CORPORATE ACCOUNTING

B.Com. Second Year

SEMESTER – IV

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B.Com. 2nd Year Semester – IV

CORPORATE ACCOUNTING

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining a 'A' Grade from the NAAC in the year 2014, the Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 285 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education with the aim to bring higher education within reach of all. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even housewives desirous of pursuing higher studies. With the goal of bringing education in the door step of all such people. Acharya Nagarjuna University has started offering B.A, and B, Com courses at the Degree level and M.A, M.Com., L.L.M., courses at the PG level from the academic year 2021-22 on the basis of Semester system.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers invited respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn facilitate the country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Coordinators, Editors and Lesson -writers of the Centre who have helped in these endeavours.

Prof. P.Rajasekhar
Vice –Chancellor,
Acharya Nagarjuna University

PROGRAMME: THREE-YEAR B COM

(General and Computer Applications)

Course Code:

Domain Subject: Commerce

Semester-wise Syllabus under CBCS

(w.e.f. 2020-21 Admitted Batch)

II Year B Com (Gen & CA)– Semester – IV

401BCO21-Course 4A:Corporate Accounting

Learning Outcomes:

At the end of the course, the student will able to;

- Understand the Accounting treatment of Share Capital and aware of process of book building.
- Demonstratetheprocedure for issue of bonus shares and buyback of shares.
- Comprehend the important provisions of Companies Act, 2013 and prepare final accounts of a company with Adjustments.
- Participate in the preparation of consolidated accounts for a corporate group.
- Understand analysis of complex issues, formulation ofwell-reasoned arguments and reachingbetter conclusions.
- Communicate accounting policy choiceswith reference to relevant laws and accounting standards.

SYLLABUS:

Unit-I:

Accounting for Share Capital: Kinds of Shares – Types of Preference Shares – Issue of Shares at Par, Discount and Premium - Forfeiture and Reissue of Shares (including problems).

Unit-II:

Issue and Redemption of Debentures and Issue of Bonus Shares: Accounting Treatment for Debentures Issued and Repayable at Par, Discount and Premium -Issue of Bonus Shares - Buyback of Shares - (including problems).

Unit-III:

Valuation of Goodwill: Need and Methods - Average Profit Method, Super Profits Method – Capitalization Method and Annuity Method (Including problems).

Unit –IV:

Valuation Shares: Need for Valuation - Methods of Valuation - Net Assets Method, Yield Basis Method, Fair Value Method (including problems).

UNIT – V:

Company Final Accounts: Provisions of the Companies Act, 2013 - Preparation of Final Accounts – Adjustments Relating to Preparation of Final Accounts – Profit and Loss Account and Balance Sheet – (including problems with simple adjustments).

Reference Books:

1. Corporate Accounting – T.S Reddy and Murthy, MarghamPublications, Chennai.
2. Advanced Accounts: M C Shukla, T S Grewal and S C Gupta, S Chand Publications
3. Corporate Accounting – Haneef & Mukherji, Tata McGraw Hill Publications.
4. Corporate Accounting – RL Gupta & Radha Swami,Sultan Chand & sons
5. Corporate Accounting – P.C. Tulsian, S.Chand Publishers
6. Advanced Accountancy: Jain and Narang,,Kalyani Publishers
7. Advanced Accountancy: R.L. Gupta and M.Radhaswamy, S Chand.
8. Advanced Accountancy :Chakraborthy, Vikas Publishers
9. Corporate Accounting: S.N. Maheswari, S.K. Maheswari, Vikas Publishing House.
10. Advanced Accounts: M.C. Shukla, T.S. Grewal, S.C. Gupta, S. Chand & Company
11. Corporate Accounting: Umamaheswara Rao, Kalyani Publishers
12. Corporate Accounting: Dr ChandaSrinivas, SevenHills International Publishers,
13. Advanced Accountancy: Arulanandam& Raman, Himalaya Publishing House.

Suggested Co-Curricular Activities:

- Assignments
- Problem Solving Exercises
- Collect and fill the share application form of a limited Company
- Collect Prospectus of a company and identify its salient features
- Collect annual report of a Company and List out its assets and Liabilities.
- Collect the annual reports of company and calculate the value of goodwill under different methods
- Power point presentations on types of shares and share capital
- Group Discussions on problems relating to topics covered by syllabus

MODEL QUESTION PAPER (401BCO21)

B. Com.(General / Comp. Appl.s) Degree Examination

Second Year – Fourth Semester

Part – II : Commerce

Paper – IV : CORPORATE ACCOUNTING

Time : Three hours **Maximum Marks : 70**

Section – A

Answer any FIVE of the following questions. (5 × 4 = 20 Marks)

1) Forfeiture of shares.
   షేర్లు జప్తు.

2) Buy back of shares.
   షేర్లు బైబ్యాక్.

3) Annuity method of Goodwill.
   యాన్యూటీ పద్ధతిలో గుడ్ విల్ చెప్పండి.

4) Fair value method.
   సరసమైన విలువ పద్ధతి.

5) Companies Act, 2013.
   కంపెనీల చట్టం 2013.

6) Equity share capital.
   ఈక్విటీ వాటా మూలధనం.

7) Dividend.
   డివిడెండ్.

8) Goodwill.
   గుడ్ విల్.

Section – B

Answer the following questions. (5 x 10 = 50 Marks)

9) (a) X Ltd forfeited 100 equity shares of Rs.10 each held by Ram on 15th December, 2015 for nonpayment of first call of Rs. 2 per share and the final call of Rs. 3 per share. These shares were reissued to Mohan on 25th December 2015 at a discount of Rs.3.50per share. Pas Journal entries.

X లిమిటెడ్ యొక్క 100 ఈక్విటీ రూ. 10 మొదటి చెలించినందుకు రామ్ 15 డిసెంబర్, 2015 న రూ. 2 షేర్ మతియు చివరికేక రూ. 3 ఈ షేర్లు 25 డిసెంబర్ 2015 న రూ. 3. తగ్గింపుతో మోహన్కు మళ్ళీ జారీ చెయ్యబడ్డాయి. జర్నల్ ఎంట్రీలను పస చేయండి.

Or

(b) What are the advantages of equity share capital and preference share capital?

ఈక్విటీ షేరు క్యాపిటల్ మరియు ప్రిఫెరెన్స్ షేరు క్యాపిటల్ యొక్క ప్రయోజనాలను వ్రాయండి.

10) (a) Explain the major sources where from the debentures can be redeemed.

డిబెంచర్ల నుండి రీడీమ్ చేయగలిగే ప్రధాన వనరులను వివరించండి.

Or

(b) What is the purpose of issue of bonus shares? What are the conditions, which have to be fulfilled while making such as issue.

బోనస్ షేర్లు జారీ ప్రయోజనం ఏమిటి? ఏ షరతులు నెరవేర్చాలి? అటువంటి సమస్యలను చేస్తున్నప్పుడు పూర్తి చేయవలెను?

11) (a) RG and Mk are the partners in the firm their capitals are 3,00,000 and 2,00,000. During the year ended 31st March, 2010 the firm earned a profit of 1,50,000. Assuming that the normal rate of return 20%, calculate the value of goodwill of the firm.

(i) By capitalization method

(ii) By super profit method if the goodwill value at 2 years purchase of super profit.

RG మరియు MK సంస్థలో భాగస్వాములు వారి పెట్టుబడులు 3,00,000 మరియు 2,00,000. మార్చ్ 31, 2010 తో ముగిసిన సంవత్సరంలో సంస్థ 1,50,000 లాభాన్ని ఆర్జించింది. సాధారణ రేటు అని ఊహిస్తే రాబడి 20% సంస్థ యొక్క గుడ్ విల్ విలువలను లెక్కించండి.

(i) క్యాపిటలైజేషన్ పద్ధతి ద్వారా

(ii) సూపర్ ప్రాఫిట్ పద్ధతి ద్వారా గుడ్ విల్ విలువను 2 సంవత్సరాల సూపర్ ప్రాఫిట్ కొనుగోలుతో అంచనా

వేయాలి.

Or

(b) Define goodwill. When may the need for evaluating goodwill arise in the case of joint stock company?

సద్భావనను నిర్వచించండి. ఉమ్మడి స్టాక్ విషయంలో గుడ్ విల్ మూల్యకంనం చేయాల్సిన అవసరం ఎప్పుడు కంపెనీకి ఏర్పడవచ్చును.

12) (a) Explain the need for valuation and method of valuation.

వాల్యుయేషన్ అవసరం మరియు వాల్యుయేషన్ పద్ధతులను వివరించండి.

Or

(b) From the following balance sheet of Sweetek Ltd, you are asked to ascertain the value of each equity share of the company.

Liabilities	Amount Rs.	Assets	Amount Rs.
20,000 equity shares Rs. 10 each fully paid	2,00,000	Goodwill	30,000
1000, 6% preference shares of Rs. 100 each fully paid	1,00,000	Land and Building	1,00,000
Reserves	60,000	Plant and machinery	1,20,000
Sundry Creditors	40,000	Investment	60,000
Provision for taken	20,000	Stock	50,000
Other liabilities	10,000	Debtors	40,000
		Cash at bank	24,000
		Preliminary expenses	6,000
	4,30,000		4,30,000

For the purpose of valuing the share of the company the assets were revalued as goodwill Rs. 50,000 land and building at cost plus 50% plant and machinery Rs. 1,00,000. Investment at book values, stock Rs. 80,000 and debtors at book value less 100%.

స్వీటెక్స్ లిమిటెడ్ యొక్క క్రింది బాలన్స్ షీట్ నుండి కంపెనీ యొక్క ప్రతి ఈక్విటీ షేర్ విలువను నిర్ధారించవలసినదిగా మిమ్మల్ని అడుగుతున్నాను.

అప్పులు	మొత్తం రూ.	ఆస్తులు	మొత్తం రూ.
20,000 ఈక్విటీ షేర్లు ఒక్కొక్కటి రూ. 10 చొప్పున	2,00,000	గుడ్ విల్	30,000
1000, 6% ప్రాధాన్యత షేర్లు రూ. 100 పూర్తిగా చెల్లిచబడ్డాయి	1,00,000	భూమి మరియు భవనం	1,00,000
నిల్వలు	60,000	ప్లాంటు మరియు యంత్రం	1,20,000
సాండ్రీ క్రెడిటర్స్	40,000	పెట్టుబడి	60,000
ప్రావిజన్ టాక్స్ కోసం	20,000	స్టాక్ సరుకు	50,000
ఇతర బాధ్యతలు	10,000	ఋణగ్రస్తులు	40,000
		బ్యాంకులో నగదు	24,000
		ముందస్తు ఖర్చులు	6,000
	4,30,000		4,30,000

కంపెనీ షేర్లలోని విలువ కోసం ఆస్తులను గుడ్ విల్ రూ. 50,000 భూమి మరియు భవనం ఖర్చుతో పాటు 50% ప్లాంట్ మరియు మిషనరీ రూ. 1,00,000 బుక్ వాల్యూలో పెట్టుబడిగా రీవాల్యూయేట్ చేసారు. స్టాక్ రూ. 80,000 మరియు 10% కంటే తక్కువ బుక్ వాల్యూతో ఋణగ్రస్తులు ఉన్నారు.

13) (a) What are the salient features and provisions of Companies Act, 2013?
కంపెనీల చట్టం 2013 యొక్క ముఖ్య లక్షణాలు మరియు నిబంధనలు ఏమిటి?

Or

(b) A Ltd. Company has an authorized capital of Rs. 10,00,000 dividend into 60,000 equity shares of Rs. 10 each and 4,000, 10% preference shares of Rs. 100 each out of which 50,000 equity shares and 3,000 preference share were issued and fully paid up. The profit for the year 2019 being the first year of operations amounted to Rs. 1,80,000 after income tax. The directors decided to declare a dividend of 22% on the equity share capital after.

(i) Statutory minimum requirement transfer to computer applications reserve.

(ii) Provisions of dividend on preference shares prepare profit and loss appropriation account and show liabilities side of the balance sheet.

A పరిమితి కంపెనీ రూ. 10,00,000 అధీకృత మూలధనాన్ని 60,000 ఈక్విటీ షేర్లుగా విభజించి రూ. 10 మరియు 4,000, 210% ప్రాధాన్యత షేర్లు రూ. 100 ఒక్కొక్కటి 50,000 ఈక్విటీ షేర్ మరియు 3,000 ప్రాధాన్యత షేర్ జారీ చేయబడ్డాయి మరియు పూర్తిగా చెల్లించబడ్డాయి. 2019 తో మొదటి సంవత్సరం ఆపరేషన్లో లాభం పన్ను తర్వాత రూ. 1,80,000 తర్వాత ఈక్విటీ షేర్ కాపిటల్ పై 22% డివిడెండ్ ప్రకటించాలని డైరెక్టర్లు నిర్ణయించారు.

(i) కంప్యూటర్ ఆప్లికేషన్స్ రీజర్వుకు కనీస సంఖ్య అవసరత బదిలీ చట్టబద్ధంగా చేయాలి

(ii) ప్రాధాన్యత షేర్లపై డివిడెండ్ అందించటం లాభం మరియు నష్టం కేటాయింపు ఖాతాను సిద్ధం చేయండి మరియు బాలన్స్ షీట్ యొక్క బాధ్యతలను చూపండి.

CONTENTS

Lesson - 1

SHARE CAPITAL ISSUE

OBJECTIVES:

After going through this lesson the student can know what is share capital ? How is its division ? and how the joint stock companies issue shares to public and their accounting treatment.

STRUCTURE:

1.1 INTRODUCTION:

The sum total of the nominal value of shares of a company is called as its share capital. The capital of the company can be divided into different units with definite value called shares. Holders of these shares are called shareholders or members of the company.

1.2 TYPES OF SHARES :

There are two types of shares which a company may issue i.e.

1. Preference shares, 2. Equity shares.

1.2.1 Preference shares :

Shares which enjoy the preferential rights as to dividend and repayment of capital in the event of winding up of the company over the equity shares are called preference shares. The holder of preference shares will get a fixed rate of dividend, preference shares may be :

a) **Cumulative Preference shares :** If the company does not earn adequate profit in any year, dividends on preference shares may not be paid for that year. But if the preference shares are cumulative such unpaid dividends are treated as arrears and can be carried forward to subsequent years. Such unpaid dividends on these shares go on accumulating and become payable out of the profits of the company, in subsequent years. Only after such arrears have been paid off, any dividend can be paid to the holder of equity shares.

b) **Non - Cumulative Preference shares :** The holders of non - Cumulative preference shares no doubt will get a preferential right in getting a fixed dividend before it is distributed to equity shareholders and as regards payment of capital is concerned. The fixed dividend is to be paid only out of the divisible profits. But if in any particular year there is no profit as to distribute it cannot be carry forward.

c) **Redeemable Preference shares :** Capital raised by issuing shares is not to be repaid to the shareholders but capital raised through the issue of redeemable preference shares is to be paid back by the company to such shareholders after the expiry of a stipulated period.

d) **Participating or Non Participating Perference Shares :** The preference shares which are entitled to a share in the surplus profit of the company in addition to the fixed rate of preference dividend are known as participating preference shares. Thus participating preference shareholders obtain return on their capital in two forms. 1)fixed dividend 2) share in excess of profits: Those preference shares which donot carry the right of shares in excess profits are known as non-participating preference shares.

1.2.2 Equity shares :

Equity shares will get dividend and repayment of capital after meeting the claims of preference shareholders. There will be no fixed rate of dividend to be paid to the equity share holders and this rate may vary from year to year. This rate of dividend is determined by directors. In case of large profits, it may evern be more than the rate attached to preference shares and such shareholders may go without any dividend if no profit is made.

1.3 DIVISION OF SHARE CAPITAL :

The main divisions of share capital are as follows :-

1. Nominal or Registered or Authorised Capital :

The amount of capital with which the company intends to be registered is called registered capital. It is the maximum amount which the company is authorised to raise by way of public subscription. There is no legal limit on the extent of the amount of authorised capital.

2. Issued Capital :

That part of the authorised capital which is offered to the public for subscription is called issued capital.

3. Subscribed capital :

That part of the issued capital for which applications are received from the public is called the subscribed capital.

4. Called up capital :

The amount on the shares which is actually demanded by the company to be paid is known as called up capital.

5. Paid up capital :

The part of the called up capital which is offered and is actually paid by the members is known as paid up capital. The sum which is still to be paid is known as calls in arrears.

6. Reserve capital :

A company may determine by a special resolution that any portion of its share capital which has not been already called up shall not be capable of being called up except in the event of winding up of the company. Such type of share capital is known as reserve capital. A note regarding reserve capital is shown in the Balance sheet.

Terms of issue of shares :

The terms on which shares are to be issued by the company are given in the prospectus. The issue price of the shares can be received in one instalment or it can be spread over different instalments. The amount when received in different instalments may be paid on application, allotment or in different calls. The amount which is received on application is called the application money, the amount which becomes due on allotment is called allotment money. Rest of the amount may be called in different calls according to the requirements and needs of the company.

1.4 SHARES ISSUED FOR CONSIDERATION OTHER THAN CASH ACCOUNTING ENTRIES :

Shares may be issued by a joint stock company for two different considerations -

1. For consideration other than cash.

2. For cash.

A company may purchase a running business and pay to the vendors the purchase consideration in the form of shares. The accounting entries will be as follows -

1. Sundry Assets Account Dr

(Dr. each Asset individually)

To Sundry Liabilities

(Cr. each liability individually)

To Vendor's Account

(Being Purchase of assets and liabilities as per agreement dated.....)

2. Vendors Account Dr

To share capital Account

(Being payment to the vendors)

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

Assets Account Dr

To share capital Account

(Being .... Shares allotted in consideration of purchase of an asset for the company)

Illustration 1 :

A company purchased a running business from m/s P.K.R Brothers for a sum of Rs. 3,00,000 payable as to Rs. 2,40,000 in fully paid shares of Rs. 10 each and balance in cash. The assets and liabilities consisted of the following :

	Rs.
Plant and Machinery	80,000
Buildings	80,000
Sundry Debtors	60,000
Stock	80,000
Cash	60,000
Sundry Creditors	40,000

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

Solution :

			Dr.	Cr
Plant and Machinery	A/c	Dr	80,000	
Buildings	A/c	Dr	80,000	
Sundry Debtors	A/c	Dr	60,000	
Stock	A/c	Dr	80,000	
Cash	A/c	Dr	60,000	
	To Sundry Creditors			40,000
	To P.K. R. Brothers			3,00,000
	To Capital Reserve			20,000
(Being assets and liabilities taken over)				
M/s P.K. R. Brothers A/C		Dr	3,00,000	
To Share Capital				2,40,000
To Bank				60,000
(Being payment to M/s P.K.R. Brothers)				

1.5 SHARES ISSUED FOR CASH - ACCOUNTING ENTRIES :

Companies generally issue shares for cash. The procedure involved is as follows :

1. On receipt of application money

 Bank Accont Dr

  To Share Application A/C

 (Being application money received)

2. On allotment of shares all application money on allotted shares is transferred to share capital account by passing the following entry :

 Share Application Account Dr

  To Share capital Account

 (Being the application money transferred to share capital Account)

3. To those applicants who could not be allotted any share their application money will be returned. For this the following entry will be passed :

   Share Application Account Dr

   To Bank Account

   (Being the application money of shares not allotted returned)

4. On the allotment of share's, the allotment money becomes due to the company, for this the company will pass the following entry :

   Share Allotment Account Dr

   To Share capital account

   (Being the allotment money due on ....shares)

5. On receipt of allotment money, the entry is :

   Bank A/c Dr

   To Share allotment A/C

   (Being the receipt of allotment money)

6. On making the first call due from shareholders the entry is :

   Share first call Account Dr

   To Share capital account

   (Being the first call money, due on .... Shares)

7. On receipt of the first call money the entry is :

   Bank Account Dr

   To Share first call Account

   (Being share first call money .... shares received)

   Similar entries will be passed for second and third calls.

Illustration 2 :

On Ist January 2008, a company offers 16,000 shares of Rs. 10 each. Applications are received for full. Money payble is all follows :

On Application	Rs. 3 Per share
On Allotment	Rs. 2 Per share
On 1st call	Rs. 3 Per share
On First call	Rs. 2 Per share

The shares were duly allotted, calls made and money realised, you are required to pass the necessary journal entries.

Solution :

JOURNAL

Date	**Particulars**	**Dr Amount Rs.**	**Cr Amount Rs.**
1-1-2008	Bank A/C Dr	48,000	
	To share Application A/C		48,000
	(Being Application money received on 16,000 shares @ Rs. 3. Per share)		
	Share Application A/C Dr	48,000	
	To share Capital A/C		48,000
	(Being Application money transferred to share capital account)		
	Share Allotment A/C Dr	32,000	
	To share Capital A/C		32,000
	(Being money due for allotment on 16000 shares @ Rs. 2 per share)		
	Bank A/C Dr	32,000	
	To share Allotment A/C		32,000
	(Being money received on allotment)		
	Share 1st call A/C Dr	48,000	
	To share Capital A/C		48,000
	(Being money due for 1st call on 16000 shares @ Rs. 3 per share)		
	Bank A/C Dr	48,000	
	To share 1st call		48,000
	(Being money received on 1st call)		
	Share Final Call A/C Dr	32,000	

	To share Capital A/C		32,000
	(Being money due on final call)		
	Bank A/C Dr	32,000	
	To share Final call A/C		32,000
	(Being money received on final call)		

1.6 WHEN BOTH PREFERENCE AND EQUITY SHARES ARE ISSUED :

When a company issues both preference and equity shares then it is desirable that the entries for application money, allotment money and calls money should be separately passed for each type of share capital. The word Equity or preference must be used in all the circumstances.

Illustration 3 :

A company was registered with an authorised capital consisting of 40,000 9% preference shares of Rs. 100 each, payable Rs.25 per share on application, Rs. 25 per share on allotment and Rs. 50 per share on first and final call. and 6,00,000 Equity shares of Rs. 10 each; payable Rs.2.50per share on application, Rs. 2.50 per share on allotment and Rs. 5 per share on first and final call. Applications were received for the whole of the preference and Equity shares. All the money due on the shares was paid. Make the necessary entries and the Balance sheet of the company :

Solution :

JOURNAL ENTIRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
1-1-2008	Bank A/C Dr		10,00,000	
	To pref. share Application A/C			10,00,000
	(Being pref. share application money received on 40,000 shares @ Rs. 25. Per share)			
	Bank A/C Dr		15,00,000	
	To Equity share application A/C			15,00,000
	(Being Equity share application money received on 6,00,000 shares @ Rs. 2.50 per share)			

		Pref. Share appliction A/C Dr	10,00,000	
		To pref. share Capital A/C		10,00,000
		(Being pref. share application money transferred to pre. share capital A/C)		
		Equity share application A/C Dr	15,00,000	
		To Equity share capital A/C		15,00,000
		(Being equity share applictaion money transferred to equity share capital account)		
		Pref. Share Allotment A/C Dr	10,00,000	
		To pref share Capital A/C		10,00,000
		(Being pref. share allotment money due on 20,000 shares @ Rs. 25 per share as per the resolution of the Board of Directors)		
		Equity share Allotment A/C Dr	15,00,000	
		To Equity share capital A/C.		15,00,000
		(Being Equity share allotment money due on 6,00,000 shares @ Rs. 2.50 per share as per the resolution of the Board of Director)		
		Bank A/C Dr	10,00,000	
		To pref. share Allotment A/C		10,00,000
		(Being pref. share Allotment money received on 40,000 shares @ Rs. 25 per share)		
		Bank A/C Dr	15,00,000	
		To Equity share allotment A/C		15,00,000
		(Being Equity share Allotment money received on 6,00,000 shares @ Rs. 2.50 per share)		

	Pref. Share 1st & Final call A/C Dr		20,00,000	
	To pref. share capital A/C			20,00,000
	(Being pref. share 1st & Final call money due on 40,000 shares @ Rs. 50 per share)			
	Equity share 1st & Final call A/C Dr		30,00,000	
	To Equityshare capital A/C			30,00,000
	(Being Equity share 1st & Final call money due on 6,00,000 shares @ Rs.5.per share)			
	Bank A/C Dr		20,00,000	
	To pref. share 1st & Final call			20,00,000
	(Being pref. share 1st & Final call money received on 40,000 shares @ Rs. 50 per share)			
	Bank A/C Dr		30,00,000	
	To Equity share 1st & Final call			30,00,000
	money received			

Balance Sheet .... co.

as on ....

Liabilities	Rs.	Assets	Rs.
Authorised capital :		Cash at Bank	1,00,00,000
40,000, 9% pref. shares of Rs. 100 each	40,00,000		
6,00,000 Equityshares of Rs. 10 each	60,00,000		
Issued and subscribed & Paid up capital :			
40,000, 9% pref. shares of Rs. 100 each	40,00,000		
6,00,000 Equity shares of Rs. 10 each	60,00,000		
	1,00,00,000		1,00,00,000

1.7 UNDER SUBSCRIPTION :

Sometimes a company may not receive applications for the total shares issued to the public. Then it is called under subscription.

Illustration 4 :

X ltd invited applications for 1,00,000 shares of Rs. 10 each payable as follows :

In application Rs. 3; on Allotment Rs. 4 and first and final call Rs. 3. 80,000 Applications were received from the public and all of these were accepted. All money due was received.

Pass necessary entries in the Journal of company. Also show how these transactions would appear in Balance sheet of the company.

Solution :

JOURNAL ENTRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
	Bank A/C Dr		2,40,000	
	To pref. share Application A/C			2,40,000
	(Being application money on 80,000 shares @ Rs. 3 per share received)			
	share Application A/C Dr		2,40,000	
	To share A/C			2,40,000
	(Being share application money transferred to share capital)			
	Share Allotment A/C Dr		3,20,000	
	To share Capital A/C			3,20,000
	(Being allotment money on 80,000 shares @ Rs. 4 per share due)			
	Bank A/C Dr		3,20,000	
	To share allotment A/C			3,20,000
	(Being allotment money received)			

		Share First & Final call A/C Dr		2,40,000	
		To pref. share Capital A/C			2,40,000
		(Being first & Final call amount on 80,000 shares @ Rs. 3. per share due)			
		Bank A/C Dr		2,40,000	
		To share First & Final call A/C.			2,40,000
		(Being First & Final call amount on 80,000 shares @ Rs. 3. per share received)			

Balance Sheet .... co.

As on ....

Liabilities	**Rs.**	**Assets**	**Rs.**
Authorised capital :		Cash at Bank	8,00,000
1,00,000 Equity shares of Rs. 10 each	10,00,000		
Issued capital :			
1,00,000 Equity shares of Rs. 10 each	10,00,000		
subscribed & Paid up capital :			
80,000 Equity shares of Rs. 10 each			
	8,00,000		8,00,000

1.8 OVER SUBSCRIPTION :

Sometimes a company may receive more applications than the issued capital to the public which is known as over subscription. Because of over subscription, the company may not allot all the shares for which applications have been received. Then the allotment is made on pro - rata basis. For example, if the company offered 20,000 shares but applications for 40,000 shares were received by the company. The directors sent letters of regret to applicants of 10,000 shares and applicants of 30,000 shares were allotted the 20,000 shares on pro-rata basis. In such a case, application money of 10,000 shares (excess received) will be adjusted either on allotment and on calls.

Illustration 5 :

A company issued Rs. 10,00,000 capital divided into Rs. 10 per share, payable as under:

On Application Re. 1 per share; on allotment Rs. 4 per share and on Final call Rs. 5 per share.

Over payments on application were to be applied towards sums due on allotment. Where no allotment was made, application money was to be returned in full. The issue was over subscribed. Applicants for 1,20,000 shares were allotted 1,00,000 shares and applicants for 30,000 shares were sent letters of regret. All money due on allotment and final call was duly received. Make the necessary entries in company's books.

Solution :

JOURNAL ENTRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
	Bank A/C Dr		1,50,000	
	To share Application A/C			1,50,000
	(Being Application money on 1,50,000 shares received)			
	Share Application A/C Dr		1,00,000	
	To share captial A/C			1,00,000
	(Being share application money on 1,00,000 shares transferred to share capital account.)			
	Share Application A/C Dr		30,000	
	To Bank Account			30,000
	(Being regreted Application money on 30,000 shares returned)			
	Share Allotment A/C Dr		4,00,000	
	To share capital A/C			4,00,000
	(Being Allotment money due)			

		Bank Account Dr Share Application A/C Dr		3,80,000 20,000	
		To share Allotment A/C			4,00,000
		(Being Allotment money received and excess amount in Application Account adjusted)			
		Share First & Final call A/C Dr		5,00,000	
		To share capital A/C.			5,00,000
		(Being share First & Final call due)			
		Bank A/C Dr		5,00,000	
		To share First & Final call A/C.			5,00,000
		(Being share First & Final call received)			

1.9 ISSUE OF SHARES AT PREMIUM :

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

Section 78 of the companies Act, 1956 gives the purposes for which securities premium account may be applied by the company.

These are :

1. For the issue of fully paid bonus shares to the members of the company;
2. For writing off priliminary expenses of the company.
3. For writing off the expenses of , or the commission paid or discount allowed, on any issue of shares or debentures of the company; and
4. For providing premium payable on the redemption of any redeemable preference shares or debentures of the company.

Journal Entries :

a. If the premium is paid with application money, the following entries will be passed :

1. Bank Account Dr

To share Application A/C.

(Being share application money along with premium received)

2. Share Application Account Dr

To share capital A/C

To securities premium A/C.

(Share application money transferred to share capital A/C and securities premium A/C)

b. If the securities premium is received along with the allotment money, then the following entries will be passed :

1. Share Allotment Account Dr

To share capital A/C

To Securities premium A/C

(Being the allotment money and securities premium money due on .... shares)

2. Bank Account Dr

To Share Allotment Account.

(Being the receipt of allotment along with share premium account)

Illustration 6 :

A company offers 20,000 of 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)

Applications are received for 30,000 shares. No allotment is made to applicants for 6,000 shares and their application money is refunded. Rest are allotted shares on a pro rata basis. All allotees pay the money due on shares as and when called up.

Pass the necessary journal entries and show how the items will appear in the company's balance sheet.

Solution :

JOURNAL ENTRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
	Bank A/C Dr		90,000	
	To share Application A/C			90,000
	(Being the application money received on 30,000 shares @ Rs. 3 per share)			
	Share Application A/C Dr		90,000	
	To share capital A/C			60,000
	To Bank A/C			18,000
	To Share Allotment A/C			12,000
	(Being application money transferred to share capital on 20,000 shares application money on 6,000 shares refunded and rest transferred to allotment)			
	Share Allotment A/C Dr		80,000	
	To share Capital A/C			60,000
	To Share premium A/C			20,000
	(Being money due on allotment on 20,000 shares @ Rs 4 per share including Re. 1. as share premium)			
	Bank Account Dr		68,000	
	To share allotment A/C			68,000
	(Being money received on allotment)			

	Share First & Final call A/C Dr		1,00,000	
	To share Capital A/C			80,000
	To share premium A/C			20,000
	(Being money due on call @ Rs. 5. per share)			
	Bank A/C Dr		1,00,000	
	To share first & Final call			1,00,000
	(Being money received on call)			

.... co Ltd.

Balance Sheet as on ....

Liabilities	Rs	Assets	Rs.
Share capital :		Current Assets :	
Authorised ...... shares of Rs. each	--------	Bank balance	2,40,000
Issued and subscribed capital :			
20,000 shares of Rs. 10 each fully paid	2,00,000		
Reserves and surplus :			
share premium	40,000		
	2,40,000		2,40,000

1.10 ISSUE OF SHARES AT DISCOUNT :

According to section 79 of the companies Act a company can issue shares at a discount i.e; Value less than the face value subject to the following conditions :

1. The issue of shares at a discount is authorised by a resolution passed by the company in general meeting and sanctioned by the central government.
2. The resolution must specify the maximum rate of discount which should not exceed 10 per cent of the nominal value of shares or such higher percentage as the central government may permit.
3. One year must have been elapsed since the date at which the company was allowed to commence business.

4. Issue must take place within two months after the date of the sanction by the court or within such extended time as the court may allow.

5. Every prospectus relating to the issue of shares and every balance sheet after the issue of shares contain particulars of the discount allowed and so much of the discount as has not been written off.

The following journal entry is passed on the issue of the shares at a discount at the time of allotment:

Share Allotment Account Dr

Discount on the issue of

shares Account Dr

To share capital Account

Discount on the issue of shares will be shown under miscellaneous head on the assets side of the balance sheet till it is completely written off from the profit and loss Account. Generally such discount is spread over some period say five years and the amount written off each year is debited to profit and loss account and the amount not yet written off is shown on the assets side of the Balance sheet.

