B.Com.

Third Year

Core Paper No.11

CORPORATE ACCOUNTING

BHARATHIAR UNIVERSITY

SCHOOL OF DISTANCE EDUCATION

COIMBATORE – 641 046

(SYLLABUS)

B.Com – III Year

CORE PAPER 15 CORPORATE ACCORDING

Objectives : To enable the students to be aware on the Corporate According in conformity with the provision of the Companies Act.

Unit – I

Issue of shares : par, premium and Discount – Forfeiture – Reissue – Surrender of Shares– Right Issue – Underwriting

Unit – II

Redemption of Preference Shares – Debentures – Issue – Redemption : Sinking Fund Method.

Unit – III

Final Account of Companies.

Unit – IV

Valuation of Shares and Good will – Need – Methods of valuation of Shares and Goodwill.

Unit – V

Liquidation of Companies – Preparation of Statement of Affairs and Deficiency Account.
NOTE Distribution of Marks : Theory 20% Problems – 80%

CONTENT

UNIT – I

ISSUE OF SHARES

CONTENTS

1.0 AIMS AND OBJECTIVES

i) To know the Meaning and definition of shares.

ii) To study the different methods of issue of shares.

iii) To understand the provisions and treatment for forfeiture and surrender of shares.

1.1 INTRODUCTION

The Companies Act, 1956 deals with the organization of the company, its creation, constitution, relationship to member and creditors, its management and winding up. According to Section 2946) of the Companies Act, "Share" means share in the share capital of the of the Company and includes stock except where a distinction between stock and share is expressed or implied. A share is one unit into which the total share capital is divided. It forms the basis of ownership in the Company and the people who contribute the money through shares, which constitute the share capital of the Company. Thus for example, when a company has a share capital of Rs.1,00,000 divided into 10,000 shares of Rs.10/- each and a person who has taken 50 shares of that company, is said to have a share in the share capital of the company to the tune of Rs.500/-.

1.2 ISSUE OF SHARES

There are two basic types of share capital based on the types of shares, which can be issued by a company under the companies Act, 1956 i.e.

a) Preference shares and

b) Equity shares.

Preference shares are those which carry the following preferential rights as to :

i) The payment of dividend at a fixed rate before anything could be paid to equity shares.

ii) The return of capital on winding up of the Company.

The above rights are conferred by the Articles of Association.

An Equity share is one which is not a Preference share. These are normally risk bearing shares.

The dividend and repayment will be done after the preference shares.

1.3 IMPORTANT POINTS TO BE NOTED IN CONNECTION WITH ISSUE OF SHARES

1. When a public company desires to raise capital by issuing its shares to the public, it invites the public to subscribe for its shares. The invitation is made through a document called the “Prospectus”.
2. An application for shares is an offer made by the applicant while the allotment in pursuance thereof by the company is its acceptance. In other words, allotment means the appropriation of a certain number of shares to an applicant in response to the application, by a resolution of the directors.
3. As per the guidelines issued by the SEBI, the minimum subscription has been fixed at 90% of the issued amount. Such subscription must be received within 60 days of the close of the issue.
4. If the number of shares applied for is less than the number of shares offered, the allotment can be only for the shares applied for provided the minimum subscription is raised. Minimum subscription refers to the number of shares which, in the opinion of the directors, should be subscribed for, by payment in cash in order to enable the company to function smoothly.
5. The primary issuances are governed by SEBI in terms of SEBI (Disclosures and Investor protection) guidelines. SEBI framed its DIP guidelines in 1992. Many amendments have been carried out in the same in line with the market dynamics and requirements.
6. Offer document” means Prospectus in case of a public issue or offer for sale and Letter of Offer in case of a rights issue which is filed Registrar of Companies (ROC) and Stock Exchanges. An offer document covers all the relevant information to help an investor to make his/her investment decision.
7. “Red Herring Prospectus” is a prospectus which does not have details of either price or number of shares being offered or the amount of issue.
8. The form for applying/bidding of shares is available with all syndicate members, collection centers, the brokers to the issue and the bankers to the issue.
9. As per the requirement, all the public issues of size in excess of Rs.10 crore are to made in Demat mode.
10. The amount payable on applications is fixed by the Directors but it cannot be less than 5% of the nominal value of shares. As per SEBI guidelines the minimum application money to be paid shall not be less than 25%of the issue price.
11. The amount received on applications for shares has to be kept in a Scheduled Bank till the minimum subscription is raised and the certificate of commencement of business is obtained in case of a new company and till the minimum subscription is raised in case of existing companies.

12. If the company fails to raise the minimum subscription within 120days of the issue of prospectus, no shares can be allotted and the application moneys received have to be returned to the applicants within the next ten days.
13. If listed, approval from the stock exchanges is a must before allotment.
14. If the number of shares applied for is more than the number of shares offered the Board of directors must set a criteria for allotment.
15. In case of oversubscription, SEBI has laid the guidelines as follows
    a) applicants will be categorized according to the number of shares applied for and
    b) the total number of shares to be allotted to each category as a whole shall be arrived at on a proportionate basis.(Pro rata basis)
16. Where both the equity and preference shares are issued, separate application, allotment, calls and capital accounts should be maintained in respect of the two classes of shares.

1.3.1 ISSUE OF SHARES AT PAR

Shares of the company may be issued in any of the following 3 ways

a) At par

b) At premium

c) At discount

Shares are said to be issued at par when the issue price is equal to the face value or nominal value of the shares i.e. issue price is Rs.10/- and the face value is also Rs.10/- When the shares are issued at par, the company may ask the payment of the face value of the shares either payable in one lump sum or in installments.

a) WHEN SHARES ARE ISSUED AT PAR AND ARE PAYABLE IN FULL IN A LUMP SUM THE ACCOUNTING ENTRY WOULD BE

i) (on receipt of application money)

Bank A/c Dr	(with the amount received on
To Share application and allotment A/c	Application)

ii) (on allotment of shares)

Share application and allotment a/c Dr	(with the money received
To Share capital a/c	on the number of shares allotted)

Note: If the company fails to raise the minimum subscription then no shares can be allotted and the application money has to be returned to the applicants.

Then the entry will be

Share application and allotment A/c Dr. (with the application money received
To Bank now refunded)

The following illustration will make us understand the above clearly

A Ltd. issued 10,000 equity share of Rs.10/- each payable in full on application. The company received application for 10,000 shares. Applications were accepted in full.

The following entry will be passed

1) Bank A/c Dr. Rs.1, 00,000/- (10,000 x 10)
To Equity share application
And allotment account) Rs.1, 00,000/-

(Being amount received for 10,000 shares @10/-each)

2) Equity share application and allotment A/c Dr. 1, 00,000/-
To Equity Share capital a/c 1, 00,000/-
(Being allotment of 10,000 shares @10/- each)

b) WHEN SHARES ARE ISSUED AT PAR AND ARE PAYABLE IN INSTALMENTS

In such a case, the various instalments are termed as follows: First instalment is called “application money”. Second instalment is called “allotment money”. Third installment is called “first call money” and the last installment is called “final call money”.

i) on receipt of the application money
Bank a/c Dr (with the amount received on
To Share application account application)
(Being application money received in respect of …. Shares @Rs…. Per share)

Note: Where the capital of the company consists of shares of different classes, a separate share application account will be opened for each class of shares. i.e. equity share application account/preference share application account etc.,

ii) on allotment of shares
Share application account Dr (with the amount of application
To Share capital account money on allotted shares)
(Being the application money on allotted shares now transferred to share capital account)
Entries at allotment stage could be
Share allotment account Dr
To Share capital Account
And

Bank Account Dr
To Share Allotment account

iii) on call on shareholders:

After allotment, whenever, the need arises, the directors may demand further money from the shareholders towards payment of the value of the shares taken up by them. Such demands are termed as calls. The different calls are distinguished from each other by their serial numbers, i.e. first call, second call, third call and so on.

When the first call is made

Share first call account Dr (with the amount due on first call
To Share Capital a/c
(being the amount due on first call @ Rs... Per share on … shares)

The amount due on particular call is to be calculated with reference to the number of shares on which the call is made and the amount of installment for that call.

On receipt of first call money

Bank A/c Dr. (With the amount received on first call
To share first call account
(Being the amount received in respect of first call @Rs… per share on .. shares)

When second call is made

Share second call account Dr. (With the amount due on second call)
To Share capital account (Being the amount due on second call @...per share on … shares)

On receipt of Second call money

Bank a/c Dr (with the amount received on
To second call account second call
(Being the amount received in respect of second call @ Rs... Per share on … shares)

When the final call is made

Share First call is made

Share final call Account Dr. (With the amount due on final call
To Share capital account
(Being the amount due on final call @Rs…. Per share on ….. Shares)

On receipt of final call money

Bank a/c Dr. (With the amount actually received
To share final call account on final call)

(being the amount received in respect of final call @ Rs..... Per share on …. Shares)

Note: In actual practice there may be cash transactions and the same have to be entered into the cash book instead of bank book as shown above)

Illustration 2

H ltd was registered with an authorized capital of Rs.10,00,000/- divided into 1,00,000 equity shares of Rs.10/- each out of which 50,000 equity shares were offered to the public for subscription. The shares were payable as under:

Rs. 3/- per share on application

Rs.2/- per share on allotment

Rs. 2/- per share on 1st call

Rs.3/- per share on 2nd and final call

The shares were fully subscribed for and the money was duly received.
Show the journal and cash book entries

SOLUTION

JOURNAL ENTRIES

		Rs.	Rs.
Equity Share Application A/c	Dr.	1, 50,000	
To Share capital A/c			1, 50,000
(Being the application money on 50,000 equity shares @Rs.3/-per share transferred to equity share capital account			
Equity Share allotment A/c	Dr.	1, 00,000	
To Equity Share capital account			1, 00,000
(Being allotment money due on 50,000 equity Shares @2/- per share)			
Equity Share first call A/c	Dr	1, 00,000	
To Equity Share capital a/c			1, 00, 000
(Being first call money on 50,000 equity shares @Rs.2/- per share)			
Equity Share Second & Final Call A/c	Dr	1, 50,000	
To Equity Share Capital A/c			1, 50,000
(Being the second and final call money due On 50,000 Equity Shares @3/- per share)			

Dr CASH BOOK (BANK COLUMN)

	Rs.		Rs.
To Equity share Application a/c (Application money@3/-per share)	1, 50,000	By Balance c/d	5,00,000
To Equity share allotment a/c (Allotment money@2/-per share)	1, 00,000		
To Equity share first call a/c (First call money @Rs.2/- per share	1,00,000		
To Equity share second and Final call a/c (Second and final call @3/- per share	1,50,000		
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	5,00,000		5,00,000

1.3.2. STOCK INVEST SCHEME:

Stockinvest is an instrument which can be used by an applicant to tender application money to shares or debentures applied for. In order to mitigate the difficulties caused to the investors because of non-receipt/delay or refund of share application money from the issuing company, the Stockinvest schemes has been introduced by the Government. The instrument is an additional facility available to an intending investor in case he so opts.

1.3.3 UNDER-SUBSCRIPTION OF SHARES

In actual practice, it rarely happens that the number of shares applied for is exactly equal to the number of shares offered to public for subscription. If the number of shares applied for is less than the number of shares issued he shares are said to be undersubscribed.

1.3.4 OVERSUBSCRIPTION OF SHARES

When the number of shares applied for exceeds the number of shares issued, the shares are said to be over-subscribed. In such a case, the directors of the company allot shares on some reasonable basis because the company can allot only that number which is actually offered for subscription. SEBI has issued clear guidelines for oversubscription.

1.4 ISSUE OF SHARES AT PREMIUM

When shares are issued at a price higher than the face value, they are said to be issued at a premium. Thus, the excess of issue price over the face value is the amount of premium. For example, if a share of Rs.10/- is issued at Rs.12/- Rs.12-10= Rs.2/- is the premium.

According to SEBI a new company set up by entrepreneurs without a track record can issue capital to public only at par.

The Premium on issue of shares must not be treated as revenue profits and shall be shown in the Balance sheet, as it is treated as a capital receipt. Separate account called "Securities Premium Account" must be credited towards the premium amount. There are no restrictions in the Companies Act on the issue of shares at a premium, but there are restrictions on its disposal. Under Section 78 of the Act, The Securities Premium Account may be used wholly or in part for

i) Issuing fuly paid bonus shares to the members

ii) Writing off preliminary expenses of the company.

iii) Writing off the expenses of or the commission paid or discount allowed on any issue of the shares or debentures of the company: or

iv) Providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

It is to be noted that utilization of the amount of premium except in any of the modes specified above, can only be done by way of reduction of capital and this will require the compliance of the provisions laid down in Section 100 of the Companies Act.

The premium is usually payable with the instalment due on allotment. In such a case, the amount of premium included in the allotment money should be segregated and credited direct to the Securities Premium Account.

