking any shares or debentures.

If the issue is not fully subscribed, the underwriter has to take all the shares or debentures which are not applied for by the public. Then he has to pay for such shares or debentures, after adjusting the commission due to him.

(2) When an entire issue is fully underwritten by two or more underwriters

If the issue is fully subscribed by the public, the underwriters are completely free from any liability. They receive commission on the portion of the issue each of them has underwritten.

If the issue is not fully subscribed by the public, the underwriters have to take the balance of shares or debentures. Liability of each underwriter is determined as follows:

Particulars	***No. of shares***
Gross liability of each underwriter as per agreed ratio	XXX

Less: Marked applications	**XXX**
Balance left	XXX
Less: Unmarked applications in the ratio of gross liability	XXX
Net liability	XXX
***Transfer**:*	
Any surplus of one underwriter to others (in their gross liability ratio)	XXX
Net liability	XXX

(b) Partial underwriting

(1) When a part of the issue is underwritten by only one underwriter

One underwriter may underwrite a part of the issue, say 70%. The company becomes responsible for the balance of 30% of the issue and is 'deemed' as the underwriter for that portion.

Underwriter's liability is determined as follows:

Particulars	No of shares
Total issue	XXX
Less: The portion of the issue for which the company is responsible	XXX
Gross liability of the underwriter	XXX
Less: Marked applications	XXX
Balance left	XXX
Less: Surplus unmarked applications (if any)	XXX
Net liability of the underwriter	XXX

(2)When a part of issue is underwritten by two or more underwriters

The company is deemed as the underwriter for the portion of the issue which is not underwritten. Liability of each underwriter is determined as follows:

Particulars	No of shares		
Gross liability of underwriters	XXX	XXX	XXX
Less: Marked applications	XXX	XXX	XXX
Balance left	XXX	XXX	XXX
Less: Surplus unmarked applications in gross liability ratio	XXX	XXX	XXX
Balance left	XXX	XXX	XXX
Less: Surplus from other underwriters divided in gross liability ratio of the recipients	XXX	XXX	XXX
Net liability of underwriters	XXX	XXX	XXX

(c) Firm underwriting

The underwriters must subscribe for the shares or debentures underwritten 'firm'. When there is over subscription also, underwriter gets priority over the general public for the shares underwritten 'firm'.

If nothing is specifically mentioned in the underwriting agreement, there are two alternative methods of dealing with 'firm underwriting' applications:

(a) The full benefit of applications for shares 'underwritten firm' is given to the respective underwriters. In effect, they are treated like 'marked forms'.
(b) The benefit of applications for shares 'underwritten firm' is divided between all the underwriter in their gross liability ratio. In effect they are treated like 'unmarked applications'.

MODEL JOURNAL ENTRIES
In the books of the Company

Particulars	*L.F*	*Dr. Rs.*	**Cr.** *Rs.*
For shares subscribed by the public BankA/c Dr. To Share Capital A/c [Being shares allotted to the public] *Note;* If details about application money, allotment money et, are given, entries must be written accordingly.		XXX	XXX
For underwriters liability Underwriter's A/c Dr To Share Capital A/c [Being shares to be taken by the underwriters as per underwriting Contract]		XXX	XXX
For underwriting Commission payable Underwriting Commission A/c Dr To underwriters A/c [Being commission payable as per agreement]			
For net amount receivable from underwriters Bank A/c Dr To Underwriter's A/c [Being amount received in settlement from the under writers]			

In the books of the underwriter
Journal entries

Particulars	*L.F*	*Debit(Rs)*	*Credit (Rs)*
For shares to be taken as underwriting obligation Share in Company A/c Dr To Company A/c [Being shares received from company as per the underwriting contract]		XXX	XXX
For Commission receivable Company A/c Dr To underwriting Commission A/c [Being Commission receivable as per the terms of the		XXX	XXX

underwriting contract] ***For payment of cash in settlement*** Company A/c Dr To Bank A/c [Being payment made in settlement to the company] ***If there is any decline in the market value of shares acquired from company*** P & L A/c Dr To Shares in the company A/c [Being decline in the market value taken into A/c]			

PROBLEMS

Complete Underwriting

1) A company issues 50,000 shares of Rs 10 each at par. The whole issue has been underwritten by X & Co for a commission of 4%. The company received applications only for 47,000 shares. All the applications were accepted. Give journal entries to record the above transactions and prepare the balance sheet at this stage assuming that all the amounts due have been received.

2) A Ltd., issued 1,00,000 equity shares. The whole of the issue was underwritten as follows:
X-40%; Y – 30%; Z – 30%
Applications for 80,000 shares were received in all, out of which applications for 20,000 shares had the stamp of X; those for 10,000 shares that of Y; and 20,000 shares that of Z. The remaining applications for 30,000 shares did not bear any stamp. Show the liability of the underwriters.

3) A Public limited company, with a capital of Rs 10,00,000 divided into equity shares of Rs 10 each, places its entire issue in the market, and the whole issue has been underwritten as follows:

Paterson & Co	30,000 shares		
Singh & Co	35,000 shares	Talukdar & Co	2,000 shares
Muzumdar & Co	10,000 shares	Bannerjee & Co	8,000 shares

All marked forms are to go in relief of the liability of the underwriters whose name they bear.
The applications received on the forms marked by the underwriters are:

Paterson & Co	25,000 shares	Prince & Co	1,000 shares
Singh & Co	23,500 shares	Talukdar & Co	2,000 shares
Muzumdar & Co	6,500 shares	Bannerjee & Co	7,000 shares

Applications for 20,000 equity shares are received on unmarked applications forms.
Calculate the liability of the individual underwriters. In terms of the underwriting agreement, the relevant proportion is to be ascertained not in of the original liability ratio but after giving credit for marked forms.

Partial Underwriting

4) Krishna underwrites the new issue of 2,000 shares of Rs 100 each of Rama Company Limited. The agreed commission was 5% payable as 60% in cash and the rest in fully paid shares. The public subscribed for 800 shares and the rest had to be taken up by the underwriter. The shares were subsequently quoted in the market at 15% discount.
Make the necessary journal entries in the books of the company and underwriter and prepare shares account in the books of the underwriter.

5) WYE Co Ltd. Issued 20,000 shares of Rs 10 each. These shares were underwritten as follows:
X – 10,000 shares, Y – 6,000 shares. The public applied for 16,000 shares which included marked applications s follows:

X – 2,400 shares; Y – 600 shares.
Determine the obligation of the underwriters.

Firm underwriting

6) Ellora Ltd., came up with an issue of 20,00,000 equity shares of Rs 10 each at par 5,00,000 shares were issued to the promoters and the balance offered to the public was underwritten by three underwriters – Anand, Vijay and Ashok equally with firm underwriting of 50,000 shares each. Subscriptions totaled 12,97,000 shares including the marked forms which are
Anand - 4,25,000 shares
Vijay – 4,25,000 shares
Ashok – 3,50,000 shares
The underwriters had applied for the number of shares covered by firm underwriting. The amount payable on application and allotment were Rs 2.50 and Rs 2 respectively. The agreed commission was 5%.
Pass summary journal entries for
(i) The allotment of shres to the underwriters
(ii) The commission due to each of them; and
(iii) The net cash paid and / or received.

7) Chaitanya Chemicals Ltd. Planned to set up a unit for manufacture of bulk drugs. For the purpose of financing the unit the Board of Directors have issued 15,00,000 equity shares of Rs 10 each. 30% of the issue was reserved for promoters and the balance was offered to the public. M, N & L have come forward to underwrite the public issue in the ratio of 3:1:1 and also agreed for firm underwriting of 30,000 : 20,000 and 10,000 shares respectively. The underwriting commission was fixed at 4%. The amount payable on application was Rs 2050 per share. The details of subscriptions are:
Marked forms of M – 5,50,000 shares
Marked forms of N – 2,00,000 shares
Marked forms of L – 1,50,000 shares
Unmarked forms - 50,000 shares

(i) You are required to show the allocation of liability among underwriters
(ii) Pass journal entries in the books of Chaitanya chemicals Ltd.
(a) For underwriter's net liability and receipt or payment of cash to or from underwriters.
(b) Determine the liability towards the payment of commission to the underwriters.