Illustration 7 :

Z Ltd. invited applications for 2,00,000 shares of Rs. 10 each at a discount of 6% payable as follows :

On Application Rs. 2.50, on Allotment Rs. 3.40 and on First and Final call Rs. 3.50.

The applications received were for 1,80,000 shares and all of these were accepted. All money due was received.

Pass necessary entries in the Journal of company. Also show how these transactions would appear in Balance sheet of the company.

Solution :

JOURNAL ENTRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
	Bank A/C Dr		4,50,000	
	To share Application A/C			4,50,000
	(Being share Application money on 1,80,000 shares @ Rs. 2.50 per share received)			

		Share Application A/C Dr		4,50,000	
		To share capital A/C			4,50,000
		(Being share Application money on 1,80,000 shares @ Rs. 2.50 per share transferred to share capital)			
		Share allotment A/C Dr		6,12,000	
		Discount on issue of shares A/C Dr		108,000	
		To share capital A/C			7,20,000
		(Being share Allotment money due on 1,80,000 sahre @ Rs. 3.40 per share and discount @ Re. 0.60 per share)			
		Bank A/C Dr		6,12,000	
		To share Allotment A/C			6,12,000
		(Being share Allotment money received on 1,80,000 shares @ Rs. 3.40 Per share)			
		Share First & Final call A/C Dr		6,30,000	
		To share Capital A/C			6,30,000
		(Being share First & Final call money due on 1,80,000 shares @ Rs. 3.50 per share as per the resolution of the Board of Directors)			
		Bank A/C Dr		6,30,000	
		To share First & Final call A/C.			6,30,000
		(Being share First & Final call money received on 1,80,000 shares @ Rs. 3.50 per share)			

Balance sheet of Z Ltd. Co., as on ....

Liabilities	Rs.	Assets	Rs.
Issued capital :		Cash at Bank	16,92,000
2,00,000 shares @ Rs. 10 per share	20,00,000	Discount on issue	
subscribed & Paid up capital :		of shares	1,08,000
1,80,000 shares @ Rs. 10 per share	18,00,000		
	18,00,000		18,00,000

1.11 CALLS IN ARREARS AND CALLS IN ADVANCE :

If any amount has been called by the company either as allotment or call money and a shareholder has not paid that money, this is known as calls in arrears. On such arrears, the company can charge interest @ 5 % if there is a provision in the Articles of Association for the period for which such amount remained in arrear from the shareholders.

Similarly, if any call has been made, while paying that call, some shareholder, has paid the amount of the rest of calls also, then such amount will be called as calls in advance and will be credited to a separate account known as calls in advance account by passing the following entry.

Bank Account Dr

To callls in Advance A/C.

Calls in Advance Account is shown on the liabilities side of the Balance sheet separately from the paid up capital, generally interest is paid on such calls according to the provisions of the Articles of Association but such rate should not exceed 6% per annum.

Illustration 8 :

On 1 st March, 2008 sony Ltd. , makes an issue of 40,000 equity shares of Rs. 10 each payable as follows :

On application Rs. 2. on allotment Rs. 3. and on first and final call Rs. 6. (Three months after allotment)

Applications were received for 52,000 shares and Directors made allotment in full to the applicants demanding ten or more shares and returned money to the applicants for 12,000 shares. One shareholder who was allotted 80 shares paid first and final call with allotment money and another share holder allotted 120 shares did not pay allotment money on his shares, but which he paid with the first and final call. Directors have decided to charge and allow interest, as the case may be, on calls in arrears and calls in advance respectively according to the provisions of Table A. Give the necessary journal entries in the books of the company.

Solution :

JOURNAL ENTRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
2008 March 1	Bank Account Dr		1,04,000	
	To share Application Account			1,04,000
	(For Application money received on 52,000 shares @ Rs. 2 Per share)			
2008 March 1	Share Application A/C Dr		1,04,000	
	To share capital A/C			80,000
	To Bank A/C			24,000
	(For application money of 40,000 shares transferred to share capital account and application money of 12,000 shares refunded)			
2008 March 1	Share allotment A/C Dr		1,20,000	
	To shares capital A/C			80,000
	To securities premium A/C			40,000
	(For allotment money and securities premium due on 40,000 shares @ Rs.2. and Re.1. per share respectively as per resolution of the Board of Directors dated........)			
2008 March 1	Bank Account Dr		1,20,120	
	To share Allotment A/C			1,19,640
	To calls in Advance Account			480
	(For the receipt of allotment money @ Rs. 3 on 39,880 shares and advance call money on 80 shares @ Rs. 6. each)			

2008 June 1	Share First & Final call A/C Dr		2,40,000	
	To share Capital A/C			2,40,000
	(For the amount due in respect of first and final call on 40,000 shares @ Rs.6 per share)			
	Bank Account Dr		2,39,880	
	To share First & Final call A/C.			2,39,520
	To share Allotment Account			360
	(For the amount received on account of first and final call on 39,880 shares @ Rs. 6 and calls in arrears of allotment)			
	Calls in Advance A/C Dr		480	
	To share First & Final call A/C.			480
	(Adjustment of calls in advance against the first and final call)			
	Interest on calls in advance A/C Dr		7.20	
	To Bank			7.20
	(Interest Paid on calls in advance on Rs. 480 for 3 months @ 6% p.a.)			
	Bank Account Dr		4.50	
	To Interest on calls in Arrears A/C			4.50
	(Receipt of interest on calls in arrears on Rs. 360 for 3 months @ 5 % p.a.)			

1.12 SUMMARY :

The capital of the company is divided into different units with definite value called shares. Holders of these shares are called shareholders. There are two types of shares. 1. Preferential shares ; 2. Equity shares. The terms on which shares are to be issued by the company are given in the prospectus. Joint stock companies may issue shares for two different considerations. 1.For consideration other than cash.; 2. For cash shares may be over subscribed or undersubscribed. A company may issue shares at a premium ; i.e. at a value greater than its face value. Similarly a company can issue shares at a discount i.e, value less than the face value.

.1.13 MODEL QUESTIONS :

1. Give the main divisions of share capital of a company.
2. What is a share ? Discuss the types of shares which a company can issue.
3. What do you understand by issue of shares at par, at a premium and at discount?
4. Distinguish between calls in advance and calls in arrears.
5. Give the journal entries for issue of shares from application money to final call.

1.14 EXERCISES :

1. Vimal co. Ltd. issued 80,000 shares of Rs. 10 each at a premium of Rs. 2. Payable as follows :

   On application Rs. 2

   On allotment Rs. 5 (Including premium)

   On 1st Call Rs. 2 and

   On final Call Rs. 3

Applications were received for 60,000 shares and allotment was made in full.

The first call was made and the amount due there on was received

2. A & Co. Ltd. invited applications for 10,000 shares of Rs. 100 each at a discount of 5% payable as follows :

   On application Rs. 25

   On allotment Rs. 34 and

   On first and final Call Rs. 36 (on call).

   The applications received were for 9,000 shares and all these applications were accepted All the money due were received.

3. A company issued 30,000 fully paid up shares of Rs. 100 each for purchase of following assets and liabilities from mohan brothers.

	Rs.
Land and Buildings	12,00,000
Plant	7,00,000
Stock in trade	9,00,000
Sundry Creditors	2,00,000

   You are required to pass the necessary journal entries

4. A company was registered with a share capital of Rs 1,00,000 divided into 5000 6 percent preference shares of Rs. 10 each. Out of these shares 1,000 preference shares and 1,000 equity shares were issued as fully paid to the vendors for purchase of property. The balance of the shares were offered to the public for subscription. The money was payable as follows on both the classes of shares :

   Rs. 3 on Application

   Rs. 2 on Allotment

   Rs. 3 on First call

   Rs. 2 on second and final call

   Applications were received for 6,000 equity shares and 5,000 preference shares. Allotment was made on prorata basis. All the calls were made and the amount due received. Pass necessary journal entries to record the above transcations.

5. Z Ltd. offered for public subscription Rs. 10, 000/- equity shares of Rs. 10/- each at a premium of Rs. 2. per share payable as follows -

   On application Rs. 2. per share

   On allotment Rs. 5 (Including premium)

   On first Call Rs. 3 and

   On final call Rs. 2

   Applications were received for 12,000 shares. All the applications were considered the excess application money is adjusted for allotment. Mr. Y to whom 500 shares were allotted fail to pay final call money.

   Prepare cash book, share capital account and balance sheet of the company.

6. A limited company issued a prospectus inviting applications for 2,000 shares of Rs.10 each at a premuim of Rs. 2 per share payable as follows :

   On Application Rs. 2

   On Allotment Rs. 5 (including premuim)

   On First call Rs. 3

   On second and final call Rs. 2

   Applications were received for 3,000 shares and allotments made pro-rata to the applicants for 2,400 shares, the remaining applications being refused. Money overpaid on applications was employed on account of sums due on allotment. All the calls were made and the amount due was received. Pass necessary journal entries to record the above transcations.

7. A company was registered with a share capital of Rs. 1,00,000 divided into 10,000 shares of Rs. 10 each. Out of these shares 2,000 shares of Rs. 10 each were issued, at a premium of Rs. 2 per share, fully paid to the vendors as consideration for purchase of Buildings, plant and machinery.

   5,000 shares were offered to the public for subscription at Rs. 12 per share. The money was payable as follows :

   On Application Rs. 3 per share

   On Allotment Rs. 4 per share (including premuim)

   On First call Rs. 2 per share (3 months after allotment)

   On Final call Rs. 3 per share (3 months after first call)

   Application were received for 8,000 shares. No allotment was made to applicants for 2,000 shares. Rest were allotted shares on a pro - rata basis. All calls were duly made and received.

   The company adopts Table A as its articles. You are required to pass the journal entries and prepare the company balance sheet.

   (Hint : Allow 6 percent p.a. as int0erest on call in advance and charge 5 percent interest on call on arrears)

8. A limited company issued a prospectus inviting applications for 2,000 shares of Rs.10 each at a premuim of Rs. 2 per share payable as follows :

   On Application Rs. 2

   On Allotment Rs. 5 (including premuim)

   On First call Rs. 3

   On Final call Rs. 2

   Applications were recived for 3,000 shares and allotment made pro-rata to the applicants of 2,400 shares. Money overpaid on applications was employed on account of sums due on allotment.

   Rajesh to whom 40 shares were allotted failed to pay allotment money. Manoj the holder of 60 shares failed to pay the two calls.

   Show Journal and cash book entries.

9. A limited company issued a prospectus inviting applications for 2,000 shares of Rs.10 each at a premuim of Rs. 2 per share payable as follows :

   On Application Rs. 2

   On Allotment Rs. 5 (including premuim)

   On First call Rs. 3 and On second call Rs. 2

Applications were received for 3,000 shares allotments made pro-rata to the applicants for 2,400 shares, the remaining applications being refused. Money overpaid on applications was employed on account of sums due on allotments. All calls were made and the amount due was received. Pass neccessary journal entries to record the above transcation.

10. Super max Ltd., invited applications for 10,000 of its equity shares of Rs. 10/- each payable on application Rs. 5 /-, on allotment Rs. 3/- and on call Rs. 2/-

    Applications were received for 15000 shares. The company allotted as follows - :

For 2000 shares applications	Full
For 12000 shares applications	8000
For 1000 shares applications	Nil

    Surplus money received on application will be adjusted towards allotment. A holder of 200 shares who was alloted on prorata basis, failed to pay allotment and call money.

    Give journal entries in the Books of the company and show the Balance sheet.

11. Blue moon company limited issued 50,000 share of Rs. 10/- each payable as under Rs.2/- on application Rs. 2.50 on allotment Rs. 3 on 1st call and Rs. 2.50 on Final call.

    The public applied for 90,000 shares. The allotment was made as follows on 1st August 1985.

To the applicants of 45,000 shares	Full
To the applicants of 20,000 shares	25%
To the remaining applicants	Nil

    The First call was made on 1st November 2008 and final call on 1st February 2009. According to the terms of issue, the surplus application money would be kept by the company against the money due on allotment and against subsequent calls. One share holder to whom 5,000 shares were allotted, paid on allotment the full amount due on shares. The interest @ 5 % P.A. on calls in advance was paid on 1st Feb 2009.

    Given cash book and Journal entries in the books of the company, assuming that all money were duly received. Also prepare calls in advance account.

12. A limited company was formed with anominal capital of Rs. 6,00,000 in shares of Rs.100 each 3,000 of which were issued payable as to

    Rs.10 on application,

    Rs. 15 on allotment,

    Rs. 25 three months after allotment and the balance to be called up when necssary. All the money were received except on call by one shareholder holding 200 shares. Another shareholder holding 150 shares paid the full amount on his holding. Make the cashbook and journal entries to record these transcations. Also show how the share capital appears in the Balance sheet of the company.

13. Harini company Ltd. issued 40,000 equity shares of Rs. 10 each, payable at

    Rs.2 on application,

    Rs. 4. on allotment and

    Rs. 4. on first and final call

    All the amount payable on allotment was duly received except in one case where the share holders failed to pay the amount due on allotment on his 100 share and another shareholder paid the shares in full at allotment on his 50 shares. The company was registered with 50,000 equity shares of Rs. 10 each. Pass necessary journal entries and prepare the Balance sheet of the company

14. Yellow limited offered for subscription 3,000 12% preference shares of Rs. 100 each at a premuim of 20% on 1st January 2008. The amount was payable as follows -

    On Application Rs. 20

    On allotment Rs. 40 (including premium - due on 1st Feb)

    On First call Rs. 30 due on 1st march

    On Second call Rs. 30 due on 1st may

    All the shares were subscribed by the public and subscription list was closed on 25th January, 2008. Money due on allotment and calls payable 15 days after the due dates.. All the amounts were duly received in times except the second call on 200 shares.

    Prepare journal and cash book in the books of the company and show them in the Balance sheet.

1.15 REFERENCE BOOKS :

1. Advanced Accountancy - M. C. Shukla & T.S. Grawal

2. Advanced Accountancy - R.L. Gupta & M. Radha - Swami

3. Advanced Accountancy - S.P. Jain & K.L. Narang

4. Advanced Accountancy - Dr. S.N. Maheswari

5. Financial Accounting - S.P. Jain & K.L. Narang

6. Advanced Accounting - K.R. Pall.

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Lesson - 2

FORFEITURE OF SHARES

OBJECTIVES:

After going through this lesson the student can know what is forfeiture of share ? and How these shares are re- issued and what is the accounting treatment ?

STRUCTURE:

2.1 INTRODUCTION:

When a shareholder fails to pay calls, the company, if empowered by its articles, may forfeit the shares. If a shareholder has not paid any call on the day fixed for payment there of and fails to pay it even after his attention is drawn to it by the secretary by registered notice, the Board of Directors pass a resolution to the effect that such shares be forfeited. Shares once forfeited become the property of the company and may be sold on such terms as directors think fit, upon forfeiture, the original shareholder ceases to be a member and his name must be removed from the register of members.

2.2 JOURNAL ENTRIES :

The following entry is passed at the time of forfeiture of shares.

Share capital Account Dr (with called amount)

To unpaid calls A/C (The amount not paid)

To Discount on issue of shares

To share forfeited A/C (with the amount already received)

On forfeiture, share capital account has been debited as it reduces the share capital and calls due but not received will be credited in order to cancel their debit balance standing in the books. Discount on the issue of shares will be cancelled like share capital on forfeiture of shares.

Premium received on the original issue of shares cannot be cancelled on the forfeiture of shares as once the premium is received it cannot be cancelled. But if securities premium is not received on the issue of shares, then it will be cancelled by debiting the securities premium account with the forfeiture entry.

Shares forfeited account balance will be shown on the liabilities side of the Balance sheet till all shares are reissued.

Illustration 1 :

A limited company has an authorised capital of Rs. 5,00,000 in Rs. 10 shares of these 8,000 shares were issued as fully paid in payment of building purchased and 16,000 shares were subscribed for by the public, and during the first year Rs. 5 per share was called payable Rs.2 on application, Rs. 1 on allotment Re.1 on first call and Re. 1 on second call. The amounts received in respect of these shares were as follows :

On 12,000 shares the full amount called

On 2,500 shares Rs. 4 per share

On 1,000 shares Rs. 3 per share

On 500 shares Rs. 2 per share

The Directors forfeited the shares on which less than Rs. 4 had been paid.

You are required to show journal entries in the books of the company, and to set out the capital as it should appear in the company's Balance sheet at the end of the first year.

Solution :

JOURNAL ENTRIES

Date	**Particulars**	**L.f**	**Dr Amount Rs.**	**Cr Amount Rs.**
	Buliding Account Dr		80,000	
	To share capital A/C			80,000
	(Being issue of 8,000 fully paid shares of Rs. 10 each for the purchase of building)			

		Bank Account Dr		32,000	
		To share Application A/C			32,000
		(Being application money transferred to share captial account on allotment of shares)			
		Share Application Account Dr		32,000	
		To share Capital A/C			32,000
		(Being application money transferred to share capital account on allotment of shares)			
		Share Allotment Account Dr		16,000	
		To share captial Account			16,000
		(Being allotment money due on 16,000 shares @ Re. 1)			
		Bank Account Dr		15,500	
		To share Allotment A/C.			15,500
		(Being allotment money received on 15,500 shares @ Re. 1 per share)			

2.3 SURRENDER OF SHARES :

After the allotment of shares sometimes a shareholder is not able to pay the further calls and return his shares to the company for cancellation. Such voluntary return of shares to the company by the shareholder himself is called surrender of shares. Surrender of shares has no separate accounting treatment but it will be like that of forfeiture of shares. The same entires will be passed in case of surrender of Shares.

2.4 REISSUE OF FORFEITED SHARES :

Forfeited shares may be reissued by the company directors for any amount but if such shares are issued at a discount then the amount of discount should not exceed the actual amount received on forfeited shares.

Accounting entries :

Bank A/C Dr (with the amount received)

Forfeited shares A/C Dr (with the discount allowed)

To share capital A/C (with face value)

For example, if a company forfeits 200 shares of Rs. 10 each on which Rs. 600 had been received, the company can allow a maximum discount of Rs. 600 on these shares. In case these shares are reissued for Rs. 1800 fully paid, the following journal entry will be passed.

Bank A/C	Dr	1,800
Share forfeited A/C	Dr	200
To share capital A/C		2,000

(Being reissue of shares)

The balance standing to the credit of forfeited shares Account, is a capital profit and, therefore it will be transferred to capital reserve. The journal entry will be

Share forfeited A/C Dr

To capital Reserve A/C

(Being Profit on reissue of forfeited shares transferred to capital reserve)

2.4.1 Reissue of forfeited shares originally issued at discount :

In case the forfeited shares were originally issued at discount, the maximum permissible reissue discount is, the sum received on forfeited shares and original discount.

For example, if a share of Rs. 10 was originally issued at a discount Re.1 is forfeited, and the amount received on it was Rs 2, the maximum discount on reissue of such a forfeited share can be Rs. 3 (i.e original discount Re.1 + Amount received Rs. 2) . The journal entry will be as follows in case the share is issued for Rs. 7 per share, fully paid up.

Bank A/C	Dr	7
Discount on issue of shares A/C	Dr	1
Forfeited shares A/C	Dr	2
To share capital A/C		10

2.4.2 Re-issue of forfeited shares originally issued at Premium :

It is not necessary that if the shares were originally issued at premium, their reissue after forfeiture should also be at premium or the premium should be at the same rate.

Illustration 2 :

A company forfeits 200 shares of Rs. 10 each, originally issued at a premium of Rs. 2 per share. The shareholder paid Rs. 4 per share on application but did not pay the allotment money of Rs. 4 per share (including premium) and call of Rs. 4 per share. The shares are subsequently reissued at Rs. 11 per share fully paid up.

Pass journal entries for forfeiture and re-issue of forfeited shares.

Solution :

JOURNAL ENTRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
	Share capital A/C Dr		2000	
	Share premium A/C Dr		400	
	To share Allotment A/C			800
	To share call A/C			800
	To share forfeited A/C			800
	(Being forfeiture of 200 shares on account of non-payment of allotment and call money)			
	Bank A/C Dr		2,200	
	To share capital A/C			2000
	To share premium A/C			200
	(Being reissue of forfeited shares)			
	Shares forfeited A/C Dr		800	
	To Capital Reserve A/C			800
	(Being transfer of profit on shares forfeited to capital reserve)			

2.5 PARTIAL RE-ISSUE OF FORFEITED SHARES :

When all forfeited shares are not issued i.e, only a part of such shares is issued, it is desirable to spread the amount of shares forfeited account on all such forfeited shares and of the amount relating to that part of forfeited shares which has been reissued, discount on reissue of shares should be deducted from such amount and the balance is transferred to captial reserve being capital profit. The amount relating to that part of shares forfeited account which has not been reissued should be shown on the liabilities side of Balance sheet as shares Forfeited Account.

Illustration 3 :

A company invited the public to subscribe for 20,000 Equity shares of Rs.100 each at a premium of Rs. 10 per share payable on allotment. Payments were to be made as follows :

On Application	Rs. 20
On Allotment	Rs. 40
On First call	Rs. 30
On Final call	Rs. 20

Application were received for 26,000 shares. Applications for 4,000 shares were rejected and allotment was made proportionately to the remaining applicants. Both the calls were made and all the money were received except the final call on 600 shares.

Solution :

JOURNAL

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
	Share First call Account Dr		16,000	
	To share capital A/C			16,000
	(Being the amount due on first call on 16,000 shares @ Rs. 1. Per share)			
	Bank Account Dr		14,500	
	To share first call A/C			14,500
	(Being amount received on account of first call on 14,500 shares @ Re. 1. per share)			

	Share second call Account Dr		16,000	
	To share Capital A/C			16,000
	(Being the amount due on second call on 16,000 shares @ Rs. 1 per share)			
	Bank Account Dr		12,000	
	To share second call A/C			12,000
	(Being amount received on account of second call on 12000 shares @ Re.1 per share)			
	Share capital account Dr		7,500	
	To share allotment A/C			500
	To share first call A/C			1,500
	To share second call A/C			1,500
	To share forfeited A/C			4,000
	(Being forfeiture of 1500 shares on which less than Rs. 4. had been paid)			

Capital as it will appear in the balance sheet

Capital and Liabilities		
Authorised Capital :		
50,000 shares of Rs. 10 each		5,00,000
Issued and subscribed capital :		
8,000 shares of Rs. 10 each issued as fully paid up for the purchase of building		80,000
14,500 shares of Rs. 10 each Rs.5 per share called up	72,500	
less calls in Arreas (second call on 2,500 shares @ Re. 1)	2,500	
	70,000	
Add share forfeited Account	4,000	74,000
		1,54,000

Which are forfeited after due notice. Later 400 of the forfeited shares were issued as fully paid at Rs. 85 per share. Pass journal entries.

Solution :

JOURNAL ENTRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
	Bank A/C Dr		5,20,000	
	To Equity share Application A/C			5,20,000
	(Application money received for 26,000 shares @ Rs. 20 per share)			
	Equity share application A/C Dr		5,20,000	
	To Equity share capital A/C			4,00,000
	To bank A/C			80,000
	To share allotment A/C			40,000
	(Application money of 20,000 shares transferred to share capital A/C and balance returned to applicants and used for share allotment account)			
	Equity share allotment A/C Dr		8,00,000	
	To Equity share Capital A/C			6,00,000
	To securities premium A/C			2,00,000
	(Allotment money due on 20,000 shares)			
	Bank A/C Dr		7,60,000	
	To Equity share allotment A/C			7,60,000
	(Receipt of amount due on allotment)			

	Equity share first call A/C Dr			6,00,000	
	To Equity share capital A/C				6,00,000
	(Amount of first call due)				
	Bank A/C Dr			6,00,000	
	To Equity share first call A/C				6,00,000
	(Receipt of amount due on first call)				
	Equity share second call and final call A/C	Dr		4,00,000	
	To Equity share capital A/C				4,00,000
	(Amount due on second & final call)				
	Bank A/C Dr			3,88,000	
	To Equity share second & final call A/C				3,88,000
	(Receipt of amount due on second & final call except on 600 shares)				
	Equity share capital A/C Dr			60,000	
	To Equity share second & final call A/C				12,000
	To share forfeited A/C				48,000
	(600 shares forfeited)				
	Bank A/C Dr Shares forfeited A/C Dr			34,000 6,000	
	To Equity share capital A/C				40,000
	(Reissue of 400 shares @ Rs. 85 per share)				
	Shares forfeited A/C Dr			26,000	
	To capital reserve A/C (Proportional balance relating to 400 shares out of shares forfeited A/C transferred to capital reserve)				26,000

Working Notes :

1. On 600 Forfeited shares, the total amount forfeited is Rs. 48,000

   For 400 shares the amount will be

   $$\frac{400}{600} \text{ X Rs. } 48,000 = \text{Rs. } 32,000.$$

   Out of this Rs. 6,000 is allowed as discount on the reissue of shares and the balance of Rs. 26,000 is transferred to Capital Reserve.

2. Rs. 16,000 i.e, that is the amount relating to 200 shares which are not reissued will be shown on the liabilities side of the Balance sheet as shares Forfeited A/C and added to the paid up capital.

2.6 PRO - RATA ALLOTMENT AND FORFEITURE OF SHARES :

It has already been discussed that in case of companies of repute, there is possibility of over - subscription. Some applications are rejected altogether and others are allotted on pro - rata basis. When shares allotted on pro - rata basis are forfeited, the problem arises about the amount to be forfeited. In such cases, the following procedure is adopted.

1. Calculate the total number of shares applied for on the basis of alloted shares.
2. Calculate the total amount received on application by multiplying the number of shares applied with application money.
3. Deduct the amount due on application on alloted shares and calculate balance, i.e; money received in advance and to be adjusted on allotment.
4. Calculate the amount due on allotment on such shares and deduct the amount already received as advance on application. This gives the amount in arrear on allotment and credited to share allotment account at the time of forfeiture of shares.

Illustration 4 :

A company offered for public subscription 20,000 shares of Rs. 10 each at Rs. 11 per share. Money was payable as follows :

Rs. 3 on application

Rs. 4 on allotment

Rs. 4 on first and final call.

Applications were received for 24,000 shares and the directors made pro-rata allotment.

a) an applicant for 240 shares, could not pay the allotment and call moneys.

b) a holder of 400 shares, failed to pay the call. All these shares were later on forfeited.

Out of the forfeited shares, 300 shares (the whole of A's shares being included) were issued at Rs. 9 per share.

Pass the journal entries for recording the above transactions.

Solution :

JOURNAL ENTRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
	Bank A/C Dr		72,000	
	To share Application A/C			72,000
	(Being application money received on 24,000 shares @ Rs. 3 per share)			
	Share Application A/C Dr		72,000	
	To share capital A/C			60,000
	To share Allotment A/C			12,000
	(Being transfer of application money to share capital account on 20,000 shares and the balance to allotment account)			
	Share Allotment A/C Dr		80,000	
	To share capital A/C			60,000
	To share premium A/C			20,000
	(Being money due on allotment @ Rs.4 per share on 20,000 shares including Re. 1 on account of share premium)			
	Bank A/C Dr		67,320	
	To share allotment A/C			67,320
	(Being money received on share allotment)			

		Share call A/C Dr		80,000	
		To share Capital A/C			80,000
		(Being money due on call on 20,000 shares @ Rs. 4 per share)			
		Bank A/C Dr		77,600	
		To share call A/C.			77,600
		(Being call money received on 19,400 shares)			
		Share capital A/C Dr Share premium A/C Dr		6,000 200	
		To share allotment A/C.			680
		To share first & final call A/C.			2,400
		To share forfeited A/C.			3,120
		(Being forfeiture of 600 shares)			
		Bank A/C Dr Shares forfeited A/C Dr		2,700 300	
		To share capital A/C.			3,000
		(Being reissue of 300 forfeited shares)			
		Share Forfeited A/C Dr		1,020	
		To Capital Reserve A/C.			1,020
		(Being profit on forfeiture and reissue of 150 forfeited shares transferred)			

Working Notes :

1. Calculation of amount received on allotment :

		Rs
Total money due		80,000
Less Amount not paid by an applicant for 240 shares who was allotted only 200 shares	Rs. 800	
Less Extra money paid with application 40x3	120	680
		79,320
Less Amount received with application		12,000
		67,320

2. Share premium has been debited only with Rs. 200 relating to A's shares. The premium money has not been received on these shares.

   In case of B, the premium has been received, the share premium account has not been debited with the amount of premium on these 400 shares though they have been forfeited.

3. Share forfeited account represents the money received on forfeited shares excluding share premium. This can be verified as follows :

	Rs.
A has paid @ Rs. 3 per share on an application for 240 shares	720
B has paid @ Rs. 6 per share on 400 shares	2,400
Total amount received.	3,120

4. Amount received from A on shares forfeited (200 in all which has been reissued) and B:

Amount received from A on shares forfeited (200 in all which has been reissued)	720
Amount received from B on shares forfeited (100 shares which have been reissued)	600
Total amount received on 300 shares which have been forfeited and reissued.	1320
less : loss on reissue	300
	1020

2.7 SUMMARY :

When a shareholder fails to pay calls, the company can forfeit these shares, if empowered by its articles. Shares once forfeited become the property of the company and may be sold upon forfeiture, the original shareholder ceases to be a member and his name must be removed from the register of members. Sometimes if a shareholder is not able to pay the futher calls and return his shares to the company for cancellation, it is called surrender of shares. Forfeited shares may be reissued by the company but if such shares are issued at a discount then the amount of discount should not exceed the actual amount received on forfeited shares. After reissued the balance in share forfeited is a capital profit and transferred to capital reserve account.

2.8 MODEL QUESTIONS :

1. What is meant by forfeiture of shares ?
2. Discuss the provisions of Indian companies act relating to share premium.
3. What are the conditions for reissue of shares at discount ?

2.9 EXERCISES :

1. Super max Ltd. invited applications for 20,000 of its Equity shares of Rs. 10/- each payable on application Rs. 5/- on allotment Rs.3/- and on call Rs. 2/-

   Application were received for 15000 shares. The company allotted as follows :

For 4,000 shares applications	Full
For 24,000 shares applications	8,000
For 2,000 shares applications	Nil

   Surplus money received on application will be adjusted towards allotment. A holder of 400 shares who was alloted on proratabasis, failed to pay allotment and call money.

   Give Journal entries in the Books of the company and show the Balance sheet.

2. A limited company issued a prospectus inviting applications for 4,000 shares of Rs. 10 each at a premium of Rs. 2 per share payable as follows -

   On Application Rs. 2

   On Allotment Rs. 5 (including premuim)

   On First call Rs. 3 and

   On Final call Rs. 2

   Applications were received for 6,000 shares and allotment made pro-rata to the applicants of 4,800 shares. Money overpaid on applications was employed on account of sums due on allotment.

Sunil to whom 80 shares were allotted failed to pay allotment money and on his subsequent failure to pay the first call his shares were forfeited. Sridhar the holder of 120 shares failed to pay the two calls and his shares were forfeited after the second call. Of the forfeited shares 160 shares were sold to kishore as fully paid for Rs. 9 per share, the whole of sunil's shares being included.

Show journal and cash book entries.

3. Riddhima Co. Ltd. issued 1,60,000 shares of Rs. 10 each at a premium of Rs. 2 payable as follows :

   On Application Rs. 2

   On Allotment Rs. 5 (including premuim)

   On First call Rs. 2 and

   On Final call Rs. 3

   Applications were received for 1,20,000 shares and allotment was made in full.

The first call was made and the amount due there on was received except the amount on 4,000 shares. These 4,000 shares were forfeited and reissued at Rs. 7 each. Pass journal entries and prepare Balance sheet.

4. A limited company issued a prospectus inviting applications for 6,000 shares of Rs. 10 each at premium of Rs. 2 per share payable as follows :

   On Application Rs. 2

   On Allotment Rs. 5 (including premuim)

   On First call Rs. 3 and

   On second call Rs. 2

   Applications were received for 9,000 shares and allotments made pro-rata to the applicants for 7,200 shares, the remaining applications being refused. Money overpaid on application was employed on account of sums due on allotment.

   X to whom 120 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited. Y. the holder of 180 shares failed to pay the two calls, and his shares were forfeited after the second call had been made of the shares forfeited, 240 shares were sold to Z, credited as fully paid, for Rs. 9 per share, the whole of the X's shares being included.

   Show journal and cash book entries and the Balance sheet.