Accounting Entry

When shares are allotted and allotment money becomes due

Share Allotment A/c	Dr.	(with the money due on allotment incl. premium.
To Securities premium	A/c	(with the premium amount)
To Share Capital	A/c	(with the share money)

ILLUSTRATION 3

A Ltd. Issued 10,000, 12% preference shares of Rs.100/- each at a premium of Rs.10/- per share payable as follows:

i) On application Rs.30/-

ii) On Allotment Rs. 30/-(including premium)

iii) On First Call Rs.25/-

iv) On final call Rs.25/-

Applications were received for 12,000 shares and the directors allotted 10,000 shares and rejected 2,000 shares with the money received thereon refunded.

The allotment money was duly received while the firs call money was received on 9,000 shares and the final call money on 8,000 shares.

Show the cash book and journal entries and prepare the balance sheet of the company

Solution:

JOURNAL ENTRIES

Particulars		Dr.	Cr.
12% preference share application and Allotment A/c	Dr.	6,00,000	
To 12% Preference share Capital A/c			5,00,000
To Securities Premium A/c			1,00,000
(Capitalisation of application money @Rs.30- per share And allotment of money due @Rs.30/-per share on 10,000, 12% preference shares including Rs.10/- as Premium)			
12% Preference Share first call A/c	Dr.	2,50,000	
To 12% preference share Capital A/c			2,50,000
(First call money due @Rs.25/- per share on 10,000 12% Preference shares)			
Calls-in- arrears A/c		25,000	
To 12% Preference share first call A/c			25,000
(being first call money due on 1,000, 12% Preference shares @Rs.25/-per share Transferred to call-in-arrear a/c)			
12% Preference share final call A/c		2,50,000	
To 12% Preference share Capital A/c			2,50,000
(being first callmoneydue @Rs.25/- per share on 10,000 12% preference shares)			
Calls-in-arrears A/c		50,000	
To 12% Preference share final call A/c			50,000
(being final call money due on 2,000,12% Preference shares@Rs.25/ - per share Transferred to call-in-arears A/c)			

CASH BOOK (Bank Column)

Dr		Cr	
To 12% Prefence share Application and Allotment A/c	3,00,000	By 12% Preference share Application A/c	60,000
To 12% Preference share appli Cation and allotment A/c	3,00,000	By Balance c/d	10,25,000
To 12% preference share First call A/c	2,25,000		
To 12% Preference share Final call A/c	2,00,000		
	10,85,000		10,85,000

Note: Application money 12,000 x Rs.30/-. Allotment money Rs.30/- on 10,000 shares. First call money Rs.25/- on 9000 shares. Final call money Rs.25/- on 8000 shares.

BALANCE SHEET OF A LTD AS AT …………

Liabilities		Amount	Assets	Amount
Share Capital :				
Authorised capital				
Issued,subscribed and			Current Assets :	
Paid-up capital – 10000,			Loans & Advances	
12% preference shares of Rs.100/-			a) Current Assets	
Each fully called up	10,00,000		Cash at Bank	10,25,000
(-) call in arrears	75,000			
	------------	9,25,000		
Reserves & Surplus;				
Securities premium account		1,00,000		
		10,25,000		10,25,000

1.5 ISSUE OF SHARES AT DISCOUNT

When shares are issued at a price lower than the face value, they are said to be issued at discount. Thus, the excess of the face value over the issue price is the amount of discount. For example, if a share of Rs.10/- is issued at Rs.9/- then Rs.(10-9) = Re.1/- is the discount.
Section 79 of the Companies Act allows a company to issue shares at a discount subject to the following conditions:

1) The share must belong to a class already issued
2) At least one year has elapsed since the date on which the company was entitled to commence business.
3) The issue is authorized by a resolution passed in the general meeting of the company and the sanction of the Central Government is obtained
4) The resolution must specify the maximum rate of discount.
5) The shares must be issued within two months from the date of receiving the sanctions from the Central Government.

There fore, shares cannot be issued at a discount
1) if it is a new company
2) if it is a new class of shares even though old company.

The discount on issue of shares must be treated as a loss of capital nature and as such debited to a separate account called " Discount on issue of shares account". Until it is written off it must be distinctly shown on the assets side of the Balance sheet under the head "miscellaneous expenditure". Discount on the issue of shares is generally recorded at the time of allotment of shares.

Accounting entry will be as follows:

1.	Share allotment A/c	Dr.	(with the amount due)
	Discount on issue of shares	Dr.	(with the discount allowed)
	To share capital account		(with the total amount)
2.	When some portion of discount is written off		
	Profit and loss A/c	Dr.	(with the amount written off
	To discount on issue of shares A/c		

Illustration 4

Elegant Ltd, issued 25,00 equity shares of Rs.10/- each at a discount of 10% payable as follows:

On application	Rs.3/- per share
On Allotment	Rs.1/- per share
On first call	Rs.2.50 per share
On final call	Rs.2.50 per share

Applications were received for 30,000 shares and the directors allotted 25,000 shares and refunded the excess application money for 5,000 shares

The allotment money was duly received on all the shares. One shareholder holding 1,000 shares did not pay the firs call money while another shareholder holding 200 shares paid the final call money along with the first call money. The company did
Not make the final call.

Show the cash book, journal entries and prepare the balance sheet of the company.

Solution:

CASH BOOK (Bank column)

Dr.			Cr.
To Equity Share application A/c	90,000	By Equity share application A/c	15,000
To Equity share allotment A/c	25,000	By Balance C/d	1,60,500
To Equity share first call A/c	60,000		
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	1,75,500		1,75,500

JOURNAL ENTRIES

		Dr.	Cr.
Equity share application A/c	Dr.	75,000	
Equity share allotment A/c	Dr.	25,000	
Discount on issue of shares A/c	Dr	25,000	
To equity share capital A/c			1,25,000
(being capitalization of application money @3/- per Share and allotment money due @Re.1/- per share Excluding discount @Re.1/- per share on allotment Of 25,000 equity shares of Rs.10/- each at a Discount of 10%)			

Equity share first call A/c	Dr.	62,500	
To Equity share capital A/c			62,500
(being first call due on 25,000 shares @Rs.2.50/- Per share)			
Calls-in-arrears A/c	Dr.	2,500	
To equity share first call A/c			2,500
(being first call due on 1,000 shares @$s.2.50/- per share Transferred to calls in arrears a/c			

BALANCE SHEET OF ELEGANT LTD AS AT …..

LIABILITIES		AMOUNT	ASSETS	AMOUNT
		Rs.		Rs.
Shares capital:			Current Assets,	
Authorised Capital			Loans and advances	
Issued & subscribed capital			A. Current assets	
25,000 equity shares of			Cash at bank	1,60,500
Rs.10/- each 2,50,000		……	Discount on issue of Shares	25,000
Paid-up-capital				
25,000 equity shares of				
Rs.10/- each Rs.7.50 per share				
Called up	1,87,500			
Less: Call-in-arrears	2,500	1,85,000		
Call-in-advance		500		
		1,85,500		1,85,500

1.6 FORFEITURE OF SHARES

If a shareholder fails to pay the allotment money and/or calls made on him, his shares are liable to be forfeited. Forfeiture may be said to be the compulsory termination of membership by way of penalty for non-payment of allotment and/or any call money.

The power to forfeit must be contained in the Articles of Association of the company.

The effect of forfeiture of shares is that the defaulting shareholder loses all the rights in the shares and ceases to be a member. The name of the shareholder is removed from the Register of Members and the amount already paid by him is forfeited. No dividend is payable to the forfeited shares. It is interesting to note that although a person ceases to be a member on the forfeiture of the shares, he/she still continues to be liable for the unpaid calls due on the date of forfeiture until the nominal value of the shares is fully paid-up.

1.6.1 Accounting entries on forfeiture of shares

The accounting treatment depends on the nature of issue of the shares i.e. i) at par or
iii) at premium or iii) at discount.

(a) Forfeiture of shares issued at par.

i) Where the unpaid calls have already been transferred to calls-in-arrear A/c and the respective call accounts have been closed:

Share Capital A/c Dr.	(with the amount of called up value of Shares forfeited i.e. number of shares Forfeited X the called up value per share)
To Shares forfeited A/c	(with the amount already paid-up-by the shareholders on the shares so forfeited)
To Calls-in-arrear	(with the amount of unpaid of calls

Alternatively

Share Capital A/c Dr.
To shares forfeited A/c
To share allotment A/c
To share first call A/c
To share final call A/c

ILLUSTRATION 5

X ltd. Forfeited 1,000 equity shares of Rs.10 each issued at par for non-payment of the first call of Rs.2/- per share and the final call of Rs.3/- per share. Give journal for the forfeiture.

SOLUTION

Equity Share Capital A/c (1000 X Rs.10/-)	Dr.	10,000	
To Shares forfeited A/c (1000 X Rs.5/-)*			5,000

To calls in arrears A/c (1000 X Rs.5/-) *			5,000

(being forfeiture of 1000 equity shares for non Payment of the first call of Rs.2/- per share And the final call of Rs.3/- per share)

ALTERNATIVELY

Equity Share capital A/c	Dr.	10,000	
To Shares forfeited A/c			5,000
To Equity share first call A/c			2,000
To Equity share final call A/c			3,000

(being forfeiture of 1000 equity shares for Non payment of the first call of Rs.2/- And the final call of Rs.3/-

b) Forfeiture of shares issued at Premium

i) where shares to be forfeited and are issued at a premium and the premium money remained unpaid, the credit already given to the "Securities Premium Account will be cancelled at the time of forfeiture of the shares by debiting "Securities Premium A/c.

The Accounting entry will be

Share Capital A/c	Dr.	(with the amount called up value of Shares forfeited, i.e. Number of shares Forfeited X called up value per share (excluding premium)
Securities Premium A/c	Dr.	with the amount of premium money Remaining unpaid on shares Forfeited)
To shares forfeited A/c		(with the amount already paid by the Shareholders on the shares forfeited)
To calls-in-arrears A/c		with the amount unpaid on calls

ALTERNATIVELY

Share Capital A/c	Dr.		
Securities Premium A/c			
To Shares forfeited A/c			
To Share Allotment A/c			
To share first call A/c			
To share final call A/c			

Where shares to be forfeited were issued at a premium and the premium money was duly received on the shares to be forfeited, Securities premium Account already credited at the time of making call will not be cancelled at the time of forfeiture of the Shares.
i.e. Share premium once received and credited cannot be cancelled.

ILLUSTRATION 6

Sri Ltd forfeited 1,500 equity shares of Rs.10/-each, issued at a premium of Rs.5/- per share for non payment of allotment money of Rs.8/- per share (including share premium of Rs.5/- per share), the first call of Rs.2/- per share and the final call of Rs.3/- per share. Give journal entry for the forfeiture.

Solution

Equity share capital A/c (1500 X Rs.10)*	Dr	15,000	
Securities premium A/c (1500 X Rs.5/-)*	Dr.	7,500	
To shares forfeited A/c (1500 X Rs.2/-)*			3,000
To calls-in-arrear A/c (1500 X Rs.13/-)*			19,500

(being forfeiture of 1,500 equity shares of Rs.10 each for non payment of allotment money of Rs.8/- per share, including a premium of Rs.5/- per share, first call money of Rs.2/- per share and the final call money of Rs.3/- per share)

Alternatively

Equity Share Capital A/c	Dr..	15,000	
Securities Premium A/c	Dr.	7,500	
To Shares forfeited A/c			3,000
To Equity shares allotment A/c			12,000
To Equity share first call A/c			3,000
To Equity share final call A/c			4,500

(being forfeiture of 1,500 equity shares of Rs.10 each for non payment of allotment money of Rs.8/- per share, including a premium of Rs.5/- per share, first call money of Rs.2/- per share and the final call money of Rs.3/- per share).

C) Forfeiture of shares issued at discount

If shares to be forfeited were issued at discount, a proportionate amount of discount allowed on such shares should be written off. Since discount on issue of shares, being a loss, is debited to "Discount on issue of shares account" at the time of issue of shares, it should be credited at the time of forfeiture of the shares. On reissue of such forfeited shares again, Discount on issue of shares account is debited making the discount on issue of shares proportionate to the shares actually issued. Thus, the position in respect of discount is quite distinct from the position in respect of premium on issue of shares. The accounting entry for forfeiture will be as follows:

Share Capital A/c	Dr.	(with the amount of called up value of Shares forfeited, i.e. No.of shares Forfeited X called up value per share (including discount)
To Shares forfeited A/c		(with the amount already paid by the Shareholders on the shares forfeited i.e. No.of shares forfeited X amount paid per share.
To Discount on issue of share A/c		with the amount of discount allowed Previously on shares forefeited i.e. No.of shares forfeited X amount paid Per share.
To Calls-in-arrear A/c		With the amount of unpaid calls i.e. No.of shares forfeited X unpaid amount Per share.

ALTERNATIVELY

Share capital A/c	Dr.	(with the amount of called up value of shares Forfeited i.e. No of shares forfeited X called Up value per share.(incl discount)
To shares forfeited A/c		with the amount of already paid by the Shareholders on the shares forfeited
To Discount on issue of Shares A/c		with the amount of discount allowed Previously on shares forfeited.
To respective calls		with the amount unpaid on respective Calls. i.e. No of shares forfeited X Amount due on respective call per share

Illustration 7

Y ltd forfeited 1,000 equity shares of Rs.10/- each, issued at a discount of 10% For non payment of first call of Rs.2/0- and the final call of Rs.3/- per share. Show the necessary journal entry.