Valuation of goodwill & shares

What do you mean by Goodwill?
Goodwill in simple words, means the *"good name"* or the "*reputation*" of the business which attracts more customers and therefore, helps in earning more profits in future. It is an intangible real asset and not a fictitious one. *" It is perhaps the most intangible of intangibles"*.

Goodwill is a valuable asset if the concern is profitable, on the other hand, it is valueless if the concern is a losing one. Therefore, it can be stated that goodwill represents the value of the reputation of a firm.

Define the term 'Goodwill'
According to the Institute of Chartered Accountants of India, goodwill is "an intangible asset arising from business connections or trade name or reputation of an enterprise".

What are the various sources of goodwill?
The following are the main sources which generally give rise to *goodwill:*
(i) The location of the business premises e.g., a retail shop located in a busy market centre.
(ii) The reputation of the articles sold arising from the high standard or quality of the goods themselves.

(iii) The personality and reputation of the owner or management arising through skill or influence Example: Chartered Accountant
(iv) Possession of trade marks, patents or copyrights.

What is the need for valuing goodwill?

In the case of a going concern, when business is to be sold, the mutual rights of the parties concerned are changed. A party which is making sacrifice must be compensated and that is normally on the basis of goodwill. Goodwill is to be valued in the following circumstances:

(a) When a new partner is admitted;
(b) When a partner retires or dies;
(c) When there is a change in the profit sharing ratio;
(d) When the business of a company is taken over by another company e.g., in case of amalgamation or absorption.
(e) When the company's shares are not quoted on the stock exchange and their value is to be determined for the purpose of estate duty and wealth tax etc.
(f) When a person wants to purchase a large block of the company's shares with a view to acquire control over the management of the company.
(g) When the business of the company is being taken over by the Government.
(h) When the management wants to write back goodwill which it wrote off earlier to reduce or eliminate the debit balance in the Profit & Loss Account.

What are the different methods of valuation of goodwill?

In the case of sale of a business, the value of goodwill will depend on mutual agreement between the purchaser and seller of the business. Normally, the following methods are followed for valuing goodwill:

(1) Average profits method
(2) Super profit method
(3) Annuity method which is a variation of the super profit method
(4) Capitalisation method

1. Average profits method or certain number of years' purchase of average profits method

Under this method, goodwill is valued on the basis of an agreed number of years' purchase of the average annual profits, calculated by reference to recent years and having regard to the probable maintenance of such profits in future years.

Here there are **two important steps** in the computation.

(a) Average normal profit of the past three or four years must be computed. Any abnormal or non-recurring losses and gains should be removed from the profit. Then any future expected savings or additional expenses be adjusted from the average profit.

(b)The years of profit should be determined, which depends on the capacity of the firm to maintain future profits.

Goodwill is the product of average profit multiplied by the number of years. For-example, if the average annual profits of a business for the past years are Rs. 16,000 and goodwill is to be valued on the basis of 3 years' purchase of such average annual profits, the value of goodwill will be Rs. 48 000.

Goodwill = Average profit x No. of years' purchased

Average Capital Employed

Average Capital Employed means the average of the capital employed at the end of the year and that employed in the beginning of the year. Thus, if the employed at the end of the year is Rs. 10,00,000

and capital employed in the beginning of the year is Rs. 4,00,000, the average capital employed is Rs. 7,00,000
(i.e., Rs 10,00,000 + Rs 4,00,000/2). The average thus computed is supposed to represent capital investment throughout the year.
The average capital employed in the business may be found out in two ways i.e., either through the assets side or through the liabilities side.

Assets side approach:

Assets at market value:

Fixed assets less depreciation		xxx
Current assets (other than goodwill, non-trading assets, -deferred expenditure like preliminary expenses, discount etc.)		xxx
		---------
Less: External liabilities(at revised values, if any)		
Creditors	xxx	
Bills Payable	xxx	
Debentures	xxx	
Taxes	xxx	
Outstanding bills etc.	xxx	
	-------	xxx

Capital employed at the end of the year		xxx
Less: Half the profit earned during the year		xxx

Average capital employed		xxx

Liabilities side approach:

Equity share capital		xxx
Preference share capital		xxx
Reserves		xxx
Profit & Loss A/c (Cr)		
Profit on revaluation of assets and liabilities		xxx
		----------
		xxx
Less: Goodwill	xxx	
Losses & past expenses not yet written off	xxx	
Loss on revaluation	xxx	

Capital employed at the end		xxx
Less: Half of current year profit		xxx

Average capital employed		xxx
		----------

2. Super profit method

Average profit of the firm is compared with the *normal profit* on the invested capital in the firm. Excess of average profit over normal profit is known as super profits.
Defined in another way super profit is the excess of profit which can be expected in future years over and above what is necessary for paying a fair return on capital employed, having regard to the risk involved in that class of business and fair managerial remuneration.
This method thus presumes normal profits to cover interest on capital and managerial remuneration and the profits of a business in excess of the normal yield are called super profits.

Steps for calculation of super profits

The following steps are to be taken for calculation of super profits:

(i) The average capital employed during the year should be ascertained

(ii) Normal profit should be calculated. The normal profit is ascertained as follows:

Normal profit = Average capital employed x Normal rate of return

Normal rate of return is the rate of profit generally earned by other similar firms in that industry.

(iii)Then, the expected average (simple or weighted) annual Trading profit after tax, preference dividend and interest on long term loans should be computed.)

[However, transfer to general reserve, dividend equalisation fund, sinking fund for redemption of debenture etc. should not be deducted since they in no way, affect the availability of profits for the equity shareholders]

(iv) From this expected average profit, reasonable managerial remuneration should be deducted.

(v) The profit as obtained after the above adjustments is to be compared with the normal profit. If the expected average profit exceeds the normal profit, the balance represents the super profits.

To sum up:

Super Profits = Expected average profit - Normal profit

Normal profit = Average capital employed x Normal rate of return

Expected average profit = Average of the previous three or four years profits,_after adjusting past abnormal losses and gains and also future expected changes in expenses and incomes.

(**3) Annuity method**: Under this method, super profit is being considered as the value of annuity over a certain number of years and for this purpose, compound interest is calculated at a certain respective percentage. The present value of the said annuity will be the value of goodwill.

This method is based on the logic that the purchaser should pay now for goodwill only at the present value of super profits calculated at a proper rate of interest. The present value of an annuity for a given number of years at a particular rate of interest can be ascertained by reference to annuity table or by using the formula

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

Where Q = the present value of an annuity of Re 1 for n years at r %

r = rate of interest per annum

n = the number of years.

Usually, reference to the annuity table will give the present value of annuity for a given number of years and at the given rate of interest.

The value of goodwill in case of this method is ascertained as follows:

Goodwill = Average annual super profit x Annuity rate.

For example, if the super profit is Rs. 25,000 and the annuity of Re. 1 at 10% for 3 years is 2.48685, then the goodwill is = Rs. 25,000 x 2.48685 = Rs. 62,171.25.

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

3. Capitalisation method

Under this method, the total value of the business (or) Capitalised Value of business is found out by capitalising the expected average profits on the basis of normal rate of return. The value of goodwill is the difference between the capitalised value of the business so found out and the actual capital employed (i.e., net tangible assets) in the business. '

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

(i) Expected average net profit should be ascertained after providing for reasonable managerial remuneration.