5. Z & Co. Ltd. invited applications for 20,000 shares of Rs. 100 each at a discount of 5% payable as follows :

   On application Rs. 25

   On allotment Rs. 34 and

   On first & final Call Rs. 36 (on call)

   The applications received were for 18,000 shares and all these applications were accepted. All the money due were received except the first and final call on 400 shares which were forfeited. Of these 200 shares were reissued @ Rs. 90/- as fully paid. You are required to pass journal entries in the books of Z Ltd. and prepare cash book, and the Balance sheet.

6. Reddy Ltd. issued 1,00,000 equity shares of Rs. 100 each at a premium of Rs. 10 per share payable as follows :

   On Application Rs. 20

   On Allotment Rs. 40 (including premuim)

   On First call Rs. 30

   On second call Rs. 20

   A member holding 2,000 shares failed to pay II call money and in consequence the shares were forefeited. At a later data 1000 of these shares were reissued as fully paid for a consideration of Rs. 80 per share write up ledger accounts.

7. Give the journal entries for the following -

   X Ltd, forfeited 30 shares of Rs 10/- each, on which they called up Rs. 7 each, on which Mr. X had paid application and allotment money of Rs. 5 per share, in total. Out of those forfeited shares 20 shares were reissued to sagar as fully paid up for Rs. 6 share

8. Give Journal entries for the forfeiture and reissue of shares in the following cases :

   a) S Ltd. forfeited 10 shares of Rs. 10 each issued at 10 percent premium to Gopalam (Rs 9 (called up) on which he did not pay allotment (including premium) of Rs.3 and first call of Rs 2. out of these, 6 shares were reissued to Madhu as fully paid up for Rs. 8 per share. and one share to karthik as fully paid up for Rs. 12 and two share to Romeo as fully paid up for Rs. 6. at different intervals of time.

   b) On 1may 2008 the directors of limited company forfeited 400 shares of Rs. 20 each, Rs. 15 per share called up, on which Rs. 10 per share has been paid by A, the amount of the first call of Rs. 5 per share being unpaid. Ten days latter, the directors re- issued the forteited shares of B credited as Rs 15 per share paid up. For payment of Rs 10 per share.

9. On 1 April 2008, excel Ltd. offered 2,00,000 equity shares of Rs. 10 each for public subscription Rs. 4,80,000 was received along with the applications at the rate of Rs. 2 per share on 1st july 2008, the company allotted the shares proportionately among all the applicants simultaneously making an allotment call of Rs. 2 per share.

   By 10 July 2008 all share holders, except an allottee of 1000 shares had paid the balance due on allotment. These shares were forfeited on 10 september 2008 the company made another call of Rs 2 per share on 30 september 2008 and by 10 october 2008 the amounts were received.

   pass journal entries (including cash/ bank transcations) to record the above in the books of excel Ltd.

10. A ltd. Company issued 4,000 shares of Rs. 10 each at a premium of Rs. 2 per share payable as follows :

    On Application Rs. 2

    On Allotment Rs. 5 (including premuim)

    On First call Rs. 3

    On second and final call Rs. 2

    Applications were received for 6,000 shares. Applications for 1200 shares were altogether rejected and to the applicants of 4,800 shares, allotment was made prorata. Money overpaid on application was adjusted on allotment.

    Ram, to whom 160 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay first call, his shares were forfeited show journal entries.

11. A Co. ltd. offered to the public 40,000 equity shares of Rs. 100 each at a premium of Rs.10 per share. The payment was to be as follows :

    On Application Rs. 20

    On Allotment Rs. 40 (including premuim)

    On First call Rs. 25

    On second and final call Rs. 25

    Applicantions were received for 10,000 shares. Applications for 20,000 shares were rejected. Applicants for 30,000 shares were allotted 20,000 shares and remaining applications were accepted in full. The directors made both the calls. One shareholder holding 500 shares failed to pay the two calls and as a consequence his shares were forfeited. 400 of these shares were reissued as fully paid at Rs. 80 per share expenses of issue came to Rs. 10,000.

    Prepare cash book, the journal and the Balance sheet on the basis of information given above.

12. Wye Ltd. was formed with an authorised capital of 4,00,000 eqvity shares of Rs. 10 each. On 1st july 2008 2,00,000 shares were issued as fully paid to the vendors for properties purchased.

On the same day the company offered 1,60,000 shares to the public. The issue was fully subscribed. The amount on these shares was payable as follows :

On Application Rs. 2.50 per share

On Allotment Rs. 2.50 per share

On First call Rs. 2.50 per share (due on 1st September)

On second call Rs. 2.50 per share (due on 1st December)

On the shares subscribed for by the public there had been paid on 30 June 2008 the following -

On 1,20,000 shares	the full amount called
On 36,000 shares	Rs 7.50 per share
On 1000 shares	Rs 5.00 per share
On 3000 shares	Rs 2.50 per share

On 30 June 2008 the directors forfeited the shares on which less than Rs. 7.50 had been paid.The calls in arrears on 36,000 shares were collected on 31st July 2008 together with the necessary interest. The forfeited shares were reissued on the same date at price of Rs. 8 per share You are required to pass the necessary journal and cashbook entries and show how the various items will appear in the company's Balance sheet as on 31 December 2008.

2.10 REFERENCE BOOKS :

1. Advanced Accountancy - M. C. Shukla & T.S. Grawal

2. Advanced Accountancy - R.L. Gupta & M. Radha - Swami

3. Advanced Accountancy - S.P. Jain & K.L. Narang

4. Advanced Accountancy - Dr. S.N. Maheswari

5. Financial Accounting - S.P. Jain & K.L. Narang

6. Advanced Accounting - K.R. Pall.

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Chapter – 3

ISSUE AND REDEMPTION OF PREFERENCE SHARES

Objectives :

After reading this lesson you should able to :

- Know various types of preference shares
- understand the provisions of the companies act on the issue and redemption of preference shares
- study the premium on the redemption of preference shares
- go analyse capital redemption reserve account

Structure :

3.1 PREFERENCE SHARES

A preference share is a combination of the features of an ordinary share and debt. Preference shares represent that part of share capital of a company which carries preferential rights and privileges with respect to income and assets over equity stock.

Preference shares are those shares which enjoy preferential rights both with respect to dividend and with respect to repayment of capital either during the life time or on winding up of the company. They will have the first charge on the distributable amount of net profits.

3.1.1 Kinds of Shares :

The preference shares may be of the following types :

1. **Cumulative Preference Shares :** The dividend payable on these shares goes on accumulating till it is fully paid off. A cumulative preference share holder has a right to claim the fixed dividend of the current year out of future profit. Company is bound to pay dividend only if it has sufficient profits available for distribution. If dividend is not paid in

any year, it goes on accumulating. In the year of profit, the company has to pay the accumulated dividend also.

2. **Non-cumulative Preference Shares :** In the case of non-cumulative preference shares, the dividend shall be payable only out of the profits of the current year. If it is not paid in a particular year, it is lost and the arrears of dividend cannot be carried forward. In other words, the unpaid dividends cannot accumulate.

3. **Participating Preference Shares :** Participating preference shares are not only entitled to a fixed rate of dividend, but also to a share in the surplus profits which remain after the claims of the equity shareholders have been met.

4. **Non-participating Preference Shares :** Non-participating preference shares entitled to only a fixed rate of dividend. They do not share in the surplus which belongs to the equity shareholders.

5. **Convertible Preference Shares :** The holders of these shares have a right to convert them into equity shares within a certain period of time.

6. **Non-Convertible Preference Shares :** The preference shares without a right of conversion into equity shares are known as non-convertible preference shares.

7. **Redeemable Preference Shares :** These are the shares to be repayable after certain specified period by the company.

8. **Non-Redeemable Preference Shares :** Non-Redeemable preference shares constitute permanent capital of the company. These shares cannot be refunded before the winding up of the company.

As a result of amendment in the Companies Act in 1996 no company limited by shares, w.e.f. 1-3-1997, can issue preference shares which are irredeemable or which are redeemable after the expiry of twenty years from the date of issue.

3.2 REDEMPTION OF PREFERENCE SHARES :

A preference share is a combination of the features of an ordinary share and debt. Preference shares represent that part of share capital of a company which carries preferential rights and privileges with respect to income and assets over equity stock.

Preference shares are those shares which enjoy preferential rights both with respect of dividend and with respect of repayment of capital either during the life time or an winding up of the company. They will have the first charge on the distribution of net profits.

3.2.1 Companies Act Provisions :

Sec.80 and 80A of Companies Act provides for the issue and Redemption of Preference shares. The following points are to be taken into account in the redemption of preference shares.

Only fully paid preference shares can be redeemed. So, partly paid preference share cannot be redeemed. To redeem partly paid preference shares a call should be made to make them fully paid. Thereafter, such shares can be redeemed.

The purpose of the provision is to protect the security available to the creditors. In the event of liquidation, redeeming partly paid preference shares deprives the creditors that extra safety margins.

3.2.2 Redemption out of profits available for dividend or out of proceeds of a fresh issue of shares :

The following points deserve attention in the redemption of preference shares.

1. Profits available for dividend are confined to revenue profits of a company. Thus, all the capital profits are excluded for the purpose of redemption.
2. `Proceeds' of a fresh issue of shares clearly indicates that amount received from fresh issue of debentures or loans arranged or assets sold cannot be taken into account technically for the redemption of redeemable preference shares.
3. The word `proceeds' implies the amount received excluding the amount of share premium on the new issue of shares. Similarly, when the new issue is at par or at a discount, the net amount received from the issue should be deemed as proceeds.
4. The main objective of Section 80 of the Companies Act is to protect the interests of the creditors of the company. So proceeds of fresh issue serve the purpose of keeping the capital structure of the company intact. Whatever amount is paid is replaced by `proceeds of the fresh issue.'

3.3 PREMIUM ON REDEMPTION :

Premium on redemption of preference share sis a capital loss which can be provided out of Securities premium account.' If securities premium does not exist or is insufficient, other profits of the company can be used to provide for the premium on redemption.

Profits available for dividend which are used for redemption have to be transferred to `Capital Redemption Reserve'. The purpose of such transfer is `to freeze or immobilize such profits from being used for any other purpose. For example, using such profits for payment of dividend or repayment of debentures is prevented by freezing. Possible cash outflow or security erosion to the creditors to thus prevented.

The capital redemption reserve account will take the place of the Redeemable preference shares capital, after the redemption. If new issue of shares was made, the new share capital takes the place of the redeemable preference shares. Thus, Section 80 of the Companies Act ensures that the preference shares redeemed are completely replaced.

Capital Redemption reserve can be used to issue fully paid bonus shares alone and for no other purpose. Bonus shares do not involve any cash outflow immediately. Such capitalization of reserve ensures that it remains with the company permanently.

Redemption of preference shares does not affect the authorized capital. So, in the balance sheet, the authorized capital remains intact. Issue of shares in the future to the extent of the redemption carried out is permissible.

Minimum fresh issue of shares :

At the time of redemption of preference shares, some companies may decide to utilize all the permissible reserves for the redemption and make new issue to shares for any balance amount required.

3.4 CAPITAL REDEMPTION RESERVE ACCOUNT

As only those profits which are otherwise available for dividends can be used for redemption of preference shares, transfer to Capital Redemption Reserve Account should be made only from such accounts as represent divisible profits. Amounts in Securities Premium Account, Forfeited shares account, Profit prior to incorporation account and Capital Reserve account must not be transferred to Capital Redemption Reserve Account. The credit balances in profit and loss account, general reserve are the examples of the balance available for distribution of dividend and hence for transfer to capital redemption reserve account.

Illu.1 : The following balances are appearing in the ledger of Portor Limited as on 31st March, 2011.

	`
Share capital – Equity shares (fully paid up)	**6,00,000**
Share capital – Preference shares (fully paid up)	**3,00,000**
General Reserve	**2,00,000**
Profit and Loss a/c (credit balance)	**1,25,000**
Securities Premium account	**50,000**

The company decided to redeem the preference shares at a premium of 10 per cent out of its general reserve and undistributed profit. Give journal entries relating to the redemption of the preference shares.

Solution :

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
	Preference Share capital a/c	Dr.		3.00,000	
	Premium on Redemption of preference shares a/c			30,000	
	To Preference shareholders a/c				3,30,000
	(Being the amount due for redemption of preference shares at a premium of 10%)				
	Securities premium a/c	Dr.		30,000	
	To Premium on redemption of preference shares				30,000
	(Being the premium on redemption provided out of share premium a/c)				
	General Reserve a/c	Dr.		2,00,000	
	Profit and Loss a/c	Dr.		1,00,000	
	To Capital Redemption reserve a/c				3,00,000
	(Being capital redemption reserve provided out of General Reserve and Profit and Loss a/c)				
	Redeemable Preference shareholders a/c	Dr.		3,30,000	
	To Bank a/c				3,30,000
	(Being preference share capital along with the premium needed to preference shareholders)				

Illu.2 : Hanuman Company Ltd., has 1,000 12% redeemable preference shares of Rs.100 each, fully paid. The company passed a resolution on 31st March, 2011 to redeem these shares at a premium of 10%. The company has Rs.4,00,000 credit balance in its profit and loss account. On 1st April, 2011 the company made the following issues.

1. **10,000 equity shares of Rs.10 each at a premium of 10%.**
2. **1,000, 6% Debentures of Rs.100 each.**

The above two issues were subscribed and the cash was realized. The redeemable preference shares were redeemed by using the balance in profit and loss account and the amount received from the above issues. Write the necessary journal entries and showing the cash transactions.

Solution :

Journal Entries in the books of Hanuman Co. Ltd.

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
2011 Ap.1	Bank a/c	Dr.		1,10,000	
	To Equity share capital a/c				1,00,000
	To Securities premium a/c				10,000
	(Being the amount received on issue of 10,000 equity shares of Rs.10 each at a premium of 10%)				
	Bank a/c	Dr.		1,00,000	
	To 6% Debentures a/c				1,00,000
	(Being the issue of 6% Debentures at Rs.100 each)				
	Securities Premium a/c	Dr.		10,000	
	To Premium on redemption of preference shares a/c				10,000
	(Being the premium on redemption provided out of share premium a/c)				
	Profit and Loss a/c	Dr.		1,00,000	
	To Capital Redemption Reserve a/c				1,00,000
	(Being the amount transferred to capital redemption reserve a/c from profit and loss a/c of redeem the preference shares)				
	Redeemable preference share capital a/c	Dr.		1,00,000	
	Premium on redemption of preference share capital a/c	Dr.		10,000	
	To Redeemable Pref.shareholders a/c				1,10,000
	(Being the transfer of amount due on redemption of 1,000 redeemable preference shares of Rs.100 each at a premium of 10%)				
	Redeemable preference shareholders a/c	Dr.		1,10,000	
	To bank a/c				1,10,000
	(Being the redemption of 1,000 preference shares of RS.100 each at a premium of 10%)				

Bank a/c

	Rs.		Rs.
To Equity share capital a/c	1,10,000	By Redeemable preference shareholders a/c	1,10,000
To 6% Debentures a/c	1,00,000	By Balance c/d	1,00,000
	2,10,000		2,10,000

Illu.3 : A Company has 8,000 redeemable preference shares of Rs.100 each fully paid. The company decides to redeem the shares on September 30, 2004 at a premium of 7%. The company has sufficient profits but in order to augment liquid funds the following issues are made:

a) 3,000, 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.

Solution :

Journal Entries

Date	Particulars		Debit Rs.	Credit Rs.
	Redeemable preference share capital a/c Premium on redemption of preference shares a/c To Preference shareholders a/c (Being transfer of amount due to redemption)	Dr.	8,00,000 56,000	 8,56,000
	Bank a/c To 6% Debentures a/c To Premium on issue of debentures a/c (Being 6% debentures issued at Premium of Rs.6 per share)	Dr.	3,18,000	 3,00,000 18,000
	Bank a/c To Equity share capital a/c To Premium on equity shares a/c (Being the issue of equity shares at 11% premium)	Dr.	2,22,000	 2,00,000 22,000
	Premium on Equity Shares a/c To Premium on redemption of Preference shares a/c (Being premium on issue of equity shares adjusted to premium on redemption of preference shares)	Dr.	22,000	 22,000
	Profit & Loss a/c To Premium on redemption of preference share a/c (Being balance in premium on redemption of preference shares transferred to Profit & Loss a/c)	Dr.	34,000	 34,000
	Profit & Loss a/c To Capital Redemption Reserve a/c (Being the transfer of profit to capital redemption reserve)	Dr.	6,00,000	 6,00,000

Illu.4 : Exchange Ltd. has on issued share capital of 650 – 7% redeemable preference shares of Rs.100 each and 4,500 equity shares of Rs.50 each. The preference shares are redeemable at premium of 7 1/2 % on April 1, 2011. The company's Balance sheet as on 31st, March 2011 was as follows:

Liabilities	Rs.	Assets	Rs.
Share Capital:		**Fixed Assets**	**3,45,000**
Issued 650-7% Redeemable		**Investments**	**18,500**
preference share of Rs.100 each fully paid	**65,000**		
4500 equity shares of Rs.50 each fully paid	**2,25,000**	**Balance at Bank**	**31,000**
Profit and Loss account	**48,000**		
Sundry creditors	**56,500**		
	3,94,500		**3,94,500**

In order to facilitate the redemption of the Preference Shares, the company decided (a) to sell all the investments for Rs.16, 000. (b) to finance part of the redemption from company's funds subject to leaving a balance of Rs.12, 000 in the Profit and Loss account and (c) to issue sufficient equity shares of Rs.50 each at a premium of Rs.13 per share to raise the balance of funds required.

The preference shares were redeemed on the due date and the issue of equity shares was fully subscribed.

You are required to prepare:

(i) The necessary journal entries to record the above transactions (including cash); and

(ii) The Balance Sheet as on completion.

Solution :

Journal of Exchange Ltd.

Date	Particulars		Debit Rs.	Credit Rs.
	Bank a/c	Dr.	16,000	
	Profit and loss a/c	Dr.	2,500	
	To Investments a/c			18,500
	(Being the investments sold for Rs.16, 000 and loss debited to Profit and Loss Account)			

Date	Particulars		Debit Rs.	Credit Rs.
	7% Redeemable Preference share capital a/c Premium on redemption a/c To Preference shareholders a/c (Being the amount payable on redemption of 650 preference shares transferred to preference shareholders a/c)	Dr. Dr.	65,000 4,875	 69,875
	Bank a/c To Equity share application & allotment a/c (Being the application money received on 630 equity shares of Rs.50 each at a premium of Rs.13 per share)	Dr.	39,690	 39,690
	Equity Shares application and allotment a/c To Equity Share capital a/c To Premium a/c (Being the allotment of 630 equity shares of Rs.50 each at a premium of Rs.13 per share vide Board Resolution dated….)	Dr.	39,690	 31,500 8,190
	Profit and Loss a/c To Capital redemption reserve a/c (Being the amount transferred out of profits equal to nominal value of shares redeemed otherwise than out of proceeds of fresh issue)	Dr.	33,500	 33,500
	Share premium a/c To Premium on redemption a/c (Being the premium payable on redemption of preference shares charged to securities premium account)	Dr.	4,875	 4,875
	Preference shareholders a/c To Bank a/c (Being the payment made on redemption of preference shares at a premium of 7 ½ %)	Dr.	69,875	 69,875

Dr. Bank Account Cr.

	Rs.		***Rs.***
To Balance b/d	31,000	By Preference shares redemption a/c	69,875
To Investments	16,000	By Balance c/d	16,815
To Share application & allotment a/c	39,690		
	86,690		**86,690**

Profit & Loss Account

	Rs.		*Rs.*
To Investment a/c	2,500	By Balance b/d	48,000
To Capital Redemption reserve	33,500		
To Balance c/d	12,000		
	48,000		**48,000**

ABC Ltd.
Balance Sheet as on 1st April 2011

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Assets	3,45,000
Authorized…..shares of Rs…. Each		Current Assets:	
issued Subscribed and paid up:			
5,130 Equity shares of Rs.50		Cash at Bank	16,815
each fully paid	2,56,500		
Reserved and Surplus; Capital redemption reserve			
	33,500		
Share premium a/c	3,315		
Profit & Loss a/c	12,000		
Current liabilities and Provisions:			
Sundry Creditors	56,500		
	3,61,815		**3,61,815**

Working Notes:

(1) Calculation of Number of Equity shares to be issued

	Rs.	Rs.
Balance of Profit & Loss Account		48,000
Less: Loss on sale of investment	2,500	
Amount to be retained as balance	12,000	14,500
Amount available for transfer to capital redemption reserve		33,500
Nominal value of Equity shares to be issued (65,000 – 33,500)		31,500

$$\text{No of equity shares} = \frac{31,500}{50} = 630 \text{ shares}$$

Illu.5 : The following balances appear in the ledger of a company as on 31-3-2001:

	Rs.
Equity Shares (Fully paid up)	**6,00,000**
Redeemable Preference Shares (Fully Paid up)	**3,00,000**
General Reserve	**2,00,000**
Profit and Loss Account (Credit balance)	**1,25,000**
Share Premium Account	**50,000**

The company decided to redeem the preference shares at a premium of 10% out of its general reserve and undistributed profits.

Solution :

Journal Entries

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
1.	Red.Pref.Share capital a/c	Dr.		3,00,000	
	Premium on redemption of Pref.Shares a/c	Dr.		30,000	
	To Pref.shareholders a/c				3,30,000
	(Being the amount payable on redemption with premium transferred to preference shareholders a/c)				
2.	Securities Premium a/c	Dr.		30,000	
	To Premium on redemption of Preference Shares a/c				30,000
	(Being the premium on redemption adjusted against securities premium a/c)				
3.	Pref.Shareholders a/c	Dr.		3,30,000	
	To Bank a/c				3,30,000
	(Being the payment made to pref.shareholders)				
4.	General Reserve a/c	Dr.		2,00,000	
	Profit & Loss a/c	Dr.		1,00,000	
	To Capital Redemption reserve a/c				3,00,000
	(Being the amount transferred to capital redemption reserve account as per the requirement of the act)				

Illu.6 : A company has issued 1,000 fully paid up 15% redeemable preference shares of Rs.100 each. All these shares were redeemable on 1-4-2002 at 5% premium. The summarized Balance Sheet of the company on that date was as following:

Liabilities	Amount Rs.	Assets	Amount Rs.
Share Capital		**Building**	**80,000**
15% Redeemable Preference Shares	**1,00,000**	**Machinery**	**1,00,000**
Equity Shares of Rs.10 each	**1,00,000**	**Furniture**	**5,000**
Share Premium	**2,000**	**Short term investments**	**80,000**
General Reserve	**80,000**	**Stock**	**20,000**
Profit & Loss a/c	**40,000**	**Cash at Bank**	**35,000**
		Cash in Hand	**2,000**
	3,22,000		**3,22,000**

It was decided to redeem the preference shares out of profits. The investments wee sold at book value.

Write the Journal entries and prepare the Balance Sheet of the company after redemption of shares.

Solution :

Journal Entries

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
1.	15% Redeemable pref. Share capital a/c	Dr.		1,00,000	
	Premium on redemption of Preference shares a/c	Dr.		5,000	
	To Redeemable Preference Shareholders a/c				1,05,000
	(Being the amount payable on 1,000 15% preference shares at a premium of 5% transferred to preference shareholders a/c)				
2,	Bank a/c	Dr.		80,000	
	To Investment a/c				80,000
	(Being the investments sold at book value)				

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
4.	Share premium a/c	Dr.		2,000	
	Profit and Loss a/c	Dr.		3,000	
	To Premium on redemption of Preference shares a/c				5,000
	(Being the premium on redemption charged to share premium a/c and the balance to P & L a/c)				
5.	General reserve a/c	Dr.		80,000	
	Profit & Loss a/c	Dr.		20,000	
	To Capital Red. reserve a/c				1,00,000
	(Being the amount transferred to capital redemption reserve a/c as per the requirement of the Act)				

Balance Sheet as on 1-4-2002

Liabilities	Rs.	Assets	Rs.
Share Capital :			
10,000 equity shares of Rs.10 each	1,00,000	Fixed Assets :	
Reserves and Surplus		Buildings	80,000
Capital redemption reserve account	1,00,000	Machinery	1,00,000
P & L a/c (40,000 – 3,000 – 20,000)	17,000	Furniture	5,000
		Current assets	
		Stock	20,000
		Cash at Bank (35,000 + 80,000 – 1,05,000)	10,000
		Cash in hand	2,000
	2,17,000		**2,17,000**

Illu.7 : ABC Company Ltd. is having 14% 40,000 Redeemable Preference shares of Rs.100 each. The company has decided to redeem the above preference shares at 10% premium in the following way.

a. **to sell the investments, the book value of which is Rs.20,00,000 at 10% less than their book value.**
b. **To issue 3,00,000 equity shares of Rs.10 each at a premium of Rs.2 per share.**
c. **To utilise the balances of the following accounts.**
   General reserve – Rs.7,50,000
   Profit and Loss a/c – Rs.2,50,000

The above decisions are implemented and the preference shares were redeemed. Write the journal entries for the above.

Solution :

Journal Entries in the books of ABC Company Ltd.

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
(i)	Bank a/c Profit & Loss a/c To Investment a/c (Being the investments sold at 18,00,000 and loss debited to profit and Loss a/c)	Dr. Dr.		18,00,000 2,00,000	 20,00,000
(ii)	14% Red.Pref. Share capital a/c Premium on Redemption of Pref.shares a/c To Pref.shareholders a/c	Dr. Dr.		40,00,000 4,00,000	 44,00,000
(iii)	Bank a/c To Equity share application & Allotment a/c (Being the application money received on 3,00,000 equity shares of Rs.10 each at a premium of Rs.2 per share)	Dr.		36,00,000	 36,00,000
(iv)	Equity shares Application & Allotment A/c To Equity share capital a/c To Securities premium a/c (Being the allotment of 3,00,000 equity shares of Rs.10 each at a premium of Rs.2 per share)	 Dr.		 36,00,000	 30,00,000 6,00,000
(v)	Securities premium a/c To Premium on redemption Preference Shares a/c (Being the premium payable on redemption of preference shares charged to securities premium account)	Dr.		4,00,000	 4,00,000
(vi)	Red. Pre. Shareholders a/c To Bank a/c (Being shareholders paid)	Dr.		44,00,000	 44,00,000

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
(vii)	P & L a/c	Dr.		50,000	
	Securities Premium a/c	Dr.		2,00,000	
	General Reserves a/c	Dr.		7,50,000	
	To Capital Redemption Reserve a/c				
	(Being the amount transferred out of profit, securities premium and general reserve to capital redemption a/c)				10,00,000

3.5 QUESTIONS

1. What are preference shares? What are the conditions of redemption of preference shares?
2. What are the rules regarding redemption of preference shares?
3. What do you mean by Capital Redemption reserve account? How is it created? How can it be utilized?
4. Can partly paid up preference shares be redeemed?
5. State the low relating to redemption of preference shares.
6. Explain the provisions of Section 80 of the Companies Act, 1956 relating to the redemption of Preference Shares?
7. State the provisions relating to redemption of preference shares.

3.6 EXERCISES

1. The following items appear in the balance Sheet of A Ltd. as on 31st March 2003.

(a) Share Capital:

Equity: Authorised – Rs.5,00,000 shares of Rs.10 each.

Issued and subscribed Rs.4,00,000 share of Rs.10 each full paid

Preference: Authorised, issued and subscribed – 60,000, 14% shares of Rs.20 each fully paid.

(b) Investments: Rs.3,50,000

(c) Profit and Loss Account: Rs.7,00,000

It was decided to redeem the 60,000 14% preference shares at a premium of 5% of 31st March 2003. It was further decided to:

(i) Sell all investments for Rs.3,00,000

(ii) Finance part of the redemption from company funds, subject to leaving a balance of Rs.2,00,000 in the profit and loss account and

(iii) Issue sufficient number of equity shares at a premium of Rs.2 to raise the balance of funds required.

The above decisions have been carried out and the preference shares redeemed. Give Journal entries to record the above transactions.

2. What entries can be made for the following redemption made by the company?

(a) In 2001 P Ltd. redeemed Rs.1,00,000 preference shares by converting them into equity shares issued at 25% premium.
(b) In 2002 P Ltd. redeemed Rs.95,000 preference shares by converting them into equity shares issued by 5% discount.
(c) In 2003 P Ltd. redeemed 10,000 preference shares of Rs.10 each at premium of Rs.1.25 per share by converting into equity shares of Rs.10 each issued at 10% discount.

3. The following is the summarised Balance Sheet of a Company on 31-3-2001:

Liabilities	**Rs.**	**Assets**	**Rs.**
10%, 1,000 Redeemable preference shares of Rs.100 each	1,00,000	Sundry assets	8,10,000
50,000 equity shares of Rs.10 each	5,00,000	Cash at Bank	90,000
General Reserve	1,00,000		
Capital Reserve	50,000		
Creditors	1,50,000		
	9,00,000		**9,00,000**

For the purpose of redemption of Preference Shares, the company made a fresh issue of 4,500 equity shares of Rs.10 each at a premium of 10%. The preference shares were redeemed at a premium of 10%.

Show Journal entries and Prepare a Balance Sheet after the redemption of Preference Shares.

4. A company in a series of operations:

(a) Issue at par 20,000 redeemable preference shares of Rs.10 each redeemable at a premium of 50 paise per share.
(b) Redeems 10,000 of the redeemable preference shares out of profits of the company.
(c) Issues at par for cash 20,000 equity of Rs.10 each and out of the proceeds redeems the balance of the redeemable preference shares.

Journalise the transactions.

3.7 REFERENCE BOOKS :

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Chapter – 4

ISSUE OF DEBENTURES

Objectives :

After reading this lesson you should able to :

- know the meaning of debenture
- find out different kinds of debentures
- discuss the provisions relating to issue of debentures
- explain on the issue of debentures at premium and discount

Structure :

4.1 DEBENTURES - MEANING

The term debenture is derived from the Latin word **"debere"** which means "to owe a debt". A debenture may, be defined as document issued by the company as an evidence of debt. It is the acknowledgement of the company's indebtedness to its holders.

4.1.1 Features:

The following are the features of debentures.

1. Debenture-holders are entitled to periodical payment of interest at an agreed rate.
2. They are also entitled to redemption of their capital as per the agreed terms.
3. They have no voting rights.
4. Usually debentures are secured by charge on or mortgage of the assets of the company.
5. Debenture holders have the right to use the company for any unpaid dues.
6. They can enforce the security by sale in case of default.
7. They can apply for winding up of the company to safeguard their interests.

4.1.2 Kinds of Debentures:

Debentures may be classified as under:

1. **Redeemable debentures:** These debentures are to be repaid within certain specified period as per the terms of their issue.

2. **Irredeemable debentures:** These are perpetual debentures. The company has no right to make the payment of the principal of these debentures during its life time. These debentures are repaid in case of winding up of the company.

3. **Bearer debentures:** These debentures are transferable by mere delivery. The name of the holder is not registered with the company.

4. **Registered debentures:** These debentures are not transferable by mere delivery. The names of the debenture-holders are registered with the company.

5. **Naked debentures:** These debentures are not mortgaged and they are issued without any charge on company's assets. The issue of these debentures is not popular with the company.

6. **Secured or Mortgaged debentures:** These debentures are secured by a charge on company's assets. This charge may be fixed or floating

4.2 DIFFERENCE BETWEEN SHAERS AND DEBENTURES

	Point of difference	Shares	Debentures
1.	**Share capital**	A share forms part of the share capital of a company	A debenture forms part of the loan capital of a company.
2.	**Ownership**	A shareholder is the owner of a company.	A debenture-holder is the creditor of the company.
3.	**Dividend**	Dividend is payable on shares	A fixed rate of interest is payable on debentures.
4.	**Security**	No security is offered for shares	Security by way of mortgage or charge on assets of the company is offered on debentures.
5.	**Right to vote**	Shareholders have right to vote.	Debenture-holders have no voice in the management.
6.	**Re-payment**	When the company is wound up, share holder has no right of priority in the matter of re-payment of his shares.	Debenture-holder enjoys a right of priority with regards to repayments.

4.3 ISSUE OF DEBENTURES

The procedure for issuing debentures is similar to that of an issue of shares. A prospectus is issued in which the terms and conditions are given. The intending purchasers (lender) apply for the debentures on a prescribed form and the same is deposited into the company's bank together with the application money. The money may be payable in full at a time or by installments.

a. **When Debentures are issued for cash:** When the amount is payable in installment, entries will be similar to the issue of shares. And premium or discount on issues of debenture is normally, adjusted at the time of making allotment.

b. **When Debentures are issued for consideration other than cash:** when a company allots debentures to the vendor of assets in payment of purchase consideration, such issue of debentures is known as 'Issue of Debentures for consideration other than Cash'.

c. **When Debentures are issued as Collateral Security:** When debentures are issued as an additional security for a loan either from a bank or form an Insurance Company, such an issue is termed as 'Issue of Debentures as Collateral Security,' i.e., it is a secondary security given for raising loan, when the loan is repaid the debentures are cancelled. In short, until and unless the loan is repaid, that remains in the possession of the lender.