SOLUTION

JOURNAL ENTRY

	Dr. Rs.	Cr. Rs.
Equity share capital A/c (1000 X Rs.10/-)	10,000	
To Shares forfeited A/c (1000 X 4)		4,000
To Discount on issue of share A/c (1000 X Re.1/-)		1,000
To Calls-in-arrear a/c (1000 x Rs.5/-)		5,000

(being forfeiture of 1,000 equity shares issued at a discount Of 10% for non payment of first call money of Rs.2/- per Share and final call money of Rs.3/- per share)

Alternatively

Equity Share capital A/c	Dr.	10,000	
To shares forfeiture A/c			4,000
To discount on issue of shares A/c			1,000
To equity share first call A/c			2,000
To equity share final call A/c			3,000
(forfeiture of 100 equity shares issued at a discount Of 10% fornon payment of first call money of Rs.2/- And final call money of Rs.3/- per share respectively)			

1.7 RE-ISSUE OF FORFEITED SHARES

The important point of consideration for reissue of forfeited shares is that the amount receivable on re-issue of such shares together with the amount already received from the defaulting member, shall not, in any case, be less than the face value of the shares. Thus, forfeited shares may be re-issued at par, at a premium or even at a discount.

1.7.1 Forfeited shares re-issued at a discount

If a forfeited shares are re-issued at a discount, the amount of discount can, in no case, exceed the amount credited to Shares forfeited account. Discount thus allowed on re-issue has to be debited Shares forfeited account. If the discount allowed on re-issue is less than the forfeited amount, there will be a surplus left in the Shares forfeited account which shall be treated as net gain on forfeiture. This gain should be treated as capital gain and thus transferred to Capital Reserve Account.

1.7.2 Forfeited shares re-issued at par

If forfeited shares are re-issued at par, the entire amount standing to the credit of Shares forfeited account would be treated as net gain and transferred to Capital Reserve account.

1.7.3 Forfeited shares re-issued at a Premium

If forfeited shares are re-issued at a premium, the amount of such premium should be credited to Securities premium Account. In such a case also, the entire amount standing to the credit of shares forfeited account would be treated as net gain and transferred to Capital Reserve Accountt.

Note: If only part of the forfeited shares are re-issued, only the proportionate amount representing the net gain on the shares re-issued should be transferred to Capital reserve account and the balance representing the amount received on the forfeited shares not yet re-issued should be left in the Shares forfeited account itself.

ACCOUNTING ENTRIES

i) If forfeited shares are re-issued at par

1) On re-issue of shares

Bank A/c Dr. (with the amount received on re-issue
To share capital A/c i.e.No. of shares re-issued X amount received per Share)

2) On Transfer of Shares forfeited account to Capital Reserve Account

Shares forfeited A/c Dr. (with the forfeited amount on shares)
To Capital Reserve A/c

ii) If forfeited shares are re-issued at a premium

1. On re-issue of shares

Bank A/c Dr. (with the total amount received on re-issue)

To Share capital A/c (with nominal value or paid-paid up value Of shares)
To Securities Premium A/c (with the premium money)

2. On transfer of Shares forfeited A/c to Capital reserve A/c
Shares forfeited A/c Dr. with the forfeited amount on shares
To Capital Reserve A/c re-issued

iii) If forfeited shares are re-issued at a discount

1. On re-issue of shares
Bank A/c Dr. (with the amount received on re-issue)
Shares forefeited A/c Dr. (with the discount allowed on re-issue)

To share capital A/c (with the total)

2. On Transfer of balance in Shares forfeited Account, if any, to capital reserve
   Shares forfeited A/c Dr.
   To Capital Reserve A/c (with the net gain, if any, on shares reissued

iii) Re-issue of forfeited shares which were originally issued at a discount

1. On re-issue of shares

Bank A/c	Dr.	With the amount received on re-issue
Discount on reissue of shares	Dr.	with the amount of discount – original discount
Shares forfeited account	Dr.	with the amount of short fall if any
To Share capital A/c		with the total

2. On transfer of balance in Share forfeited A/c if any to Capital reserve A/c

   Shares forfeited A/c Dr. with the net gain,.on re-issue
   To capital Reserve

Illustration 8

Give Journal entries for the forfeiture and re-issue of shares in the following cases

(a) S.S. Ltd forfeited 300 shares of Rs.10/- each, fully called up for non payment of final call money of Rs.4/-per share. These shares were Subsequently re-issued by the company for Rs.10/-per share as fully Paid up.

(b) R.S. ltd forfeited 300 shares of Rs.10/- each, fully called up for non- Payment of final call money of Rs.4/- per share. These shares were Subsequently re-issued by the company for Rs.12/- per share as Fully paid up.

(c) S.P. ltd forfeited 200 shares of Rs.10/- each, Rs.8/- per share being Called up on which a share holder paid application and allotment Money of Rs.5/- per share but did not pay the first call money of Rs. 3/- per share. Of these forfeited shares, 150 shares were subsequently re-issued by the company as fully paid-up for Rs.8/- per share

(d) R.P Ltd forfeited 100 shares of Rs.10/- each, Rs.8/- per share being Called up, which were issued at a discount of 10% for non-payment Of first call money of Rs.3/- per share. Of these forfeited shares, 80 shares were subsequently re-issued by the company at Rs.5/- as Rs.8/- paid up.

Solution

Journal entries

	Dr. Rs.	Cr. Rs.
(a) 1. Share Capital A/c	3,000	
(300 X Rs.10)		
To Share forfeited		1,800
(300 X Rs.6/-)		
To shares final call A/c		1,200
(300 X Rs.4/-)		
(forfeiture of 300 shares of Rs.10/- each for Non payment of final call money of Rs.4/- per share)		
2. Bank A/c	3,000	
To share capital A/c		3,000
(re-issue of 300 forfeited shares of Rs.10/- Each fully paid up)		
3. Shares forfeited A/c	1,800	
To Capital Reserve A/c		1,800
(Transfer of profit on re-issue of forfeited shares To Capital reserve a/c)		
(b) 1. Share Capital A/c	3,000	
(300 X Rs.10/-)		
To shares forfeited A/c		1,800
(300 X Rs.6/-)		
To Share final call A/c		1,200
(300 X Rs.4/-)		
(forfeiture of 300 shares of Rs.10/- each for non Payment of final call money of Rs.5/- per share)		

2. Bank A/c (300 X Rs.12)		3,600	
To Share Capital A/c (300 X Rs.10/-)			3,000
To Securities premium a/c (300 X Rs. 2/-)			600
(Re-issue of forfeited shares of Rs.10/- each at A premium of Rs.2/- per share)			
3. Shares forfeited A/c		1,800	
To capital reserve A/c			1,800
(Transfer of profit on re-issue of forfeited Shares to capital reserve A/c)			

(c) 1. Share Capital A/c (200 X Rs.8/-)	Dr.	1,600	
To shares forfeited A/c (200 X Rs.5/-)			1,000
To share first call A/c			600
(forfeiture of 200 shares of Rs.10/- each Rs.8/- being Called up for non-payment of first call money Of Rs.3/- per share)			
2. Bank A/c (150 X Rs.8)	Dr.	1,200	
Shares forfeited A/c (150 X Rs.3/-)	Dr.	300	
To Share Capital			1,500
(Re issue of 150 forfeited shares of Rs.10/- each As fully paid-up for Rs.8/- per share, i.e. at a Discount of Rs.2/-)			
3. Share Forfeited A/c	Dr.	450	
To Capital reserve			450
(transfer of capital profit proportionate To forfeited shares re-issued. i.e. on 150 share To capital reserve A/c)			

(d)	1. Share Capital A/c (100 x 8)	Dr.	800	
	To share forfeited A/c (100 X Rs.4/-)			400
	To Discount on issue of Shares A/c 100 X re.1/-)			100
	To share first call A/c (100 X Rs.3/-)			300
	(forfeiture of 100 shares of Rs.10 each, Rs.8/- Being called up, issued at a discount of re.1/- Per share for non-payment of first call @Rs.8/- Per share)			
	2. Bank A/c (80 X Rs.5/-)	Dr.	400	
	Discount on issue of shares	Dr.	80	
	Share forfeited A/c (80 X Rs.2/-)	Dr.	160	
	To Share Capital A/c (80 X Rs. 8/-)			640
	(Re-issue of 80 forfeited shares of Rs.10/- Each, Rs.8/- being called up originally issued At discount of 10% for Rs.5/- per share Credited as Rs.8/- per share)			
	3. Shares forfeited A/c	Dr.	160	
	To Capital Reserve A/c			160
	(Transfer of Capital profit proportionate to Forfeited shares re-issued i.e 80 shares)			

1.8 SURRENDER OF SHARES

When on non payment of money called on shares, the shares of a holder are forfeited, it is called forfeiture. This action is a penalizing action. On the other hand, when the holder accepts inability to pay the called money and wants to give up holding, it is known as surrender of shares. The law does not provide guidelines for this particular issue. While Forfeiture is punitive in nature, Surrender is a voluntary action by the shareholder who is not able to pay the amount being called on shares by the company whose shares are held by him. Surrender of shares means the return of shares by the shareholder to the company for cancellation voluntarily. It is a shortcut to the long procedure of forfeiture of shares otherwise the causes and effects are the same. A company can accept surrender of partly paid-up shares only.

Thus surrender of shares is at the instance of the share holders while the forfeiture of shares is at the instance of the company. Surrender will be void if it amounts to purchase of shares by the company or it is accepted to relieve a member from his/her liabilities.

Accounting entries are the same as Forfeiture of shares

1.9 RIGHTS ISSUE

Under section 81, of the Companies Act, the existing shareholders have a right to subscribe, in their existing proportion to the fresh issue of capital or to reject the offer or to sell their rights. Before offering it to public a special resolution should have been passed by the existing share holders. This rights issue can be done after the expiry of two years of formation of the company or at any time after the expiry of one year from the date of first allotment of shares whichever is earlier.

The value of the right is calculated with reference to the market value of the shares and the following steps may be taken:

1. The market value of the shares held by a shareholder has to be ascertained.
2. The price of the new share which is required to be paid to the company has to be added with the market value of the shares held to ascertain the total price of all the shares.
3. The average price of one share has to be ascertained by dividing the total price of all the shares by the number of shares.
4. The value of the right will be the difference between the market value and the average price of the share.

Illustration 9

A Company has decided to increase its existing share capital by making rights issue to the existing shareholders in the proportion of one new share for every two old shares held. You are required to calculate the value of the right if the market value of share at the time of announcement of right issue is Rs.240/- . The company has decided to give one share of Rs.100/- each at a premium of Rs.20/- each

Solution	Rs.
Market value of 2 shares already held by a share holder =2 X 240	480
Add: The price required to be paid for acquiring one More share	120

Total price of 3 shares	600

Average price of one share = 600/3 = 200

Value of right = market value – average value
= (Rs.240/- - Rs.200/- = Rs.40/-

An alternative formula is
(New shares/ Total shares) X cum rights price – new issue price
Accordingly 1/3 X (240-120) = Rs.40

Proof : Suppose a person wants to hold three shares in the company, he can buy two existing shares @Rs.240/- each and then he can get one additional share from the company for Rs.120/- he will spend Rs.600/- in all for the three shares. i.e. Rs.200/-
Per share. Alternatively, the rights attached to each existing shares enables one to buy ½ new share: for buying one new shares, two rights are required and for buying three shares one needs six rights which will cost Rs.240/- in all, one must pay Rs.360/- to the company for the three additional shares making a total of Rs.600/- in all for Rs.200/- per share.

Issuing bonus shares is a way of rewarding the shareholders & creating shareholder wealth. Only companies which have huge reserves (i.e. undistributed accumulated profits) in comparison to its equity capital which have been accumulated over the years issue bonus shares as bonus shares means capitalisation of reserves. The company, only when it is confident of delivering sustained profits & would be able to maintain the dividend pay-out ratio on diluted equity capital (i.e. after bonus shares) will reward the shareholders by a bonus issue.

1.10 UNDERWRITING

Underwriting may be defined as a contract entered into by the company with persons or institutions, called underwriters, who undertake to take up the whole or a portion of such of the offered shares or debentures as may not be subscribed for by the public, in consideration of remuneration called underwriting commission. The name derives from the Lloyd's of London insurance market in London, united kingdom. Financial bankers, who would accept some of the risk on a given venture, (historically a sea voyage with associated risks of shipwreck) in exchange for a premium, would literally write their names under the risk of information which was written on a Lloyd's ship created for this purpose. Underwriting of shares is the way business customers are assessed by investment houses for access to either equity or debt capital. This is a way of placing a newly issued security, such as stocks or bonds, with investors

The persons or institutions underwriting a public issue of shares or debentures are called underwriters. The underwriters may be individuals, partnership firms or even joint stock companies. But, an issue of shares or debentures is hardly underwritten by a single individual as it involves more risk and attaches greater responsibility.

The leading underwriters set up by Government of India are Industrial Credit and Investment Corporation of India, Industrial finance Corporation of India, Life insurance corporation of India, Industrial development bank of India, Unit Trust of India etc., Nationalized banks do the business of underwriting shares or debentures of companies but to a limited extent.