(ii) Capitalised value of profit is to be calculated on the basis of normal rate of return. The formula is

$$\text{The total value of the business} = \frac{\text{Expected average profit}}{\text{Normal rate of return}} * 100$$

(iii) Net tangible assets (i.e., total tangible assets - liabilities to outsiders) should also be calculated.

(iv)When the net tangible assets are deducted from the total value of the business, the difference is goodwill.

Goodwill = Total value of business – Net tangible assets

PROBLEMS

Average Profit Method

1) Goodwill is to be valued at 3 years purchase of five years' average profits. The profits for the last five years of the firm were:

2004 – Rs 2,400; 2005 – Rs 3,000; 2006 – Rs 3,400; 2007 – Rs 3,200; 2008 – Rs 4,000.
Calculate the amount of goodwill.

2) Calculate the amount of goodwill on the basis of three years purchase of the last five years average profits. The profits for the last five years are:
   I year – Rs 4,800
   II year – 7,200
   III year – 10,000
   IV year – 3,000
   V year – 5,000
3) The profits of Thilaga Ltd. For the last 5 years were as follows:
   2004 – Rs 15,000; 2005 – 18,000; 2006 – 22,000; 2007 – 25,000; 2008 - 27,000
   Compute the value of goodwill of Thilaga Ltd. On the basis of 4 years purchase of weighted average profit after assigning weights 1,2,3,4 and 5 serially to the profits.

4) The following information is presented for five years ending 31st December 2008

Year	Profits(after tax) Rs	Taxation (Rs)	Transfer to reserve(Rs)	Director's remuneration(Rs)
2004	25,000	9,000	5,000	2,000
2005	27,500	10,000	6,000	2,250
2006	24,000	7,500	4,000	2,250
2007	32,500	12,500	7,500	2,500
2008	36,000	17,500	7,500	3,000

Fixed assets have been revalued and the same showed an appreciation of Rs 2,50,000 (depreciation to be provided for @ 10%). The company has a 8% preference share capital of Rs 50,000. The current rate of taxation may be taken @ 50%.

Calculate the value of goodwill on the basis of four years' purchase of the past five years' averagen profits.

5) The following particulars are available in respect of the business carried on by Bal Thakrey Ltd.
   (a) Profit earned ; 2006-Rs 50,000; 2007- Rs 48,000; and 2008- Rs 52,000.
   (b) Profit of 2007 is reduced by Rs 5,000 due to stock destroyed by fire and profit of 2006 included a non – recurring income of Rs 3,000.
   (c) Profit of 2008 include Rs 2,000 income on investment.

(d) The stock is not insured and it is thought prudent to insure the stock in future. The insurance premium is estimated at Rs 500 p.a.

(e) Fair remuneration to the proprietor (not taken in the calculation of profits) is Rs 10,000 p.a.

You are required to calculate the value of goodwill on the basis of 2 years purchase of average profits of the last three years.

Super Profits method

6) A partnership firm earned net profits during the last three years as follows:
2006 – Rs 17,000; 2007 – Rs 20,000; 2008 – 23,000.

The capital investment in the firm throughout the above mentioned period has been Rs 80,000. Having regard to the risk involved, 15% is considered to be a fair return on the capital. Calculate the value of goodwill on the basis of 2 years' purchase of average super profits earned during the above mentioned three years.

7) The Balance sheet of James Ltd. As on 31st December 2008 was as follows:

Liabilities	Rs	Assets	Rs
20,000 shares of Rs 10 each Profit & Loss A/c Debentures Trade creditors Provision for taxation Proposed dividend	2,00,000 40,000 30,000 40,000 18,000 30,000	Land & Buildings Plant & machinery Furniture & fittings 5% (tax free) Govt. bonds Stock Book debts cash	1,68,000 1,20,000 10,000 40,000 4,000 12,000 4,000
	3,58,000		3,58,000

The net profits of the company after charging depreciation and taxes were as follows:
2004 –Rs 34,000; 2005 – Rs 38,000; 2006 – 36,000; 2007 – Rs 40,000; 2008 – Rs 38,000.

On 31st December 2008 Land & Buildings were revalued at Rs 1,90,000; plant & machinery at Rs 1,42,000; and furniture & fittings at Rs 8,000.

10% represents a fair commercial rate of return on investment in the company.

Calculate the value of goodwill basing it at five year's purchase of the average super profits for the last five years.

8) Following is the balance sheet of shanty Niketan Ltd. for the year ending 31.3. 2008

Laibilities	Rs	Assets	Rs
Share capital: 20,000 shares of Rs 10 each Reserves & Surplus: P & L A/c 20,000 Profit for 2007-2008 1,60,000 ------------ Secured Loans: 7% Debentures Current Liabilities: Sundry Creditors	2,00,000 1,80,000 1,40,000 80,000	Fixed Assets: Buildings Machinery Current assets: Sundry debtors Stock Cash at bank	2,00,000 1,00,000 1,00,000 80,000 1,20,000
	6,00,000		6,00,000

Normal rate of return on average capital employed is 10%. Find out the value of goodwill on the basis of 2 years purchase of super profit. Buildings are revalued at Rs 3,00,000 and machinery at Rs 80,000. All other assets are worth their book value.

Capitalization method:

9) A firm earns Rs 1,20,000 as its annual profits, the rate of normal profit being 10%. The assets of the firm amount to Rs 14,40,000 and liabilities to Rs 4,80,000. Find out the value of goodwill by capitalization method.

10) From the following information calculate the value of goodwill by capitalization method
(a) Average capital employed in the business Rs 7,00,000
(b) Net trading profit of the firm for the past three years – Rs 1,47,600; Rs 1,48,100 and Rs 1,52,500
(c) Rate of interest expected from capital having regard to the risk involved -18%
(d) Fair remuneration to the partners for their services – Rs 12,000 per annum.
(e) Sundry assets (excluding goodwill) of the firm Rs 7,54,762 and sundry liabilities Rs 31,329.

11) The following is the balance sheet of Alpha trading co. lit., as on 31st December 2010

Liabilities	Rs	Assets	Rs
Paid up capital: 2,500 equity shares of Rs 100 each Profit & loss A/c Bank overdraft Sundry creditors Provision for taxation	 2,50,000 56,650 58,350 90,500 19,500	Goodwill at cost Land & Buildings at – cost Plant & machinery at cost less depreciation Stock at cost Book debts	25,000 1,10,000 1,00,000 1,50,000 90,000
	4,75,000		4,75,000

The company commenced operations in 2006 with a paid up capital of Rs 2,50,000. The profits earned before providing taxation have been as follows:
2006 – Rs 61,000; 2007 – Rs 64,000; 2008 – Rs 71,500; 2009 – Rs 78,000 and Rs 2010 – Rs 85,000.
You may assume that income tax at the rate of 50% has been payable on these profits.

The average dividend paid by the company for four years is 10% which is taken as reasonable return expected on the capital invested in the business. You required to ascertain the value of the goodwill of the company.

Annuity Method:

12) From the following particulars, find out the value of goodwill as per annuity method:
(a) capital employed: Rs 3,00,000
(b) normal rate or return: 10%
(c) present value of Re 1 for 5 years at 10% at 3.78
(d) normal profit for 5 years:
1st year Rs 30,000; 2nd year Rs 32,000; 3rd year Rs 34,000; 4th year Rs 36,000; 5th year Rs 38,000.
Non-recurring income: Rs 1,600
Non recurring expenses: Rs 1,000.

Valuation of Shares:

The valuation of shares may be done by an accountant for two reason:
(i) Where there is no market price as in the case of a proprietory company.
(ii) Where for special reasons, the market price does not reflect the true or intrinsic value of shares.

The problem does not arise if the shares are quoted on the stock exchange as it provides a ready means of ascertaining the value placed on such shares by the buyers and sellers.

What is the need for valuation of shares?