4.4 ISSUE OF DEBENTURES AT PREMIUM

Debentures can be issued at a price more than the face value of debentures. The excess of issue price over the face value of debentures is the premium The premium is the gain for the company. So it is credited to premium on issue of debentures account when the installment contained premium is made due. The installment is received including premium.

Premium on issue of debentures is a capital gain, so it is shown at the liabilities side of the Balance Sheet under the head "Reserve and Surplus". The premium can be utilised in meeting capital losses. The journal entry regarding share premium is as under.

Date	Particulars	L.F.	Debit	Credit
	Debenture allotment a/c Dr.		x x x	
	To Debentures a/c			x x x
	To Premium on Issue of Debentures a/c			x x x
	(Being allotment money on … debentures … @ Rs… including premium made etc.)			

When receiving Debenture allotment, premium on issue of debentures will neither be debited nor credited. Ordinarily premium is called up with debenture allotment. If premium is received with application, premium on issue of debentures account is credited while transferring Debenture application money to Debentures Account. In case, the premium is called up with calls, it will be credited when call is made due. The amount of debenture premium can be used for writing off fictitious assets and certain debit balances such as discount or loss or expenses on issue of shares and debentures, preliminary expenses and underwriting commission. It may also be used for forming Debenture Redemption Fund.

4.5 ISSUE OF DEBENTURES AT DISCOUNT

Discount on issue of debentures is the amount which the company receives lesser than the face value of debentures. For example, receiving Rs.90 for a debenture of Rs.100. The amount received lesser is a loss and thus debited in Discount on issue of debentures account. Discount on issue of debenture account is supposed to be on allotment, unless otherwise mentioned. There is no legal restriction on issuing debentures at discount. The following is the journal entry to be passed for the issue of debentures at a discount.

Date	Particulars	L.F.	Debit	Credit
	Debenture allotment a/c Dr.		x x x	
	Discount on Issue of Debentures a/c Dr.		x x x	
	To Debentures a/c			x x x

Discount on issue of debenture account is a fictitious asset, so it should be written off as early as possible during the life time of the debentures. Discount on issue of debentures account will be shown on the assets side of the Balance sheet, under the head “Miscellaneous Expenditure” until it is written off.

Journal Entries

A. Issue of Debentures at Par: (When Debentures are issued for cash):

I. When the entire amount is received in lump sum:

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
	Bank a/c Dr.		x x x	
	To Debentures a/c			x x x

II. If the Value of debenture is received in certain installments:

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
	On receipt of application amount:				
	Bank a/c	Dr.		x x x	
	To Debenture Application a/c				x x x
	For transfer of application amount to Debentures:				
	Debentures Application a/c	Dr.		x x x	
	To Debentures a/c				x x x
	For debenture allotment amount due:				
	Debenture Allotment a/c	Dr.		x x x	
	To Debentures a/c				x x x
	On receipt of Debenture allotment amount:				
	Bank a/c	Dr.		x x x	
	To Debenture allotment a/c				x x x
	For making debenture call due:				
	Debenture call a/c	Dr.		x x x	
	To Debentures a/c				x x x
	On receipt of call amount:				
	Bank a/c	Dr.		x x x	
	To Debenture call a/c				x x x

III. Issue of Debentures at Premium:

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
	When premium is payable with allotment money:				
	Debenture allotment a/c	Dr.		x x x	
	To Debenture a/c				x x x
	To Premium on Debentures a/c				x x x

IV. Issue of Debentures at Discount:

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
	Debenture allotment a/c	Dr.		x x x	
	Discount on Issue of Debentures a/c	Dr.		x x x	
	To Debenture a/c				x x x

B. When Debentures are issued for consideration other than Cash:

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
	For Purchase of Assets:				
	Sundry assets a/c	Dr.		x x x	
	To Vendors a/c				x x x
	For Issue of Debentures to Venders:				
	Vendors a/c	Dr.		x x x	
	To Debentures a/c				x x x

Illu.1: Kalyan Ltd., issued 1,000 6% Debentures of Rs.100 each, payable as to Rs.20 on application, and the balance on allotment. Applications were received for 1,500 debentures out of which applications for 900 were allotted fully, applications for 400 were allotted 100 debentures and the remaining rejected. All sums were received Journalise and show Balance Sheet.

Solution:

Journal Entries in the Books of Kalyan Ltd.

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
	Bank a/c (1,500×20)	Dr.		30,000	
	To Debenture application a/c				30,000
	(Being application money received on 1,500 debentures @ Rs.20 per debenture)				
	Debenture application a/c (1,500×20)	Dr.		30,000	
	To 6% Debentures a/c (1,000×20)				20,000
	To Debenture allotment a/c (300×20)				6,000
	To Bank a/c (200×20)				4,000
	(Being Debenture application money on 1,000 debentures transferred to 6% Debentures, excess application money to Debenture Allotment a/c and the balance of application money returned)				
	Debenture allotment a/c	Dr.		80,000	
	To 6% Debentures a/c				80,000
	(Being Debenture allotment money due on 1,000 debentures @ Rs.80 per debenture)				
	Bank a/c	Dr.		74,000	
	To Debenture allotment a/c				74,000
	(Being Debenture allotment money received) (Rs.80,000-6,000 = 74,000)				

Balance Sheet of Kalyan Ltd. as on ……

	Liabilities	Rs.		Assets	Rs.
I.	Share Capital:	--	I.	Fixed Assets:	--
II.	Reserve & Surplus:	--	II.	Investments	-
III.	Secured Loans:		III.	Current Assets:	
	1000, 6% Debentures @			Cash at Bank	1,00,000
	Rs.100 each	1,00,000			
		1,00,000			1,00,000

Illu.2: A Public Company issued 20,000 12% Debentures at Rs.100 each at a discount of 5% repayable after 5 years at a premium of 5%. Show the Journal entries for issue and redemption of Debentures.

Solution:

Journal Entries

When debentures are issued at discount and repayable at premium:

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
I.	**At the time of issue:**				
	Bank a/c	Dr.		19,00,000	
	Loss on issue of Debentures a/c	Dr.		2,00,000	
	To 12% Debentures a/c				20,00,000
	To Premium on Redemption of Debentures a/c				1,00,000
	(Being the issue of Rs.2,00,000 debentures at 5% discount and redeemable at 5% premium)				
II.	**At the time of Redemption:**				
	12% Debentures a/c	Dr.		20,00,000	
	Premium on Redemption of Debentures a/c	Dr.		1,00,000	
	To Debentures holders a/c				21,00,000
	(Being 12% Debentures and the premium on redemption of Debentures transferred to Debenture holder's a/c)				
	Debenture holders a/c	Dr.		21,00,000	
	To Bank a/c				21,00,000
	(Being Debenture holders paid off)				

Working Notes:

		Rs.
(1)	Value of 12% Debentures issued (20,000×Rs.100)	20,00,000
	Less: Discount given at 5% (20,00,000 × $^5/_{100}$)	1,00,000
	Cash received on issue of Debentures:	19,00,000
(2)	Loss on issue of Debentures:	
	(a) Discount given	1,00,000
	(b) Premium on redemption (20,00,000×$^5/_{100}$)	1,00,000
		2,00,000

Illu.3: A Company issued 200 12% Debentures of Rs.1,000 each. Write Journal entries for issue of the following:

(a) Debentures are issued at a Premium of 10% redeemable at par.
(b) Debentures are issued at a discount at 5% redeemable at a premium of 10%.

Solution:

Journal Entries in the Books of 'A' Company

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
(a)	Bank a/c Dr.		2,20,000	
	To 12% Debentures a/c			2,00,000
	To Debenture premium a/c			20,000
	(Being 200, 12% Debentures issued at a premium of 10%)			
	(2,00,000+2,00,000×$\frac{10}{100}$ =2,20,000)			
	Bank a/c Dr.		1,90,000	
	Loss on issue of Debentures a/c Dr.		30,000	
	To 12% Debentures a/c			2,00,000
	To Premium on Redemption of Debentures a/c			20,000
	(Being 12% Debentures issued at a discount of 5% and redeemable at a premium of 10%)			

Notes:

			Rs.
(1)	Loss on Issue of Debentures:		
	(1) Discount allowed: 5%	$2,00,000 \times \frac{5}{100}$	10,000
	(2) Premium on Redemption: 10%	$2,00,000 \times \frac{10}{100}$	20,000
			30,000
(2)	Value of Debentures issued: 200 12% Debentures × 1,000		2,00,000
	Less: Discount given: 5%	$2,00,000 \times \frac{5}{100}$	10,000
			1,90,000

Illu.4: A company issues 1000 debentures of Rs.1000 each pass the necessary entries for the issue of Debentures in each of the following cases:-

(a) Debentures issued at Rs.950 repayable at Rs.1000
(b) Debentures issued at 950 repayable at Rs.1050
(c) Debentures issued at 1000 repayable at Rs.1050 and
(d) Debentures issued at Rs.1050 repayable at Rs.1,000 you may assume that all the amounts due on the issue of debentures have been received.

Solution:

Journal Entries

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
(a)	Bank a/c (1,000×Rs.950)	Dr.		9,50,000	
	Discount on issue of Debentures a/c (1,000×50)	Dr.		50,000	
	To Debentures a/c (1,000×1,000)				10,00,000
	(Being issue of 1,000 debentures of Rs.1,000 each at Rs.950 per debenture)				
(b)	Bank a/c (1,000×950)	Dr.		9,50,000	
	Loss on issue of Debenture a/c (1,000×100)	Dr.		1,00,000	
	To Debentures a/c (1,000×1,000)				10,00,000
	To Premium on redemption of Debentures a/c (1,000×50)				50,000
	(Being issue of 1,000 debentures of Rs.1,000 each at Rs.950 per debenture repayable at Rs.1,050 per debenture)				

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
(c)	Bank a/c (1,000×1,000)	Dr.		10,00,000	
	Loss on issue of Debenture a/c (1,000×50)	Dr.		50,000	
	To Debentures a/c (1,000×1,000)				10,00,000
	To Premium on redemption of Debentures a/c (1,000×50)				50,000
	(Being issue of 1,000 debentures of Rs.1,000 each repayable at Rs.1,050 per debenture)				
(d)	Bank a/c (1,000×1,050)	Dr.		10,50,000	
	To Debentures a/c (1,000×1,000)				10,00,000
	To Premium on issue of Debentures a/c (1,000×50)				50,000
	(Being issue of 1,000 debentures @ Rs.1,050 repayable at Rs.1,000 per debenture)				

Illu.5: Pass journal entries relating to the issue of the following debentures.

(i) 100 8% Rs.1,000 debentures are issued at 5% discount and are repayable at par.

(ii) 100 7% Rs.1,000 debentures are issued at 5% discount and repayable at 10% premium.

(iii) 100 9% Rs.1,000 debentures are issued at 5% premium.

(iv) 500 8½% Rs.100 debentures are issued as collateral security against a loan of Rs.50,000.

Solution:

Journal entries

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
	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 debentures issued at discount with a condition of redemption at par)				
	Bank a/c	Dr.		95,000	
	Discount on issue of debentures a/c	Dr.		5,000	
	Loss on issue of debentures a/c	Dr.		10,000	
	To 7% Debentures a/c				1,00,000
	To Premium on redemption of debentures a/c				10,000
	(Being debentures issued at discount with a condition redemption at premium)				

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
	Bank a/c Dr.		1,05,000	
	To 9% Debentures a/c			1,00,000
	To Premium on issue of debentures a/c			5,000
	(Being debentures issued at premium)			
	Debentures suspense a/c Dr.		50,000	
	To 8½% Debentures a/c			50,000
	(Being debentures issued as collateral security against a loan)			

4.6 QUESTIONS

1. What are debentures?
2. Explain their features.
3. State the provisions relating to the issue of debentures
4. Explain the issue debentures at premium.
5. How do you treat issue of debentures at discount from accounting point of view?
6. Explain the accounting treatment of:
   (a) Debentures issued at discount and repayable at par
   (b) Issued at discount and repayable at premium
   (c) Issue of debentures as collateral security.
7. Define debentures. What are the types of debentures.

4.7 EXERCISES

1. ABC Ltd. issued at par Rs.60 lakhs 15% non-convertible debentures of Rs.1,000 each, payable 20% on application, 20% on allotment, 30% on first call and the balance after three months from the date of first call. Excepting the allotment money on 400 debentures and call money on 600 debentures which were in arrears the debentures money was duly received. Pass journal entries to reflect the above transactions.

2. A company issued Rs.1,00,000, 7½% debentures at par redeemable at 5% premium after 10 years. Pass necessary journal entries to record the transactions.

3. A company issued Rs.1,00,000 7½% debentures at 5% discount redeemable after 10 years at a 5% premium. Pass necessary journal entries.

4. Give entries to record the following issue of debentures.

a. 6% debentures, Rs.1,00,000 issued at premium of 10%

b. 5% debentures, Rs.1,00,000 issued at a discount of 5% but redeemable at a premium of 5%.

5. What journal entries will be made for the following types of issues.

a. A company issued 1,000 6% debentures of Rs.100 each at par;

b. A company issued 1,000 6% debentures of Rs.100 each at 10% premium; and

c. A company issued 1,000 6% debentures of Rs.100 each at 10% discount.

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Chapter – 5

REDEMPTION OF DEBENTURES

Objectives :

After reading this lesson you should able to :

- know the features and redemption of debentures
- find out methods of redemption of debentures
- understand the reasons for the creation of debenture redemption reserve.

Structure :

5.1 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 specific in the debenture trust deed.

5.2 METHODS OF REDEMPTION OF DEBENTURES

The various methods of redemption of debentures are as follows:

1. **Lumpsum payment method:** Under this method, the debentures are redeemed by repayment in one lump-sum at the end of the stipulated period of time. Normally a company creates a sinking fund or an insurance policy fund for this purpose.

   (i) Sinking Fund: 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 is not a charge against the profits. The latter is created by debiting profit and loss account and is a charge against the profits. Sinking fund for redeeming debentures is also called 'debenture redemption fund' to distinguish it from any other sinking funds.

   (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.

2. **Annual drawings method:** Under this method, a certain amount of debentures is redeemed at regular intervals during the life time of the debentures. In other words, redemption of debentures is done in installments by draw a lots.

3. **Purchase in the open market method:** Under this method, a company may redeem its debentures by purchase in the open market. In this case, the debentures repurchased may be either cancelled immediately or may be retained as investment and cancelled later on along with other debentures. The debentures purchased as investment are called "Own debentures."

4. **Conversion Method:** Under this method, the company gives an option to the debenture-holders to covert their debentures into new debentures/preference shares/equity shares.

5.3 DEBENTURE REDEMPTION RESERVE

As per the present regulations, it is obligatory for all the companies raising resources through debentures to create a Debenture Redemption Reserve equivalent to 50% of the amount of debenture issue before redemption of debentures begins. These guidelines are issued in the interest of debenture-holders. The effect of these guidelines is that it is compulsory for a company to create Debenture Redemption Reserve for non-convertible debentures. A Company cannot redeem its debentures purely out of profits or out of capital. The following points are to be considered in the creation of redemption of reserves.

1. A moratorium upto the date of commercial production can be provided for creation of the debenture redemption reserve in respect of debentures raised for project finance.

2. The debenture redemption reserve may be crated either in equal installments for the remaining period or with higher amounts if profits permit

3. In the case of partly convertible debentures, debenture redemption reserve should be created in respect of non-convertible portion of debentures issue on the same lines as applicable for fully non-convertible debenture issue. In respect of convertible issues by new companies the creation of debenture redemption reserve should commence from the year the company earns profit for the remaining life of debentures.

4. Company should create DRR equivalent to 50% of amount of debentures issue before debenture redemption commences. Withdrawal from DRR is permissible only after 10% of the debenture liability has been actually redeemed by the company.

5. Debenture redemption reserve will be treated as a part of General Reserve for consideration of bonus issue proposal.

Journal Entries

Issue of debentures form condition of redemption point of view:

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
	Debentures issued at par and redeemable at par:			
	Bank a/c Dr.		x x x	
	To Debentures a/c			x x x
	Debentures issued at Premium and redeemable at par:			
	Bank a/c Dr.		x x x	
	To Debentures a/c			x x x
	To Premium on issue of Debentures a/c			x x x
	Debentures issued at discount and redeemable at par:			
	Bank a/c Dr.		x x x	
	To Discount on issue of Debentures a/c			x x x
	To Debentures a/c			x x x
	Debentures issued at par, redeemable at premium:			
	Bank a/c Dr.		x x x	
	Loss on issue of Debentures a/c Dr.		x x x	
	To Debentures a/c			x x x
	To Premium on Redemption of Debentures a/c			x x x
	Debenture issued at discount, redeemable at premium:			
	Bank a/c Dr.		x x x	
	Loss on issue of Debentures a/c Dr.		x x x	
	To Debentures a/c			x x x
	To Premium on Redemption of Debentures a/c			x x x

Illu.1: A Public Company issued 20,000 12% Debentures at Rs.100 each at a discount of 5% repayable after 5 years at a premium of 5%. Show the Journal entries for issue and redemption of Debentures.

Solution:

Journal Entries

When debentures are issued at discount and repayable at premium:

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
I.	**At the time of issue:**				
	Bank a/c	Dr.		19,00,000	
	Loss on issue of Debentures a/c	Dr.		2,00,000	
	To 12% Debentures a/c				20,00,000
	To Premium on Redemption of Debentures a/c				1,00,000
	(Being the issue of Rs.2,00,000 debentures at 5% discount and redeemable at 5% premium)				
II.	**At the time of Redemption:**				
	12% Debentures a/c	Dr.		20,00,000	
	Premium on Redemption of Debentures a/c	Dr.		1,00,000	
	To Debentures holders a/c				21,00,000
	(Being 12% Debentures and the premium on redemption of Debentures transferred to Debenture holder's a/c)				
	Debenture holders a/c	Dr.		21,00,000	
	To Bank a/c				21,00,000
	(Being Debenture holders paid off)				

Working Notes:

		Rs.
(1)	Value of 12% Debentures issued (20,000×Rs.100)	20,00,000
	Less: Discount given at 5% (20,00,000 × $^5/_{100}$)	1,00,000
	Cash received on issue of Debentures:	19,00,000
(2)	Loss on issue of Debentures:	
	(a) Discount given	1,00,000
	(b) Premium on redemption (20,00,000×$^5/_{100}$)	1,00,000
		2,00,000

Illu.2: A Company issued 200 12% Debentures of Rs.1,000 each. Write Journal entries for issue of the following:

(a) Debentures are issued at a Premium of 10% redeemable at par.
(b) Debentures are issued at a discount at 5% redeemable at a premium of 10%.

Solution:

Journal Entries in the Books of 'A' Company

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
(a)	Bank a/c	Dr.		2,20,000	
	To 12% Debentures a/c				2,00,000
	To Debenture premium a/c				20,000
	(Being 200, 12% Debentures issued at a premium of 10%)				
	$(2,00,000+2,00,000\times\frac{10}{100}=2,20,000)$				
	Bank a/c	Dr.		1,90,000	
	Loss on issue of Debentures a/c	Dr.		30,000	
	To 12% Debentures a/c				2,00,000
	To Premium on Redemption of Debentures a/c				20,000
	(Being 12% Debentures issued at a discount of 5% and redeemable at a premium of 10%)				

Notes:

			Rs.
(1)	Loss on Issue of Debentures:		
	(1) Discount allowed: 5%	$2,00,000\times\frac{5}{100}$	10,000
	(2) Premium on Redemption: 10%	$2,00,000\times\frac{10}{100}$	20,000
			30,000
(2)	Value of Debentures issued: 200 12% Debentures × 1,000		2,00,000
	Less: Discount given: 5%	$2,00,000\times\frac{5}{100}$	10,000
			1,90,000

Illu.4: A company issues 1000 debentures of Rs.1000 each pass the necessary entries for the issue of Debentures in each of the following cases:-

(a) Debentures issued at Rs.950 repayable at Rs.1000

(b) Debentures issued at 950 repayable at Rs.1050

(c) Debentures issued at 1000 repayable at Rs.1050 and

(d) Debentures issued at Rs.1050 repayable at Rs.1,000 you may assume that all the amounts due on the issue of debentures have been received.

Solution:

Journal Entries

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
(a)	Bank a/c (1,000×Rs.950)	Dr.		9,50,000	
	Discount on issue of Debentures a/c (1,000×50)	Dr.		50,000	
	To Debentures a/c (1,000×1,000)				10,00,000
	(Being issue of 1,000 debentures of Rs.1,000 each at Rs.950 per debenture)				
(b)	Bank a/c (1,000×950)	Dr.		9,50,000	
	Loss on issue of Debenture a/c (1,000×100)	Dr.		1,00,000	
	To Debentures a/c (1,000×1,000)				10,00,000
	To Premium on redemption of Debentures a/c (1,000×50)				50,000
	(Being issue of 1,000 debentures of Rs.1,000 each at Rs.950 per debenture repayable at Rs.1,050 per debenture)				
(c)	Bank a/c (1,000×1,000)	Dr.		10,00,000	
	Loss on issue of Debenture a/c (1,000×50)	Dr.		50,000	
	To Debentures a/c (1,000×1,000)				10,00,000
	To Premium on redemption of Debentures a/c (1,000×50)				50,000
	(Being issue of 1,000 debentures of Rs.1,000 each repayable at Rs.1,050 per debenture)				
(d)	Bank a/c (1,000×1,050)	Dr.		10,50,000	
	To Debentures a/c (1,000×1,000)				10,00,000
	To Premium on issue of Debentures a/c (1,000×50)				50,000
	(Being issue of 1,000 debentures @ Rs.1,050 repayable at Rs.1,000 per debenture)				

Illu.5: Give journal entries in the books of Purchasing company.

a. A company purchased assets of Rs.1,75,000 and took over liabilities of Rs.15,000. It agreed to pay the purchase price, Rs.1,65,000 by issuing debentures of Rs.100 each at a premium of 10%.

b. A company purchased assets of Rs.1,80,000 and took over liabilities of Rs.17,500. It agreed to pay purchase price of Rs.1,17,475 by issuing debentures of Rs.100 each at a premium of 10% and Rs.65 by cash. The debentures of the same company are quoted in the market at Rs.130.

c. A company purchased assets of Rs.1,90,000 and took over the liabilities of Rs.15,000 at an agreed value of Rs.1,66,500. The company issued debentures at 10% discount in full settlement of the purchase price.

Solution:

Journal Entries in the books of Purchasing Company

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
(a)	Assets a/c	Dr.		1,75,000	
	Goodwill a/c (Balancing figure)	Dr.		5,000	
	To Liabilities a/c				15,000
	To Vendor a/c				1,65,000
	(Being business of vendor company is acquired)				
	Vendor a/c	Dr.		1,65,000	
	To Debentures a/c				1,50,000
	To Premium on issue of debentures a/c				15,000
	(Being liquidator is paid off by issuing debentures of Rs.100 each at Rs.110)				
(b)	Assets a/c	Dr.		1,80,000	
	Goodwill a/c	Dr.		5,007	
	To Liabilities a/c				17,500
	To Vendor a/c				1,67,507
	(Being business of vendor company is Purchased)				
	Vendor a/c	Dr.		1,67,507	
	To Debentures a/c				1,52,250
	To Premium on issue of debentures a/c				15,225
	To Cash a/c				32
	(Being purchase consideration paid)				

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
(c)	Assets a/c	Dr.		1,90,000	
	To Liabilities a/c				15,000
	To Capital reserve a/c (Balancing figure)				8,500
	To Business purchase a/c				1,66,500
	(Being business of vendor company acquired)				
	Liquidator of vendor company a/c	Dr.		1,66,500	
	Discount on issue of debentures a/c	Dr.		18,500	
	To Debentures a/c				1,85,000
	(Being purchase consideration paid)				

Illu.6: Pass journal entries relating to the issue of the following debentures.

- **(i) 100 8% Rs.1,000 debentures are issued at 5% discount and are repayable at par.**
- **(ii) 100 7% Rs.1,000 debentures are issued at 5% discount and repayable at 10% premium.**
- **(iii) 100 9% Rs.1,000 debentures are issued at 5% premium.**
- **(iv) 500 8½% Rs.100 debentures are issued as collateral security against a loan of Rs.50,000.**

Solution:

Journal entries

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
	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 debentures issued at discount with a condition of redemption at par)				
	Bank a/c	Dr.		95,000	
	Discount on issue of debentures a/c	Dr.		5,000	
	Loss on issue of debentures a/c	Dr.		10,000	
	To 7% Debentures a/c				1,00,000
	To Premium on redemption of debentures a/c				10,000
	(Being debentures issued at discount with a condition redemption at premium)				

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
	Bank a/c	Dr.		1,05,000	
	To 9% Debentures a/c				1,00,000
	To Premium on issue of debentures a/c				5,000
	(Being debentures issued at premium)				
	Debentures suspense a/c	Dr.		50,000	
	To 8½% Debentures a/c				50,000
	(Being debentures issued as collateral security against a loan)				

Illu.7: On 1.1.2003 Keerthi Co. Ltd. issued 7% Debentures of Rs.6,00,000 with a condition that they should be redeemed after 3 years at 10% premium. The amount set aside for the redemption of debentures is invested in 5% Government Securities. The sinking fund table shows that 0.31720856 at 5% compound interest in 3 years will become Re.1. You are required to write the journal entries for recording the above transactions for three years.

Solution:

Journal Entries in the Books of Keerthi Co. Ltd.

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
2003	Bank a/c	Dr.		6,00,000	
Jan.1	Loss on the issue of Deb. a/c	Dr.		60,000	
	To 7% Debentures a/c				6,00,000
	To Premium on Redemption of Deb. a/c				60,000
	(Being issue of 7% Debentures of Rs.6,00,000 issued at par and repayable at 10% premium)				
Dec.31	Profit & Loss Appro. A/c	Dr.		2,09,357.65	
	To Deb. Redemption Fund a/c				2,09,357.65
	(6,60,000 × 0.317207856 = 2,09,357.65)				
	(Being the annual contribution set aside for the redemption of 7% Debentures)				
Dec.31	Debenture Redemption Fund Investment a/c	Dr.		2,09,357.65	
	To Bank a/c				2,0,357.65
	(Being the amount invested in 5% Govt. securities)				

Date	Particulars		L.F	Debit Rs.	Credit Rs.
2004 Dec.31	Bank a/c	Dr.		10,467.88	
	To Debenture Redemption Fund a/c				10,467.88
	(Being Interest received at 5% on Investments)				
Dec.31	Profit & Loss Appr. A/c	Dr.		2,09,357.65	
	To Deb. Redemption Fund a/c				2,09,357.65
	(Being the annual contribution set aside for the redemption of 7% Debentures)				
Dec.31	Deb. Redemption Fund Investment a/c	Dr.		2,19,825.53	
	To Bank a/c				2,19,825.53
	(Being the amount invested in 5% Govt. securities) (2,09,357.65+10,467.88)				
2005 Dec.31	Bank a/c	Dr.		21,459.17	
	To Deb. Redemption Fund a/c				21,459.17
	(Being Interest received at 5% on Investments) (2,09,357.65+2,19,825.53 = 4,29,183.18$\times\frac{5}{100}$)				
Dec.31	Profit & Loss Appro. a/c	Dr.		2,09,357.65	
	To Deb. Redemption Fund a/c				2,09,357.65
	(Being the annual contribution set aside for the redemption of 7% Debentures)				
Dec.31	Bank a/c	Dr.		4,29,183.18	
	To Debenture Redemption Fund Investment a/c				4,29,183.18
	(Being the amount received on the sale of Investment at par value)				
2006 Dec.31	7% Debentures a/c	Dr.		6,00,000	
	Premium on Redemption of Debentures a/c	Dr.		60,000	
	To Debenture Holders a/c				6,60,000
	(Being 7% Debentures along with premium transferred to Debenture holders a/c)				

Date	Particulars	L.F	Debit Rs.	Credit Rs.
Dec.31	Debenture Holders a/c Dr. To Bank a/c (Being the Debenture Holders paid)		6,60,000	6,60,000
Dec.31	Debentures Redemption Fund a/c Dr. To Loss on issue of Deb. a/c (Being the loss transferred to Debenture Redemption Fund a/c)		60,000	60,000
Dec.31	Debenture Redemption Fund a/c Dr. To General Reserve a/c (Being the balance in Debenture Reserve Fund a/c transferred to General Reserve)		6,00,000	6,00,000

Working Notes:

1. for Re.1 the amount required is …… 0.31720856
   For Rs.6,60,000 the amount required is …… ?

i.e. Rs.6,66,000×0.31720856 = Rs.2,09,357.65ps.

(2) Amount payable on Redemption
= Rs.6,00,000 @ a premium of 10%
= Rs.6,00,000 + (6,00,000$\times\frac{10}{100}$)

Ledger Account of Keerthi Co. Ltd.

Dr. **1. Debenture Redemption Fund a/c** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2003 Dec.31	To Balance c/d	2,09,357.65	2003 Dec.31	By Profit & Loss Appropriation a/c	2,09,357.65
		2,09,357.65			2,09,357.65
2004 Dec.31	To Balance c/d	4,29,183.18	2004 Jan.1	By Balance b/d	2,09,357.65
			Dec.31	By Bank a/c (Interest) (2,09,357.65$\times\frac{5}{100}$)	10,467.88
			Dec.31	By Profit & Loss Appropriation a/c	2,09,357.65
		4,29,183.18			4,29,183.18

2005		Rs.	2005		Rs.
Dec.31	To Loss on issue of Debentures a/c	60,000	Jan.1	By Balance b/d	4,29,183.18
	To General Reserve a/c	6,00,000	Dec.31	By Bank a/c (Interest) $(4{,}29{,}183.18 \times \frac{5}{100})$	21,459.17
			Dec.31	By Profit & Loss Appropriation a/c	2,09,357.65
		6,60,000.00			6,60,000.00

Dr. **2. Debenture Redemption Fund Investment a/c** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2003			2003		
Dec.31	To Bank a/c	2,09,357.65	Dec.31	By Balance c/d	2,09,357.65
		2,09,357.65			2,09,357.65
2004			2004		
Jan.1	To Balance b/d	2,09,357.65	Dec.31	By Balance b/d	4,29,183.18
	To Bank a/c (10,467.88+2,09,357.65)	2,19,825.59			
		4,29,183.18			4,29,183.18
2005			2005		
Jan.1	To Balance b/d	4,29,183.18	Dec.31	By Bank a/c (Sale of Investments)	4,29,183.18
		4,29,183.18			4,29,183.18

Dr. **3. 7% Debentures a/c** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2002			2002		
Dec.31	To Balance c/d	6,00,000	Jan.1	By Bank a/c	6,00,000
		6,00,000			6,00,000
2003			2003		
Dec.31	To Balance c/d	6,00,000	Jan.1	By Balance b/d	6,00,000
		6,00,000			6,00,000
2004			2004		
Dec.31	To Debenture holders a/c	6,00,000	Jan.1	By Balance b/d	6,00,000
		6,00,000			6,00,000

Dr. **4. Debenture Holders a/c** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2004 Dec.31 3rd year	To Bank a/c	6,60,000	2004 Dec.31 3rd year	By 7% Debentures a/c	6,00,000
				By Premium on Redemption of Debentures a/c	60,000
		6,60,000			6,60,000

Dr. **5. Premium on Redemption of Debentures a/c** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
2003 Dec.31	To Balance c/d	60,000	2003 Jan.1	By Loss on issue of 7% Debenture a/c	60,000
		60,000			60,000
2004 Dec.31	To Balance c/d	60,000	2004 Jan.1	By Balance b/d	60,000
		60,000			60,000
2005 Dec.31	To Debenture holders a/c	60,000	2005 Jan.1	By Balance b/d	60,000
		60,000			60,000

5.4 SELF ASSESSMENT QUESTIONS

1. What are different methods of redemption of debentures?
2. Explain the accounting treatment of:
   (a) Debentures issued at par and redeemable at premium.
   (b) Issue of debentures as collateral security.
3. Sinking Fund for the redemption of debentures
4. Debenture Redemption fund

5.5 EXERCISES

1. What journal entries will be made in the following cases:
   a. A company issued Rs.40,000 6% debentures at par redeemable at par;
   b. A company issued Rs.40,000 6% debentures at discount of 10% redeemable at par;
   c. A company issued Rs.40,000 6% debentures at premium of 5% redeemable at par;

d. A company issued Rs.40,000 6% debentures at par redeemable at 10% premium; and

e. A company issued Rs.40,000 6% debentures at a discount of 5% and redeemable at 5% premium.