1.10.1 TYPES OF UNDERWRITING

An underwriting may be

(i) Complete underwriting: If the whole issue of shares or debentures of a company is underwritten, it is said to be complete underwriting.

(ii) Partial underwriting: If only a part of the issue of shares or debentures of a company is underwritten, it is said to be partial underwriting.

(iii) Firm Underwriting: It refers to a definite commitment by the underwriter or underwriters to take up a specified number of shares or debentures of a company irrespective of the number of shares or debentures subscribed for by the public. In such a case, the underwriters are committed to take up the agreed number of shares or debentures in addition to unsubscribed shares or debentures, if any. Even if the issue is over-subscribed, the underwriters are liable to take up the agreed number of shares or debentures.

1.10.2 UNDERWRITING COMMISSION:

The consideration payable to the underwriters for the underwriting the issue of shares or debentures of a company is called underwriting commission. Such a commission is paid at a specified rate on the issue price of the whole of the shares or debentures underwritten whether or not the underwriters are called upon to take up any shares or debentures. Thus, the underwriters are paid for the risk they bear in the placing of shares before the public.

Underwriting commission may be paid in addition to brokerage. Company may pay a commission to any person inconsideration of

i) his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in or debentures of the company, or

ii) His procuring or agreeing to procure subscription whether absolute or conditional for any shares in or debentures of the company.

iii) The commission paid or agreed to be paid does not exceed in the case of shares @5% of the price at which the shares are issued or the amount of rate authorised by the articles, which ever is less. In the case of debentures it is 2.5% of the price at which the debentures are issued or the amount or rate authorised by the articles which ever is less.

iv) The rate or amount should be mentioned in the prospectus or statement in lieu of prospectus.

1.10.3 DETERMINING THE LIABILITY OF THE UNDERWRITERS

i) Complete underwriting.

a) If the whole of the issue of shares or debentures is underwriten only by one underwriter: in such a case, the underwriter will be liable to take up al the shares or debentures that have not been subscribed for by the public.

Liability = shares or debentures offered – total applications received

If the whole of the issue of shares or debentures is underwritten by a number of underwriters in an agreed ratio: in such a case the liability of the respective underwriters can be determined as follows:

The gross liability of each underwriter according to the agreed ratio should be reduced first by the marked applications and then credit may be given in respect of unmarked applications sent directly to the company by way of deduction from the balance left in the ratio of their gross liability. Thus, the liability of each underwriter in such a case will be as follows:

Gross liability according to the agreed ratio	…….
LESS: Marked applications	…….

Balance left	
Less: Unmarked applications in the ratio of Gross liability	……

Net liability	……

Illustration 10

Sun limited issued 50,000 equity shares. The whole of the issue was underwritten as follows:

Red 40% white 30% Blue 30%

Applications for 40,000 shares were received in all, out of which applications for 10,0000 shares had the stamp of Red; those for 5,000 shares that of white; and those for 10,000 shares that of Blue. The remaining applications for 15,000 shares did not bear any stamp. Determine the liability of the underwriters.

Solution

NET LIABILITY OF UNDERWRITERS

	RED 40% Shares	WHITE 30% Shares	BLUE 30% Shares
Gross liability in the agreed Ratio of 40:30:30	20,000	15,000	15,000
Less: Marked applications	10,000	5,000	10,000
Balance left (Resultant liability	10,000	10,000	5,000
Less: Unmarked applications In the above ratio	6,000	4,500	4,500
NET LIABILITY	4,000	5,500	500

1.10.4. ACCOUNTING TREATMENT RELATING TO UNDERWRITING OF SHARES OR DEBENTURES

a) When the shares or debentures are allotted to the underwriters in respect of their liability:

Underwriters A/c	Dr.	(with the value of the shares or debentures taken up by the Underwriters)
To Share Capital/debentures		

b) When commission becomes payable to the underwriters:

Underwriters Commission A/c	Dr.	(with the amount of commission
To Underwriters A/c		due on the total issue price of
		Shares underwritten)

c) When the net amount due from the underwriters on the shares or debentures Taken up by them is received

Bank A/c	Dr.	(with the amount due
To underwriters A/c		

Note: Underwriting commission is not generally paid in cash. Instead the same is adjusted against the money due on shares or debentures taken up by the underwriters and only the net amount (i.e. total amount due on shares or debentures taken up by the underwriters minus the underwriting commission) is received from the underwriters.

Illustration 11

W Ltd., invited the public to subscribe to the following:

i) 10,000 equity shares of Rs.100/-each at a premium of 5% and

ii) Rs.2,50,000 in 14$ Debentures of Rs.100/- each at Rs.96/-

60% of the shares and the whole of the issue of debentures were underwritten by M/s S and F for the commission allowable by the Government. The applications from the public totalled 6,000 shares and 2,000 debentures. The underwriters fulfilled their obligations. Show the journal entries that would appear in the books of the company.

Solution

JOURNAL ENTRIES	**Dr.**	**Cr.**
	Rs.	Rs.
Bank A/c	8,22,000	
To Equity share application & Allotment A/c		6,30,000
To Debentures Application and Allotment A/c		1,92,000
(being receipt of application money on 6,000 equity shares @Rs.105/- each including premium of Rs.5/- each and on 2,000 debentures @Rs.96/- each at a discount of Rs.4/- each)		

quity share application and allotment A/c	6,30,000	
To Equity share capital A/c		6,00,000
To Securities Premium A/c		30,000
(being allotment of 6,000 equity shares of Rs.100/- Each at a premium of Rs.5/- each to public)		
14% Debenture application and allotment A/c	1,92,000	
Discount on issue of Debenture A/c	8,000	
To 14% debentures A/c		2,00,000
(being allotment of 2,000 14% debentures of Rs.100/- Each at a discount of Rs.4/- each to public)		
M/s S & F	48,000	
Discount on issue of Debentures A/c	2,000	
To 14% Debentures A/c		50,000
(Allotment of 500 debentures allotted to M/s S & F Being their liability)		
Underwriting commission A/c	19,830	
To S & F A/c		19,830
(being underwriting commission due on issue price of Shares @2.5% (as per Govt.rate) on Rs.6,30,000/- and on Debentures @1.5% and 2.5% on Rs.1,92,000/-and Rs.48,000 Respectively)		
Bank A/c	2,80,170	
To M/s S & F A/c		2,80,170
(Receipt of the net amount due from M/s S & F i.e. Rs. (2,52,000+48,000- 19830)		

WORKING NOTES:

i) Liability of S and F

	Shares	Debentures
	60%	100%
Gross Liability	6,000	2,500
Less: Marked applications		
Shares 60% of 6,000 and debentures100% of 2000	3,600	2,000
Net Liability	2,400	500

ii) Underwriting commission

Underwriting commission has been calculated as per the rates applicable in force:

Equity Shares

2.5% on the issue price of 6,000 shares Underwritten = 6,30,000 X 2.5%		Rs.15,750
Debentures		
On amounts subscribed by the public:		
1.5% on issue price of 2,000 debentures = 2,000 X 96 X 1.5%	Rs.2,880	
On the amounts devolved on underwriters 2.5% on issue price of 500 debentures = 500 X 96 X 2.5% =	Rs. 1,200	4,080
	Total	19,830

1.11 ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

A Company may also issue shares for consideration other than cash to vendors who sell some assets to the company or to the promoters for their services. When share are so issued, the Companies Act, requires that the same must be clearly stated in the balance sheet and must be distinguished from the issue made for cash

1.12 ISSUE OF SHARES TO VENDORS

A company may purchase assets from the vendors and instead of paying the vendors cash, may settle the purchase price by issuing fully paid up shares in the company. This type of issue of shares to the vendors is called issue of shares for consideration other than cash. Such shares may be issued by the vendors either i) at par ii) at premium iii) at a discount.

1.13 ISSUE OF SHARES TO PROMOTERS

A Company may allot fully paid shares to promoters or any other party for the services rendered by them by way of furnishing technical information, engineering services, plant lay out, drawing and designing etc., without payment. This type of issue of shares to promoters is called issue of shares for consideration other than cash. As the amount paid to promoters for services rendered by them is supposed to be utilized by the company over a long period of time, such expenditure should be treated as capital expenditure and debited to Goodwill Account. The accounting entry in such a cash will be as follows

Goodwill A/c	Dr.	with the nominal value of the
To share capital account		shares allotted

To find out the number of shares to be issued the formula to be followed is

= Purchase consideration / Issue price

1.14 LET US SUM UP

Share, forms the basis of ownership in the Company and the people who contribute the money through shares, which constitute the share capital of the Company. As a accounting person one is expected to know the meaning, definition of shares, the issue of shares and he ways of issuing the same.

1.15 LESSON-END ACTIVITIES

1 What do you mean by a ‘share’ and what are the types of shares?

2. Distinguish between a Equity share and Preference share?

3. What do you mean by a “offer document”?

4. What is “Red Herring Prospectus”?

5. What are 3 ways a company may issue its shares?

6. Explain Stock invest scheme.

7. Distinguish between oversubscription and undersubscription of shares

8. A Company issued 10,000 shares of Rs.10/- each. Total applications were

   For 12,000 shares. Allotment was made pro-rata. Application money was

   Rs.2/- per share and allotment money Rs.3/- per share. X failed to pay the allotment money on his 300 shares. How much is due from X for allotment?

9. E ltd had allotted 10,000 shares to applicants for 14,000 shares on a pro rata

   Basis. The amount payable was Rs.2/- on application, Rs.5/- on allotment (including premium of Rs.2/- each), Rs.3/.- on first call and Rs.2/- on final call. V failed to pay the first cal and final call on his 300 shares. All the shares were forfeited and out of these 200 shares were re-issued @Rs.9/- per share. What is the amount credited to capital reserve?

10. R Ltd forfeited 150 shares of Rs.10/- issued a premium of Rs.2/- for non

   Payment of the final call of Rs.3/-. Of these 100 shares were re-issued @Rs.11/- per share. How much is transferred to capital reserve?

1.16 REFERENCES

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UNIT - II

2.0 AIMS AND OBJECTIVES

i) To study the issue of Redeemable preference shares & Debentures
ii) To know the meaning of redemption of preference shares, debentures.
iii) To study the methods of redeeming preference shares
   a) out of profit
   b) out of capital
   c) redemption of debentures by sinking fund method

2.1 INTRODUCTION

Section 80, of the Companies act provides for the issue and redemption of preference shares. Redemption is the process whereby a company can redeem shares through repayment of the nominal value to the shareholder. Any Indian company that issues debentures must create a debenture redemption service to protect investors against the possibility of default by the company.

2.2 REDEMPTION OF PREFERENCE SHARES

2.2.1 What is special about Preference shares:

Ordinary shareholders are not automatically entitled to a dividend every year. The dividend will be paid only if the company makes a profit and declares a dividend. This is not the case with preference shares. A preference shareholder is entitled to a dividend every year. If the company doesn't have the money to pay dividends on preference shares in a particular year, the dividend is then added to the next year's dividend. If the company can't pay it the next year as well, the dividend keeps getting added until the company can pay. These are known as cumulative preference shares. Some preference shares are non-cumulative -- if the company can't pay the dividend for one particular year, the dividend for that year lapses.

Usually, preference shares are most commonly issued by companies to institutions. That means, it is out of the reach of the retail investor. Companies, on the other hand, may need money but are unwilling to take a loan. So they will issue preference shares. The banks and financial institutions will buy the shares and the company gets the money it needs. The big disadvantage of preference shares, of course, is the fact that they aren't traded on the markets.

2.2.2 Redeemable preference shares - Meaning

Shares which, on a stated maturity date, the issuing company will buy back at a predetermined price. Being Preference shares, they rank ahead of ordinary shares, but behind debentures, in any claim on the assets of the company. Redeemable preference shares have been used mostly as a form of debt financing. A conventional redeemable preference share issue would involve the issue of shares which were redeemable for an amount equal to the capital and premium subscribed for them, with no further right to participate in profits on redemption or a winding up - that is, the rights to return of capital and premium corresponded closely with a right to repayment of principal of a loan. The redeemable preference shares would generally carry a fixed cumulative dividend. Redeemable preference shares can be redeemed only when the company is financially capable of doing so. Whereas, in the case of bankruptcy, issuers of debt or ECBs are ahead of holders of preference shares."

The other conditions are

(a) no such shares shall be redeemed except out of profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made or the purposes of the redemption;

(b) no such shares shall be redeemed unless they are fully paid;

(c) the premium, if any, payable on redemption shall have been provided for out of the profits of the company or out of the company's share premium account, before the shares are redeemed;

(c) where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall, out of profits which would otherwise have been available for dividend, be transferred to a reserve fund, to be called 1[the capital redemption reserve account], a sum equal to the nominal amount of the shares redeemed; and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if 1[the capital redemption reserve account] were paid-up share capital of the company.

(2) Subject to the provisions of this section, the redemption of preference shares there under may be effected on such terms and in such manner as may be provided by the articles of the company.

(3) The redemption of preference shares under this section by a company shall not be taken as reducing the amount of its authorised share capital.