Shares of a limited company have to be valued for different purposes:

- When shares of unquoted private companies should be purchased or sold
- When controlling number of shares are purchased by a company in another
- When amalgamation or absorption of companies takes place
- For settlement of dissenting shareholders in a reconstruction scheme
- For assessment of wealth tax, capital gains tax, etc.
- For sanctioning loan by financial institutions on the security of
- For conversion of preference shares into equity shares.

Discuss the factors affecting the value of shares

The value of shares of a company is greatly affected by the economic , political and social factors, some of which are noted below:

(i) The economic condition of the country;
(ii) The nature of company's business;
(iii) Other political and economic factors (e.g., possibility of nationalisation / (excise duty on goods produced, etc.)
(iv) The demand and supply of shares;
(v) Proportion of liabilities and capital;
(vi) Rate of proposed dividend and past profits of the company;
(vii) Yield of other related shares of the stock exchange, etc.

Give a brief note on "Methods of valuation of shares"

The valuation of shares may broadly be classified as under;

- Net assets method (or) Intrinsic value method
- Yield method (or) Earning capacity method
- Fair value

- **Net assets method (or) Intrinsic value method:**

This method measures the value of the net assets of the company against each share. Since the valuation is made on the basis of the assets of the company, it is known as asset basis or asset backing method. At the same time, the shares are valued on the basis of real internal value of the assets of the company that is why the method is termed an intrinsic value method or real value method.

Net assets value may be expressed by the following formula:

$$\textbf{Net assets value of a share} = \frac{\textbf{Net value of assets - Liabilities – Preference shareholders claims}}{\textbf{Number of equity shares}}$$

$$\textbf{Intrinsic value per share} = \frac{\textbf{Net assets available for equity share holders}}{\textbf{Number of equity shares}}$$

- **Yield method (or) Earning capacity method:**

Yield is the effective rate of return on the investment made in the shares 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 method.

This method of valuation should be used in all but exceptional cases. Since an investor is much concerned with the return that he expects, this method is valuable.

$$\textbf{Expected rate of return} = \frac{\textbf{Profit available for equity dividend}}{\textbf{Paid up capital}} * 100$$

$$\text{Yield value per share} = \frac{\text{Expected rate of return}}{\text{Normal rate of return}} \times \text{paid up value per equity share}$$

There are some accountants who do not prefer to use net assets value or yield value for ascertaining the correct values of shares. They however prefer the fair value of shares, which is the average of net assets value and yield value which provides a better indication about the value of shares than the earlier two methods.

$$\text{Fair value} = \frac{\text{Intrinsic value} + \text{Yield value}}{2}$$

Net assets method (or) Intrinsic value method

1) The Balance Sheet of Saraswati Co. Ltd. disclosed the following particulars on 31st December 1998.

Liabilities	Rs	Assets	Rs
Share capital:		Goodwill	1,65,000
6,000 equity shares of Rs.	6,00,000	Investments	5,25,000
100 each Profit & Loss A/c	75,000	Stock	6,60,000
General reserve	2,25,000	Sundry debtors	3,90,000
6% debentures	4,50,000	Cash at bank	60,000
Sundry creditors	1,50,000		
Workmen's savings bank A/c	3,00,000		
	18,00,000		18,00,000

(i) The profits for the past five years were: 1994-Rs. 30,000; 1995-Rs. 70,000; 1996-Rs. 50,000; 1997-Rs.55,000 and 1998-Rs. 95,000.

(ii) The market value of investments was Rs. 3,30,000.

(iii) Goodwill is to be valued at three years purchase of the average annual profits for the last five years.

Find the intrinsic value of each share.

2) From the following information, find out the value of each share:

Liabilities	Rs	Assets	Rs
Share capital:		Fixed assets:	
20,000 equity shares of Rs 10 each	2,00,000	Goodwill	1,90,000
		Investments	3,00,000
Reserves & Surplus:	2,50,000	Current assets:	
Reserves	30,000	Loans & advances:	
Profit & Loss A/c	80,000	Current assets	50,000
Unsecured loans	20,000	Loans & advances	30,000
Current liabilities		Miscellaneous expenditure	10,000
	5,80,000		5,80,000

For the purpose of valuation of shares goodwill shall be taken at two years purchase of the average profit of the last five years. The profits for the last five years are- Rs 60,000; Rs 70,000; Rs 40,000; Rs 50,000 and Rs 50,000.

3) On 31st Dec 2008 the balance sheet of a company was as follows:

Liabilities	Rs	Assets	Rs

10,000 equity shares of Rs 100 each, fully paid Profit & loss A/c Creditors Provision for tax Proposed dividend	10,00,000 2,00,000 1,80,000 1,00,000 1,50,000	Land & Buildings Plant & machinery Stock debtors	4,40,000 1,90,000 7,00,000 3,00,000
	16,30,000		16,30,000

The net profits of the company after providing for taxation were : 2004 – Rs 1,70,000; 2005 – Rs 1,92,000; 2006 – 1,80,000; 2007 – Rs 2,00,000 and 2008- Rs 1,90,000.

On 31st Dec 2008 Land & Buildings were revalued at Rs 5,00,000, plant & machinery at Rs 3,00,000 and debtors at 10% less. In view of the nature of the business it is considered 10% a reasonable return on investment.

Calculate the value of company's shares, valuing goodwill at five year's purchase of the annual super profits.

Yield method (or) Earning capacity method:

4) The issued share capital of a company was Rs 10,00,000 consisting of 10,000 equity shares of Rs 100 each. The net profits for the last 5 years were ; Rs 1,00,000; Rs 80,000; Rs 1,20,000; Rs 1,60,000 and Rs 1,40,000 of which 20% was placed to reserve, this proportion being considered reasonable in the industry in which the company is engaged and where a fair investment return may be taken at 12%. Compute the value of the company's share by the yield value method.

5) X Ltd. Has 10,000 equity shares of Rs 10 each , Rs 8 paid and 1,00,000 6% preference shares of Rs 10 each fully paid. The company has a practice of transferring 20% of the profit to general reserve every year. If the expected profit (based on past year's performance) before tax is 2,00,000 and the rate of tax is 50%. You are required to calculate the value of equity share. It may be assumed that normal rate or dividend is 20%.

6) The following is the balance sheet of Jaya Co. Ltd. As on 31st Dec 2008.

Liabilities	**Rs**	**Assets**	**Rs**
Share capital: 9,000 equity shares of Rs 100 each 21,000 8% preference shares of Rs 100 each. Profit & Loss A/c Sundry creditors	 9,00,000 21,00,000 3,00,000 4,50,000	Land & Building Plant & machinery Stock -in-trade Sundry debtors Cash at bank	10,00,000 14,00,000 6,00,000 6,00,000 1,50,000
	37,50,000		37,50,000

The net profits of the company for the past five years before providing for taxation were:
2004-Rs 5,40,000; 2005 – Rs 6,00,000; 2006 – Rs 5,40,000; 2007 – Rs 4,50,000 and 2008 – Rs 3,00,000.

Another company engaged in the same type of business pays a dividend of 10% and its shares are quoted on the stock exchange at Rs 100. Assuming taxation at 50% and appropriation of 10% of the balance to reserves, calculate the value of each equity share.

Fair value method:

7) From the following information, you are required to ascertain the fair value of each share:

1,00,000 equity shares of Rs 10 each fully paid: Rs 10,00,000
Net assets available to equity shareholders : Rs 25,10,000
Expected rate of return : 90%
Normal rate of return : 10%

8) For the above problem No 6 calculate value of share through Fair Value Method.