Also show how will you deal with the loss on issue of debentures in the books.

7. On 1st January 2001, A Ltd., issues 2,000 6% debentures of Rs.100 each repayable at the end of four years at a premium of 5 per cent. It has been decided to institute a sinking fund for the purpose, the investments being expected to realise four per cent net. Sinking fund tables show that 0.235490 annually amounts to one @ 4%, in four years. Investments were made a multiples of hundred only.

Only 31st December 2005 the balance at Bank was Rs.59,000 and the investments realised Rs.1,56,800. The debentures were paid off. Give journal entries in the books of the company.

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Chapter – 6

ISSUE OF BONUS SHARES

Objectives :

After studying this chapter you should be able to :

- understand the meaning of bonus shares
- discuss the SEBI Guidelines on bonus shares
- study the conditions for the issue of bonus shares
- find out the advantages of the issue of bonus shares
- go through the accounting treatment on bonus shares

Structure :

6.1 INTRODUCTION

Bonus shares are the shares allotted to existing equity shareholders without any consideration being received from them, in cash or in kind. They are issued to capitalize profits of the company. Bonus shares can be issued only if Articles of Association of the company permit such an issue. Thus, the shares issued by the company to the existing equity shareholders in settlement of the bonus declared are termed as 'Bonus shares'. The Bonus shares issued become permanently a part of its issued share capital and the process is known as **'Capitalization of Profits or Reserves'.**

Bonus shares cannot be issued in lieu of dividends. Before issuing bonus shares the company has to follow the guidelines issued by the Securities Exchange Board of India (SEBI).

6.1.1 Reasons for the issue of Bonus Shares:

The following circumstances warrant the issue of bonus shares.

(i) When a company possesses large capital or revenue profits (either past profits in the shape of reserves or current profits) and it wants to capitalize these profits by issuing bonus shares;
(ii) When cash resources of the company are not adequate to pay cash bonus;
(iii) When a company wants to show to its shareholders as well as outsiders its correct earning capacity i.e., the true relationship between its capital structure (i.e., capital employed) and earning capacity;
(iv) When the value of fixed assets far exceeds the amount of capital;
(v) When the market value of shares far exceeds the amount of capital; and
(vi) When it is not possible to declare high rate of dividend regularly every year out of accumulated reserves, bonus shares may be issued to facilitate the payment of regular dividend from year to year which is proportionate to the profits earned.

6.2 BONUS SHARES - SEBI GUIDELINES

The Securities Exchange Board of India (SEBI) has issued certain guidelines regarding issue of bonus shares. The following is the effect of these guidelines on a listed company.

(i) The bonus issue can be made only out of free reserves built out of the genuine profits or securities premium collected in cash.
(ii) Reserves created by revaluation of fixed assets are not available for issue of bonus shares.
(iii) The bonus issue cannot be made unless the partly-paid shares, if any, existing, are made fully paid-up.
(iv) The declaration of bonus issue, in lieu of dividend, cannot be made.
(v) Once the company announces bonus issue after the approval of the Board of Directors, it must implement the proposal within a period of six months from the date of such approval and it does not have the option of changing the decision.
(vi) If the Articles of Association of the company does not already contain a provision for capitalization of reserves etc; for issue of bonus shares, the company must pass a resolution at its general body meeting making provisions in the Articles of Association for capitalization.
(vii) If consequent to the issue of bonus shares, the subscribed and paid-up capital exceeds the authorized share capital, the company has to pass a Resolution at its general body meeting for increasing the authorized capital.
(viii) No company can pending conversion of Fully Convertible Debentures/Partly Convertible Debentures (FCDs/PCDs) issue bonus shares unless similar benefit is extended to the holders of such FCDs/PCDs through reservation of shares in proportion to such convertible part of FCDs and PCDs. The shares so reserved may be issued at the time of conversion of such debentures on the same terms on which the bonus issue was made.
(ix) The company issuing bonus shares must not have defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principle

on redemption thereof. It also must have sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

Note: SEBI guidelines are silent on ratio of bonus issue. Therefore, a company can issue bonus shares in any ratio.

6.3 CONDITIONS FOR THE ISSUE OF BONUS SHARES

According to Companies Act, a company is permitted to issue bonus shares only when the following conditions are fulfilled.

1. Issue of Bonus shares should be authorized by the Articles of Association.
2. The Board of directors' proposal regarding issue of bonus shares should be approved by the members in the general body meeting.
3. The company should have adequate profits and reserves to permit the issue of bonus shares.

6.3.1 Sources for the Issue of Bonus shares:

The Bonus shares may be issued from the following sources

(a) Balance in Profit and Loss account including current year's profit after tax.
(b) General Reserve
(c) Other reserves accumulated out of profits, like dividend equalization fund, accident compensation fund, insurance fund etc.
(d) Capital profits comprising of:
  (i) Profits prior to incorporation
  (ii) Profits on acquisition of business
  (iii) Secret reserves built as a result of under valuation of assets and under valuation of liabilities.
  (iv) Premium on issue of debentures.
  (v) Profits on the redemption of debentures.
(e) Capital Reserve arising from profit on sale of fixed assets received in cash.
(f) Capital Redemption Reserve created at the time of redemption of redeemable preference shares.
(g) Balance standing to the credit of the debenture redemption fund after the redemption of debentures.
(h) Premium received on issue of shares received in cash only.

It should be noted that the securities premium and the capital redemption reserve can be used only for issuing fully paid bonus shares. Other items can be used either for issuing fully paid bonus shares or for making partly paid shares as fully paid shares.

6.3.2 Reserves not to be used for Bonus Shares:

The following reserves are not to be used for the issue of bonus shares.

1. Capital reserves arising due to revaluation of assets.
2. Securities premium arising on issue of shares on amalgamation or take over.
3. Investment allowance reserve before expiry of 8 years of creation.
4. Balance in debenture redemption reserve account before redemption takes place.
5. Surplus arising from a change in the method of charging depreciation.

6.4 ADVANTAGES OF ISSUE OF BONUS SHARES

Issue of Bonus shares is always a preferable method of satisfying the shareholders of the company and increasing the prestige of the company in industry. As such the issue of bonus shares is advantageous both to the company and the shareholders.

6.4.1 Advantages to the company:

The following are the advantages to the company which issues bonus shares.

(i) **No cash outflow:** As there is no outflow of cash, liquidity position is not affected. At the same time, company can satisfy the desire of shareholders to receive dividend by issuing bonus shares.

(ii) **Balanced capital structure:** Issue of bonus shares presents a more realistic relationship between the capital structure of the company and its earning capacity.

(iii) **Increase in the reputation:** Capitalization of reserves increases substantially the credit worthiness of the company.

(iv) **Problems with high dividend:** The company may not be able to declare high rate of dividends due to some problems like tall claims of the employees and regulations by Government. Hence, it is preferable to issue bonus shares in those circumstances.

6.4.2 Advantages to the Shareholders:

The following are the advantages to the shareholders.

(i) As it is very costly to buy shares of successful companies from the market, the issue of bonus shares will enable the shareholders to increase their holding;
(ii) The shareholders can receive dividend on the increased shareholding;
(iii) The shareholders can dispose of the bonus shares for cash whenever they need cash.

6.5 ACCOUNTING TREATMENT

On issue of bonus shares, reserves used for such an issue are debited and bonus to Equity shareholders account will be credited with the amount for which bonus shares are issued. Then, Bonus to Equity Shareholders Account is debited and equity share capital account is credited with the amount of the issue. The journal entries for the issue of bonus shares are to be passed in the following two circumstances.

1. When the payment of bonus is made by the issue of fully paid up bonus shares,
2. When the bonus is given by making partly paid shares into fully paid shares i.e., if the bonus is utilised for making partly paid up shares into fully paid up shares.

Journal Entries

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
1.	**In case of issue of free fully paid bonus shares:**				
	Profit & Loss a/c	Dr.		x x x	
	General Reserve a/c	Dr.		x x x	
	Capital Redemption Reserve a/c	Dr.		x x x	
	Securities Premium a/c	Dr.		x x x	
	Capital Reserve a/c	Dr.		x x x	
	To Bonus to shareholders a/c				x x x
	(Being the amount transferred for issue of bonus shares – depending upon the available balance in the above said accounts)				
	Bonus to shareholders a/c	Dr.		x x x	
	To Share capital a/c				x x x
	(Being the issue of bonus shares with premium)				
2.	**If the bonus is given by making partly paid shares into fully paid shares**				
	Profit & Loss a/c	Dr.		x x x	
	General Reserve a/c	Dr.		x x x	
	Capital Profit a/c	Dr.		x x x	
	To Bonus to shareholders a/c				x x x
	(Being the bonus declared)				
	Share final call a/c	Dr.		x x x	
	To Share capital a/c				x x x
	(Being the final call on shares)				
	Bonus to shareholders a/c	Dr.		x x x	
	To Share final call a/d				x x x
	(Being the application of bonus to the calls)				

Illu.1: Well done Ltd., has Rs.1,60,000 paid up capital divided into 20,000 equity shares of Rs.10 each, Rs.8 called up. Now the Directors of the company wish to apply the profits earned during the year for making the partly paid up shares fully paid up. Give journal entries for carrying out their wishes.

Solution:

Working Notes :

Called up amount to be adjusted on partly paid shares
Rs.20,000 shares @ Rs.2 = Rs.40,000

Therefore, Rs.40,000 was declared as bonus from the profit earned during the year.

Journal Entries in the books of Well Done Company Ltd.

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
	Equity share final call account Dr.		40,000	
	To Equity share capital a/c			40,000
	(Being the equity share final call money due)			
	Profit and Loss a/c Dr.		40,000	
	To Bonus to shareholders a/c			40,000
	(Being the bonus declared to shareholders)			
	Bonus to shareholders a/c Dr.		40,000	
	To Equity share final call a/c			40,000
	(Being the bonus given to shareholders by converting partly shares into fully paid up shares)			

Illu.2: The following are seen in the balance sheet of Continental health care products ltd. Madras as on 31st December, 2009

- **a. 1,00,000 equity shares of Rs.100 each, Rs.70 paid.**
- **b. General reserve Rs.36,00,000**
- **c. Share premium Rs.10,00,000**
- **d. Capital reserve Rs.14,00,000**

A resolution was passed for capitalizing the general reserve, changing the partly paid shares into fully paid shares by using share premium and capital reserve. Also passed a resolution for the issue of shares at Rs.20 each with premium of 20% as fully paid up shares. Necessary journal entries in the books of the company.

Solution:

Journal entries in the books of Continental Health Care Products Limited

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
	General Reserve a/c Dr. Profit & Loss a/c Dr. Capital Reserve a/c Dr. To Bonus share holders a/c (Being the bonus declared out of general reserve, P & L a/c, Capital reserve a/c)		30,00,000 10,00,000 14,00,000	 54,00,000
	Equity share final call a/c Dr. To Equity share capital a/c		30,00,000	 30,00,000
	(Being 1,00,000 equity shares at Rs.30 equity share final call amount due)			
	Bonus to shareholders a/c Dr. To Share final call a/c (Being the adjustment of Rs.30,00,000 bonus for the final call amount to be paid on 1,00,000 shares)		30,00,000	 30,00,000
	Bonus to shareholders a/c Dr. To Equity share capital a/c To Share premium a/c (Being the bonus left Rs.24,00,000 used for issuing 1,00,000 shares of Rs.20 each at 20% premium as fully paid)		24,00,000	 20,00,000 4,00,000

Working Notes :

1. Out of Rs.36,00,000 of credit in General reserve a/c, an amount of Rs.30,00,000 was required for share final call. As such, an amount of Rs.30,00,000 was only utilized from the general reserve towards the adjustment of final call amount on shares.

2. Amount remaining for the issue of bonus shares = Rs.24,00,000

Face value of each bonus share	Rs.20
Add : 20% premium	4
Value of bonus share with premium	24

No. of bonus share issued = Remaining amount of bonus/share value with premium

= Rs.24,00,000/24 = 1,00,0000 shares

Face value of 1,00,000 shares = 1,00,000 shares x Rs.20 = Rs.20,00,000

Premium on these shares = 1,00,000 shares x Rs.4 = Rs.4,00,000

Illu.3: The Balance sheet of a company is given below .

Authorised Capital	**Rs.**
20,000 Equity Shares of Rs.10 each	**2,00,000**
Issued and subscribed capital:	
10,000 Equity shares of Rs.10 each	
Rs.8 per share paid up	**80,000**
Share premium	**2,000**
Capital redemption reserve	**4,000**
General reserve	**40,000**

The company passed the following resolution :

(a) That the general reserve be utilized in making the partly paid shares as fully paid up.

(b) That further 1,000 fully paid equity bonus shares of Rs.10 each be issued to the existing shareholders. For the purpose, general reserve should be utilized to the minimum extent.

You are required to the pass the journal entries.

Solution:

For every 10 shares …… 1 bonus share issued
For 10,000 shares …… ?
= $^{10,000}/_{10} \times 1$ = 1,000 shares

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
a.	Equity share final call a/c	Dr.		20,000	
	To Equity share capital a/c				20,000
	(Being the final call due on 10,000 shares @ Rs.2 per share)				
	General reserve a/c	Dr.		20,000	
	To Bonus to share holders a/c				20,000
	(Being the bonus declared along with the general reserve)				
	Bonus to shareholders a/c	Dr.		20,000	
	To Equity share final call a/c				20,000
	(Being the amount due on final call adjusted against bonus declared)				
b.	Share premium a/c	Dr.		2,000	
	Capital redemption reserve a/c	Dr.		4,000	
	General reserve a/c	Dr.		4,000	
	To Bonus to shareholders a/c				10,000
	(Being appropriation made to facilitate issue of bonus shares)				
	Bonus to shareholders a/c	Dr.		10,000	
	To Share capital a/c				10,000
	(Being the issue of fully paid up bonus share by using reserve)				

6.6 SELF ASSESSMENT QUESTIONS

1. What is a Bonus share? When are they issued?
2. From which sources bonus shares can be issued?
3. Cash bonus and capital bonus
4. Under what circumstances does a company issue Bonus shares?
5. Explain the reasons for the issue of bonus shares
6. What are various guidelines for the issue of bonus shares by SEBI.
7. State the advantages of issue of bonus shares to the company.
8. State the advantages of issue of bonus shares to the shareholders.
9. Explain the conditions for the issue of bonus shares.
10. What are various sources for the issue of bonus shares by companies.
11. Enumerate the reserves or sources that can be used for the issue of bonus shares.

6.7 EXERCISES

1. Balarama Bearing Ltd. has resolved to utilise Rs.2,40,000 out of its reserve fund in declaration of bonus to its shareholders. For this purpose 6,000 equity shares of Rs.100 each and Rs.60 paid up shall be treated as fully paid-up. Write necessary journal entries to that extent.

2. Bharat Ltd., had issued 10,000 equity shares of Rs.10 each, Rs.8 per share were called up. The directors of the company now wish to apply the profits earned during the year for making the partly paid up shares fully paid up. Give journal entries for carrying out their wishes.

3. A limited company has resolved to utilise Rs.5,00,000 out of its reserve fund in declaration of a bonus to the shareholders. The bonus, however is to be applied to the extent of Rs.2,00,000 in payment of final call of Rs.40 per share on 5,000 Equity Shares of Rs.100 each and to the extent of Rs.3,00,000 in the issue of 3,000 fully paid Equity Shares of Rs.100 each to the existing shareholders. Give the journal entries necessary to give effect to the above resolution.

4. A company issued 10,000 equity shares of Rs.10 each, Rs.8 paid up. It passed the following resolutions.

a. the profits be used in making the partly paid up shares fully paid up.

b. that further 1,000 shares fully paid up as bonus shares of Rs.10 each be issued to the existing shareholders.

c. that the following balances appearing in the books be used.

Share premium account of Rs.2,000 and capital redemption reserve account Rs.4,000. You are required to give journal entries for recording the above transactions.

5. Ambujodara Air conditioners Ltd., has a large balance in Reserve Account and the directors decide to utilise a part of it for distribution as bonus to its shareholders.

At present the company has a paid-up share capital of Rs.15,00,000 comprising 1,35,000 equity shares of Rs.10 each fully paid up and 30,000 equity shares of Rs.10 each Rs.5 per share paid. The company now proposes to issue one bonus share at a premium of Rs.10 for every fully paid share held and to treat the partly paid shares as fully paid. On the date of allotment of bonus shares the market price of equity share stands at Rs.33 each.

Give necessary journal entries to effect the above changes.

6. The following balances are extracted from Best & Co. Ltd:

Authorised capital: 20,000 equity shares of Rs.10 each

Issued & Subscribed: 8,000 equity shares full paid

Reserve fund: Rs.36,000 P & L A/c (Cr.) Rs.29,000.

Company approved to capitalize Rs.16,000 from reserve and the rest from the P & L a/c to issue 1 bonus share for every 4 shares held. Journalise the same and show the items in balance sheet.

7. The Balance sheet of ABC Company Ltd. is given below on 31-12-2009.
1,00,000 Equity shares of Rs.10 each unit called up and paid up Rs.8 per share. Reserve fund Rs.8,00,000.
Director's of the company decided to utilise reserve fund for the following purposes.

a. Converting partly paid up shares into fully paid up shares
b. Issue of one Bonus share of Rs.10 each at a premium of Rs.2 per share for every two Equity shares in the company.

Pass the entries in the Books of the company.

8. X Ltd. has 10,000 shares of Rs.100 each. The Board of Directors has resolved to issue 2 bonus shares of Rs.100 each for every 5 shares in the company. From the following information write the journal entries for issue.
General Reserve Rs.2,00,000
Profit and Loss account Rs.1,50,000
Share premium account Rs.1,50,000

9. The Balance Sheet of A Co. Ltd. on 31st December 2009 was as follows

	Rs.		Rs.
Share Capital:			
2,000 Shares of Rs.100 each	2,00,000	Sundry Assets	4,75,000
Share Premium	50,000		
Reserve Fund	1,00,000		
P & L account	80,000		
Creditors	45,000		
	4,75,000		4,75,000

The Company decided to issue Bonus Shares at the rate of three shares for every four shares held and decided, for this purpose, to utilise share-premium Rs.60,000 out of reserve and the balance out of P & L a/c. Give Journal entries.

10. The Balance sheet of Vikas Limited, is given below on 31st December, 2009.

	Rs.
Authorised Capital	
20,000 Equity Shares of Rs.10 each	2,00,000
Issued and subscribed capital:	
7,000 Equity shares of Rs.10 each	70,000
Reserve Fund	36,000
Profit and Loss Account	29,000

The Board of Directors pass a resolution to capitalise a part of existing reserves and profits by issuing bonus shares. One bonus share is being issued for every four equity shares held. For this purpose Rs.10,000 is to be provided out of reserve fund and the balance out of profits. Show journal entries and also Balance Sheet.

11. The following is the balance sheet of Jai Hind Limited.

Balance Sheet as on 31st March, 2010

Liabilities	Rs.	Assets	Rs.
Authorised Share Capital		Sundry Assets	17,00,000
1,50,000 Equity shares of Rs.10 each	15,00,000		
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	2,50,000		
Securities Premium Account	1,50,000		
Investment Allowance Reserve	2,50,000		
General Reserve	3,00,000		
	17,00,000		17,00,000

The company wanted to issue bonus share to its shareholders at the rate of one share for every two shares held. Necessary resolutions were passed; requisite legal requirements were compiled with.

You are required to:

a. Give effect to the proposal by passing journal entries in the books of Jai Hind Ltd.

b. Show the amended Balance Sheet.

12. Vijaya Sai Ltd. has Rs.5,60,000 in Equity share capital comprising of 40,000 shares of Rs.10 fully paid and 20,000 shares of Rs.10, Rs.8 paid per share. It has Rs.20,000 in Capital Reserve, Rs.20,000 in Share Premium account, Rs.70,000 in capital Redemption reserve account. Rs.1,50,000 in General Reserve.

By way of Bonus dividend the partly paid up shares are converted into fully paid up shares, and the holders of fully paid-up shares are also allotted fully paid-up bonus shares in the same ratio.

Pass Journal entries showing separately the two types of bonus issue stated above. It is desired that there should be minimum reduction in free reserves.

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Chapter – 7

VALUATION OF GOODWILL

Objectives :

After studying this unit, you should be able to :

- To understanding the need for valuation of goodwill.
- To identify the factors affecting the value of goodwill.
- To acquire knowledge about different methods for valuation of goodwill.
- To know computation the value of goodwill.

Structure of the lesson :

7. 1. MEANING OF GOODWILL

Over a period of time, a well-established business develops an advantage of good name, reputation and wide business connections. This helps the business to earn more profits as compared to a newly set up business. In accounting, the monetary value of such advantage is known as “goodwill”. It is as an intangible asset. In other words, goodwill is the value of the reputation of a firm in respect of the profits expected in future over and above the normal profits. It is generally observed that when a person pays for goodwill, he/she pays for something, which places him in the position of being able to earn super profits as compared to the profit earned by other firms in the same industry. In simple words, goodwill can be defined as "the present value of a firm's anticipated excess earnings" or as "the capitalised value attached to the differential profit capacity of a business". According to the **Institute of Charted Accountants of India**, goodwill is 'an intangible asset arising from business connections or trade name or reputation of an enterprise'. Thus, goodwill exists only when the firm earns super profits. Any firm that earns normal profits or is incurring losses has no goodwill.

On the basis of above definitions, goodwill is thus the extra saleable value attached to a prosperous business beyond the intrinsic value of net assets. Since it is invisible, the goodwill is called an intangible asset, but since its existence can be felt through extra earning power, it is real asset.

7. 2. FEATURES OF GOODWILL

7. 2. 1. It is an Intangible Asset: Goodwill cannot be seen or touched. It does not have any physical existence. Thus, it belongs to the category of intangible assets such as patents, trademarks, copy rights, etc.

7. 2. 2. It does not have an existence separate from that of an Enterprise: Goodwill of an enterprise entirely depends on the enterprise and the situation of its profits. Thus, normally it has realisable value when business is sold.

7.2. 3. It is helpful in earning Higher Profits.

7. 2. 4. It is an Attractive Force: It is an attractive force as it brings in customers regularly to the place of business.

7.2. 5. It comes into existence due to various factors: The factors affecting the value of a firm's goodwill may be locational advantages, favourable contracts, brands, trademarks, copyrights, market reputation, etc.

7.2.6. It is difficult to place an exact value on goodwill: This is because its value may fluctuate from time to time due to changing circumstances which are internet and external to business. Moreover, the value of goodwill is subjective as it depends on the assessment of the valuer.

7. 2.7. Its value is liable to constant fluctuations: While goodwill does not depreciate, its value is liable to constant fluctuation. It is always present as a silent asset in a business where there are super profits (i.e., more than the normal) but declines in value with the decline in earnings.

7. 3. FACTORS AFFECTING THE VALUE OF GOODWILL

A firm that manufactures good-quality products can earn more profits than a firm that has low demand because of poor-quality products. The major factors affecting the value of goodwill are:

7.3.1. **Stable Location of the Business**: The firm's location is important in determining the value of goodwill. A firm located in the main market or at a prominent place that has more customer traffic would earn more profits, leading to more goodwill.

7.3.2. **Time**: As goodwill is a long-term asset, time influences its value. A well-established firm surely has a better reputation than a newly set up firm, even if they are in the same locality.

7.3.3. **Nature of Business**: Nature of business refers to the type of products manufactured by the firm, the demand for those products, accessibility of raw materials, the competition faced by the firm, and government regulations that affect firm activities; all these factors are considered to determine the value of goodwill. If these conditions work in favour of the firm and it has some kind of monopoly in the market, it would earn more and have more goodwill.

7.3.4. **Owner's Reputation**: A firm's goodwill is influenced by the goodwill of its owner. If the owner is truthful and trustworthy, they would have a good reputation in the market; this, in turn, would attract more customers to the business.

7.3.5. **Managerial Skill**: When the management is able, efficient and competent in the business, it will have high productivity and increased profits, which help create goodwill. Goodwill is the money value of a continuation of the various benefits which are being received by the business because of the efficient management of the business.

7.3.6. **Capital Required**: A firm that earns a high profit despite a small amount of capital will attract more buyers than a firm that requires more capital but has a lower profit-earning rate.

7.3.7. **Trends in Profits**: A firm's goodwill is determined by its earning capacity. If the trend in profit is constantly rising, the firm will have goodwill. However, instability in profits will affect the value of goodwill adversely.

7.3.8. **Risk in Business**: when the risk is less in the business, it creates more goodwill but if the risk is more, it will create less goodwill.

7.3.9. Possession of Patents and Trade Marks: The products, branded with Trade Marks, registered with the Registrar of Patents and Trade Marks, prevents and distinguishes rival products from its product. The object is to acquire monopolistic rights, which create goodwill.

7.3.10. Other Factors: There are many other factors which influence the value of goodwill, say, for instance, general economic conditions, Government Policies, availability of raw materials, market conditions, trade cycles, political stability, etc.

7.4. NATURE OF GOODWILL

Goodwill has been said to be the attractive force which brings in customers. Hence, to determine the nature of the goodwill in any one given case, it is necessary to consider the type of business and the type of customers. The following are the principle classes of Goodwill.

(a) **Cat Goodwill**: Special feature of a cat is that it remains at one place and does not change its living place from time to time. It is said that cat loves place more than person. Goodwill of some business is like cat because it depends on the place of business and it does not change due to change in ownership. The cat stays in the old home although the person who has kept the home leaves, and so it represents the customer who goes to the old shop whoever keeps it, and provides local goodwill. This type of goodwill has stability and therefore its value is always maximum.

(b) **Dog Goodwill**: Dogs are attached to the persons. Dog has more affection for its owner than the place. The faithful dog is attached to the person rather than to the place, he will follow the outgoing owner if he does not go too far. There are some businesses whose goodwill depends on the owner. Such goodwill is called Dog Goodwill and its value is less.

(c) **Rat Goodwill**: The characteristic of a rat is that it moves from place to place. The rat has no attachments and is purely casual. If the goodwill of a business often changes, it is known as Rat Goodwill. Such goodwill is valueless.

(d) **Rabbit Goodwill**: The rabbit is attracted by more propinquity. He comes because he happens to live close by and it would be more troublesome to go elsewhere.

7.5. NEED FOR VALUATION OF GOODWILL

Normally, the need for valuation of goodwill arises at the time of sale of a business. ***But, in the context of a partnership firm it may also arise in the following circumstances*:**

(i) Change in the profit sharing ratio amongst the existing partners;

(ii) Admission of new partner;

(iii) Retirement of a partner;

(iv) Death of a partner; and

(v) Dissolution of a firm involving sale of business as a going concern.

(vi) Amalgamation of partnership firms

***The need for valuation of goodwill in case of a Joint stock company arises in the following circumstances*:**

(i) When the business of a company is taken over by another company, e.g., in case of amalgamation or absorption.

(ii) When the company's shares are not quoted on the stock exchange and their value is to be determined for the purposes of estate duty and wealth tax, etc.

(iii) 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.

(iv) When the business of the company is being taken over by the Government.

(v) When the Management wants to write back goodwill which it wrote off earlier to reduce or eliminate the debit balance in the profit and loss account.

7.6. CLASSIFICATION OF GOODWILL

7.6.1. Purchased Goodwill: Purchased goodwill means goodwill for which a consideration has been paid e.g. when business is purchased the excess of purchase consideration of its net assets i.e. Assets – Liabilities is known as Purchased Goodwill. It is separately recorded in the books because as it is purchased by payment in cash or kind.

Characteristics:

(i) It arises on purchase of a business or brand.

(ii) Consideration is paid for it. So, it is recorded in books.

(iii) Shown in Balance Sheet as on asset.

(iv) It is amortised (depreciated) at the earliest but not later than its estimated useful life.

(v) Value is a subjective judgment & ascertained by agreement of seller & purchaser. It is approximate value and cannot be sold separately in the market or in parts.

7.6.2. Self-generated Goodwill: It is also called as inherent goodwill. It is an internally generated goodwill which arises from a number of factors that a running business possesses due to which it is able to earn more profits in the future.

Characteristics:

(i) It is generated internally over the years.

(ii) A true cost cannot be placed on this type of goodwill.

(iii) Value depends on subjective judgment of the value.

(iv) As per Accounting Standard 26 (Intangible Asset), it is not recorded in the books of accounts because consideration in money or money's worth has not been paid for it.

7.7. METHODS OF VALUATION OF GOODWILL

Since goodwill is an intangible asset it is very difficult to accurately calculate its value. Various methods have been advocated for the valuation of goodwill of a partnership firm. Goodwill calculated by one method may differ from the goodwill calculated by another method. Hence, the method by which goodwill is to be calculated, may be specifically decided between the existing partners and the incoming partner.

The important methods of valuation of goodwill are as follows:

1. Average Profits Method
2. Super Profits Method
3. Capitalisation Method
4. Annuity Method

7.7. 1. Average Profit Method: Under this method, the goodwill is valued at agreed number of 'years' purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill, therefore, should be calculated by multiplying the past average profits by the number of years during which the anticipated profits are expected to accrue. When the maintainable free average profit is calculated, the following factors are to be considered:

(i) Non-operating profit or loss to be excluded.

(ii) The loss, if any, in any year to be deducted.

(iii) Deduct such incomes or special incomes which may not be continued in future.

(iv) Past special type of expenses, which will not incur in future, are added.

(v) Provision may be made for managerial remuneration.

(vi) Depreciation on fixed assets should be provided.

By making the above additions and deductions in the profit, the average profit is found out. The average profit is multiplied by certain number of years in order to get the value of goodwill. Generally, the actual trading profit of the immediately preceding three or four years are accounted for after the adjustment of abnormal items, if any. A simple average is used where the profits are almost uniform but weighted average is employed otherwise.

$$\textbf{Average Profit} = \frac{\textbf{Total Profits for all the Years}}{\textbf{Number of Years}}$$

Value of Goodwill = Average Profit X Years' Purchase

Illustration-1: If the past average profits of a business works out at Rs. 20,000 and it is expected that such profits are likely to continue for another three years, the value of goodwill will be:

Solution:

Goodwill = Average Profit × No. of Years Purchase

It can be calculated as

= Rs. 60,000 (Rs. 20,000 × 3)

Illustration-2:

Manohar & Co. decided to purchase a business for Rs.80,000. Its profit for the last 4 years are 2011-Rs.20,000; 2012-Rs.25,000; 2013-Rs.24,000; 2014-Rs.23,000. The business was looked after by the management. Remuneration from alternative employment, if not engaged in the business, for the management comes to Rs.3,000 p.a.

Find out the amount of goodwill if it is valued on the basis of three year's purchase of the average net profit for the last four years.

Solution:

	Profits (Rs.)
2011	20,000
2012	25,000
2013	24,000
2014	23,000
Total of 4 years Profit	92,000
Average Profits = 92,000 ÷ 4	23,000
Less: Management Remuneration	3,000
Adjusted Profit	**20,000**

Value of Goodwill = 20,000 × 3 = Rs.60,000/-

7.7.2. Super Profit Method: Super profit refers to that average profit which is earned by a business in excess of normal earnings. Really speaking the super profit is the difference between actual average profit and normal profit. That is, the term super profit means the profit over and above the normal profit. Or

Super Profit = Average Profit (Adjusted) – Normal Profit

Value of Goodwill = Super Profit × Years' Purchase

An assumption is made regarding the percentage of profit earned on a certain investment of capital in similar industries. This is considered as the normal expected profit in similar concerns. This normal profit is compared with the actual profit. When the actual profit is more, there will be goodwill. To arrive at the value of goodwill, the super profit is multiplied by the number of years.

Illustration-3: The following particulars are available in respect of the business carried on by R.N. Murthy:

		Rs.
(1) Capital Invested		50,000
(2) Trading Results:		
2011	Profit	12,200
2012	Profit	15,000
2013	Loss	2,000
2014	Profit	21,000
(3) Market rate of interest on investment		8%
(4) Rate of risk return on capital invested in business		2%
(5) Remuneration from alternative employment of the proprietor (if not engaged in business)		

Compare the value of goodwill of the business on the basis of 3 years' purchase of super profits taking average of last four years.