(4) Where in pursuance of this section, a company has redeemed or is about to redeem any preference shares, it shall have power to issue shares up to the nominal amount of the shares redeemed or to be redeemed as if those shares had never been issued; and accordingly the share capital of the company shall not, for the purpose of calculating the fees payable under 2[section 611], be deemed to be increased by the issue of shares in pursuance of this sub-section:

2.2.3 Redemption out of Capital:

i) When fresh issue of shares is made at par:

In such a case, there should not be any confusion. The nominal value of shares issued will constitute the proceeds and the same should be considered for determining the amount to be credited to Capital Redemption reserve.

ii) When fresh issue of shares is made at a Premium:

In such a case, the confusion may arise as to whether the nominal value of the shares issued should constitute the "proceeds" or both the nominal value of the shares issued and the premium money received on those shares should constitute the "proceeds".

iii) When fresh issue of shares is made at a discount:

In such a case, the confusion may arise as to whether the net amounts received after deduction of discount from the nominal value of shares issued constitute the proceeds.

2.3 ACCOUNTING ENTRIES FOR REDEMPTION OF PREFERENCE SHARES

i) If the redeemable preference shares are redeemed out of the profits of the company which would otherwise be available for dividend:-

1) When profits available for dividend are transferred to Capital Redemption Reserve Account:

General Reserve A/c	Dr.	
Profit Loss Appropriation A/c	Dr.	
Dividend equalization A/c	Dr.	
To Capital Redemption Reserve A/c		With the nominal value of the Shares to be redeemed

2) If Current Assets are realized to provide cash for redemption of preference shares:

Bank A/c	Dr.	With the realized value of assets
To Respective Asset A/c		

3) On transfer of redeemable preference share capital to be redeemed to Preference Shareholders A/c

Redeemable Preference Share Capital A/c	with the nominal value of the shares to be Redeemed
To Preference Shareholders A/c	

4) If Preference shares are to be redeemed at Premium:

Premium on Redemption of Preference Shares A/c	with the amount of premium payable
To Preference Shareholders A/c	

NOTE: Entries 3 and 4 can be combined

5) On writing off premium on redemption of preference shares:

Securities Premium A/c	Dr.	With the amount of Premium paid on redemption of preference shares
OR Profit loss appropriation A/c	Dr.	
To Premium on redemption of Preference share A/c		

6) On redemption of preference shares:
Preference shareholders A/c with the amount paid
To Bank

ii) If the Redeemable preference shares are redeemed out of the proceeds of
Of a fresh issue of shares made for the purpose of redemption

First all entries for fresh issue of shares will be passed. The entries
3,4,5 and 6 will be passed as given above.

NOTE: In such a case,. New share Capital account (preference/equity) replaces
The redeemable Preference Share Capital Account redeemed.

iii) If the redeemable preference shares are redeemed partly out of the profits of the company which would otherwise be available for dividend and partly out of the proceeds of a fresh issue of shares made for he purpose of redemption.
Here, all the entries shown under (i) and (ii) have to be passed. But there are certain common entries which can be combined together.

NOTE; In this case, capital redemption Account and the new capital account will jointly replace the Redeemable preference share capital account redeemed.

ILLUSTRATION 1
(WHEN PREFERENCE SHARES ARE REDEEMED OUT OF THE PROFITS OF THE COMPANY)

Hema overseas Ltd had an issue 1,000, 12% redeemable preference shares of Rs.100/- each, repayable at a premium of 10%. These shares are to be redeemed now out of the accumulated reserves, which are more than the necessary sum required for redemption. Show the necessary entries in the books of the company, assuming that the premium on redemption of shares has to be written off against the company's Securities Premium Account.

Solution:

Journal Entries

			Rs	Rs
1.	General reserve A/c	Dr	100000	
	To Capital Redemption A/c			100000
	(Transfer of Reserves to Capital Redemption Reserve Account on Redemption of Redeemable Preference Shares)			

2.	12% Redeemable Preference Share Capital A/c	Dr	100000	
	Premium on Redemption of Preference Shares A/c	Dr	10000	
	To 12% Preference Shareholders A/c			110000
	(Amount Payable to 12%Prefrence Shareholders on redemption of 12% preference Shareholders on Redemption of 12% preference Shares at a Premium of 10%)			
3.	Securities Premium A/c	Dr	10000	
	To Premium on Redemption of Preference Share A/c			10000
	(Application of Securities Premium Account to Write off Premium on Redemption of Preference Shares)			
4.	12% Preference Shareholders A/c	Dr	110000	
	To Bank			110000
	(Amount due to 12% preference Shareholders on Redemption paid)			

Notes: Capital Redemption Reserve Account Replaces the 12% Redeemable Preference Shares Capital Account and the Capital Structure of the Company Remains unchanged.

Illustration 2

(When Redeemable Preference Shares are redeemed out of the Proceeds of Fresh issue made for the purpose)

Sure and Fast Ltd. has part of it’s share capital in 2,000, 12% Redeemable Preference Shares of Rs.100 each, repayable at a premium of 5% . The Shares have now become ready for redemption. It is decided that the whole amount will be redeemed out of a fresh issue of Rs.10 each at Rs.11 each. The whole amount is received in cash and the 12% preference shares are redeemed.

Show the necessary journal entries in the books of the company.

Solution:

Journal entries

	Particulars		Rs	Rs
1.	Bank A/c	Dr	220000	
	To Equity Share Application and Allotment A/c			220000
	(Application money on 20000 equity Shares @ Rs.11 per Share including a premium of Re.1 Per Share)			
2.	Equity share Application and Allotment A/c	Dr	220000	
	To Equity Share Capital A/c			200000
	To Securities Premium A/c			20000
	(Allotment of 20000 equity shares Rs.10 each issued at a premium of Re.1 Per share As Pet Board's Resolution dated….)			
3.	12% Redeemable Preference Share capital A/c	Dr	200000	
	Premium on Redemption of Preference share A/c	Dr	10000	
	To 12% Preference Shareholders A/c			210000
	(Amount Due to 12% preference shareholders on redemption of 8% preference shares at a premium of 5%)			
4.	Securities Premium A/c	Dr	10000	
	To Premium on Redemption of Preference shares A/c			10000
	(Application of Securities Premium Account to Write off Premium on Redemption of preference share)			
5.	12%Preference shareholders A/c	Dr	210000	
	To Bank			210000
	(Amount due to 12% preference Shareholders on redemption paid)			

Note: Equity Share Capital Account replaces the 12% Redeemable Preference Share Capital Account and the Capital Structure of the Company remains unchanged)

Illustration 3:

The Following is the Balance sheet of Oscar India Ltd. as on 31st March 2006:

Liabilities	Rs	Assets	Rs
Preference Share Capital:		Fixed Assets	600000
2500 shares of Rs.100			
each fully called-up	250000	Investment	50000
less: Final call@ Rs.20		Bank	90000
Per share unpaid	2000		
Equity share capital:			
30000 shares of Rs.10			
Each fully paid-up	300000		
Profit and loss A/c	150000		
Securities Premium	15000		
Creditors	27000		
	740000		740000

On 30th June 2006, the board of Directors decided to redeem the Preference shares at Premium of 10% and to sell the investments at it's market price of Rs.40000. They also decided to issue sufficient number of equity shares of Rs.10 each at a Premium of Re.1 Per share, required after utilising the profit and loss account leaving a balance of Rs. 50000. Premium on redemption is required to be set off against Securities Premium account.

Repayments on Redemption were made in full except to one shareholder holding 50shares only due to his leaving India for good.

You are required to show the journal entries and the balance sheet of the company after redemption. Assumption made should be shown in the working.

Solutions:

Journal entries in the books of Oscar Ltd.

Date	Particulars		Debit	Credit
2006 June 30	Bank A/c	Dr	40000	
	Profit and loss A/c	Dr	10000	
	To Investments			50000
	(Being the sale of investments at a loss of Rs.10000)			
	Bank A/c	Dr	1650000	
	To Share capital A/c			150000
	To Securities premium A/c			15000
	(Being the issue of required number of equity shares at a premium of 10%)			
	Preference share capital A/c	Dr	240000	
	Premium on Redemption A/c	Dr	24000	
	To Preference shareholders A/c			264000
	(Being the transfer of the amount due to preference shareholder on redemption)			
	Securities Premium A/c	Dr	24000	
	To Premium on Redemption A/c			24000
	(Being the transfer of securities premium account to write off premium on redemption account)			
	Profit and loss A/c	Dr	90000	
	To Capital Redemption Reserve A/c			90000
	(Being the transfer of profit used for redemption of Preference Shares transferred to capital redemption reserve A/c)			
	Preference shareholders A/c	Dr	258500	
	To Bank			258500
	(Being the payment to preference Shareholders except for 50 shares)			

Balance Sheet of Oscar India Ltd. as on 1st July 2006
(After Redemption)

Liabilities		Rs	Assets	Rs
Pref.share Capital			Fixed Assets	600000
100 shares of			Bank	36500
Rs.100 each	10000			
Less: Calls in arrears	2000	8000		
Equity share capital				
45000 shares of Rs.100 each		450000		
Capital Red. Reserve		90000		
Profit and loss A/c		50000		
Securities Premium		6000		
Current Liabilities				
Creditors		27000		
Pref.Shareholders		5500		
		636500		636500

Working Notes:

1 .Calculation of required Number of Fresh Issue of Equity shares

	Rs	Rs
Profit and loss A/c balance		150000
Less: loss on sale of investment	10000	
Balance Required	50000	60000
		90000
Profit Available for Redemption		240000
Amount available from Profit and loss A/c		90000
New issue Required 15000 shares		150000

2. **Bank Account**

To Balance b/d	90000	By Preference shareholders A/c	258500
To Investment	40000	By balance b/d	36500
To Share capital A/c	150000		
To Securities Premium A/c	15000		
	295000		295000

3. Premium on redemption of preference shares has been met out of securities premium account.

Illustration: 4

(When Redeemable Preference Shares are redeemed partly out of the profits of the company and partly out of the proceeds of fresh issue of shares made for the purpose)

The Balance Sheet of Producers ltd. as at 31st march 2006 is as follows:

Liabilities	Rs	Assets	Rs
Share Capital:		Fixed Assets:	
Authorised capital		Plant and Machinery	190000
40000 equity shares		Furniture and Fixtures	20000
of Rs.10 each	400000	Investments	60000
1000 8% Preference shares		Current Assets, loans and	
of Rs.100 each	100000	Advances:	
	500000	A. Current Assets:	
Issued and subscribed Capital:		Stock	130500
25000 Equity Shares of		Debtors	49550
Rs.10 each fully Paid	250000	Cash at Bank	4950
1000 8% Preference shares		B. Loans And Advances	
Of Rs.100 each fully Paid-up		Prepaid Expenses	1000
Reserves and Surplus:			
Securities premium Account	9000		
Profit and Loss Account			
Current Liabilities and Provisions			
A. Current Liabilities:			
Sundry Creditors	22500		
B. Provisions:			
Provisions for taxation	19500		
	456000		456000

In order to redeem its Preference shares, the company issued 5,000 equity shares of Rs.10 each at a premium of 10% and sold its investment of Rs.70800. Preference shares were redeemed at a premium of 10%.

Show the necessary journal entries in the books of the company and prepare the balance sheet of the company immediately after redemption of Preference shares.

Solution:

Journal Entries

Particulars		Dr	Cr
Bank A/c		55000	
To Equity share Application and AllotmentA/c			55000
(Application money received on 5,000 equity Shares of Rs.10 at a Premium of 10%)			
Equity share Application and Allotment A/c	Dr	55000	
To Equity share capital A/c			50000
To Securities Premium A/c			5000
(Allotment of 5000 equity shares of Rs.10 Each issued at a premium of 10% as per Board's resolution Dated…)			
Profit and loss A/c	Dr	50000	
To Capital Redemption Reserve A/c			50000
(Transfer of the balance amount of the Nominal value Preference shares to be redeemed not covered by fresh issue, i.e., Rs. 100000- Rs.5000 on redemption to Capital Redemption Reserve A/c)			
Bank	Dr	70800	
To Investments A/c			60000
To Profit and Loss A/c			10800
(Sale on investments at a profit and transfer Of profit on sale to Profit and loss A/c)			
8% Redeemable Preference share capital A/c	Dr	100000	
Premium on Redemption of Preference Shares A/c	Dr	10000	
To 8% Preference shareholders A/c			110000
(Amount due to 8% preference shareholders On redemption)			
Securities premium A/c	Dr	10000	
To Premium on redemption of Preference shares A/c			10000
(Application of Securities premium to write off Premium on redemption of Preference shares)			

8% Preference shareholders A/c Dr	110000	
To Bank		110000
(Amount due to 8% Preference Shareholders on Redemption paid)		

Balance Sheet of Producers Ltd. as at 31st March, 2006
(After Redemption Preference Shares)

Liabilities	Rs	Assets	Rs
Share capital:		Fixed Assets:	
Authorised Capital:		Plant and Machinery	1,90,000
40,000 shares of Rs.10 each	4,00,000	Furniture and Fixtures	20,000
1,000, 8% Preference shares		Investments	Nil
of Rs.100 each	1,00,000	Current Assets, loans and	
	5,00,000	Advances:	
		A. Current Assets:	
Issued and Subscribed Capital:		Stock	1,30,500
30,000 Equity Shares of		Debtors	49,550
Rs.10 each fully paid-up	3,00,000	Cash at bank	20,750
		B. Loans and Advances	
Reserves and Surplus:		Prepaid Expenses	1,000
Capital Redemption			
Reserve Account	50,000		
Securities Premium Account	4,000		
Profit and Loss Account	15,800		
Current Liabilities and Provision:			
A. Current Liabilities:			
Sundry Creditors	22,500		
B. Provisions:			
Provisions for taxation	19,500		
	4,11,800		4,11,800

Working Notes:

(i) Dr. **Bank A/c** Cr

To Balance b/d	4,950	By 8% Preference Shareholders A/c	1,10,000
To Equity share Application And Allotment A/c	55,000	By Balance C/d	20750
To Investment A/c	60,000		
To Profit and Loss A/c	10,800		
	1,30,750		1,30,750

(ii) Dr **Securities premium A/c** Cr

To Premium on Redemption of preference shares Account	10,000	By balance b/d	9,000
To Balance c/d	4,000	By Equity share Application and Allotment A/c	5,000
	14,000		14,000

(iii) **Dr** **Profit and loss A/c** **Cr**

To Capital Redemption Reserve A/c	50,000	By Balance b/d	55,000
To Balance c/d	15,800	By Bank (Profit on sale of investment)	10,800
	65,800		65,800

Note:

Equity share capital issued at Rs.50,000 and capital redemption reserve Account Rs.50,000 jointly replace 8% redeemable Preference share capital Rs.1,00,000 . Hence The capital Structure of the company remains unchanged.