9) the following is the summarized balance sheet af Adams Ltd., as on 30th sep 2008

Liabilities	Rs	Assets	Rs
Share capital: 30,000 equity shares of Rs 10 each Reserves & surplus: General Reserve Capital reserve Profit & loss A/c Current liabilities & provisions; Creditors Income tax payable Proposed dividend Bills payable	3,00,000 1,20,000 40,000 1,20,000 93,700 11,500 34,500 82,000	Freehold property Plant Stock Debtors Bank cash	1,20,000 50,000 3,10,000 2,03,000 1,17,000 1,700
	8,01,000		**8,01,000**

Net profit(before taxation) for the past three years ended:
30.9.2006 – Rs 1,38,000; 30.9.2007 Rs 1,83,000; 30.9.2008 –Rs 1,97,000
Free hold property was valued early in 2008 at Rs 1,60,000
Average yield in this type of business is 15% on capital employed. It is the practice of the company to transfer 25% of the profits to reserve.
You are required to findout the value of each equity share on the basis of the above mentioned facts.

(UNIT IV COMPLETED)

UNIT: V

PROFITS PRIOR TO INCORPORATION

Introduction

A running business may be acquired by another firm. If one company acquires the business of another, it is called *'Absorption'*. When a company acquires the running business of a sole trader or partnership firm, it is termed as *'acquisition'* of business. The acquiring company may be an existing company or a newly started company. In the latter case, the accounting problem of ascertaining profit or loss prior to incorporation arises.

How do you treat Profit or Loss prior to Incorporation?

Under this agreement with the vendor provides otherwise, profit or loss from the date of purchase of business till the date of incorporation belongs to the company. Such profit should not be regarded as 'normal trading profit' or 'revenue profit' since the company cannot earn profit or incur loss 'before it comes into existence'. The profit or loss should be regarded as 'capital' in nature, increasing or decreasing the 'net assets' acquired by the company.

The following are the methods of dealing with profit or loss prior to incorporation in the books of accounts of a company:

(A) Profit prior to incorporation

(i) Being capital profit in its nature, it cannot be allowed to be a part of profit and loss account.
(ii) It should not be used for payment of dividend to the shareholders.
(iii) It is preferable to credit it to 'Capital Reserve Account' which may be used to write off capital losses and expenses like 'preliminary expenses', 'underwriting commission', ' discount on issue of debentures', etc. Unutilised portion of such capital reserve appears in the liabilities side of the balance sheet under the heading 'reserves and surpluses'.

(B) Loss prior to incorporation

(i) Being a 'capital loss', it should not be allowed to be a part of profit and loss account.
(ii) It can be debited to a separate account called 'Loss prior to incorporation account'. This loss can be written off using other capital profits of the company. It appears on the assets side of the balance sheet under the heading 'miscellaneous expenditure'.
(iii) It may be treated as goodwill and debited to goodwill account.
(iv) It may also be treated as' deferred revenue expenditure' and may be written off out of the profits of the company over several years.

What are the methods of ascertaining profit or loss prior to Incorporation?

There are three possible methods of ascertaining profit or loss prior to incorporation:

(1)Preparation of Trading & Profit & Loss account for the period up to the date of incorporation:

A trial balance has to be prepared as on the date of incorporation of the company by balancing the books of accounts of the business. The closing stock on that date has to be valued. Trading and P & L Account has to be prepared in the normal way.

Profit or loss prior to incorporation can be ascertained accurately in this method. At the end of the accounting year, profit or loss of the post incorporation period may be found.

(2) (a) Preparation of Trading and profit and loss account for the whole accounting period and apportionment of the resulting profit or loss between pre and post incorporation periods:

Under this method, Trial Balance is prepared and Trading and Profit and Loss account are prepared at the end of the accounting period. Then, a separate note is prepared, in the form of a statement showing pre and post incorporation profits by apportioning the various expenses between the respective periods.

These profit or loss figures are incorporated in the profit and loss account, by transferring the profit prior to incorporation to capital reserve account. Any loss prior to incorporation may be separately shown or it may be debited to goodwill account.

(b) **Preparation of Common Trading Account and the Profit and Loss account in 'columnar form'.**

Under this method, trading account is prepared at the end of the accounting year from the trial balance in the usual manner. Unless otherwise mentioned, the date of incorporation does not affect the computation of gross profit

The profit and loss account is prepared in columnar form, with separate columns for pre and post incorporation periods. All expenses and the gross profit are divided between the two periods in an appropriate manner.

Under methods (a) and (b) above, profit or loss for the two periods cannot be ascertained as accurately as under the first method. These methods can only give an estimate of the profit or loss of the two periods.

Give a brief note on "Basis of Apportionment of expenses"

The various expenses which are shown in profit and loss account should be divided between pre and post incorporation periods on some logical and appropriate basis. The following are the usual bases for such apportionment:

(1) Time Ratio: This is the ratio of months or days before and after incorporation during the accounting period. For example, if business was acquired on 1-1-2010, the company was incorporated on 1-5-2010 and accounts are closed on 31-12-2010, the time ratio is 4:8 or 1:2. From 1-1-2010 till 1-5-2010, there are four months before incorporation. Similarly, there are 8 months after incorporation i.e., from 1-5-2010 to 31-12-2010.

All expenses of a company which can be linked or related to *'time'* must be divided between pre and post incorporation periods in *Time Ratio.* Examples are Salaries, rent, stationery, postage, depreciation, bank charges, interest etc.

(2) 'Weighted' or 'Adjusted' Time Ratio: If any changes were made in the number of employees, or office accommodation, etc., weight age must be given to the changes in arriving at the time ratio. Such a ratio is called '*Weighted Time Ratio'*. Similarly, when some expenditure is incurred only for a part of the accounting period, separate ratio has to be computed, based on the actual months or days in pre and post incorporation periods.

(3)Sales Ratio: This is the ratio of sales or turnover of the company before and after incorporation. For example, when sales before and after incorporation were Rs. 2,00,000 and Rs. 6,00,000 respectively, the sales ratio is 1:3.

Sales ratio is the logical basis to divide the gross profit earned by the company; similarly, all expenses related to sales are also to be apportioned in sales ratio. *Examples:* Advertising, salesmen's commission, sales promotion expenses, carriage outwards, bad debts, discount allowed, etc.

(4)Weighted Sales Ratios: If sales were not uniform throughout the accounting period, weightage must be given to the *trends observed* in the sales. Sales ratio adjusted for the *change in trend is* called '*weighted sales ratio'*.

(5)Allocation of Expenses: Specific expenses which can be identified with either period have to be fully allocated to that period. All company related expenses like debenture interest, directors' remuneration or fees, preliminary expenses written off, donations given by the company, etc., have no connection with the pre incorporation period. So, they must be fully charged to the post incorporation period. (Similarly, partners' salaries, interest on purchase price till the date of incorporation maybe allocated to the pre incorporation period.

(6)Actual Expenditure: If specific details are available about any particular item of expenditure as to how much was spent in the pre and post incorporation periods, the actual amount should be charged to the respective periods.

Note: Auditors of a company are appointed only after incorporation. So, audit fee may be shown as post incorporation expenditure. However, the auditors have to audit the accounts of pre incorporation period also.

Thus, audit fee can be divided in time ratio also. Whichever way is followed the alternative may be shown as a note.

What are the steps involved in ascertaining pre and post incorporation profits?

Step 1: Trading account has to be prepared for the accounting period and gross profit has to be found.

Step 2: After a careful scrutiny of the sales, expenses etc, sales ratio and time ratio have to be computed and a list of expenses which can be allocated to specific periods should be drawn up.

Step 3: If a statement is preferable for ascertaining pre incorporation profit, normal P *& L* A/c can be prepared. Otherwise, columns for basis of apportionment, total, pre incorporation and post incorporation should be provided on both the sides of the P & L A/c.

The gross profit and the expenses can be recorded, dividing them or showing them appropriately.