Solution: Trading profits of last 4 years

	Rs.
Trading Results:	
2011	12,200
2012	15,000
2013	(-) 2,000
2014	21,000
	46,200

Average Profit = 46,200 ÷ 4 = 11,550

	Rs.
Average Profit	11,550
Less: proprietor's Remuneration	3,600
	7,950
Less: Reasonable Return on Capital invested	5,000
Super Profit	2,950

Value of goodwill on the basis of 3 years'

Purchase of Super Profit = 2,950 × 3 = Rs.8,850.

7.7.3. Capitalisation Method: Goodwill is determined in two ways as follows:

a) Capitalisation of Super Profit

Under this method, it is estimated as to how much capital will be required to earn super profit at normal rate of profit. This capitalised value of super profit is treated as goodwill.

(b) Capitalisation of Average Method

Under this method, average annual profit is to be ascertained after providing for reasonable management remuneration. This profit should be capitalised at the rate of reasonable return to find out the total value of the business. Now the value of goodwill will be the total value of the business minus its net assets. If, however, the net assets is greater, there will be no goodwill but badwill.

$$\textbf{Capitalised Value of Profit} = \frac{\textbf{Profit (Adjusted)}}{\textbf{Normal Rate of Return}} \times 100$$

Value of Goodwill = Capitalised Value of Goodwill – Net Tangible Assets

Illustration – 4: The net profits of a company, after providing for taxation, for the past five years are Rs.42,000; Rs.45,000; Rs.39,000 and Rs.47,000. The capital employed in the business is Rs.4,00,000 on which a reasonable rate of return of 10% is expected. Calculate the goodwill under (a) Capitalisation of Average Profit Method and (b) Capitalisation of Super Profit Method.

Solution:

(a) $$\textbf{Average Profit} = \frac{\textbf{Total Profits of 5 Years}}{5}$$

$$= \frac{42{,}000 + 47{,}000 + 45{,}000 + 39{,}000 + 47{,}000}{5}$$

$$= \frac{\mathbf{2,20,000}}{\mathbf{5}} = \mathbf{Rs.44,000.}$$

Capitalised Value of the Business at 10% $= \frac{44,000 \times 100}{10} = 4,40,000$

Less: Capital Employed (given) = 4,00,000

Value of Goodwill = 40,000

(b) Average Profit (as above) = 44,000
Less: Normal return on capital employed
(at 10% on Rs.4,00,000) = 40,000
Super Profit = **4,000**

Capital Value of Super Profit $= \frac{4,000 \times 100}{10} =$ Rs.40,000.

Illustration-5: Mr. Wilson has invested a sum of Rs.2,00,000 in his own business which is a very profitable one. The annual profit earned from his business is Rs.45,000 which includes a sum of Rs.10,000 received as compensation of a part of his business premises.

As an alternative to his engagement in this business, he could have invested the money in long-term deposit with Bank earning a normal rate of interest of 10% and also could engage himself in employment thereby getting an annual salary income of Rs.7,200.

Considering 2% as fair compensation for the risk involved in the business, calculate the value of goodwill of his business on capitalisation of super profits at the normal rate of interest.

Solution:

	Rs.	**Rs.**
Annual Profits earned		45,000
Less: Compensation received (Abnormal Income)	10,000	
Normal Salary	7,200	17,200
Maintainable Average Profit		27,800
Less: Normal Return @10 + 2% on Rs.2,00,000		24,000
		3,800

Goodwill on Capitalisation of Super Profit at normal rate of Interest @10% p.a.

$= 3,800 \times 100 \div 10 =$ Rs.38,000/-

7.7.4. Annuity Method:

When a business is purchased goodwill is paid by the purchaser at the time of purchase of business for the super profits of the business, but these super profits are made in future years. Let us take a clear example. Suppose the super profit of a business has been calculated Rs.50,000 and it has been considered reasonable that 5 years' purchase of the super profit approximates the value of goodwill. The contention behind this is that the purchaser of the business can expect to enjoy super profit of Rs.50,000 per year for next five years. If this is the contention it is not reasonable that he should pay Rs.50,000 × 5 = 2,50,000. He should pay an amount which will give him an annuity of Rs.50,000 over the next 5 years at the current rate of interest. In other words, the value of goodwill is the present value of an annuity of the annual super profit payable over an expected number of years at the current rate of interest. This is what is known as the annuity method of valuation of goodwill. The amount of goodwill under this method can be found out by (i) Annuity Table or (ii) Formula.

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

where, A = Present Value of Annuity of Rupee 1

r = Normal Rate of Return

n = Number of Years

Value of Goodwill = Average Super Profit × A (Present Value of annuity for Rupee at given rate of interest)

Illustration-6: The Net Profits of a company after providing for taxation, for the past five years are: Rs.40,000; Rs.42,000; Rs.45,000; Rs.46,000 and Rs.47,000. The capital employed in the business is Rs.4,00,000 on which a reasonable rate of return of 10% is expected.

It is expected that the company will be able to maintain its super profits for the next five years.

Calculate the value of the Goodwill of the Business:

(a) On the basis of an annuity of super profits taking the present value of an annuity of one rupee for five years at 10% interest as Rs.3.78.

(b) On the basis of capitalising the excess of the annual average distributable profits over the reasonable return on capital employed.

Solution:

Profits for the last five years:

	Rs.
1st Year	40,000
2nd Year	42,000
3rd Year	45,000
4th Year	46,000
5th Year	47,000
Total	2,20,000

Average Profit = 2,20,000/5 = Rs.44,000/-

	Rs.
Average Profit	44,000
Less: Reasonable return on Capital Employed (10% on Rs.4,00,000)	40,000
Super Profit	**4,000**

(a) Value of goodwill on the basis of an annuity of super profits.

Annuity (Super Profit)	Present Value (Goodwill)
1	3.78
4,000	?

? = 4,000 × 3.78 = Rs.15,120/-

(b) Value of goodwill on the basis of capitalisation of super profits:

Rs.4,000 capitalisation at 10%

4,000 × 100/10 = Rs.40,000/-

Illustration-7:

The net profit of a company after providing for taxation for the past five years is:

Year	**Profit (Rs.)**
2018	40,000
2019	50,000
2020	30,000
2021	70,000
2022	88,000

The net tangible assets in the business are Rs. 4, 00,000 on which the normal rate of return is expected to be 10%. It is also expected that the company will be able to maintain its super profits for next five years. Calculate the value of goodwill of the business on the basis of an annuity of super profits, taking present value of an annuity of Rs.1 for five years at 10% interest is Rs. 4.57.

Solution:

Calculation of Average Profits:

	Rs.
2018	40,000
2019	50,000
2020	30,000
2021	70,000
2022	88,000
Total	2,70,000

Average Profit = 2,70,000/5 = Rs.54,000/-

Calculation of Super Profits:

	Rs.
Average Profit	54,000
<u>Less</u>: Normal Profit (10% on Rs.4,00,000)	40,000
Super Profit	**14,000**

Value of Goodwill = Super Profits × Value of an Annuity

= Rs.14,000 × 4.57 = Rs.63,980/-

Illustration-8:

From the following information calculate value of goodwill**:**

(i) Average capital employed in the businessRs.6,00,000.

(ii) Net trading profits of the firm for the past three years were: Rs.1,07,600; Rs.90,700; and Rs.1,12,500.

(iii) Rate of interest expected from capital having to the risk involved 12%.

(iv) Fair remuneration to the partners for their service Rs.12,000 p.a.

(v) Sundry assets of the firm Rs.7,54,762; current assets Rs.31,329.

Solution:

$$\text{Average expected profit} = \frac{1,07,600+90,700+\text{ Rs.}1,12,500}{3}$$

$$= \frac{3,10,800}{3} = \text{Rs.}1,03,600.$$

= 1,03,600 – 12,000 (far remuneration)

= Rs.91,600.

Calculation of Normal Profit = Capital Employed X Normal Return

= 6,00,000 X 12% = Rs.72,000

Super Profit = Average Profits - Normal Profit

= Rs.91,600 – Rs.72,000

= Rs.19,600

Goodwill on the basis of purchase of three years Super Profit

= Average Profits × Normal Profit

= 19,600 × 3

= Rs.58,800/-

Illustration-9:

From the following information find out Goodwill (a) as per annuity method, (b) as per 4 years' purchase of super profit, and (c) as per capitalisation of super profit method.

Net profits for 4 years:

	Rs.
1st Year	30,000
2nd Year	40,000
3rd Year	50,000
4th Year	60,000

Average Capital Employed Rs.3,00,000

Normal Rate of Profit 10%

Present Value of Annuity of Re.1 for 4 years at 10% is 2.5.

Solution:

Total Profits:

	Rs.
1st Year	30,000
2nd Year	40,000
3rd Year	50,000
4th Year	60,000
Total	1,80,000

$$\text{Average Profits} = \frac{1,80,000}{4} = \text{Rs.}45,000.$$

	Rs.
Average Profit	45,000
Less: Non-recurring profit	3,000
	42,000

$$\text{Normal Profits} = \frac{3,00,000 \times 10}{100} = \text{Rs.}30,000.$$

Super Profit = Average Profits - Normal Profit

= Rs.42,000 – Rs.30,000

= Rs.12,00/-

(a) Goodwill as per annuity method: 12,000 × 2.5 = Rs.30,000.

(b) Goodwill as per purchase of super profit method: 12,000 × 4 = Rs.48,000.

(c) Goodwill as per Capitalisation Method:

$$= \frac{12,000 \times 100}{10} = \text{Rs.}1,20,000/-$$

7.8. SUMMARY

Goodwill is an intangible but not fictitious assets that means it has some realisable value. From the accountant's point of view, goodwill, in the sense of attracting custom, has little significance unless it has a saleable value. To the accountant, therefore, goodwill may be said to be that element arising from the reputation, connection, or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by the net tangible assets employed in the business. In considering the return normally to be expected, regard must be had to the nature of the business, the risks involved, fair management remuneration and any other relevant circumstances.

Since goodwill is an intangible asset it is very difficult to accurately calculate its value. Various methods have been advocated for the valuation of goodwill of a partnership firm. Goodwill calculated by one method may differ from the goodwill calculated by another method.

1. Average Profits Method
2. Super Profits Method
3. Capitalisation Method
4. Annuity Method

7.9. KEY WORDS

1. Capital employed for Equity Shareholders : It represent the equity shareholder's funds in a company.

2. Goodwill : An intangible asset arising from business connections or trade name.

3. Normal Rate of Return : The rate of return expected by an ordinary investor on his investment.

7.10. SELF ASSESSMENT QUESTIONS

1. Define goodwill. State the circumstances under which the need for valuation of goodwill arises in case of a joint stock company.
2. Explain and illustrate the Super-Profit method of valuation of goodwill.
3. What are the factors affecting the value of goodwill?
4. Describe the features of goodwill.
5. Enumerate the need for valuation of goodwill.
6. Distinguish between purchased goodwill and self-generated goodwill. How is each type of goodwill treated in company accounts?
7. What are the different methods of valuation of goodwill? Explain.
8. X agreed to purchase the business of Y on 30th June, 2016. Profits earned by Y for the three preceding years were as below:

`

Year ending	**Rs.**
31/12/2013	82,000
31/12/2014	80,000
31/12/2015	84,000

The profit for the year 2014 includes an abnormal income of ` 3,000. The profit for the year 2015 is after writing off a loss due to theft of ` 4,000. At present, the assets of the business are not insured. X wants to take a comprehensive policy and has ascertained that an annual premium of ` 400 would have to be paid. X would like to manage the business whole time and this would involve giving up the present job in which he is drawing ` 2,000 per month. If X manages the business, the employment of the manager who is looking after the business for a salary of ` 1,500 per month can be terminated and X will draw a salary of ` 2,000 per month from the business. Calculate the goodwill if both the parties have agreed to value it at 2 year's purchase of average profits.

9. P is negotiating with M for the purchase of the latter's business. It was decided to value goodwill according to the super profit method. M has been running the business only for the three years and hence P would like to attach weights for the profits of the three years in such a way that the most recent profits would be assigned a higher weight than the other year's profits. The profits of the past three years are as follows:

Year	**Rs.**
2013	36,000
2014	40,000
2015	38,000

Calculate the annual average profits.

10. The following particulars are available in the books of Bharti Telecom:
   (a) Capital employed ` 1,50,000
   (b) Trading profit after tax

Year	**Rs.**
2012	1,12,200
2013	1,15,000
2014	1,02,000 (loss)
2015	1,21,000

   (c) Market rate of interest on investment 8%.
   (d) Rate of risk return on capital invested in business 2%.
   (e) Remuneration from alternative employment of the proprietor (if not engaged in business ` 13,600 p.a.).

You are required to compute the value of goodwill on the basis of 3 years' purchase of super profits of the business calculated on the average profit of the last four years.

8. From the following information given by Tata Telecom, calculate the value of goodwill:
   (a) Average capital employed Rs. 12,00,000.
   (b) Company declares 15% dividend on the shares of Rs.20 each fully paid which is quoted in the market at Rs.25.
   (c) Net trading profit of the firm (after tax) for the past 3 years Rs.2,15,200, Rs.1,81,400 and Rs. 2,25,000.

You are required to compute the value of goodwill on the basis of 5 years' purchase of super profits of the business calculated on the average profit of the last three years.

11. From the following information, calculate value of the goodwill for Reliance Ltd. by:
   (i) Super profit method.
   (ii) Capitalisation method.

(a) Average capital employed in the business Rs.6,00,000.

(b) Net trading profit of the firm for the past three years were Rs.1,07,600, Rs.90,700 and Rs.1,12,500.

(c) Rate of interest expected from capital having regard to the risk involved 12%.

(d) Fair Remuneration to the firm for their services Rs.12,000 per annum.

(e) Sundry assets of the firm Rs.7,54,762.

(f) Sundry liabilities Rs.31,329.

Note: Take 8 years' purchase of super profit as value of goodwill.

7.11. SUGGESTED READINGS

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Chapter – 8

VALUATION OF SHARES

Objectives :

After reading this unit you should be able to :

- Understand the need for valuation of shares
- Discuss the methods of valuation of shares
- Go through the valuation of shares under intrinsic method, yield method and fair value method

Structure:

8.1 VALUATION OF SHARES

Valuation of shares is one of the important issues in accounting calling for accountant's judgement experience and knowledge.

8.1.1 Need for Valuation of shares:

The need for the valuation of shares arises due to the following reasons.

1. For amalgamation and absorption purpose.
2. For wealth tax purpose – to be valued every year.
3. When a block of shares are purchased
   i. To acquire controlling interest i.e., merger, take over etc.
   ii. In case, where there is no interest in acquiring controlling interest.
4. For selling shares of a shareholder to a purchaser in the absence of stock exchange quotation.
5. For conversion of one class of shares to another class of shares.
6. For payment of compensation to a company consequent upon nationalization.

7. When shares are to be taken as a security against loan.
8. On death of the owner for the purpose of distribution of shares of heirs.
9. When partners in a firm jointly hold some shares of a company for distribution among partners on dissolution on the basis of valuation of shares made.
10. For ascertaining capital gains tax at the time of sale or transfer of shares.

8.2 METHOD OF VALUATION OF SHARES

8.2.1 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.

a. The economic condition of the country
b. The nature of company's business
c. Other political and economic factors (e.g., possibility of nationalization, excise duty on goods produced, etc.)
d. The demand and supply of shares
e. Proportion of liabilities and capital
f. Rate of proposed dividend and past profits of the company
g. Yields of other related shares of the stock exchange etc.

8.2.2 Methods of Valuation of Shares :

There are three methods in the valuation of shares. These are:

i. Intrinsic Method
ii. Yield Method
iii. Fair Value Method

8.3 INTRINSIC METHOD OR NET ASSET METHOD

This method is also known as **assets backing method, balance sheet method, real value method or break-up value method**. Under this method, the valuation may be made either: (i) On a going concern basis or (ii) Break-up value basis. In the case of going concern basis, utility of the assets to the business is to be considered. But in the case of Break-up value basis the realizable value i.e., market value of assets should be taken into consideration for the purpose of valuation of shares.

Net Assets Method of Valuing Shares

	Rs	Rs.
Goodwill		x x x
Land		x x x
Buildings		x x x
Plant		x x x
Furniture		x x x
Stock		x x x
Debtors		x x x
Bills receivable		x x x
Cash and Bank		x x x
Total Assets		x x x
Less: Payments in the event of Liquidation		
Debentures	x x x	
Creditors	x x x	
Other Liabilities	x x x	x x x
Net Assets of the business		x x x
Less: Preference share capital with arrears of dividend		x x x
Balance available for equity shareholders		x x x

$$\text{Value of equity share} = \frac{\text{Amount available to equity shareholders}}{\text{No.of equity shares}}$$

Alternatively the value of equity share under this method may be ascertained in the following way.

	Rs.	Rs.
Equity share capital		x x x
Reserves		x x x
Other surpluses		x x x
Profit on revaluation		x x x
Gross equity		x x x
Less: Loss on revaluation	x x x	
Miscellaneous expenditure and losses	x x x	x x x
Net equity		x x x

$$\text{Value of equity per share} = \frac{\text{Net equity}}{\text{No.of equity shares}}$$

8.3.1 Factors to be considered in valuing the assets :

1. In valuation of company assets, goodwill should be valued at current cost and therefore any book value appearing as a result of purchase of goodwill must be eliminated.
2. Fictitious assets such as debit balance of profit and loss account, discount on issue of shares and debentures, preliminary expenses, etc., should be excluded.
3. All other assets (including non-trading assets such as investments) should be taken at their market values. In the absence of information in the question regarding the market values of the different assets, book values may rightly be taken as the market values of the different assets.
4. While calculating the value of inventories, finished goods may be valued at market price and raw materials, stocks and work in progress should be valued at cost price.
5. In case of book debts, it must be valued after making provision for bad and doubtful debts.

8.3.2 Valuation of Liabilities :

1. Generally liabilities are to be taken at book values. However, due consideration is to be given for contingent liabilities. Similarly it is necessary to provide adequate provision for outstanding expenses.
2. It is necessary to provide adequate provision for taxation and dividends, so that these are included in the liabilities
3. In case the share capital comprises both equity shares and preference shares, it is necessary to deduct preference share capital from the assets.
4. In case, the preference shares are participating preference shares, their claim for surplus should also be deducted from the value of the assets,

Illu.1: On December 31, 2009. The Balance Sheet of a limited company disclosed the following position:-

Liabilities	Rs.	Assets	Rs.
Issued capital in Rs.10 shares	**8,00,000**	**Fixed Assets**	**10,00,000**
Reserves	**1,80,000**	**Current Assets**	**4,00,000**
Profit and Loss A/c	**40,000**	**Goodwill**	**80,000**
5% Debentures	**2,00,000**		
Current Liabilities	**2,60,000**		
	14,80,000		**14,80,000**

On December 31, 2009 the fixed assets were independently valued at Rs.7,00,000 and goodwill at Rs.1,00,000. The net profits for the three years were, 2007 Rs.1,03,200, 2008 Rs.1,04,000, 2009 Rs.1,03,000 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 10%. Compute the value of company's share by Net assets method

Solution:

Value of company's share by Net Assets Method

Particulars	**Rs.**	**Rs.**
Assets:-		
Goodwill		1,00,000
Fixed Assets		7,00,000
Current Assets		4,00,000
		12,00,000
Less: Liabilities:-		
5% Debentures	2,00,000	
Current Liabilities	2,60,000	
		4,60,000
Net Assets		**7,40,000**

$$\text{No.of Equity shares} = \frac{\text{Equity share capital}}{\text{Value of equity share}} = \frac{8{,}00{,}000}{10} = 80{,}000 \text{ shares}$$

$$\text{Intrinsic value of the share} = \frac{\text{Net Assets}}{\text{Total No. of Equity shares}}$$

$$= \text{Rs.}\frac{7{,}40{,}000}{80{,}000} = \text{Rs.}9.25$$

Illu.2: From the following balance sheet, you required to value of the equity share.

Liabilities	**Rs.**	**Assets**	**Rs.**
2,000 6% preference shares of Rs.100 each	**2,00,000**	**Assets at book value**	**6,00,000**
30,000 equity shares of Rs.10 each	**3,00,000**		
Liabilities	**1,00,000**		
	6,00,000		**6,00,000**

The market value of ½ of the assets is considered at 10% more than the book values and that of remaining half at 5% less than the book value. There was a liability of Rs.5,000 which remain unrecorded. Assume Preference share have no priority as to payment of capital or dividend.

Solution :

Valuation of equity share by net assets method

	Rs.	Rs.
First half assets value (Rs.6,00,000 x ½)	3,00,000	
Add : Increase in Assets value (Rs.3,00,000 x 10/100)	30,000	3,30,000
Second half assets value (Rs.6,00,000 x ½)	3,00,000	
Less : Decrease in asset value (Rs.3,00,000 x 5/100)	15,000	2,85,000
		6,15,000
Less : Liabilities	1,00,000	
Unrecorded liability	5,000	1,05,000
Net Assets		5,10,000
Less : Amount available to preference shareholders (Rs.5,10,000 x 2,00,000/5,00,000)		2,04,000
Amount available to Equity shareholders		3,06,000

$$\text{Value of equity share} = \frac{\text{Amount avilable to equity shareholders}}{\text{No. of equity shares}} = \frac{3{,}06{,}000}{30{,}000} = \text{Rs.}10.20$$

Intrinsic value of equity share = Rs.10.20

Illu.3: The following is the summarised Balance Sheet of a company as at 31st December, 2009.

	Rs.		Rs.
Share Capital:		**Fixed Deposits:**	**38,00,000**
10,000 5% pref. shares of		**Investments**	**10,25,000**
Rs.100 each fully paid	**10,00,000**		
2,00,000 equity shares of		**Current Assets:**	
Rs.10 each fully paid	**20,00,000**	**Stock-in-Trade**	**5,72,000**
Reserves & Surplus:		**Sundry Debtors**	
General Reserve	**15,00,000**	**Less: Provisions**	**12,78,000**
P & L Account	**12,00,000**	**Cash and Bank balances**	**2,25,000**
Secured Loans:			
6% Debentures	**8,00,000**		
Current Liabilities:			
Sundry Creditors	**2,75,000**		
Liabilities for expenses	**1,25,000**		
	69,00,000		**69,00,000**

For purposes of valuation of shares, Fixed Assets are to be depreciated by 10 per cent and investments are to revalued at Rs.10,80,000. Debtors will realize Rs.12,14,000.

Interest on Debentures is accrued due for 9 months and preference dividend for the year ending 31st December, 2008 is also due; neither of these has been provided for in the Balance Sheet. Calculate the value of each Equity Share.

Solution:

Valuation of equity share by Net Assets method

	Rs.	Rs.
Fixed Assets		34,20,000
Investments as per revaluation		10,80,000
Stock-in-trade		5,72,000
Sundry Debtors		12,14,000
Cash and Bank Balances		2,25,000
		65,11,000
Less: Liabilities		
6% Debentures	8,00,000	
Sundry Creditors	2,75,000	
Liabilities for Expenses	1,25,000	
Interest on Debentures (accrued for 9 months)	36,000	
		12,36,000
Net Assets		52,75,000
Less: Preference Share Capital	10,00,000	
Preference Share Dividend @ 5% on Rs.10,00,000	50,000	
		10,50,000
Amount available to equity shareholders		42,25,000

$$\text{Intrinsic value of equity share} = \frac{\text{Rs.}42{,}25{,}000}{2{,}00{,}000} = \text{Rs.}21.13$$

8.3.3 Treatment of partly paid-up equity shares :

When there are fully paid-up and partly paid-up equity shares, it is necessary to convert partly paid-up shares into fully paid-up shares by making a notional call and uncalled amount should be added to net assets, before dividing the same by the number of shares. The value of each partly paid up share will then be the value of each fully paid up share minus the amount due on it.

8.3.4 Valuation of preference shares :

In India, preference shares have priority as to payment of dividend and repayment of capital over equity shares in the event of company's winding up. They are taken as cumulative but non-participating unless otherwise stated. Their valuation generally on ``Dividend basis'' according to the following formula :

$$\text{Paid up value} \times \frac{\text{Average maintainable dividend rate}}{\text{Normal rate of return}}$$

In case of dividend on cumulative preference shares is in arrears, the present value of such arrears of dividend (if there is a possibility of their payment) should be added to the value of a preference share calculated as above. The dividend basis for valuation of preference shares is useful only in those cases where the preference share capital has adequate assets backing and the company is a going concern. In case the preference share capital does not have adequate assets backing or the company is going into liquidation it will be appropriate to value preference shares according to the net asset method.

In case of participating preference shares of companies in liquidation, their share in the surplus assets remaining after payment to the equity shareholders is taken into account.

Applicability of the method :

1. The method is particularly applicable when the shares are valued at the time of amalgamation, absorption and liquidation of companies, and
2. The permanent investors determine the value of shares under this method at the time of purchasing the shares
3. This method is also applicable when shares are acquired with control motives.

Illu.4: The following information are obtained from the books of Sunrise Company Limited, as on 31 December, 2009:

Capital:	**Rs.**
20,000 A Equity Shares of Rs.10 each fully paid up	**2,00,000**
20,000 B Equity Shares of Rs.10 each, Rs.7.50 per share called and paid up	**1,50,000**
20,000 C Equity Shares Rs.10 each, Rs.5 per share called and paid up	**1,00,000**
General Reserve	**2,70,000**
Liabilities to Sundry Parties	**1,10,000**
Fixed Assets *less* Depreciation	**3,34,000**
Commission on Issue of Shares	**12,000**
Preliminary Expenses	**18,000**
Floating Assets	**4,66,000**

Calculate the values of each type of share by the assets backing method (excluding goodwill)

Solution:

Valuation of Equity Shares of a company by Net Assets Method

	Rs.	**Rs.**
Tangible Assets:		
Fixed Assets *less* Depreciation	3,34,000	
Floating Assets	4,66,000	8,00,000
Less: Liabilities		
Sundry Creditors		1,10,000
		6,90,000
Add: Notional Call:		
(a) On B Equity Shares: 20,000 @ Rs.2.50	50,000	
(b) On C Equity Shares: 20,000 @ Rs.5.00	1,00,000	1,50,000
Net Assets		**8,40,000**

$$\text{Value per fully paid share} = \frac{\text{Rs.8,40,000}}{60{,}000} = \text{Rs.14.00}$$

Rs.7.50 Equity share value paid up = Rs.14.00 – 2.50 = Rs.11.50
Rs.5.00 equity share value paid up = Rs.14.00 – 5.00 = Rs.9.00
The value of each A Equity Share = Rs.14
The value of each B Equity Share = Rs.11.50 (i.e., Rs.14.00 – Rs.2.50)
The value of each C Equity Share = Rs.9 (i.e., Rs.14.00 – Rs.5.00)

Illu.5: Given below is the Balance Sheet of Victory Co. Ltd. as on 31st December, 2009:

BALANCE SHEET

Liabilities	**Rs.**	**Assets**	**Rs.**
1,000 8% Preference Shares of Rs.100 each fully paid	**1,00,000**	**Building**	**1,30,000**
2,000 Equity Shares of Rs.100 each fully paid	**2,00,000**	**Machinery**	**1,20,000**
General Reserve	**1,10,000**	**Furniture**	**20,000**
Profit & Loss Account	**40,000**	**Investments in 6% Govt. Securities**	**90,000**
Creditors	**1,00,000**	**Stock**	**1,00,000**
		Debtors	**60,000**
		Cash and Bank Balance	**20,000**
		Preliminary Expenses	**10,000**

	5,50,000		**5,50,000**

You are given the following information:

(1) The present value of Building is Rs.1,80,000 and that of Machinery is Rs.80,000

(2) Companies doing similar business show profit earning capacity of 10% on market value of their shares.

(3) The average annual profit after 50% tax of last three years is Rs.48,000.

(4) The company has held 6% Govt. Securities for last 3 years and the interest on the Govt. Securities is liable to tax.

(5) Goodwill of the company is to be taken at 5 years' purchase of super profits.

Calculate the fair value of the share of the company.

Solution :

Calculation of Goodwill :

		Rs.	Rs.
I.	Capital employed :		
	Buildings		1,80,000
	Machinery		80,000
	Furniture		20,000
	Stock		1,00,000
	Debtors		60,000
	Cash and bank balances		20,000
	Total Assets		4,60,000
	Less : Creditors		1,00,000
	Capital employed		**3,60,000**
II.	Calculation of Super profits :		
	Average annual profit after 50% tax		48,000
	Less : Interest on Govt. Securities		
	(Rs.1,00,000 x 6/100)	6,000	
	Less : Tax 50%	3,000	3,000
			45,000
	Less : Normal profit (Rs.3,60,000 x 10/100)		36,000
	Super profit		**9,000**

iii. Calculation of Goodwill :

Goodwill = Super profits x 5 years = Rs.9,000 x 5 = Rs.45,000

Valuation of share by Net Assets Method

	Rs.
Goodwill (calculated value)	45,000
Add : Govt. Securities	90,000
Add : Other Net Assets [as per (i)]	3,60,000
Total Net Assets	4,95,000
Less : Preference share capital	1,00,000
Net assets available to equity shareholders	3,95,000

$$\text{Intrinsic value of share} = \frac{\text{Net assets available to equity shareholders}}{\text{No. of equity shares}}$$

$$= \frac{3,95,000}{2,000} = Rs.197.50$$

Valuation of share by Yield Method :

	Rs.
Average annual profit	48,000
Less : Preferential dividend (Rs.1,00,000 x 8/100)	8,000
Profits available to equity shareholders	40,000

$$\text{Earning rate} = \frac{\text{Profits available to equity shareholders}}{\text{Equity share capital}} \times 100 = \frac{40,000}{2,00,000} \times 100 = 20\%$$

$$\text{Share market value} = \frac{\text{Earning rate}}{\text{Normal rate of return}} \times \text{paid up value of share}$$

$$= \frac{20}{10} \times 100 = \text{Rs.}200$$

Calculation of fair value of share :

$$\text{Fair value of share} = \frac{\text{Intrinsic value of share} + \text{Market value of share}}{2}$$

$$= \frac{197.50 + 200}{2} = \text{Rs.}198.75$$

8.4 YIELD 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 percentages. Since the valuation of shares is made on the basis of yield, and therefore, 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. While investing funds, the investor's main point of view is the return, although asset backing is also important because it provides the security. A genuine investor who finds that a company has low dividend rate but high asset backing never invests in the company with a view to liquidating the company and getting the benefit of high asset backing.

Under this method, the future maintainable profit for equity dividend is estimated by reference to past performance. This is adjusted by eliminating non-recurring incomes, deducting income tax, making allocation to reserves and preference dividend. The adjusted profit is capitalized at the normal rate of return in similar business. The yield method of valuation may taken any of the following forms.

(i) Return on capital employed (ROCE) or
(ii) Expected future dividends

The first method is adopted in case of majority holding, whereas the second method is adopted in case of minority holding.

8.4.1 Return on Capital Employed (ROCE):

$$. \text{ROCE} = \frac{\text{Profit earned}}{\text{Capital employed}} \times 100$$

$$. \text{Value of share} = \frac{\text{ROCE}}{\text{Normal rate of return}} \times \text{Paid up value of share}$$

Note: Profit earned means the profit before deducting debenture interest and preference dividend but after charging income tax. Capital employed includes preference share capital, Equity share capital, Reserve and Surplus, Debentures and long-term loans.

8.4.2 Dividend basis:

a. On the basis of total amount of dividend:

$$\text{i. Capitalised value of profit} = \frac{\text{Total amount of dividend}}{\text{Normal rate of return}} \times 100$$

$$\text{ii. Value of Equity share} = \frac{\text{Capitalised value of profit}}{\text{No.of equity shares}}$$

b. On the basis of rate of dividend:

i. When the rate of dividend is not given it may be ascertained as follows

$$\text{Rate of dividend} = \frac{\text{Expected profit to equity shareholders}}{\text{Equity share capital (paidup)}} \times 100$$

ii. Value of each equity share:

$$= \frac{\text{Expected rate of dividend}}{\text{Normal rete of return}} \times \text{Paidup value of shares}$$

8.5 FAIR VALUE METHOD

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. Fair value is the average of intrinsic value and yield value.

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

Illu.6: From the following information, calculate the value of an equity share:

(i) The paid-up share capital of a company consists of 1,000, 15% Preference Shares of Rs.100 each and 20,000 Equity shares of Rs.10 each.

(ii) The average annual profits of the company, after providing for depreciation and taxation amounted to Rs.75,000. It is considered necessary to transfer Rs.10,000 to General Reserve before declaring any dividend.

(iii) The normal return expected by investors on equity shares from the type of business carried on by the company is 10%.