Illustration: 5

(When fresh issue of shares is made at a discount)

The Balance Sheet of ultra-modern Ltd. As at 31st march, 2006 is as follows:

Liabilities	Rs	Assets	Rs
Share capital		Fixed Assets:	
Issued and Subscribed Capital:		Land and Building	2,00,000
1,000, 9% Redeemable		plant and machinery	60,000
Preference shares of		Furniture and Fixtures	9,000
Rs.100 each	1, 00,000	Current Assets:	
Rs.18,000 Equity Shares of		Stock	60,000
Rs.10each			
	1,80,000	Debtors	25,000
Reserves and Surplus:		Investments	54,000
Securities premium A/c	20,000	Bank	42,000
General Reserve Account	60,000		
Profit and loss Account	40,000		
Current Liabilities:			
Sundry Creditors	50,000		
	4,50,000		4,50,000

The Company decided to redeem its preference shares at a premium shares at a Premium of 5% on1st April, 2006.

A fresh issue of 3,000 equity shares of Rs.10 each was made at Rs.9 share, payable in full on 1st April, 2006. These were fully subscribed and all moneys were duly collected. All the investments were sold for Rs.50,000 to provide cash for redemption of preference shares. The directors wish that only a minimum reduction Should be made in the revenue reserves.

You are required to give the journal entries, including those relating to cash to record the above transactions and to draw up the balance sheet as it would appear after redemption of preference shares.

Solution:

Journal Entries

Date	Particulars		Dr	Cr
2006s				
April 1	Bank A/c	Dr	27,000	
	To Equity share Application and Allotment A/c			27,000
	(Receipt of Application money on 3,000 Equity shares at Rs.9 per Share)			
	Equity share Application and Allotment A/c	Dr	27,000	
	Discount on issue of shares A/c	Dr	3,000	
	To Equity Share capital A/c			30,000
	(Allotment of 3,000 shares of Rs.10 each issued at a discount of Re.1 per share as per Board's resolution dated…)			
	Bank A/c	Dr	50,000	
	Profit and loss A/c	Dr	4,000	
	To investment A/c			54,000
	(Sale of investment at a loss and transfer of loss on sale to profit and loss Account)			
	Profit and loss Appropriation A/c	Dr	36,000	
	General Reserve A/c	Dr	37,000	
	To Capital Redemption Reserve A/c			73,000
	(Transfer of the balance amount of the nominal value of preference shares to be redeemed not covered by fresh issue, i.e. Rs.1,00,000- Rs.27,000 on redemption to capital redemption reserve Account)			
	9% Redeemable of Preference share capital A/c	Dr	1,00,000	
	Premium on Redemption of Preference Shares A/c	Dr	5,000	
	To 9% reference shareholders A/c			1,05,000
	(Amount due to 9% preference shareholders on redemption)			
	Securities Premium A/c	Dr	5,000	
	To Premium on Redemption of preference shares A/c			5,000

(Application of securities premium Account to write off Premium on Redemption Preference Shares Account)			
9% Preference Shareholders A/c	Dr	1,05,000	
To bank			1,05,000
(Amount due to 9% preference shareholders on redemption paid)			

Balance sheet of ultra-modern ltd. As at 1st April, 2006
(After Redemption of preference shares)

Liabilities	Rs	Assets	Rs
Share capital:		Fixed Assets:	
Authorised capital:		Land and building	2,00,000
Issued, subscribed and paid-up		Plant and machinery	60,000
Capital		Furniture and Fixtures	9,000
21,000 equity shares of		Current Assets, loans and	
Rs.10 each fully paid-up	2,10,000	Advances:	
Reserves and surplus:		A. Current Assets:	
Capital redemption reserve a/c	73,000	Stock	60,000
Securities premium A/c	15,000	debtors	25,000
General reserve	23,000	Bank	14,000
Current Liabilities:		B.Loans and Advances	Nil
Sundry Creditors	50,000	Miscellaneous Expenditure	
		Discount on issue of shares	3,000
	3,71,000		3,71,000

Working Notes:

(i) Dr **Bank Account** Cr

To Balance c/d	42,000	By 9% Preference share holders A/c	1,05,000
To Equity share Application And Allotment A/c	27,000	By Balance c/d	14,000
To Investment A/c	50,000		
	1,19,000		1,19,000

(ii) Profit and Loss A/c

To Investment A/c	4,000	By Balance b/d	40,000
To Capital Redemption Reserve A/c	36,000		
	40,000		40,000

(iii) General Reserve Account

To Capital Redemption Reserve Account	37,000	By Balance b/d	60,000
To Balance c/d	23,000		
	60,000		60,000

(iv) Securities premium A/c

To Premium on Redemption of Preference share A/c	5,000	By Balance b/d	20,000
To Balance c/d	15,000		
	20,000		20,000

Note:

(1) Proceeds of fresh issue of equity shares Rs.27,000 and Capital redemption Reserve Account Rs.73,000 jointly replace 9% Redemption Preference share capital Account Rs.1,00,000. Hence Capital Structure of the company remains unchanged.

(2) Discount on issue of shares amounting to Rs.3,000 can be written off against Securities premium Account, in which case the balance sheet total will be Rs.3,68,000/-

2.4 REDEMPTION OF DEBENTURES:

Redemption of debenture refers to the discharge of the liability in respect of the debenture issued by a company. Debenture can be redeemed at any time either at par or at a premium or at a discount without any legal formalities to be complied with. The prospectus inviting applications for the debentures generally contains terms of redemption of the debentures. But irredeemable debentures are perpetual in nature and cannot be redeemed expect on the happening of a contingency.

Section 121 of the companies Act, 1956 provide that where a company has redeemed any debentures previously issued, it has the right to re-issue them either by issuing the same debentures or by issuing other debenture. Upon such re-issue the debenture holders will enjoy the same rights and properties as if the debentures had never been redeemed.

2.4.1 Mobilisation of funds for Redemption of Debentures:

If no provision is made for mobilizing additional funds required for the redemption of the debentures, the company may find great difficulty in discharging the liability when the debentures become due for payment. Even if it is assumed the liquid position of the company would permit such redemption, the working capital and consequently the profits of the company would be adversely affected if a large sum of money is withdrawn from the business at a time.

In order to overcome the above difficulties the following courses of actions are open to the company for mobilizing the additional funds required at the time of redemption:

2.1.1 Utilizing a part of the profits of the company:

A part of the profit may be withheld and utilized by the company for the purpose of redemption of the debentures. Here again, the company is having the following options:

(a) The amount of profits withheld by the company may be retained in the business itself as owned capital in the form of general reserve.

(b) The amount of the profit withheld by the company may be withdrawn from the business and the same may be invested either

    (i) in readily convertible securities or (ii) in taking out an insurance Policy to provide funds when needed.

.

2.4.2 Raising the capital:

In order to provide for additional funds required for the redemption of the debentures, the company may issue new shares or debentures. For this purpose. old debentures will be redeemed out of the proceeds of fresh issue and the new share capital or debentures will take the place of the old debentures.

2.4.3 Disposing of the assets of the company:

Additional funds required for the redemption of debentures may also be provided by the company by disposing of some of its fixed assets.

2.5 METHODS OF REDEMPTION OF DEBENTURES:

There are three different methods of redeeming the debentures which are follows:

2.5.1 By annual drawings by lots:

Under this method, a certain portion of the total debentures is redeemed every year over the life-time of the debentures and thus at the end of the life time of the debentures, the debentures are fully redeemed. Which debenture should be paid in which year usually depends on the drawings. What is actually done in that slips bearing the number of debentures are mixed up and put into a drum and then as many slips as the debentures to be redeemed are taken out of the drum at random. This procedure is known as "Drawing by lot". The amount of debentures to be redeemed every year is generally calculated by dividing the total amount of the debentures by the number of years for which they have been issued. In such a case, the amount of annual drawings will be equal. But the amount Of annual drawings will be equal. But the amount of annual drawings may also be unequal in some cases. When debenture are redeemed by annual drawings, the amount of annual drawings should be transferred to general Reserve account created out of the profits of the company and the same need not be invested in any other way.

2.5.2 By payment in one lump sum at the expiry of a specified period or at the option of the company at a date within such specified period:

Under this method the entire amount of the debenture debt is paid to the debenture holders in one lump sum at the expiry of the specified period according to the terms of issue. As the amount involved is large and the date of which debentures have to be redeemed is known to the company well in advance, it is possible for the company to make necessary arrangement to provide for the additional funds required for the debentures from the very beginning. In such a case, the best method is to set aside every year throughout the life of the debentures a part of the profits of the company which would otherwise be available for dividend and to invest the same in readily convertible securities together with compound interests at a fixed rate. The investments, thus made, are sold when the debentures become due for payment. This method ensures the availability of sufficient cash for the redemption of debentures when they become due and is known as "Sinking Fund method".

2.5.3 By purchase of debentures in the open market:

Under this method, a company may purchase its own debentures in the open market if it seems to be convenient and profitable to the company. When the market price of the debentures goes down below par or debentures are quoted at a discount on the stock exchange, the company usually takes the opportunity to buy the debentures in the open market and to cancel them. Own debentures may, also, be purchased by the company for its own investment when it is desired to keep the debentures alive with a view to issuing them in future. The law does not prohibit a company from purchasing its own debentures unless the terms of issue specify otherwise. In such a case, the purchase of debentures can be made out of the amount realized on sale of investments where sinking funds exist. Where there is no sinking fund, the debentures can be purchased out of the company's cash balance.

2.5.4 By conversion into shares:

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

2.6 PROTECTION OF THE INTEREST OF THE DEBENTUREHOLDERS

According to Section 117C of the Companies Act, where a company issues debentures, it should create a debenture redemption reserve account for the redemption of such debenture to which adequate amount shall be credited out of its profit every year, until such debentures are redeemed. The amount credited to the debentures redemption reserve account cannot be utilized by the company for any other purpose.

SEBI has made it obligatory for all companies raising resources through debentures to create a Debenture Redemption Reserve equivalent to 50% of the amount of debenture issued before the company intends to redeem the debentures.

When a company has created a sinking fund of the equivalent amount of debenture issue, it means that there is no need to create Debenture Redemption Reserve. However no redemption can begin unless Sinking Fund accumulates a sum of 50% of the amount of debenture issue. When the debentures are redeemed, a sum equivalent to the amount of face value debentures redeemed shall a transferred to General Reserve Account for disclosure to investors because sinking fund itself substitutes for DRR. Debenture Redemption Reserve is not required in case of convertible debenture i.e., conversion of debentures into either or new debentures.

2.7 REDEMPTION OF DEBENTURE OUT OF PROFIT

When the company withholds a part of divisible profits for redeeming the debentures, the amount of profit is reduced to the extent of the debentures to be redeemed and hence not available for distribution by way of dividends among the shareholders. The payment to debenture holders in such a case is out of profit earned in the course of the business and therefore it is termed as redemption out of profits. Thus the exiting liquid resources are not affected out of profits. Thus the existing liquid resources are not affected by redemption in this method.

There are two options available to the company in this regard:

(i) The amount of divisible profits withheld by company may be retained in the business itself as a source of internal financing i.e. in the form of general reserve and no investment is made outside to provide cash for redemption.

In such a case the following journal entries are passed.

(1) On debentures becoming due for payment

Debentures A/c Dr. (with the nominal value)

Premium Redemption of debenture A/c Dr. (with the amount of Premium, if any)

To Debentureholders A/c (with the amount paid)

(2) On redemption

Debentureholders A/c Dr (with the amount paid)

To Bank

(3) On transfer of profit to General Reserve

Debenture Redemption Reserve Dr.