Step 4: In the profit and loss appropriation A/c, the amount of pre incorporation profit should be transferred to capital reserve. If there is loss in pre incorporation period, it is carried down from Profit and Loss Account to Appropriation Account debit side. Then it can be shown on the credit side of the appropriation account as Loss prior to incorporation (or) as *goodwill* which will appear on Balance sheet asset's side.

Table showing treatment of different items

Sl. No	Nature of items	Basis of Apportionment
1	Gross profit / loss	Sales ratio or weightage sales ratio
2	All fixed expenses like salaries, rent, rates, taxes, insurance, depreciation, postage etc.	Time ratio or weightage or adjusted time ratio
3	All variable expenses directly varying with turnover like commission, discount, salesmen's remuneration, advertisement, carriage outwards.	Sales ratio or weightage sales ratio
4	All expenses related to pre incorporation period alone such as vendor's salary till the incorporation date.	Allocation to the pre incorporation period
5	All expenses wholly applicable to post incorporation period like director's fees, debenture interest, discount on issue of debentures, preliminary expenses written off, donations given by the company etc.	Allocation to the post incorporation period

PROBLEMS

1) **(a)**Ganesh Ltd., was incorporated on 1st May 2006 to purchase the running business of Vinayak and Co., with effect from 1st January 2006. The company obtained certificate of commencement of business on 24th August 2006. Calculate the time ratio, if the accounts were finalized on 31st December 2006.
   (b) A company was incorporated on 1-2-2008 to purchase the business of Abdul Kalam & sons, as from 1st November 2007.
   There were 10 employees before incorporation but 5 more were appointed on 1-2-2008. You are required to ascertain the weighted time ratio for dividing salaries between the pre and post incorporation periods, assuming that the accounts are finalized on 31st October.

2) Razik Mila Ltd., was formed on 1st May 2004 to purchase the business of Jaleel & Co., with effect from 1-1-2004. While preparing final accounts on 31-12-2004, it was observed that
   (a) Total sales for the year were Rs 10,00,000

(b) Sales in the second half of the year were double to those in the first half, on a monthly average basis.
You are required to find out the sales ratio for the purpose of determining the pre and post incorporation profits.

3) A company was incorporated on 1st July 2006 to acquire a running business from 1st April 2006. When accounts were finalized on 31st March 2007, the following facts were as under during the specified months.
April, July, September, December – Average sales. May, August, October and February 50% of the average sales.
You are required to find out the sales ratio for the purpose of ascertaining profits prior to incorporation.

4) Raja Ltd., was incorporated on 1-7-2004, which took over a running concern with effect from 1-1-2004. The sales for the period up to 1-7-2004 was Rs 2,70,000 and the sales from 1-7-2004 to 31-12-2004 amounted to Rs 3,30,000.
The expenses debited to Profit and loss account included:

	Rs
(a) Director's fees	15,000
(b) Bad debts	1,800
(c) Advertisement (Rs 500 per month)	6,000
(d) Salaries and general expenses	32,000
(e) Preliminary expenses written off	3,000

The gross profit was (1-1-2004 to 31-12 2004) Rs 2,40,000. Ascertain the profit prior to incorporation.

5) A company was incorporated on 1st May 2004 to take over a business as a going concern from 1st January of the same year. The turnover for the year ended 31st December was Rs 2,00,000 namely Rs 60,000 for the first period upto 1st May and Rs 1,40,000 for the following period. From the profit & loss account given below for the year ended 31st December 2004. You are required to ascertain profits prior to incorporation.

Particulars	Rs	Particulars	Rs
To Rent & Rates	3,240	By Gross profit	72,000
To Insurance	720		
To Lighting	2,040		
To salaries	7,800		
To Director's fees	2,000		
To Audit fees	2,000		
To sales discount	5,000		
To sales commission	10,000		
To general expenses	2,400		
To carriage outwards	3,000		
To bank charges	420		
To repairs	1,380		
To Bad debts	600		
To to loan interest	1,200		
To net profit	30,200		
	72,000		**72,000**

<u>FINAL ACCOUNTS – FORMAT</u>

Profit & Loss Appropriation Account

Particulars	Rs	Particulars	Rs
To transfer to reserve	XXX	By last year's profit balance b/d	XXX
To income tax for previous year not provided	XXX	By Net profit for the	XXX

To interim dividend To proposed final dividend To Surplus (carried to Balance Sheet)	XXX XXX XXX	current year By transfer from general reserve or any other reserve By provisions such as income tax, provision no longer required	XXX XXX
	XXX		XXX

BALANCE SHEET
Name of the Company….
Balance Sheet as at …

		Schedule No	**Figures at the end ofcurrent financial year (Rs)**	**Figures at the end of previous financial year (Rs)**
I	**Source of funds:** (1) Share holders' funds: a. Capital b. Reserves and surplus (2) Loan funds: a. Secured loans b. Unsecured loans TOTAL **Application of funds:** (1) Fixed assets a. Gross block b. Less depreciation c. Net block d. Capital work- in-progress (2) Investments (3) Current assets, Loans & advances a. Inventories b. Sundry Debtors c. Cash & Bank Balances d. Other current assets e. Loans & Advances Less: Current liabilities & provisions a. Liabilities b. Provision NET CURRENT ASSETS (4) a. miscellaneous expenditure to the extent not written off or adjusted (5) profit & Loss A/c			
	TOTAL			

Managerial Remuneration

The Companies Act lays down a number of restrictions on managerial remuneration payable by a public company or a private company which is a subsidiary of a public company. The term 'managerial remuneration' includes remuneration payable to the (i) Managing Director, (ii) Manager (iii) Part time directors, and (iv) Whole time directors. It does not include the remuneration payable to technical advisors or secretaries.

According to Section 198 of the Companies Act, 1956 the total managerial remuneration payable by a public company or a private company which is subsidiary of a public company to its directors and its manager in respect of any financial year shall not exceed 11% of the net profits of that company for that financial year.

What are the Perquisites to be included in managerial remuneration?

Section 198 provides that the term "remuneration" includes the following:

(i) Any expenditure incurred by the company in providing any rent-free accommodation or any other benefit or amenity in respect of accommodation free of charge.

(ii) Any expenditure incurred by the company in providing any other benefit or amenity free of charge or at a concessional rate.

(iii) Any expenditure incurred by the company in respect of any obligation or service, which but for such expenditure by the company, would have been incurred by any of the persons aforesaid; and

(iv) Any expenditure incurred by the company to effect any insurance on the life of or to provide any pension, annuity or gratuity for any of the persons aforesaid or his spouse or child.

Give a brief note on "Remuneration payable to different categories of managerial personnel"

The following are the amount of remuneration payable to different categories of managerial personnel:

I. ***Manager*:** He is an employee of the company, He is the person who has got the control of the whole or substantially the whole of the affairs of the company. A company cannot have more than one manager at a time. The remuneration payable to the manager cannot be more than 5% of the net profits of the company.

II. ***Managing Director:*** He is a director who has substantial powers of management. The remuneration payable to the managing director shall not exceed 5% of the net profits of the company. If a company has more than one managing director, the total remuneration payable to the managing directors shall not exceed 10% of the net profits of the company.

III. ***Whole time directors:*** He is a director who spends his whole attention for the company. It is permissible to have one or more whole time directors with or without a managing director. The remuneration payable to the whole time director shall not exceed 5% of the net profits of the company.

If a company has more than one whole time director, the total remuneration payable to the whole time directors (including managing director, if any) should not exceed 10% of the net profits of the company.

IV. ***4. Director:*** He is the person who guides, directs or manages the affairs of the company. As per the Companies Act, the term director includes any person occupying the position of director by whatever name called.

A public company must have at least three directors. Whereas in case of private company, it must have at least two directors.

The remuneration payable to all directors, when not assisted by whole by whole time directors or manager or managing directors, shall not exceed 3% of the net profits of the company.