Solution:

Particulars	Rs.
Profit after tax	75,000
Less: Transferred to General Reserve	10,000
	65,000
Less: Preference dividend @ 15% on Rs.1,00,000	15,000
Profits available to Equity Shareholders	**50,000**

$$\text{Expected Rate of Dividend} = \frac{\text{Profit available for Dividend}}{\text{Total paid - up Equity Share Capital}} \times 100$$

$$= \frac{\text{Rs.50,000}}{\text{Rs.2,00,000}} \times 100 = 25\%$$

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

$$= \frac{25\%}{10\%} \times \text{Rs.10} = \text{Rs.25}$$

Illu.7: From the following particulars calculate the value of share.

	Rs.
2,000 9% Preference shares of Rs.100 each	**2,00,000**
50,000 Equity shares of Rs.10 each Rs.8 per share paid up	**4,00,000**
Expected profit per year before tax	**2,18,000**
Rate of tax – 50%	

Transfer to General reserve every year – 20% of profit. Normal rate of earnings 15%.

Solution:

1. Calculation of Profit Available for Equity Shareholders:

	Rs.
Expected Profit	2,18,000
Less: Tax at 50% Rs.2,18,000 x 50/100	1,09,000
Profit after tax	1,09,000
Less: Transfer to General Reserve at 20% Rs.1,09,000 x 20/100	21,800

Profit after General Reserve and Tax	87,200
Less: 9% Preference Dividend on Rs.2,00,000	
Preference Share capital (2,00,000 × $^{9}/_{100}$)	18,000
Profit available for Equity shareholders	69,200

2. Calculation of Expected Rate of Earnings:

$$\text{Expected Rate} = \frac{\text{Profits available to Equity shareholders}}{\text{Total paid - up Equity Capital}} \times 100$$

$$= \frac{69{,}200}{4{,}00{,}000} \times 100 = 17.3\%$$

3. Calculation of Value of Equity Share:

$$\text{Value of Preference shares} = \frac{\text{Expected rate}}{\text{Normal rate of return}} \times \text{paid up value of each share}$$

$$= \frac{17.3}{15} \times 8 = Rs.9.23$$

Illu.8: Narmada Ltd., declared dividend at 100% on its shares of Rs.10. Rs.7 paid up. Its share are quoted in market at Rs.32. You are required to calculate the normal rate of earnings.

Solution:

Paid up Value of the Share = Rs.7
Declared Dividend = 100%
Amount of Dividend = Rs.7 × $^{100}/_{100}$ = Rs.7

$$\text{Normal Rate of Earnings} = \frac{\text{Amount of Dividend}}{\text{Market value of share}} \times 100 = \frac{7.00}{32} \times 100 = 21.88\%$$

Normal Rate of Earnings = 21.88%

Note : 100% Dividend was declared on shares. As the Paid up value of share is Rs.7, Dividend at 100% on paid up value of the share will become Rs.7.

Illu.9 : The paid up capital of Kennedy Ltd. consists of 8,000 equity shares of Rs.10 each and 5,000 10% preference shares of Rs.10 each. Raju holds 1,000 equity shares in this company. It is ascertained that the normal annual net profit of such a company is

Rs.30,000 and the normal return by way of dividend on this paid up value of equity share capital is 15%. You are required to value Raju's share.

Solution :

	Rs.
Normal Annual net profit of a company	30,000
Less : Dividend payable to preference shareholders (Rs.50,000 x 10/100)	5,000
Profits available to equity shareholders	25,000

$$\text{Rate of return} = \frac{\text{Expected profits}}{\text{Equity share capital}} \times 100 = \frac{25,000}{80,000} \times 100 = 31.25\%$$

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

$$= \frac{31.25}{15} \times 10 = \text{Rs.}20.83$$

Value of 1,000 equity shares = 1,000 x Rs.20.83 = Rs.20,830

Illu.10: The following particulars are available in related to Dhrakshrameswara Ltd..

- **i.** **Capital 450, 6% preference shares of Rs.100 each fully paid. 4,500 equity shares of Rs.10 each fully paid.**
- **ii.** **External liabilities Rs.7,500**
- **iii.** **Reserves and surplus Rs.3,500**
- **iv.** **The average normal profit (after taxation) earned every year by the company Rs.8,505.**
- **v.** **The normal profit earned on the market value of equity shares, fully paid, of the same type of companies is 9%. Calculate the value of each type of shares by (1) the asset backing method, assuming that the total assets worth Rs.350 are fictitious; (2) the earning capacity method.**

Solution:

Calculation of Value per share on the basis of:

I. Asset – Backing Method:

Value of Assets as per shareholder's Capital & Liabilities:

		Rs.
(i)	6% Preference Share Capital:	
	450 preferences shares @ Rs.100 each	45,000
(ii)	Equity Share Capital:	
	4,500 equity shares @ Rs.10 each	45,000
(iii)	Reserves & Surplus	3,500
		93,500
	Less: Fictitious assets	350
		Rs,
	Net Assets value	**93,150**
	Less: Amount payable to preference shareholders	45,000
	Net Assets available to equity shareholders	48,150
	Total No. of Equity Shares	4,500

$$\text{Value per equity share} = \frac{\text{Net Assets}}{\text{Total No. of equity shares}}$$

$$= \frac{48{,}150}{4{,}500} = \textbf{Rs.10.70}$$

$$\text{Intrinsic value of Preference shares} = \frac{\text{Net assets available from preference shareholders}}{\text{No. of preference shares}}$$

$$= \frac{45{,}000}{450} = \text{Rs.}100$$

II. Earning Capacity Method:

		Rs.
I.	Average Normal Profits (after taxation)	8,505
	Less: Dividend on Preference Capital i.e. @ 6% on Rs.45,000 ($45{,}000 \times {}^{6}/_{100}$)	2,700
	Profits available to Equity Shareholders	5,805

$$\text{II. Expected Rate of Dividend} = \frac{\text{Expected profits}}{\text{Equity share capital} \times 100}$$

$$= \frac{5,805}{45,000} \times 100 = \mathbf{12.9\%.}$$

III. Earning capacity value per share =

$$\frac{\text{Expected Rate}}{\text{Normal Rate}} \times \text{Paid up value of each share} = \frac{12.9}{9} \times 10.$$

Value per share = Rs.14.33.

$$\text{Value of Preference shares} = \frac{\text{Expected rate}}{\text{Normal rate of return}} \times \text{paid up value of each share}$$

$$= \frac{6}{6} \times 100 = \text{Rs.}100$$

Value of preference share – Rs.100

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

$$\text{Fair value of equity share} = \frac{\text{Rs.}10.70 + 14.33}{2} = \text{Rs.}12.52$$

$$\text{Fair value of preference share} = \frac{\text{Rs.}100 + 100}{2} = \text{Rs.}100$$

Illu.11: The following is the Balance Sheet of X Ltd. as at 31-12-2009.

Liabilities	Rs.	Assets	Rs.
Share Capital 10,000		**Land and Buildings**	**55,000**
Shares of Rs.10 each	**1,00,000**		
General Reserve	**20,000**	**Plant and Machinery (at loss depreciation)**	**65,000**
Taxation Reserve	**30,000**	**Trade Marks**	**10,000**
Workmen Savings	**15,000**	**Stock**	**24,000**
Profit and Loss A/c	**16,000**	**Debtors**	**44,000**
Sundry Creditors	**49,000**	**Cash at Bank**	**26,000**
		Preliminary Expenses	**6,000**
	2,30,000		**2,30,000**

The Plant and Machinery is worth Rs.60,000 and Land and Buildings have been valued at Rs.1,20,000 by an independent valuer, Rs.4,000 of the debts are

bad. The profits of the company have been as follows: 2007 Rs.40,000; 2008 Rs.45,000; 2009 Rs.53,000

It is the company's practice to transfer 25% of the profits to reserve ignoring taxation, find out the value of shares. Similar companies give a yield of 10% on the market value of their shares. Goodwill may be taken to be worth Rs.80,000.

Solution:

(a) Net Assets Method or Intrinsic Method

(b)

Particulars	Rs.	Rs.
Assets:-		
Goodwill		80,000
Land & Buildings		1,20,000
Plant and Machinery		60,000
Trade Marks		10,000
Stock		24,000
Debtors	44,000	
Less: Bad debts	4,000	40,000
Cash at Bank		26,000
Total Assets		3,60,000
Less: Liabilities:-		
Workmen's Savings	15,000	
Sundry Creditors	49,000	
		64,000
Net Assets		**2,96,000**

$$\text{Intrinsic value of the share} = \frac{\text{Net Assets}}{\text{Total No. of Equity shares}} = \frac{2,96,000}{10,000} = \text{Rs.}29.60$$

(b) Yield Method:-

I. Average profits of the Company for

	Rs.
2007	40,000
2008	45,000
2009	53,000
	1,38,000
Less: Bad debts during 2009	4,000
	1,34,000
Average Profit = $^{Rs.1,34,000}/_{3}$	44,467
Less: Transfer to General Reserve (25%) = 44,667 × $^{25}/_{100}$ = 11,167	11,167
Average Profits available to Equity shareholders	**33,500**

II. $\text{Expected Rate of Return} = \dfrac{\text{Average Profits}}{\text{Equity share capital}} \times 100$

$$= \frac{33{,}500}{1{,}00{,}000} \times 100$$

III. $\text{Yield value of Shares} = \dfrac{\text{Expected Rate}}{\text{Normal Rate}} \times \text{Paid up value of each share}$

$$= \frac{33.5}{10} \times 10 = \text{Rs.}33.50$$

Expected Rate = **33.5%**

Illu.12: The Balance Sheet of Govind Ltd., as on 31-3-2010 was as under:

Liabilities	Rs.	Assets	Rs.
2,000 Equity shares of Rs.100 each	**2,00,000**	**Land and Buildings**	**1,25,000**
General Reserve	**50,000**	**Machinery**	**75,000**
Profit and Loss a/c	**25,000**	**Investments at cost (Market Value Rs.37,500)**	**45,000**
Creditors	**45,000**	**Debtors**	**50,000**
Provision for Taxation	**20,000**	**Stock**	**37,500**
Provident Fund	**17,500**	**Cast at Bank**	**25,000**
	3,57,500		**3,57,500**

Additional Information:

(1) Land and Building and Machinery are valued at Rs.1,37,500 and Rs.55,000 respectively.

(2) Of the total debtors, Rs.2,500 are bad.

(3) Goodwill is to be taken at Rs.25,000.

(4) The normal rate of dividend, declared by such type of companies is 15% on the up capital.

(5) The average rate of dividend, declared and paid by this company is 18% on its paid up capital.

Capital the fair value of the Equity Share of the Company.

Solution:

Value of Equity Shares on the Basis of Intrinsic Value	**Rs.**	**Rs.**
Land and Buildings		1,37,500
Machinery		55,000
Investments at market Value		37,500
Debtors less Bad Debts Rs.2,500		47,500
Stock		37,500
Cash at Bank		25,000
Goodwill		25,000
		3,65,000
Less: Creditors	45,000	
Provision for Taxation	20,000	
Provident	17,500	82,500
Net Assets available for Equity Shareholders		**2,82,500**
Number of Equity Shaers		2,000

$$\text{Value of Equity shares} = \frac{\text{Rs.}2{,}82{,}500}{2{,}000} = \text{Rs.}141.25$$

Value of Equity Share according to Yield Method

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

$$= \frac{18\%}{15\%} \times \text{Rs.}100 = \text{Rs.}120$$

Fair Value of Equity Share

$$= \frac{\text{Value on the Basis of Yield} + \text{Value on the Basis of Net Assets}}{2}$$

$$= \frac{\text{Rs.}120 + \text{Rs.}141.25}{2} = \text{Rs.}130.62.$$

Illu.13: The following information are obtained from the books of Sunrise Company Limited, as on 30 April, 2010:

Capital:	**Rs.**
10,000 Equity Shares of Rs.10 each fully paid up	**1,00,000**
10,000 Equity Shares of Rs.10 each, Rs.7.50 per share called and paid up	**75,000**
10,000 Equity Shares Rs.10 each, Rs.5 per share called and paid up	**50,000**

	Rs.
General Reserve	**1,35,000**
Liabilities to Sundry Parties	**55,000**
Fixed Assets *less* Depreciation	**1,67,000**
Commission on Issue of Shares	**6,000**
Preliminary Expenses	**9,000**
Floating Assets	**2,33,000**

It is estimated that the normal average profit *less* tax of the company will be maintained at Rs.34,000, and the expected rate for capitalization purpose is 8%. Calculate the values of each type of share by the assets backing method (excluding goodwill) and also by the earning capacity method. Assume dividends are declared on paid up capital.

Solution:

Valuation of Shares by the Assets Backing:

	Rs.	Rs.
Tangible Assets:		
Fixed Assets		1,67,000
Floating Assets		2,33,000
		4,00,000
Less: Liabilities to Sundries		55,000
		3,45,000
Add: Notional Call:		
(a) On 2nd Equity Shares: 10,000 @ Rs.2.50	25,000	
(b) On 3rd Equity Shares: 10,000 @ Rs.5.00	50,000	75,000
Net Assets		**4,20,000**

$$\text{Value per fully paid share} = \frac{\text{Rs.}4{,}20{,}000}{30{,}000} = \text{Rs.}14$$

The value of each 1st Equity Share = Rs.14.
The value of each 2nd Equity Share = Rs.11.50 (i.e., Rs.14 – Rs.2.50)
The value of each 3rd Equity Share = Rs.9 (i.e., Rs.14 – Rs.5)

Valuation of Shares by the Earning Capacity:

Total paid-up Capital = Rs.2,25,000
Normal Average Profit = Rs.34,000

$$\text{Earning Rate} = \frac{34{,}000}{2{,}25{,}000} \times 100 = 15.11\%$$

The value of each 1st Equity Share = $^{15.11}/_{8} \times 10$ = **Rs.18-89**
The value of each 2nd Equity Share = $^{15.11}/_{8} \times$ 7-50 = **Rs.14-17**
The value of each 3rd Equity Share = $^{15.11}/_{8} \times 5$ = **Rs.9-44**

8.6 QUESTIONS

1. What is need for the valuation of shares?
2. Discuss different methods of valuing equity shares.
3. Explain the 'Yield Method' of valuing equity shares.
4. Describe the methods of valuation of shares and discuss which method, in your view, is most appropriate in valuing 'minority' and majority holdings.
5. Distinguish between 'Intrinsic' and 'market' value of shares
6. What are the aims of valuation of shares?
7. What are the factors affecting valuation of shares?
8. Explain the necessity of valuation of shares
9. Explain the circumstances under which valuation of shares is essential and discuss the various methods of valuing the shares.
10. Value of a share under yield method
11. What are the merits and demerits of net assets and yield method?
12. Explain the methods of Valuation of shares
13. Yield method
14. Intrinsic value
15. Briefly explain the various methods of valuation of shares.

8.7 EXERCISES

1. NTT Ltd. declared dividend at 25% on its shares of Rs.10, Rs.6 paid up. Its share are quoted in the market at Rs.10. You are required to calculate the normal rate of earnings.

[Ans.: Normal Rate of Earnings = 15%]

2. X Ltd., declared dividend at 25% on its shares of Rs.10, Rs.8 paid up. Its shares are quoted in the market at Rs.10. You are required to calculate the normal rate of earnings.

[Ans.: Normal Rate of Earnings = 20%]

3. Padmaja Ltd., declared dividend at 100% on its shares of Rs.10. Rs.12 paid up. Its share are quoted in market at Rs.41. You are required to calculate the normal rate of earnings.

[Ans.: Normal rate of return = 29.26%]

4. A company's share has a market value of Rs.15. Dividend paid on the share is Rs.2, what is the normal rate of return?

[Ans.: Normal Rate of Return = 13.33%]

5. A company's share has a face value of Rs.10 and market value of Rs.15. The dividend paid by the company on an average is 30% What is the normal rate of return.

[Ans.: Normal Rate of Return = 20%]

6. A company declared dividend at 20% on its equity shares having a paid up value of Rs.10 and a market price of Rs.25. Calculate the Dividend Yield Ratio.

[Ans.: 8%]

7. X Ltd., declares dividend at 20% on its Rs.50 fully paid up share. If normal expected rate in the market is 10% what shall be the value of a share on yield basis?

[Ans.: Value of Share Rs.100]

8. The following particulars of a company are available.

(a) Equity share capital : 10,000 equity shares of Rs.10 each fully paid.
(b) Preference share capital : 1,000 12% preference shares of Rs.100 each fully paid
(c) Reserves and surplus Rs.15,000
(d) External liabilities : Creditors Rs.12,000, Bills payable Rs.6,000
(e) The average normal profit after tax earned each year by the company Rs.28,500
(f) Transferred to general reserve – 10^%

Assets of the company include one fictitious item of Rs.800. The normal rate of return in respect of the equity share of this type of company is ascertained at 10% (ignore goodwill).

Compute the value of the company's share by (a) the asset backing method; and (b) yield method.

[Ans.: (a) Rs11.42; (b) 13.65]

9. On the basis of the following information, calculate the value of Equity Shares.

	Rs.
10,000 10% Preference shares of Rs.100 each paid	10,00,000
60,000 Equity shares of Rs.10 each fully paid	6,00,000
Total Assets other than Goodwill	20,00,000
Total Outside liabilities	2,00,000
Average net profit after tax	1,00,000

Expected normal yield for Equity Shares 7% of capital. Goodwill is to be taken at 5 years purchase of super profits.

[Ans.: Rs.17.00]

10. From the following information calculate the value per equity shares.

	Rs.
5,000 8% preference shares of Rs.100 each	5,00,000
75,000 Equity shares of Rs.10 each, Rs.8 per share paid up	6,00,000
Expected profits per year before tax	2,80,000
Rate of tax	50%
Transfer to general reserve every year	20% of the profit
Normal rate of earnings	10%

[Ans.: Profits available to equity shareholders Rs.72,000; Normal rate of return 12%; Value of equity share = Rs.9.60]

11. Find the intrinsic value of the share from the following information. Net realisable value of the assets:

	Rs.
Goodwill	4,50,000
Fixed Assets	39,00,000
Other Assets	12,00,000
Capital	
Equity share of Rs.100 each	30,00,000
10% preference share of Rs.100 each	15,00,000
Other Liabilities	Nil

[Ans.: Rs.135]

12. Surabhi Ltd., has 5,000 equity shares of Rs.10 each, Rs.8 paid and 50,000 6% preference shares of Rs.10 each fully paid. The company transfers 20% of the profit to General Reserve every year. If the expected profit (Based on past year's performance) before Tax is Rs.1,00,000 and the rate of tax is 50%, you required to calculate the value of equity shares by yield method. Assume that the normal rate of dividend is 20%.

[Ans.: Profit available for Equity shareholders Rs.10,000; Expected Rate of Earnings 25%; Value of the Equity Share Rs.10]

13. The following figures are extracted from the books of M/s Prosperous Ltd.

Share Capital:	Rs.
9 percent preference shares of Rs.100 each	3,00,000
1000 equity shares of Rs.100 each Rs.50 called up	50,000
1000 equity shares of Rs.100 each Rs.25 called up	25,000
1000 equity shares of Rs.100 each fully called up	1,00,000
	4,75,000

Reserves and Surplus:	Rs.
General Reserve	2,00,000
Profit and Loss Account	50,000
	7,25,000

On a fair valuation of all the assets of the company, it is found that they have an appreciation of Rs.75,000.

The articles association provided that, in case of liquidation, the preference shareholders will have a further claim to the extent of 10 percent of the surplus assets.

Ascertain the value of each preference and equity share.

[Ans.: Value of each Preference Share Rs.110.83; Value of each equity share (a) Rs.197.50; (b) Rs.147.50; (c) Rs.122.50]

14. On December 31, 2009 the Balance Sheet of a Limited company reveals the following position:

Liabilities	Rs.	Assets	Rs.
Issued Share capital each at Rs.10	4,00,000	Fixed Assets	5,00,000
Reserves	90,000	Current Assets	2,00,000
Profit and Loss a/c	20,000	Goodwill	40,000
5% Debentures	1,00,000		
Current Liabilities	1,30,000		
	7,40,000		7,40,000

On December 31, 2009, the fixed assets were independently valued at Rs.3,50,000 and goodwill at Rs.50,000

The net profits for three years were:

	Rs.
2007	51,600
2008	52,000
2009	51,650

Of which 20% was placed under 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 10%. Compute the value of the company's share by

a. net assets method, and

b. yield value method.

[Ans.: (a) Rs.9.25 (b) Rs.10.35]

15. The following is the Balance Sheet of Madhu Ltd. as on 31.03.2010

Liabilities	Rs.	Assets	Rs.
10,000 Equity Shares of Rs.10 each fully paid	1,00,000	Fixed Assets	2,20,000
10,000 Equity Shares of Rs.10 each Rs.8 per share paid up	80,000	Current Assets	1,10,000
10,000 Equity shares of Rs.10 each Rs.5 per share paid up	50,000	Preliminary expenses	5,000
Reserves	50,000	Floating Assets	5,000
Profit & Loss A/c	50,000		
Creditors	10,000		
	3,40,000		3,40,000

The normal average profit of the Company (after tax) will be maintained at Rs.46,000 and normal rate of return is 8%.

Calculate the value of each type of Equity Share by the Assets-Backing Method, and Yield Basis Method.

[Ans.: (i) Rs.13.17, Rs.11.17, Rs. 8.17 (ii) Rs.25.00, Rs.20.00, Rs.12.50]

16. The following is the balance sheet of Visaka Industries Ltd., as at 31st December, 2009

Liabilities	Rs.	Assets	Rs.
Share capital:		Land, Buildings	41,250
7,500 shares, of Rs.10 each	75,000	Plant & Machinery	48,750
General Reserve	15,000	(at cost less depreciation)	
Taxation Reserve	22,500	Trade marks	7,500
Workmen Savings account	11,250	Stock	18,000
Profit & Loss a/c	12,000	Debtors	33,000
Sundry Creditors	36,750	Cash at Bank	19,500
		Preliminary expenses	4,500
	1,72,500		1,72,500

The Plant and Machinery is worth Rs.45,000 and land and buildings have been valued at Rs.90,000 by an independent valuer. Rs.3,000 of the debtors are bad. The profits of the company have been as follows: 2007 Rs.30,000; 2008 Rs.33,750, 2009 Rs.39,750. It is the company practice to transfer 25% of the profits to reserve. Ignoring taxation, find out the value of the share on the yield basis and also on the next assets basis. Similar companies give an yield of 10% on the market value of their shares.

Goodwill may be taken to be worth Rs.60,000

[Ans.: Intrinsic Value of Share Rs.29.60; Yield value of shares Rs.33.50]

17. Following is the Balance Sheet of Universal Company Ltd. as on 31.3.2010

Liabilities		Rs.	Assets		Rs.
1000, 12% Preference Shares of Rs.200 each fully paid		2,00,000	Building at cost less depreciation		1,70,000
4000 Equity Share of Rs.200 each fully paid		8,00,000	Furniture at cost less depreciation		6,000
Reserve fund		3,00,000	Stock in Trade		9,00,000
P & L A/c. Bal. On 1.4.2009	1,60,000		4% Govt. Securities at cost (Face value Rs.8,00,000)		7,50,000
Profit for 2010	8,60,000	10,20,000			
Provision against			Debtors	6,00,000	
(i) Buildings	20,000		Less: Provision	40,000	5,60,000
(ii) Investments	90,000	1,10,000	Cash and Bank balance		1,20,000
Creditors		96,000	Preliminary Expenses		20,000
		25,26,000			25,26,000

Further information:

1. The Company's Prospects for 2010-11 are equally good.
2. The buildings are now worth Rs.11,30,000.
3. The income-tax liability may be assumed @ 50%.
4. Goodwill is to be valued at three years purchase of Super Profits.
5. Companies doing similar business show a profit earning capacity of 12% on market value of their shares.
6. Profits for the past three years have shown an increase of Rs.1,00,000 annually.

Ascertain the intrinsic value of each equity share.

[Ans.: Goodwill Rs.2,23,320; Intrinsic value of Equity Share Rs.825.83]

18. The following is the balance sheet of Mallikarjuna Ltd. on 31.3.2010:

Liabilities	Rs.	Assets	Rs.
10,000 6% pref. Shares	1,00,000	Sundry Assets	5,10,000
30,000 equity shares	3,00,000	Discount on debentures	10,000
Debentures Redemption Fund	30,000	Preliminary expenses	30,000
7% Debentures	50,000	P & L a/c	60,000
Depreciation fund	30,000		
Sundry creditors	1,00,000		
	6,10,000		6,10,000

Sundry Assets were worth Rs.5.45 Lakhs. Interest on debentures and preference dividend are in arrears for one year. You are required to value the equity shares, if preference shares:

(a) have priority for Repayment of Capital and arrears of dividend.

(b) have no priority for Repayment of capital and arrears of dividend.

[Ans.: (a) Rs.9.52; (b) Rs.9.78]

19. The following is the Balance Sheet of X Ltd. as at March 31, 2010

Liabilities	Rs.	Assets	Rs.
Share Capital: 2,000 Shares of Rs.100 each	2,00,000	Land and Buildings	1,10,000
General Reserve	40,000	Plant & Machinery (at cost less depreciation)	1,30,000
Profit and Loss A/c	32,000	Patents, Trade Marks	20,000
Sundry Creditors	1,28,000	Stock	48,000
Taxation Reserve	60,000	Debtors	88,000
		Cash at Bank	52,000
		Preliminary Expenses	12,000
	4,60,000		4,60,000

The Plant and Machinery is worth Rs.1,20,000 and Land and Buildings have been valued at Rs.2,40,000 by an independent valuer, Rs.8,000 of the debts are bad. The profits of the company have been as follows: 2008 Rs.80,000; 2009 Rs.90,000; 2010 Rs.1,06,000.

It is the company's practice to transfer 25% of the profits to reserve ignoring taxation, find out the value of shares. Similar companies give a yield of 10% on the market value of their shares. Goodwill may be taken to be worth Rs.1,60,000.

[Ans.: Expected rate of Dividend Rs.296; Yield value of Each Share Rs.291.87; Fair Value of each share Rs.293.93]

20. Smt. Dayana intends to invest Rs.32,000 in equity shares of Glory Company Limited and seeks your advice as tot he maximum number of shares she can expect to acquire based on a fair value of the shares to be determined by you. The following information is available.

Issued and Paid up Capital	Rs.
6% Preference shares of Rs.100 each	5,50,000
Equity shares of Rs.10 each	3,50,000
	9,00,000

Average net profit of the business is Rs.75,000. Expected normal yield is 6% in case of such equity shares. It is observed that the net assets on revaluation are worth Rs.70,000 more than the amounts at which they are stated in the books. Goodwill is to be calculated at 5 years' purchase of super profits, if any. Ignore taxation.

[Ans.: Intrinsic Value Rs.12; Value of Equity Share Rs.20]

8.8 REFERENCE BOOKS :

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Lesson - 9

COMPANY FINAL ACCOUNTS

OBJECTIVES:

After going through this lesson the student can know how the final accounts of the companies prepared ? What are the legal provisions regarding final accounts of companies.

STRUCTURE:

9.1 Introduction

9.2 Preparation and presentation of the final accounts

9.3 Form and contents of profit & loss account

9.4 Features of profit & loss appropriation account of companies

9.5 Form and contents of Balance sheet

9.6 General Instructions for preparation of Balance sheet

9.7 Horizontal and Vertical form of Balance sheet

9.8 Illustrations

9.9 Summary

9.10 Model Questions

9.11 Exercises

9.12 Reference Books

9.1 INTRODUCTION:

There is no statutory obligation upon sole proprietorship or partnership firm to prepare final accounts, but companies have a statutory obligation to prepare final accounts required by sec. 210 of the companies Act. A joint stock company must confirm to certain legal provisions as given in the companies Act, 1956 in respect of forms and contents of the final accounts.

9.2 PREPARATION AND PRESENTATION OF THE FINAL ACCOUNTS:

Sections 210 and 211 of the companies Act govern the preparation of final accounts of a company. Important provisions are as follows :

1. At every annual general meeting of the company, the Board of Directors of the company shall lay before the company :

   a) The balance sheet as at the end of the accounting period, and

   b) a profit and loss account for the period.

2. The profit and loss account and the balance sheet of a company must give a true and fair view of the state of affairs of the company. The balance sheet should be in the form as given in part I of schedule VI. The profit and loss account should comply with the requirements of part II of schedule VI to the companies Act.

9.3 FORM AND CONTENTS OF PROFIT & LOSS ACCOUNT :

The following special points should be kept in mind while preparing the profit and loss account of a company.

1. In case of companies, it is not necessary to split the profit and loss account into three sections Viz, trading account, profit and loss account and profit and loss appropriation account. The profit and loss account may be prepared under the following two headings

   i) profit and loss account

   ii) profit and loss appropriation account.

2. Items which are of abnormal nature, Viz. loss on account of fire, profit or loss on sale of machinery, penalty imposed by the government etc, should be disclosed separately and not mixed up with any other item.

3. Any adjustment which related to previous years should preferably shown in the profit and loss appropriation account.

4. In case of companies certain tax adjustments are required such as :

   a. Tax deducted at source : A company is required to deduct tax from any amount paid by it by way of interest, dividends, salaries to its employees. The following journal entry is passed :

   Interest on Debentures / Salaries A/C Dr

   To Bank A/C

   To Tax Deducted at source A/C

   The profit and loss account is debited with the gross amount of salaries or interest. The tax deducted is shown on the liabilities side of the balance sheet till it is finally paid by the company to the government.

b. Advance payment of tax : The following entry is passed when tax is paid in advance.

Tax paid in Advance Account Dr

To Bank Account

c. Provision for taxation : A company makes provision for taxation in respect of profit made during a particular accounting year. It is shown in the profit and loss Appropriation account as it is an appropriation of profit. However, it has become customary these days to show it in the profit and loss account.

The following entry is made :

profit & loss Account Dr

To provision for taxation

Provision for taxation appears as a liability till assessment in respect of that year is finalised.

Illustration 1 :

The following are the extracts from the trial balance of a company on 31. December 2008:

	Dr Rs	Cr Rs
Provision for taxation		20,000
Advance Tax paid for 2007	16,000	
Advance Tax paid for 2008	20,000	
Tax deducted at source 2008	2,000	
Provision for tax 2007		4,000
Profit & loss Account Balance 2007		40,000

Assessment for the year 2007 was finalised during the year 2008. The final total tax liability for that year was fixed at Rs. 24,000. The net profit earned by the company during 2008 before tax amounts to Rs. 60,000. The company is in 50 percent tax bracket.

You are required to pass the necessary journal entries and show how the various items will appear in the company's final accounts.

Solution :

JOURNAL ENTRIES

Date	Particulars	L.f	Dr Amount Rs.	Cr Amount Rs.
	Profit and loss Appropriation A/C Dr		4,000	
	To provision for Taxation (2007) A/C			4,000
	(Extra provision made for 2007)			
	Provision for Taxation (2007) A/C Dr		24,000	
	To Advance Tax (2007) A/C			16,000
	To Tax payable (2007) A/C			8,000
	(Advance tax paid for 2007 adjusted against provision for tax for 2007)			
	Profit and loss Account Dr		30,000	
	To provision for Taxation Account			30,000
	(Provision for tax made for 2008)			

Profit and loss account
for the year ending 31st Dec. 2008

Particulars	Rs.	Particulars	Rs.
To provision for Taxation	30,000	By net profit before Tax	60,000
To Net profit after Tax	30,000		
	60,000		60,000

Profit and loss Appropriation account
for the year ending 31st Dec. 2008

Particulars	Rs.	Particulars	Rs.
To provision for Taxation 2007	4,000	By Balance b/d	40,000
To Balance of profit taken to B/s	66,000	By Net profit after tax for 2008	30,000
	70,000		70,000

Balance sheet
as on 31st Dec. 2008

Liabilities	Rs.	Assets	Rs.
Reserves & Surplus :		**Loans and Advances :**	
Profit & loss Account	66,000	Advance Tax paid 2008	20,000
Current liabilities and provisions :			
Provision for taxation 2008	30,000	Tax deducted at source (2008)	2,000
Tax deducted at source 2008	4,000		
Tax payable 2007	8,000		

5. **Dividends :** The term dividend refers to that part of the profits of a company which is distributed among its shareholders. It may be of two types :

   i. Interim Dividend : It is the dividend declared by the directors during the course of the accounting year in respect of the same accounting year.

   ii. Final Dividend : It is the dividend declared by the shareholders at " The annual general meeting of the company which is recommended by the Board of Directors. On declaration of dividend a company is required to deposit the amount of dividend payable in a separate Dividend Bank Account.