Profit and Loss Appropriation A/c Dr. (with the nominal value of

To General Reserve A/c debentures redeemed)

2.8 RESERVE ON REDEMPTION OF ALL THE DEBENTURES.

(A) The an\mount of divisible profits withheld from distribution as dividend may be invested either in (i) readily marketable securities or (ii) taking out insurance policy to provide funds when required. In either case, the profit set aside will be accumulated in an account styled as Debenture Redemption Fund or Sinking Fund.

(i) Debenture Redemption Fund / Sinking Fund Method:

The Accounting entries in such a case will be as follows:

First Year (At the end)

(1) On the transfer of profits to Debenture Redemption Fund Account –

Profit and Loss Appropriation A/c	Dr.	with the annual amount set
To Debenture Redemption Fund A/c		aside out of profit*

(2) On investment of the amount of the profit set aside in readily marketable securities-

Debenture Redemption Fund Investment A/c	Dr.	with the amount invested
To Bank		

Debenture Redemption Fund Investment Account will appear on the Assets side of the Balance Sheet while Debenture redemption Fund Account will appear on the liabilities side of the Balance Sheet, substituting Profit and Loss Appropriation Account partly, under the head "Reserves and Surplus".

Second and subsequent years over the life of the Debentures exception the last year(At the end)-

(1) On the receipt of interest on Debenture Redemption Fund Investment –

Bank	Dr.	with the amount of interest
To Interest on Debenture Redemption Fund Investment A/c		received on investment.

(2) On Transfer of the interest to Debenture Redemption Fund –

Interest on Debenture Redemption Fund Fund Investment A/c	Dr.	with the amount of interest
To Debenture Redemption Fund A/c.		set aside

(3) On Transfer of Profits to Debenture Redemption Fund Account –

Profit and Loss Appropriation A/c	Dr.	with annual amount of profit
To Debenture Redemption Fund A/c		set aside

(4) On investment of annual profit and interest received on investment –

Debenture Redemption Fund Investment A/c	Dr.	(with the total amount of profit
To Bank		set aside plus interest received on investments).

In the last year when the debentures become due for redemption (at the end)-

(1) On the receipt of interest on Debentures Redemption Fund Investment –

Bank	Dr.	with the amount of interest
To interest on Debenture Redemption		received on investment.

(2) On transfer of the interest –

Interest on debenture Redemption Fund investment A/c	Dr.	with amount of interest
To Debenture Redemption Fund A/c		received on investments

(3) On the transfer of profits to Debenture Redemption Fund A/c-

Profits and Loss Appropriation A/c	Dr.	with the amount of annual
To Debenture Redemption Fund A/c		profit set aside

(4) On realisation of Investments made so as to provide cash for the redemption –

Bank	Dr.	(with the realized value of
To Debenture Redemption Fund Investments A/c		investments)

(5) If there is any profit or loss on sale of investments, the same has also to be transferred to Debenture Redemption Fund Account –

(a) **In case of profit –**

Debenture Redemption Fund Investments A/c	Dr.	with the amount of profit
To Debenture Redemption Fund A/c		

(b) **In case of loss-**

Debenture Redemption Fund A/c	Dr	With the amount of loss
To Debenture Redemption Fund Investment A/c		

(6) On transferof Debenture to debenture holders Account for payment to be made-

Debenture A/c	Dr	with the nominal value of
To Debenture holders A/c		the debentures

(7) If debentures are redeemable at premium-

Premium on redemption of Debenture A/c Dr with the amount of premium
To Debenture holders A/c on redemption

8) On Payment-

Debenture holders A/c Dr with the amount paid
To bank A/c

(9) On Transfer of premium on Redemption of Debentures to debenture Redemption Fund Account (In case Premium on Redemption of debentures Account is not opened at the time of issue of debentures)

Debenture Redemption Fund A/c Dr with the amount of premium
To Premium on Redemption
of Debenture A/c

(10) On transfer of loss of issue of debentures Account to Debenture redemption fund Account (In case the loss on issue of debentures account is not yet written off)-

Debenture redemption fund A/c Dr
To loss of issue of debentures A/c

N.B : Either entry (9) or entry (10) may be passed depending upon the circumstances:

(11) On transfer of debenture redemption fund account balance to general reserve-

Debenture Redemption Fund A/c Dr (with the balance left after all the
To General Reserve A/c debentures are redeemed)

Notes:

(1) No investment should be made in last year for the simple reason that payment have to be made to the Debenture holder in the last year by realizing the investment. Therefore, there is no logic behind making investment in the last year and then immediately realizing the same.

(2) If the debentures are redeemable at e premium, the total amount to be accumulated in debenture Redemption Fund Account must include the amount of Premium.

(3) This method assumes the availability of profit and sufficient cash investment.

(4) Sometimes, it may so happen that Sinking fund may not be cumulative. In such a case, the interest received on investments should not be credited to the sinking fund nor should it be invested. Instead, interest should be treated as interest earned, as on general investment and credited to profit and loss account.

(5) The balance in the Debenture Redemption Fund is transferred to General Reserve Account after the redemption of all the debentures.

(6) While transferring the balance of the Debenture redemption fund to General Reserve, the Profit of Cancellation debenture and Profit on Sale of investments transferred to Debenture Redemption Fund should be eliminated and the same should be transferred to capital reserve.

(7) Where only a part of the debentures are redeemed, it must be ensured that the balance in sinking fund is equal to 50% of the amount of debenture issue on the date of redemption.

(8) According to SEBI guidelines, creation of debenture Redemption reserve equivalent to 50% of the debenture issue is obligatory. However, a company may create more reserve if it so desires, this being justified by the creation of sinking fund.

1.0 Sinking Fund to Replace an Asset to Reply a Liability

The sinking fund is created to provide the cash on the known data for two specific purposes

(a) to replace an asset and

(b) redeem debentures (liability).

Though in practice the sinking funds for redemption of a liability and that for replacement of an asset operate in a similar manner, yet there are some differences at stated below

i. The annual installment set aside for sinking fund for the replacement on an asset is really depreciation and is a charge against profit and therefore it is debited to profit and loss account. On the other hand, in cash of sinking fund created for redemption of a liability, the annual installment is an appropriation of profit and debited to profit and loss appropriation account since the purpose is to accumulate profits and not to distribute dividends until the liability is repaid.

ii. At the end of the estimated useful life of the assets, the sinking fund investments are sold to replace the old asset. The ultimate balance in sinking fund account then this utilized to write off the book value of the old asset requiring replacement. The sinking fund is therefore extinguished. In the other cash, the sale proceeds of the investments would be utilized to discharge the liability involving the closure of liability account and sinking fund investment account. The balance in the sinking fund account is transferred to general reserve. It is in the nature of free reserves and which can be used to pay dividends at the discretion of the company.

(ii) Insurance policy Method

Under this method also, profit are set aside and credited to Debenture redemption fund account in the same manner as it is done in case of Sinking fund Method. But instead of investing the amount of profit set aside in readily convertible securities an insurance policy is taken out for the required sum and an amount equal to the profit se aside is paid as premium. Thus, at the maturity of the policy, the required cash would be available for carrying out redemption of debentures. This method differs from the sinking fund method in respect of interest on investment. Unlike sinking fund method, interest will not be received every year but will accrue at a fixed rate. The total amount of premium will always be less than the amount of policy. Thus, the difference between the amount of policy amount and the total amount of premium paid on the policy is the total amount of interest that accrues on the premium paid. The main advantages of this method is that the policy is not subscribed to any fluctuation in prices unlike securities in the sinking fund method and as such the exact sum insured will be available at maturity. However, the following disadvantages may be accounted for:

(i) the annual rate of interest is lower than that obtainable from investment; and

(ii) if the policy is cancelled on account of non-payment of premium, the surrender value will be very much less than the amount which has been paid by way of annual premiums.

The accounting entries will be as follows:

All the years till the maturity of the policy (including the last year)-

(1) On payment of premium at the beginning of the year-

Debenture Redemption Fund policy A/c Dr with amount of annual premium
To Bank

(2) On transfer of profit to Debenture Redemption fund Account at the end of the year-

Profit and loss Application A/c Dr with the amount of profit
To Debenture redemption Fund A/c set aside

In the last year on maturity of the policy.

In addition to the above two entries, the following entries are also required on maturity of the policy at the end of the last year.

(3) On realization of the policy amount from the insurance company-

Bank Dr with the amount policy
To Debenture Redemption Fund policy A/c

(4) On transfer of accrued interest (i.e. the difference between the policy amount and the total premium paid) to Debenture Redemption Fund Account-

Debenture redemption Fund policy A/c Dr with the difference between
To Debenture Redemption Fund A/c the policy amount and the total
Premium paid.

(5) On transfer of Debentures Account to Debentures' Account for payment to be made-

Debentures A/c	Dr	with the nominal value of
To Debentureholders		the debentures

(6) If debentures are redeemable at a premium-

Premium on Redemption of Debentures A/c	Dr	with the amount of premium
To Debentureholders		Of redemption

(7) On payment-

Debentureholders	Dr	with the amount paid
To Bank		

(8) On transfer of Premium on Redemption of Debentures to Debenture to Redemption Fund A/c (In cash Premium on Redemption of Debenture Account is not opened at the time of issue of debentures)-

Debenture Redemption fund A/c	Dr	with the amount of premium
To premium on Redemption of Debentures A/c		on redemption

(9) On transfer of Loss of issue of Debentures account to debenture Redemption Fund Account (In cash loss on Debentures Account is not yet written off)-

Debenture Redemption Fund A/c	Dr	with the amount
To loss of issue of debenture A/c		

N.B.: Either entry (8) or entry (9) may be passed depending upon the Circumstances.

(10) On transfer of debenture redemption fund Account balance on General Reserve-

Debenture Redemption Fund A/c	Dr	with the balance left
To General Reserve A/c		

Note: In some Cases, the company may decide to take credit every year. In such a case, the entry for interest will be-

Debenture Redemption Fund policy A/c	Dr	with the interest
To Debenture Redemption Fund A/c		

Illustration: 1

(**when debentures are redeemed out of profits)**

Strong Ltd. issued 10,000, 14% debentures of Rs.100 each on 1st April, 2001 at a discount of 5% repayable at a premium of 10% after 5 years out of the profits of the company. On 1st April, 2006, balance in the debenture Redemption Reserve Account stood At Rs.3,40,000.

You are required to give journal entries in the books of the company both at the time of issue and redemption of debentures.

Solution:

	Journal Entries		**Dr**	**Cr**
2001				
April 1	Bank	Dr	9,50,000	
	Loss on issue of Debentures A/c	Dr	1,50,000	
	To 14% Debenture A/c			10,00,000
	To Premium on Redemption of Debenture A/c			1,00,000
	(Allotment of 10,000, 14% debenture of Rs.100 each issued at a discount of 5% and redeemable at a Premium of 10% as per the Board resolution dated…)			
2006				
April 1	14% Debenture A/c	Dr	10,00,000	
	Premium on redemption of Debenture A/c	Dr	1,00,000	
	To Debenture holders A/c			11,00,000
	(Being the amount due on redemption)			
	Profit and loss Appropriation A/c	Dr	1,60,000	
	To Debenture Redemption Reserve A/c			1,60,000
	(Being the transfer of profit to debenture Redemption reserve account as required Under SEBI guidelines)			

Debenture holders A/c	Dr	11,00,000	
To Bank			11,00,000
(Being the amount paid to debenture holders)			
Profit and loss Appropriation A/c	Dr	5,00,000	
To General Reserve			5,00,000
(Being the transfer of profit to the extent Of 50% of the face value of debenture redeemed)			
Debenture Redemption Reserve A/c	Dr	5,00,000	
To General Reserve A/c			5,00,000
(Being the transfer of balance in debenture Redemption reserve account to General Reserves on redemption of debenture)			

Note: Loss on issue of Debentures Account ahs to be written off by the company over the period of 5 years preferably at the rate of (Rs. 1, 50000 *1/5)= Rs. 30,000 per year.

Illustration 2: (when sinking fund is created to redeem debentures at the end of the specified period).

Steady Ltd. issued 2,000, 9% Debentures of Rs. 100 each at par on 1st April 2001 repayable at the end of 5 years at a premium of 6%. It was decided to institute a sinking fund for the purpose, the investments being expected to yield 8% p.a. Sinking fund tables show that Re.1 per annum at 8% compound interest amounts to Rs.5.867 in 5 years. Investments were made in multiples of rupees ten only.

On 31st March, 2006 the investments realized Rs.1, 75,000 and the debentures were redeemed. The bank balance as that date was Rs. 54,800.

You are required to show the journal entries relating to the creation of sinking fund and to prepare the relevant ledger accounts in the books of the company. Ignore debenture interest.