The maximum remuneration payable to different categories of managerial personnel, as stated above can be summarized as follows:

Managerial personnel	Maximum percentage of

		net profits
(i)	Maximum remuneration to all the managerial personnel	11%
(ii)	Manager	5%
(iii)	Managing director or whole time director	5%
(iv)	Managing directors or whole time directors when there is more than one	10%
(v)	Part time directors when the company is not having managing director, whole time director or manager	3%
(vi)	Part time directors when assisted by a managing director, whole time director or manager	1%

PROBLEMS

Managerial Remuneration

1) From the following particulars, determine the maximum remuneration available to a full time director of a manufacturing company.

The profit & Loss A/c of the company showed a net profit of Rs 40, 00,000 after taking into account the following items:

	Rs
(a) Depreciation (including special depreciation of Rs 40,000)	1,00,000
(b) Provision for income tax	2,00,000
(c) Donation to political parties	50,000
(d) Ex-gratia payment to worker	10,000
(e) Capital profit on sale of assets	15,000

2) Determine the maximum remuneration available to the part time directors and manager of Blueprint Co ltd. (A manufacturing company) under section 309 and 387 of the companies Act, 1956, from the following particulars:

Before charging any such remuneration the profit & loss A/c showed a credit balance of Rs 6,60,000 for the year ended March 31, 2003 after taking into account the following matters:

	Rs
Capital Expenditure	1,50,000
Subsidy received from Govt	1,20,000
Special depreciation	20,000
Multiple shift allowance	30,000
Bonus to foreign technicians	90,000
Provision for taxation	8,00,000
Compensation paid to injured workman	20,000
Ex-gratia to an employee	10,000
Loss on sale of fixed asset	20,000
Profit on sale of investment	60,000

3) From the following calculate the maximum commission permissible to Directors when not assisted by managing director or manager or whole time directors.

P & L A/c

Particulars	Rs	Particulars	Rs
To Bonus to foreign technician To repairs To interest on debentures To donation to university To compensation to injured worker	20,000 5,000 10,000 75,000 5,000 8,50,000 6,000	By Gross profit B/d Bu profit on sale of building: Cost price 90,000 WDV 70,000	36,41,000 80,000

To provision for taxation To loss on sale of vehicle (W.D.V Rs 11,000) To Net profit	27,50,000		
	37,21,000		37,21,000

4) From the following profit & Loss Account of Soundarya Ltd. For the year ended 31.12.2002 and additional data given, calculate commission due to managing director at 5% of net profit. Salary of managing director is to be treated as part payment of the commission:

P & L A/c for the year ended 31.12.2002

Particulars	Rs	Particulars	Rs
To opening stock To Bonus (including Rs 500 for 2001) To Director's fees To managing director: Salary Commission To development rebate reserve To provision for tax To establishment expenses To loss on sale of investments To Net profit c/d	11,000 5,000 3,000 2,000 1,000 800 3,000 40,000 200 1,22,000	By sales By closing stock By other incomes: Discount Profit on sale of fixed assets	1,70,000 15,000 2,000 1,000
	1,88,000		1,88,000

The book value of the fixed assets sold was Rs 2,000 and their original cost was Rs 2,600.

5) The following P & L A/c is presented by B.B. Patil Ltd for the year ended 31.12.2008

P & L A/c

Particulars	Rs	Particulars	Rs
To salaries & wages To director's fees To repairs To depreciation(including development rebate Rs 16,000) To scientific Research(New laboratory set up) To general expenses To income tax To proposed dividends To interest on debentures To balance c/d	1,28,000 4,000 27,000 1,06,000 20,000 15,000 1,00,000 1,00,000 24,000 59,000	By Gross profit b/d By capital profit on sale of company's land By subsidy received from state government	5,08,000 25,000 50,000
	5,83,000		5,83,000

Income tax authorities have allowed Rs 82,000 as depreciation excluding development rebate. Calculate the remuneration payable to the managing director.

PROBLEMS

Final Accounts of company (Trading, P&L A/c, P&L Appropriation A/c)

1) Nidhi Ltd. Carried forward a balance of Rs 15,000 in the profit & Loss Account for the year ended 31st March 2005. During the year 2005-2006, it further made a profit of Rs 1,50,000. It resolved to carry out the following:
(i) Provision of taxation Rs 75,000.
(ii) Dividend equalization account Rs 10,000.
(iii) Dividend on 10% preference shares of Rs 1,00,000.
(iv) Dividend at 15% on 15,000 equity shares of Rs 10 each fully paid.
(v) General Reserves Rs 17,500.
(vi) Asset replacement reserves Rs 17,500 for payment of dividend.
Prepare profit & Loss Appropriation A/c on the assumption that rate of tax deducted at source is 10%.

2) The accounts of the Thackery Ltd., showed an amount of Rs 3,00,000 to the credit of P &L A/c on 31.3.2008 out of which the directors decided to place Rs 60,000 to general reserve and Rs 42,000 to debenture redemption fund. At the annual general meeting held on 15.6.2008, it was decided to place Rs 20,000 to a development reserve and to pay a bonus of 2 ½% of the profit to the directors as additional remuneration. The payment of the half – yearly dividends on Rs 5,00,000 6% cumulative preference shares on Sept.30, 2007 and March, 31, 2008 was confirmed and a dividend @ 10% was declared on the equity share capital of the face value of Rs 6,00,000. The balance of P & L A/c is to be carried forward to next year.
Prepare Profit & Loss Appropriation A/c showing the above arrangements,.

3) Nathiya Ltd, has a credit balance on P & L A/c of Rs 3,00,000 on 1-4-2000 and the net profit for the year 2000-2001 is Rs 30,00,000. It was decided that the following decisions be carried out regarding provisions, reserves and dividends:
(i) General Reserve Rs 3,50,000
(ii) Investment allowance Reserve Rs 3,50,000.
(iii) Provision for taxation @ 50%.
(iv) Dividend equailsation fund A/c Rs 2,00,000.
(v) Dividend on 10% preference shares of Rs 20,00,000.
(vi) Dividend at 15% on 3,00,000 equity shares of Rs 10 each fully paid.
You are required to give P&L Appropriation A/c.

4) A company carried forward a balance of Rs 1,20,000 in the P & L A/c from the year ended 31st March 2006. During the year 2007 it made a further profit before tax of Rs 8,00,000. It was decided that following provisions and transfers be carried out:
(i) Dividend equalization account Rs 30,000.
(ii) Provision for taxation Rs 2,20,000.
(iii) General Reserve Rs 1,05,000.
(iv) Development rebate reserve Rs 1,10,000.
(v) Dividend at 9% on preference shares of Rs 5,00,000
(vi) Dividend at 15% on 1,00,000 equity shares of Rs 10 each fully paid.
You are required to prepare P & L Appropriation A/c .

5) Following is the list of balances of Lakshmi Ltd as on 31-3-2000

Rs		Rs	
Gross profit	87,050	Discount (cr)	3,000
Furniture	17,000	salaries	7,500
Rent	4,000	sundry expenses	7,050
P & l Appr. A/c (Cr.) as on 31-3-1999	15,000	Dividend paid (For 1998-1999)	9,000
Share capital	1,00,000	Debtors	27,500
Creditors	17,500	Plant	29,000

Bank balance	46,200	General Reserve	15,500
Bills Receivable	9,800	Bills payable	7,000

Prepare Profit & loss A/c and Profit & Loss Appropriation A/c for the year ending 31-3-2000 after providing for:

(a) Depreciation at 20% on fixed assets
(b) Provision for doubtful debts at 5%
(c) Provide for 15% dividend.