The following are the accounting entries in respect of dividends :

Final Dividend :

1. On recommendation :

   Profit & loss Appropriation A/C Dr

   To proposed Dividend A/C

2. On declaration of dividend :

   Profit Dividend A/C Dr

   To Dividend payable A/C

   To Income Tax / Tax deducted at source A/C.

3. On opening a separate bank account :

   Dividend Bank A/C Dr

   To Bank A/C

   (with the net amount payable as dividend)

4. On payment of dividend :

Dividend payable A/C Dr

To Dividend Bank A/C

5. On payment to tax deducted at source :

Income Tax/ Tax Deducted at source A/C Dr

To Bank A/C

Interim Dividend :

On declaration of Interim dividend :

Interim Dividend Account Dr

To Interim dividend payable A/C

To Income Tax/ Tax deducted at source A/C

Other entries are same as explained above in case of final dividend.

At the end of the accounting year the amount of interim dividend will be transferred to profit and loss appropriation account by means of the following entry.

Profit & loss appropriation A/C Dr

To Interim Dividend A/C

6. Transfer to reserves. The entry will be :

Profit & loss Appropriation A/C Dr

To general / Specific Reserve A/C

9.4 FEATURES OF PROFIT & LOSS APPROPRIATION A/C OF COMPANIES :

The profit and loss appropriation section of the profit and loss account shows the appropriation of profit and is popularly known as " below the line " It is prepared as follows :

Particulars	Rs.	Particulars	Rs.
To Transfer to reserve		By Last year's Balance b/d	
To Income tax for previous year year not provided for		By Net profit for the year b/d	
To Interim Dividend		By Amount with drawn form general Reserve or any other Reserve.	
To corporate dividend Tax		By provision such as Income Tax	
To surplus carried to Balance sheet		By provision No longer required.	

Dividend paid or declared are subject to corporate dividend tax @ 10% w.e.f from 1st june 1997.

Illustration 2 :

Pratima Ltd. carried forward balance of Rs. 2,05,000 in the profit and loss account for the year ended on 31st March 2008. During the year 2008 - 09 it made a profit of Rs. 5,24,000 before charging depreciation and manager's commission. Depreciation for the year 2008 - 09 amounted to Rs. 84,000 and a commission of 5% on net profit before charging such commission was to be paid to the manager. It is decided that following decisions be carried out.

a. Transfer Rs. 1,25,000 to the General Reserve

b. Tansfer Rs. 50,000 to the Dividend Equalisation Reserve.

c. Pay the year's dividend on Rs 5,00,000, 11% cumulative preference shares.

d. Pay 20% dividend on Rs. 6,00,000 Equity share capital.

e. Pay Rs. 7,700 dividend on tax - free pref. shares (tax rate is 23 %)

f. Transfer Rs. 75,000 to Debenture Redemption Fund.

Prepare the profit and loss appropriation account showing the above appropriations.

Solution :

Profit and loss account of pratima Ltd.
for the year ending 31st March. 2009

Particulars	Rs.	Particulars	Rs.
To Depreciation	84,000	By profit for the year	5,24,000
To Managers commission			
(5% of Rs. 5,24,000 - Rs 84,000	22,000		
To Net profit C/d	4,18,000		
	5,24,000		5,24,000

Profit and loss Appropriation account of Pratima Ltd.
for the year ending 31st March. 2009

Particulars	Rs.	Particulars	Rs.
To General reserve	1,25,000	By Balance b/d (Last year bal.)	2,05,000
To Dividend Equalisation Reserve A/C	50,000	By Net profit as per profit & loss A/c	4,18,000
To proposed preference share dividend A/c	55,000		
To tax free proposed preference dividend A/c $(7700 \times \frac{100}{77})$	10,000		
To proposed Equity dividend	1,20,000		
To tax on dividend @ 10%	12,000		
To debenture Redemption fund account	75,000		
To surplus carried to Balance sheet	1,76,000		
	6,23,000		6,23,000

9.5 FORM AND CONTENTS OF BALANCE SHEET :

Section 210 of the companies Act requries that at every annual general meeting of the shareholder, the Board of Directors of the company shall lay before the company a balance sheet as at the end of each trading period. It is laid down in section 211 (1) that every Balance sheet of a company shall be prepared in the form given in part of the schedule VI of the companies act, 1956. The objective of prescribing the form for the balance sheet in schedule VI is to make sure that balance sheet exhibits a true and fair view of the state of affairs of the company.

The Balance sheet of a company shall be either in a horizontal form or a vertical form.

SCHEDVLE VI - PART I
(Sec 211)
A. Horizontal Form

Balance Sheet of .... as on ....

Figures For the Previous year Rs.	Liabilities	Figures For the Current year Rs.	Figures For the Previous year Rs.	Assest	Figures For the Current year Rs.
	Share Capital Authorised .... shares of Rs...... each **Issued :** (Distinguishing between the various classes of captial and stating the particulars specified below, in respect of each class).... shares of Rs...... each. **Subscribed :** (Distinguishing between the various classes of capital and stating the particulars specified below in respect of each class)..... .... shares of Rs.......... each .... Rs. .... called up. (of the above shares ...... shares are allotted as fully paid up pursuant to a contract without payments being received in cash).			**Fixed assets :** Distinguishing as far as possible between expenditure upon : a. good will b. land c. buildings d. leaseholds e. railway sidings f. plant and machinery g. furniture and fittings h. development of property i. patents, trade marks and designs j. live stock, and k. vehicles etc. (Under each head the original cost and the additions there to and deductions there from during the year, and the total depreciations written off or provided up to the end of the	

(of the above shares........ shares are allotted as fully paid up by way of bonus shares).

(Specify the source from which bonus shares are issued. e.g : Capitalisation of profits or reserves or from shares premium account)

Less : Calls Unpaid :

i By Directors

ii By others

Add : Forfeited shares :

(amount originally paid up)

(any capital profit on reissue of forfeited shares should be transferred to capital reserve).

Notes :

1. Terms of redemption or conversion (if any) redeemable preference capital are to be stated together with earliest date of redemption or conversion.
2. Particulars of any option on unissued share capital are to be specified.

year is to be stated. Depreciation written off or provided shall be allotted under the different assets heads and deducted in arriving at the value of fixed assets.

In every case where the original cost cannot be ascertained, without unreasonable expense or delay, the valuation shown by the books is to be given. For the purpose of this paragraph, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminition in values and where any such asset is sold, the amount of sale proceeds shall be shown as deduction.

Where sums have been written off on a reduction of capital or a revaluation of assets, every balance sheet, (after the first balance sheet) subsequent to the reduction or revaluation shall show the reduced figures with the date of the reduction in places of the original cost.

3. Particulars to the different classes of preference share are to be given.

These particulars are to be given along with share capital.

In the case of subsidiary companies, the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries shall be separately stated in respect of subscribed share capital. The auditor is not required to certify the correctness of such share holdings as certified by the management)

Reserves and surplus :

1. Capital Reserve
2. Capital Redemption reserve.
3. Share premium account (showing details of its utilisation in the manner provided in section 78 in the year of utilisation)
4. Other reserves specifying the nature of each reserve and the amount in respect there of .

Each balance sheet for the first five years subsequent to the date of the reduction, shall show also the amount of the reduction made.

Similarly, where sums have been added by writing up the assets,every balance sheet subsequent to such writing up shall show the increased figures with the date of the increase in place of the original cost. Each balance sheet for the first five years subsequent to the date of the writing up shall also show the amount of increase made.

Investments :

Showing nature of investments and mode of valuation, for example, cost or market value, and distinguishing between :

1. Investments in government or trust securities.
2. Investments in shares, debentures or bonds.
3. Immovable properties

less: Debit balance in profit and loss account (if any).

(The debit balance in the profit and loss account shall be shown as a deduction from the uncommitted reserves, if any)

5. Surplus i.e. balance in profit and loss account after providing for proposed allocations namely :

   Dividend, Bonus or reserves.

6. Proposed additions to reserves.
7. Sinking Fund.

Secured loans :

1. Debentures.
2. Loans and Advances from banks
3. Loans and Advances for Subsidiaries
4. Other loans and Advances.

   (Loans from directors or manager should be shown separately)

   The Nature of security should be specified.

4. Investments in the capital of partnership firm
5. Balance of unutilised money raised by issues.

Current assets, loans and Advances :

A. Current assets:

1. Interest Accurued on Investments
2. stores and spare parts
3. Loose Tools.
4. Stock - in - Trade
5. Work - in - Progress
6. Sundry Debtors.

   a. Debts outstanding for a period exceeding six months

   b. Other debts

Less provision

In regard to sundry debtors particulars to be given separately of :

a. debts considered good and in respect of which

Unsecured Loans :

1. Fixed Deposits
2. Loans and Advances from subsidiaries
3. Short - term loans and Advances :
   a. From banks.
   b. From others.
4. Other loans and Advances :
   a. From banks.
   b. From others.

Current Liabilities and provisions :

A. Current Liabilities :

1. Acceptances
2. Sundry creditors.
   i) Total outstanding dues of small scale industrial undertakings
   ii) Total outstanding dues of creditors other than small scale industrial undertakings
3. Subsidiary companies
4. Advance payments and un expired discounts for the portion for which value

the company is fully secured

b. debts considered good for which the company holds no security other than the debtor's personal security and

c. debts considered doubtful or bad.

7. A. cash balance on hand

7. B. Bank Balance
   a. With scheduled banks
   b. With others.

B. Loans and Advances :

8. A. Advances and loans to subsidiaries.

8. B. Advances and loans to partnership firm in which the company or any of its subsidiaries is a partner.

9. Bills of exchange

10. Advances recoverable in cash or in kind or for value to be received.

	has still to be given i.e. in the case of the following companies :Newspaper, Fire Insurance, clubs banking etc. 5. Unclaimed Dividends 6. Other liabilities (if any) 7. Interest accrued but not due on loans **B. Provisions :** 8. Provision for Taxation 9. Proposed Dividends 10. For contingencies 11. For providend fund scheme 12. For Insurance, pension and similar staff benefit schemes. 13. Other provisions. A foot note to the balance sheet may be added to show separately. 1. Claim against the company not acknowledged as debts. 2. uncalled liability on shares partly paid. 3. Arrears of fixed cumulative dividends.			11. Balances with customs, port trust etc. **Miscellaneous Expenditure** 1. Preliminary expenses 2. Expenses including commission or brokerage, under writing 3. Discount allowed on the issue of shares or debentures. 4. Interest paid out of capital during construction 5. Development expendiutre not adjusted 6. Other sums profit and loss account.	

VERTICAL FORM OF BALANCE SHEET

Name of the company____

Balance sheet as at ____

(I) Sources of Funds	Shedule No.	Figures as at the end of current Year	Figures as at the end of previous Year
1. Shareholder's Funds			
(a) Capital	___________	___________	___________
(b) Reserves and surplus	___________	___________	___________
2. Loan Funds			
(a) Secured loans	___________	___________	___________
(b) Unsecured loans	___________	___________	___________
(II) Application of Funds			
1. Fixed Assets			
(a) Gross Blocks	___________	___________	___________
(b) Less Depreciation	___________	___________	___________
(c) Net Block	___________	___________	___________
(d) Capital work in progress	___________	___________	___________
2. Investments			
3. Current Assets, Loan & Advances			
(a) Inventories	___________	___________	___________
(b) Sundry debtors	___________	___________	___________
(c) cash and bank balances	___________	___________	___________
(d) other current Assets	___________	___________	___________

Less : Current Liabilities and Provisions			
(a) Liabilities	______	______	______
(b) Provisions	______	______	______
Net current Assets			
3. (a) Miscellaneous expenditure to the extent not written off or adjusted	______	______	______
(b) Profit & Loss Account	______	______	______
TOTAL			

Notes :

1. Details under each of the above items be given in seperate schedules. The schedules shall incorporate all the information required to be given under part 1A of schedule VI read with notes containing general instruction for preparation of balance sheet
2. The schedules referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet.
3. The figures in the balance sheet may be rounded off to the nearest '000 or '00 as may be convinient or may be expressed in letters of decimals of thousands.
4. A footnote to the balance sheet may be added to show seperately contingent liabilities.

9.8 ILLUSTRATIONS :

The following is the trial balance of suraj Co. Ltd. as at 30th June 2008:

	Rs	Rs
Stock, 30 - 06 - 2008	1,50,000	
Sales		7,00,000
Purchases	4,90,000	
Wages	1,00,000	
Discount		10,000
Furniture and Fittings	34,000	
Salaries	15,000	
Rent	9,900	

Sundry expenses	14,100	
Profit and loss appropriation		
Account (30 - 06 - 2007)		30,060
Dividend Paid	18,000	
Share capital		2,00,000
Debtors & Creditors	75,000	35,000
Plant & Machinery	58,000	
Cash and Bank	32,400	
Reserve		31,000
Patents and Trade Marks	9,660	
	10,06,060	10,06,060

Prepare trading account, profit and loss account, profit and loss appropriation account for the year ended 30-06-2008 and balance sheet as on that date. Take into consideration the following adjustments.

1. Stock on 30 - 06 - 2008 was valued at Rs. 1,64,000
2. Depreciation on fixed assets @ 10%
3. Make a provision for income - tax @ 50 %.

Solution :

SURAJ Co., Ltd.

Trading and profit and loss account for the year ended 30-06-2008

	Rs.		Rs.
To opening stock	1,50,000	By sales	7,00,000
To purchases	4,90,000	By closing stock	1,64,000
To wages	1,00,000		
To gross profit c/d	1,24,000		
	8,64,000		8,64,000

To salaries	1,500	By gross profit b/d	1,24,000
To rent	9,900	By Discount	10,000
To sundry expenses	14,100		
To Depreciation on :			
Plant & Machinery	5,800		
Patents & Trade marks	966		
Furniture & fittings	3,400		
To Pro. for income Tax	42,417		
To Net profit c/d	42,417		
	1,34,000		1,34,000

Balance sheet of Suraj Co. Ltd.
as on 31-06-2008

LIabilities	Rs.	Assets		Rs.
Share capital	2,00,000	Fixed Assets		
Reserves & Surplus :		Plant and Machinery	58,000	
Reserve	31,000	less : Depreciation	5,800	52,200
Profit & loss Account	54,476	Furniture & fittings	34,000	
Current Liabilities and Provisions :		less : Depreciation	3,400	30,600
Creditors	35,000	Patents & Trade marks	9,660	
Provision for tax	42,417	less : Depreciation	966	8694
		Current Assets :		
		Stock		1,64,000
		Debotrs		75,000
		Cash at bank		32,400
	3,62,894			3,62,894

Illustration 4 :

The following balances have been extracted from the books of sai and sreya limited as on 31st March, 2008 :

	Rs.		Rs.
Freehold land	4,00,000	Income from investments	4,000
Buildings	1,50,000	Provision for	
		doubtful debt (1-4-2007)	4,000
Debtors	1,00,000	creditors	60,000
Stock (31-3-2008)	80,000	Provision for Depreciation (1-4-2007)	
Furniture	40,000		
Cash at bank	10,000		
Cash in hand	2,000		
Cost of goods sold	6,00,000	Buildings	10,000
Salaries and wages	30,000	Furniture	8,000
Mis. Expenses	16,000	Suspense	5,000
Investments in shares	3,60,000	Equity share capital	7,35,000
Interest	6,000	6% cum.pref. share cap.	1,60,000
Bad debts	2,000	Share premium	20,000
Repairs	3,000	Bank over draft	1,00,000
Advance payment of income tax	12,000	sales	3,50,000
		P & L A/C (1-4-2007)	5,000
	18,11,000		18,11,000

The following further particulars are available :

1. The land was revalued on 1st jan. 2008 at Rs. 6,00,000 by an expert valuer but no effect has been given in the books although the directors have decided to adjust the revalued amount.
2. Provision for doubtful debt is to be adjusted to 5% on the amount of debtors.
3. Equity share capital is composed of Rs.1 shares 72,800 fully paid and 1000 on which final call of Rs. 3 remains unpaid.

4. Suspense amount represents money received from the new allottee for re-issue of 1000 shares forfeited during the year for non payment of the final call, but no entry for adjustment there of has been passed.
5. Provision for taxation is to be made at 45 percent.
6. Market value of investment was Rs. 3,70,000 on 31st March 2008.
7. The company is managed by the directors who are entitled to a remuneration calculated at 3 percent of the annual net profits.
8. Depreciation is to be charged on

   Building at 2 percent

   Furniture at 10 percent
9. The land and buildings of the company are mortgaged in favour of the bank as security for overdraft sanctioned upto a limit of Rs. 5,00,000
10. Dividend on cum. pref. shares were in arrears for 5 years upto 31st March 2008. The directors have recommended payment of dividend for two years.

You are required to prepare the profit and loss account for the year ended 31st March 2008 and a balance sheet as on that date after making such assumptions as may be considered necessary. Ignore previous year's figures.

Solution :

Sai and Sreya limited
Profit and loss account
for the year ended 30-06-2008

	Rs.		**Rs.**
To cost of goods sold	6,00,000	By sales	7,00,000
To gross profit c/d	1,00,000		
	7,00,000		7,00,000

To salaries & wages		30,000	By gross profit b/d	1,00,000
To Mis. expenses		16,000	By Income from investments	4,000
To interest		6,000		
To Bad debts	2,000			
Add Provision	5,000			
	7,000			
less existing provision	4,000	3,000		
To Repairs		3,000		
To Directors remuneration		1,230		
To Depreciation :				
Builidng	2,800			
Furniture	3,200	6,000		
To provision for tax		17,460		
To Net profit c/d		21,310		
		1,04,000		1,04,000

Profit and loss Appropriation A/C

	Rs.		Rs.
To proposed dividend		By balance b/d	5,000
(preference shares)	19,200	By Net profit	21,310
To Balance c/d	7,110		
	26,310		26,310

Sai and Sreya limited
Balance sheet
as on 31- 03-2008

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital Authorised			Fixed Assets		
6% cumulative pref.			land at cost	4,00,000	
shares of Rs. 100 each		XXXX	Add Appreciation	2,00,000	6,00,000
issued, subscribed and			Buildings at cost	1,50,000	
and paid up			less depreciation	12,800	1,37,200
73,800 equity shares			furniture at cost	40,000	
of Rs. 10 each fully			Less : Depreciaton	11,200	28,800
paid up		7,38,000			
1600,6% cum. pref					
shares of Rs.100			Investments (at cost)		
each fully paid up		1,60,000	In fully paid shares		
		8,98,000	(Market value		
Reserves & surplus :			Rs. 3,70,000)		3,60,000
Share premium		20,000	Current assets,		
Capital reserve :			Loans and advances:		
Profit on reissue of			A. current Assets		
Forfeited shares	2,000		stock valued at cost		80,000
Appreciation in land	2,00,000	2,02,000	Debtors (unsecured)		
profit and loss			exceeding 6months)	1,00,000	
Account		7,110			
Secured loan :			Less : provision		
Bank overdraft			for doublful debts	5,000	95,000
Secured by mortgage			Cash at Bank	10,000	
of co's land & Buildings		1,00,000	Cash in hand	2,000	8,000
Current Liabilities			B. Loans & advances		
& provisions:					
A. current liabilities			Income tax paid in		
sundry creditors		6,1230	in advance		12,000
B. Provisions					
Provisions for					
taxation	17,460				
Proposed dividend	19,200	36,660			
		13,25,000			13,25,000

Contingent liability arrears of cummulative preference dividend for 3 years **Rs. 28,800.**

Working Notes :

1. Calculation of Net profit for director's remuneration :

   Profit before provision for taxation, provision for bad debts but after writing off

Bad debts	Rs.	4,000
Director's remuneration 3 % thereof		1,230

2. Depreciation has been calculated on written down value.
3. Calls in arrear on 1000 shares @ Rs. 3 per share amounts to Rs. 3,000, amount received against these shares from new allottee is Rs. 5,000. The difference has been credited to capital reserve.

9.9 SUMMARY :

Companies have a statutory obligation to prepare final accounts. Sections 210 and 211 of the companies Act govern the preparation of final accounts. The balance sheet of a company shall be either in a horizontal form or a vertical form.

9.10 MODEL QUESTIONS :

1. Give a specimen form of balance sheet and profit and loss account of a company according to companies Act.
2. Give an imaginary form of the profit and loss appropriation account of a limited company.
3. Write short notes on :

   a. provisions for taxation and dividends.

   b. corporate dividend tax
4. Write down the important provisions of sec 210 and 211 of companie's Act for preparation and presentation of final accounts.
5. Breifly explain the terms Interim dividend and final dividend.

9.11 EXERCISES :

1. Following balances are extracted on 31st march 2008 from the books of Rao company ltd :

	Rs.		Rs.
Factory premises at cost	4,50,000	Share capital	
Plant & Machinery at cost	3,49,160	30,000 7% preference shares	
Motor lorries at cost	73,000	Shares of Rs. 10 each	3,00,000
Sundry Debtors	1,21,780	60,000 shares (equity)	
Bad debts written off	2,850	of Rs. 10 each	6,00,000
Rent, Rates and taxes	28,400	Profit and loss A/C	16,240
Advertisment	19,500	Gross profit for the year	2,46,640
Cash in hand and at Bank	68,500	Provision for doubtful debts	9,000
Directors fees	3,600	Sundry creditors	1,29,640
Audit fees	10,000	Transfer fees	110
Stock on 31-3-2002	1,14,600	Accrued wages	12,840
Rent & taxes paid in advances	7,980	staff benevolent fund	17,900
Salaries and wages	32,000		
Dividends paid on preference shares	21,000		
Dividend on equity shares	15,000		
Discount on issue of shares	15,000		
	13,32,370		13,32,370

The provision for doubtful debts is to be made upto Rs. 10,200. The factor premises, plant and Machinery and motor lorries are to be depreciated by 3%, 15% and 20% respectively. Authorised capital of the company is Rs. 10,00,000 divided into 1,00,000 shares of Rs. 10 each. You are required to prepare.

i. profit & loss account for the year and 31 - 3- 2008.

ii. A balance sheet as at 31 -3-2008 in the form prescribed under the companies Act, 1986. previous years figures are not required and also ignore taxation.

2. The following trial balance has been extracted from the books of ZYX Ltd. as on 31st march 2008. You are required to prepare profit and loss account and balance sheet as on that date.

Debit	Rs.	Credit	Rs.
Land & building	34,000	Share capital	1,00,000
Furniture	6,000	General Reserve	5,000
Plant & Machinery	15,000	10 % debentures	40,000
stock on 31st March 2008	75,000	Sundry creditors	4,000
Salaries	25,000	Gross profit	75,000
Debtors	10,000	Interest on Investments	1,000
5% Investments	20,000	Profit & loss A/C on 1st April	35,000
Bank	5,000		
Advance income tax	2,000		
Debentures interest	2,000		
Directors fees	7,000		
Rent, Rates and insurance	24,000		
Good will	35,000		
	2,60,000		2,60,000

Depreciate the following assets :

Land & Building at 10% p.a, plant & Machinery 8% p.a, provision for bad debts at 6%

The directors have recommended :

a. Transfer Rs. 3,000 to general reserve A/C

b. Equity dividend at 10% on teh paid up capital

c. Provision for income tax for Rs. 4,000

3. The following information is extracted from lakshmi ltd. on 31st march, 2008. You are required to prepare profit and loss account and Balance sheet as on that date.

Debit	Rs.	Credit	Rs.
Factory premises	4,50,000	Share capital (9000 shares)	9,00,000
Plant & Machinery	3,60,000		
Motor lorries	1,40,000	Profit & loss A/C	24,000
Sundry debtors	1,20,000	Gross profit for the year	2,60,000
Bad debts written off	4,000	Provision for doubtful debts	5,000
Rent & Taxes	25,000		
Advertisment	10,000	Sundry creditors	75,000
Bank	20,000	Transfer fee	8,000
Director's fee	5,000	Out standing salaries	5,000
stock 31st march 2008	1,40,000	General Reserve	33,000
Salaries , wages	30,000		
Dividend paid interim	6,000		
	13,10,000		**13,10,000**

Additional Information :

The provision for doubtful debts is to be made upto Rs. 15,000/- factory premises and plant and machinery are to be depreciated at 10% p.a. Provide for income tax Rs. 20,000/- final dividend at Rs. 5/- per share is payable.

4. From the following trial balance of Naidu company ltd. prepare profit and loss appropriation account and balance sheet after making the following adjustment, as per compaines Act-

Debit	Rs.	Credit	Rs.
land & Building	50,000	Profit & loss appropriation A/C	7,000
Machinery	40,000	Profit & loss A/C (for the Current year	31,000
Interim dividend	6,000		
stock	34,000	Share capital	1,00,000
Debtors	25,000	Creditors	10,000
Bank	15,000	Reserve fund	17,000

Calls in arrears	10,000	Employes provident fund	8,000
Investments	50,000	Share premium account	
		Debentures	50,000
	2,30,000		**2,30,000**

Transfer Rs. 10,000 to reserve fund, Rs. 5,000 to employees provident fund and provide Rs. 5,000 towards dividend on equity shares.

5. The following balances are extracted from the books of Tirupathi earth movers ltd. as on 31-3-2008.

Debit	Rs.	Credit	Rs.
stock 1-4-2007	3,77,000	Profit and loss Account	66,170
Fuel and power	13,390	Sales	4,74,500
Salaries and wages	2,82,100	Share capital	6,50,000
Purchases	3,01,860	provision for tax	19,500
Rent and taxes	9,750	Provision for bad debts	8,190
Insurance	13,000	Bank loan (secured)	
Prepaid expenses	35,750	on fixed assets	1,62,500
Repairs to Buildings	3,900	General Reserve	1,30,000
Repairs to Machinery	23,400	Unclaimed dividends	2,080
Managerial commission	13,650	sundry creditors	1,31,300
Directors fees	780	Bills payable	41,600
Land and Buildings	6,17,500	Out standing expenses	97,500
Machinery & plant	4,55,000	Managerial commission outstanding	2,340
Furniture	11,050	Depreciation Account	8,11,200
Office equipment	5,200	Mis. Receipts	780
Motor vehicles	29,250		
sundry debtors	3,77,000		
Cash in hand	4,225		
Cash at Bank	23,855		
	23,97,660		23,97,660

Prepare trading and profit and loss Account for the year ended 31-3-2008 and a balance sheets as on that date in the prescribed form, taking the following into consideration -

i. stock at cost on 31 - 3- 2008 was Rs. 6,60,400

ii. Provide Rs. 26,000 for further taxation

iii. Depreciation written off was as follows as on 31 - 3- 2007 land and buildings Rs. 3,75,960. Machinery & plant Rs. 4,02,090, Furniture Rs. 9,750 office equipment Rs. 4,550 and Motor vehicles Rs. 18,850.

iv. No depreciation should be provided for 2007 - 08

v. All amounts due to the company by the debtors are unsecured. Debts for Rs. 8,190 are over six months old of which Rs. 2,600 are bad and to be written off now, the rest are doubtful. All other debts are considered good.

vi. The directors transfered Rs. 78,000 to general reserve and recommended a dividend of Rs.750/- per share for the year ended 31-3-2008.

vii. The nominal capital of the company is 13,000 shares of Rs. 100 each all of which have been issued and subscribed for and Rs. 50 per share paid up.

6. The following is the trial balance of Pavan and Pavani co. Ltd. as at 30th June 2008. Prepare trading and profit and loss account and balance sheet.

	Rs.	**Rs.**
Authorised capital		5,00,000
50,000 shares of Rs. 10 share Subscribed capital 10,000 shares of Rs. 10 per share		1,00,000
Call in arrears	6,400	
Land	10,000	
Buildings	25,000	
Plant and Machinery	15,000	
Furniture and fixtures	3,200	
Carriage inwards	2,300	
Wages	21,400	
Salaries	4,600	
Bad debt provision 1.7.07		1,400

Sales return and sales	1,700	80,000
Bank Charges	100	
Coal, gas and water	700	
Rates and taxes	800	
Preliminary expenses	500	
Purchases and purchases returs	50,000	3,400
Bills receivable and bills payable	1,200	1,000
Discount on issue of debenture	1,000	
General expenses	1,900	
Sundry debtors and creditors	42,800	13,200
Stock 1.7.2007	25,000	
Fire insurance	400	
Cash in hand and at bank	15,500	
Share premium		6,000
General reserve		24,000
Discount	500	
	2,30,000	2,30,000

Adjustments :

1. Charge depreciation on buildings at 2 1/2%, plant and machinery at 10% and furniture and fixtures @ 10%
2. Make a provision of 5% on sundry debtors for bad debts.
3. Unexpired fire insurance Rs. 120
4. Provide the following outstanding liabilities, wages Rs. 3,200, Salaries Rs. 500, Rent, rates and taxes Rs. 235
5. Write off preliminary expenses
6. The value of stock as on 30th june 2008 was Rs. 30,000.

7. The following is the trial balance of Raji and co. as on 31.12.2008 prepare profit and loss account and balance sheet of the company.

Particulars	Dr. Rs.	Cr. Rs.
Stock (1.1.2002)	7,500	
Sales		25,000
Purchases	24,500	
Wages	5,000	
Discounts	700	
Salaries	750	
Rent	495	
General expenses (Including insurance)	1,705	
Profit and loss Account (1.1.2002)		1,503
Dividend paid	900	
Capital 1,000 shares of Rs. 10 each		10,000
Debtors and creditors	3,750	1,750
Machinery	2,900	
Cash in hand	1,620	
Reserves		1,550
Bad debts	483	
	50,303	50,303

Additional information :

a. Stock on 31.12.2008 Rs. 8,200

b. Depreciate machinery at the rate of 10% per annum

c. provide 5% discount on debtors

d. Allow 2 1/2% discount on creditors

e. One month rent at the rate of Rs. 550 per annum was due on 31.3.2009

f. Six months insurance was unexpired at Rs. 75 per annum

g. Provide managing Directors commission at 15% on the net profits before deducting his commission.

8. Radha co. ltd. is a company with an authorised capital of Rs. 5,00,000 divided into 5,000 equity shares of Rs. 100 each on 31 - 3 - 2008, 2,500 shares were fully called up. The following are the balances extracted from the ledger of the company as on 31 - 3-2008.

	Rs.		Rs.
Stock	50,000	Advertising	14,300
Sales	4,25,000	Debtors	38,700
Purchases	3,00,000	Creditors	35,200
Wages (productive)	70,000	Plant and Machinery	80,500
Discount allowed	4,200	Furniture	17,100
Discount Received	3,150	Cash & Bank	1,34,700
Insurance upto 30-6-08	6,720	Reserve	25,000
Salaries	18,500	Loan from	
Rent	6,000	managing Director	15,700
General expenses	8,950	Bad debts	3,200
profit and loss account	6,220	Call in Arrears	5,000
Printing and stationary	2,400		

You are required to prepare trading and profit and loss account for the year ended 31-3-2008 and balance sheet as on that date of the company.

The following further information is given :

1. Closing stock Rs. 91,500.
2. Depreciation to be charged on plant and Machinery and funiture at 15% and 10% respectively.
3. Outstanding liabilities - wages Rs. 5,200 ; salaries Rs. 1,200 and Rent Rs. 600.
4. Dividend @ 5% on paid up share capital to be provided.

10. The following is the trial balance of vanaja and co as on 31.12.2008 prepare profit and loss account and balance sheet of the compnay.

Particulars	Rs.	Rs.
Stock (1.1.2001)	7,500	
Sales		25,000
Purchases	24,500	
Wages	5,000	

Discounts	700	
Salaries	750	
Rent	495	
General expenses (Including insurance)	1,705	
Profit and loss Account (1.1.2001)		1,503
Dividend paid	900	
Capital 1,000 shares of Rs. 10 each		10,000
Debtors and creditors	3,750	1,750
Machinery	2,900	
Cash in hand	1,620	
Reserves		1,550
Bad debts	483	
	50,303	50,303

Additional information :

a. Stock on 31.12.2008 Rs. 8,200

b. Depreciate machinery at the rate of 10% per annum

c. provide 5% discount on debtors

d. Allow 2 1/2% discount on creditors

e. One month rent at the rate of Rs. 550 per annum was due on 31.3.2008

f. Six months insurance was unexpired at Rs. 75 per annum

g. Provide managing Director's commission at 15% on the net profits before deducting his commission.

9.12 REFERENCE BOOKS :

1. Financial Accounting - S.P. Jain & K.L. Narang

2. An introduction to Accountancy - Dr. S.N. Maheswari & Sk. Maheswari

3. Financial Accounting - R.L. Gupta & V.K. Gupta

4. Advanced Accountancy - M. C. Shukla & T.S. Grawal

5. Advanced Accounting - K.R. Pall.

6. Advanced Accounting - S.P. Jain & K.L. Narang

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