Final Accounts of company (Trading, P&L A/c, P&L Appropriation A/c and Balance Sheet)

6) The following are the balances of John Co ltd. As on 31st March 2006:

Credit	Rs	Debit	Rs
Share capital	40,00,000	Premises	30,72,000
12% Debentures	30,00,000	Plant	33,00,000
P & L Account	2,62,500	Stock	7,50,000
Bills payable	3,70,000	Debtors	8,70,000
Creditors	4,00,000	Goodwill	2,50,000
Sales	41,50,000	Cash and Bank	4,06,000
General Reserve	2,50,000	Calls in arrear	75,000
Bad Debt provision on 1-4-2005	35,000	Interim dividend paid	3,92,000
			18,50,000
		Purchases	50,000
		Preliminary expenses	9,79,800
			68,350
		Wages	2,02,250
		General expenses	21,100
		Salaries	1,80,000
		Bad debts	
		Debenture interest paid	
	1,24,67,500		1,24,67,500

Information:

(a) Depreciate plant by 15%
(b) Write off Rs 5,000 from preliminary expenses.
(c) Half year's debenture interest due.
(d) Create 5% provision on debtors for doubtful debts.
(e) Provide for income tax @ 50%.
(f) Stock on 31st March 2003 was Rs 9,50,000
(g) A claim of Rs 25,000 for workmen's compensation is being disputed by the company. Prepare final accounts of the company.

7) A Ltd. Was registered with an authorized capital pf Rs 6,00,000 in equity shares of Rs 10 each. The following is its Trial Balance on 31st March 2008.

	Debit (Rs)	Credit(Rs)
Goodwill	25,000	-
Cash	750	-
Bank	39,900	-
Purchases	1,85,000	-
Preliminary expenses	5,000	-
Share capital	-	4,00,000
12% Debentures	-	3,00,000
P & L A/c(Cr)	-	26,250
Calls- in- arrears	7,500	-

Premises	3,00,000	-
Plant & machinery	3,30,000	-
Interim dividend	39,250	-
Sales	-	4,15,000
Stock(1.4.2007)	75,000	-
Furniture & fixtures	7,200	-
Sundry debtors	87,000	-
Wages	84,865	-
General expenses	6,835	-
Freight and carriage	13,115	-
Salaries	14,500	-
Director's fees	5,725	-
Bad debts	2,110	-
Debenture interest paid	18,000	-
Bills payable	-	37,500
Sundry creditors	-	40,000
General reserve	-	25,000
Provision for bad debts	-	3,500
	12,46,750	12,46,750

Prepare profit & loss A/c, profit & loss appropriation A/c an Balance Sheet in proper form after making the following adjustments:

(1) Depreciate plant & machinery by 15%
(2) Write off Rs 500 from preliminary expenses
(3) Provide for 6 months interest on debentures
(4) Leave bad and doubtful debts provision at 5% on sundry debtors.
(5) Provide for income tax at 50%
(6) Stock on 31.3.2008 was Rs 95,000.

8) The auto parts manufacturing co ltd. Was registered with an authorized capital of Rs 10,00,000 divided into shares of Rs 10 each, of which 40,000 shares had been issued and fully paid.

The following is the trial balance extracted on 31st march 2006.

Particulars	Debit (Rs)	Credit(Rs)
Stock (1st April, 2005)	1,86,420	-
Purchases and sales	7,18,210	11,69,900
Returns	12,680	9,850
Manufacturing wages	1,09,740	-
Sundry manufacturing expenses	19,240	-
Carriage inwards	4,910	-
18% bank loan (secured)	-	50,000
Interest on bank loan	4,500	-
Office salaries and expenses	17,870	-
Auditor's fees	8,600	-
Director's remuneration	26,250	-
Preliminary expenses	6,000	-
Freehold premises	1,64,210	-
Plant & machinery	1,28,400	-
Furniture	5,000	-
Loose tools	12,500	-
Debtors and creditors	1,05,400	62,220
Cash in hand	19,530	-
Cash at bank	96,860	-
Advance payment of tax	84,290	-
P & L A/c on 1st April, 2005	-	38,640
Share capital	-	4,00,000

	17,30,610	17,30,610

You are required to prepare trading and profit & loss A/c for the year 31st, March 2006 and a Balance Sheet as at that date after taking into consideration the following adjustments:

(1) On 31st march, 2006 outstanding manufacturing wages and outstanding office salaries stood at Rs 1,890 and Rs 1,200 respectively. On the same date stock was valued at RS 1,24,840 and loose tools at Rs 10,000.
(2) Provide for interest on Bank loan for 6 months.
(3) Depreciate on P & M is to be provided @ 15% while on office furniture it is to be @ 10%.
(4) Write off one-third of balance of preliminary expenses.
(5) Make a provision for income tax @ 50%.
(6) The directors recommended maiden (first) dividend @ 15% of the year ending 31st March 2006 after a transfer of 5% of net profits to general reserve.

9) SS Ltd. Has a nominal capital of Rs 6,00,000 divided into shares of Rs 10 each. The following trial balance is extracted from the books of the company as on 31.12.2007.

	Rs		Rs
Calls in arrear	7,500	6% debentures	3,00,000
Premises (Rs 60,000 added on 1.7.2007)	3,60,000	P & L A/c (1.1.2007)	14,500
Machinery	3,00,000	Creditors	50,000
Interim dividend paid	7,500	General reserve	25,000
Purchases	1,85,000	Share capital(called up)	4,60,000
Preliminary expenses	5,000	Bills payable	38,000
Freight	13,100	Sales	4,15,000
Director's fees	5,740	Provision for bad debts	3,500
Bad debts	2,110		
4% Govt securities	60,000		
Stock (1.1.2007)	75,000		
Furniture	7,200		
Sundry debtors	87,000		
Goodwill	25,000		
Cash	750		
bank	39,900		
Wages	84,800		
General expenses	16,900		
Salaries	14,500		
Debenture interest	9,000		
	13,06,000		13,06,000

Prepare final accounts of the company for the year ending 31.12.2007 in the prescribed form after taking into account the following adjustments:

(a) Depreciate machinery by 10% and furniture by 5%.
(b) Write off half of the preliminary expenses
(c) Wages include RS 10,000 paid for the construction of a compound wall to the premises and no adjustment was made.
(d) Provide 5% for bad debt on sundry debtors.
(e) Transfer Rs 10,000 to general reserve.
(f) Provide for income tax Rs 25,000.
(g) Stock on 31.12.2007 was Rs 1,01,000.

10) Moon and star Co. Ltd. has a company with an authorized capital of Rs 5,00,000 divided into 5,000 equity shares of Rs 100 each on 31.12.2005 of which 2,500 shares were fully called up. The following are the balances extracted from the ledger as on 31.12.2005.

Debit	**Rs**	**Credit**	**Rs**
Opening stock	50,000	Sales	3,25,000

Purchases	2,00,000	Discount received	3,150
Wages	70,000	Profit & loss A/c	6,220
Discount allowed	4,200	Creditors	35,200
Insurance (upto	6,720	Reserves	25,000
31.3.2006)	18,500	Loan from managing	15,700
Salaries	6,000	director	2,50,000
Rent	8,950	Share capital	
General expenses	2,400		
Printing	3,800		
Advertisement	10,500		
Bonus	38,700		
Debtors	1,80,500		
Plant	17,100		
Furniture	34,700		
Bank	3,200		
Bad debts	5,000		
Calls –in arrears			
	6,60,270		6,60,270

You are required to prepare P & L A/c for the year ended 31.12.2005 and a balance sheet as on that date. The following further information is given;

(a) Closing stock was valued at Rs 1,91,500
(b) Depreciate plant at 15% and furniture at 10% should be provided.
(c) A tax provision of Rs 8,000 is considered necessary.
(d) The directors declared an interim dividend on 15.8.2005 for 6 months ending June 30, 2005 @ 6%.

(UNIT V COMPLETED)

Reference Books;

- Corporate Accounting – Reddy & Murthy
- Corporate Accounting – S.P. Jain & Narang