Solution:

Date	Journal entries		Dr	Cr
2001				
April 1	Bank A/c	Dr	2,00,000	
	Loss on Issue of Debenture A/c	Dr	12,000	
	To 9% Debentures A/c			2,00,000

Date	Particulars		Dr (Rs.)	Cr (Rs.)
	To Premium on redemption on debenture A/c			12,000
	(Allotment of 2000 9% debentures of Rs.100 each issued at par redeemable at a Premium of 6%)			
2002 Mar 31	Profit and loss Appropriation A/c	Dr	36,134	
	To Debenture Redemption Fund A/c			36,134
	(transfer of the Amount out of Profit to Debenture Redemption fund Account to provide for the Redemption of Debenture)			
	Debenture Redemption Fund Investment A/c	Dr	36,130	
	To Bank			36,130
	(Amount of profit set aside invested in outside securities in multiples of Rs.10)			
2003 Mar 31	Bank	Dr	2,890	
	To Interest on Debenture Redemption Fund Investment A/c			2,890
	(Receipt of interest on investments @ 8% p.a)			
	Interest on Debenture Redemption Fund Investment A/c	Dr	2,890	
	To Debenture Redemption Fund A/c			2,890
	(Transfer of interest to Debenture Redemption Fund Account)			
	Profit and Loss Appropriation A/c	Dr	36,134	
	To Debenture Redemption Fund A/c			36,134
	(Transfer of the amount out of the profit to Debenture Redemption Fund Account to provide for the redemption of debenture)			
	Debenture Redemption Fund A/c Investment A/c	Dr	39,020	
	To Bank			39,020
	(Amount of Profit set aside together with the interest received on investments invested in outside securities in multiplies of Rs.10)			

2004				
Mar 31	Bank	Dr	6,012	
	To interest on Debenture Redemption Fund investment A/c			6,012
	(Receipt of interest on investment @8%p.a)			
	Interest on Debenture Redemption Fund investment A/c	Dr	6,012	
	To Debenture Redemption Fund A/c			6,012
	(Transfer of interest to Debenture Redemption fund Account)			
2004				
Mar 31	Profit and Loss Appropriation A/c	Dr	36,134	
	To Debenture Redemption fund A/c			36,134
	(Transfer of the amount out of profit to Debenture Redemption fund Account to provide for the Redemption of debentures)			
	Debenture Redemption fund investment A/c	Dr.	42,150	
	To Bank			42,150
.	(Amount of profit set aside together With the interest received on Investments invested in outside Securities in outside securities in Multiples of Rs.10)			
2005				
Mar 31	Bank	Dr.	9,384	
	To interest on Debenture Redemption Fund investment A/c			9,384
	(Receipt of interest on investments@ 8% P.a.)			
	Interest on Debenture Redemption fund Investment A/c	Dr.	9,384	
	To Debenture Redemption fund A/c			9,384
	(Transfer of interest to debenture Redemption fund Account)			
	Profit and loss Appropriation A/c	Dr	36,134	
	To Debenture Redemption Fund A/c			36,134
	(Transfer of the amount out of profit to debenture Redemption Fund Account to provide for the redemption of debentures)			

	Debenture Redemption Fund Investment A/c	Dr	45,520	
	To Bank			45,520
	(Amount of profit set aside together with the interest received on investments invested in out side securities in multiples of Rs.10)			
2006 Mar 31	Bank A/c	Dr	13,025	
	To interest on Debenture Redemption Fund Investment A/c			13,025
	(Receipt of interest on investment @8%)]			
	Interest on Debenture Redemption Fund investment A/c	Dr	13,025	
	To Debenture Redemption Fund A/c			13,025
	(Transfer of interest to debenture Redemption Fund Account)			
	Profit and loss Appropriation A/c	Dr	36,153	
	To Debenture Redemption Fund A/c			36,153
	(Transfer of the amount out of profit to Debenture Redemption Fund Account to Provide for the redemption of debentures)			
	Bank	Dr	1,75,000	
	To Debenture Redemption Fund investment A/c			1,75,000
	(Realisation of investments to pay off the debentures)			
	Debenture Redemption Fund Investment A/c	Dr	12,180	
	To Debenture Redemption Fund A/c			12,180
	(Transfer of profit on sale of investment to Debenture Redemption Fund A/c)			
	9% Debentures A/c	Dr	2,00,000	
	Premium on Redemption of Debentures A/c	Dr	12,000	
	To Debenture holders A/c			2,12,000
	(Amount due on redemption at a premium of 6%)			
	Debenture holders A/c	Dr	2,12,000	
	To Bank			2,12,000
	(Payment made for amount due)			

Debenture redemption Fund A/c	Dr	12,000	
To Loss on issue of Debentures A/c			12,000
(Transfer of loss on issue of debentures account to Debenture Redemption Fund A/c)			
Debenture Redemption Fund A/c	Dr	2,12,180	
To General Reserve A/c			2,00,000
To Capital Reserve A/c			12,180
(Transfer of balance standing at Debenture Redemption Fund Account to General Reserve Account and General Reserve A/c)			

Ledger Accounts

Dr 9% Debentures Account Cr

		Rs			
31.3.2002	To Balance c/d	2,00,000	1.4.2001	By Bank	2,00,000
31.3.2003	To Balance c/d	2,00,000	1.4.2002	By Balance b/d	2,00,000
31.3.2004	To Balance c/d	2,00,000	1.4.2003	By Balance b/d	2,00,000
31.3.2005	To Balance c/d	2,00,000	1.4.2004	By Balance b/d	2,00,000
31.3.2006	To Debenture Holder's A/c	2,00,000	1.4.2005	By Balance b/d	2,00,000

Debenture holder Account

31.3.2006	To Bank	2,12,000	31.3.2006	By 9% Debenture A/c	2,00,000
				By Premium on Redemption of Debentures A/c	12,000
		2,12,000			2,12,000

Debenture Redemption Fund Account

31.3.2002	To Balance c/d	36,134	31.3.2002	By Profit and loss Appropriation A/c	36,134
31.3.2003	To Balance c/d	75,158	1.4.2002	By Balance b/d	36,134
			31.3.2003	By interest on Debenture Redemption Fund Investment A/c	2,890
				By Profit and loss Appropriation A/c	36,134
		75,158			75,158

31.3.2004	To Balance c/d	1,17,304	1.4.2002	By Balance b/d	75,158
			31.3.2003	By interest on Debenture Redemption Fund Investment A/c	6,012
				By Profit and loss Appropriation A/c	36,134
		1,17,304			1,17,304
31.3.2005	To Balance c/d	1,62,822	1.4.2004	By Balance b/d	1,17,304
			31.3.2005	By interest on Debenture Redemption Fund Investment A/c	9,384
				By Profit and loss Appropriation A/c	36,134
		1,62,822			1,62,822
31.3.2006	To Loss on issue of Debenture A/c	12,000	1.4.2005	By Balance b/d	1,62,822
	To General Reserve A/c	2,00,000	31.3.2006	By Interest on Debenture Redemption Fund Investment A/c	13,025
	To Capital Reserve A/c (Profit on sale of investment treated as capital profit)	12,180		By Profit and loss Appropriation A/c	36,153
				By Debenture Redemption Fund Investment A/c (Profit on sales of investments)	12,180
		2,24,180			2,24,180

Debenture Redemption Fund Investment A/c

31.3.2002	To Bank	36,130	31.3.2002	By Balance c/d	36,130
1.4.2002	To Balance b/d	36,130	31.3.2003	By Balance c/d	75,150
31.3.2003	To Bank	39,020			
		75,150			75,150

1.4.2003	To Balance b/d	75,150	31.3.2004	By Balance c/d	1,17,300
31.3.2004	To Bank	42,150			
		1,17,300			1,17,300
1.4.2004	To Balance b/d	1,17,300	31.3.2005	By Balance c/d	1,62,820
31.3.2005	To Bank	45,520			
		1,62,820			1,62,800
1.4.2005	To Balance b/d	1,62,820	31.3.2006	By Balance c/d	1,75,000
31.3.2006	To Debenture Redemption Fund A/c (Profit on sale)	12,180			
		1,75,000			1,75,000

Interest on Debenture Redemption Fund Investment Account

Dr		Rs		Cr	Rs
31.3.2003	To Debenture Redemption Fund A/c	2,890	31.3.2003	By Bank A/c	2,890
31.3.2004	To Debenture Redemption Fund A/c	6,012	31.3.2004	By Bank A/c	6,012
31.3.2005	To Debenture Redemption Fund A/c	9,384	31.3.2005	By Bank A/c	9,384
31.3.2006	To Debenture Redemption Fund A/c	13,025	31.3.2006	By Bank A/c	13,025

Working Notes:

(1) Sum required for the redemption of debentures has been arrived at as follows:

	Rs
Nominal value of 2,000 9% debentures @ Rs.100	2,00,000
Add: Premium payable on redemption @ 6%	12,000
Sum required after 5 years	2,12,000

(2) Amount of profit set aside every year has been arrived at as follows:

Sinking fund tables show that Re.1 per annum at 8% compound interest amounts to Rs.5.867 in 5years. Since Rs.2,12,000 is required. The amount appropriated per annum Will be:

2,12,000 / 5.867 = Rs.36,134(approx).

(3) Profit on sale of investment is a capital profit and hence transferred to capital Reserve Account.

(5) The payment of debenture interest is ignored.

Illustration: 3

(When Sinking Fund is created and debentures are redeemed party at any time within the specified period).

S.S ltd.., had Rs.1,50,000, 12% debentures outstanding on 1st April,2006. The Debenture Redemption Fund Account of the company stood at Rs.78,000 on the sane date represented by investment in securities of rs.100 each. The directors of the company decided to sell Rs.50,000 worth of securities at Rs.102 and to redeem rs.50,000 debentures at a premium of 5%.

You are required to show the journal entries in the books of the company relating to the sale of securities and the redemption of debentures.

Solution:

	Journal entries		**Dr** Rs	**Cr** Rs
2006				
April 1	Bank A/c	Dr	51,000	
	To Debenture Redemption Fund Investment A/c			51,000
	(Realisation of investments in securities of Rs.100 each at Rs.102 each to pay off the debenture)			
	Debenture Redemption Fund Investment A/c	Dr	1,000	
	To Debenture Redemption fund A/c			1,000
	(Transfer of profit on sale of Investments to Debenture Redemption fund Account)			
	12% Debenture A/c	Dr	50,000	
	Premium on Redemption of Debenture A/c		2,500	
	To Debenture holders A/c			52,500
	(Amount due on redemption at a premium of 5%)			
	Debenture holders A/c	Dr	52,500	
	To Bank			52,500
	(Payment made of amount due)			
	Debenture Redemption fund A/c	Dr	2,500	
	To Premium on Redemption of Debenture A/c			2,500

(Transfer of premium on Redemption of Debentures to Debenture Redemption Fund A/c)

Debenture Redemption Fund A/c	Dr	50,000	
To General Reserve A/c			50,000
(Transfer of nominal value of debenture redeemed to General Reserve A/c)			
Debenture Redemption Fund A/c	Dr	1,000	
To Capital Reserve A/c			1,000
(Profit on sale of investment transferred to Capital Reserve)			

Notes:

(1) It has been assumed that the provision has been made for the premium on redemption. Hence, it has been debited to debenture Redemption Fund Account or else it can be adjusted against Securities Premium Account.

(2) After debentures are redeemed, an amount equal to the nominal value of the redeemed has been transferred to General Reserve from the Debenture Redemption Fund Account.

Illustration: 4

(When Insurance policy is taken out to provide cash for redemption of debentures).

G.G Ltd. Issued 500, 12% Debentures of Rs.100 each at par on 1st April, 2003, repayable at par after 3 years on 31st March,2006. The directors decided to take

out an insurance policy to provide necessary cash for the redemption of the debentures. The annual premium for the policy, payable on 1st April every year was Rs.15,705.

You are required to show the journal entries and to prepare the relevant ledger accounts in the books of the company relating to the issue and redemption of debentures.

Solution:

	Journal Entries		**Dr**	**Cr**
2003				
April 1	Bank	Dr	50,000	
	To 12% Debenture A/c			50,000

	(Allotment of 500 12% Debenture of Rs.100 each as per Board's resolution dated….)			
	Debenture Redemption fund Policy A/c	Dr	15,705	
	To Bank			15,705
	(Payment of annual premium for the policy taken out to provide cash for redemption of debenture)			
2004 March 31	Profit and loss Appropriation a/c	Dr	15,705	
	To Debenture Redemption Fund A/c			15,705
	(Transfer of profit to Debenture Redemption Fund Account)			
2004 April 1	Debenture Redemption Fund policy A/c	Dr	15,705	
	To Bank A/c			15,705
	(Payment of annual premium for the policy taken out to provide cash for redemption of debenture)			
2005 March 31	Profit and loss Appropriation a/c	Dr	15,705	
	To Debenture Redemption Fund A/c			15,705
	(Transfer of profit to Debenture Redemption Fund Account)			
2005 April 1	Debenture Redemption Fund policy A/c	Dr	15,705	
	To Bank A/c			15,705
	(Payment of annual premium for the policy taken out to provide cash for redemption of debenture)			
2006 March 31	Profit and loss Appropriation a/c	Dr	15,705	
	To Debenture Redemption Fund A/c			15,705
	(Transfer of profit to Debenture Redemption Fund Account)			

2006				
March 31	Bank	Dr.	50,000	
	To Debenture Redemption Fund Policy A/c			50,000
	(Receipt of Policy amount on maturity)			

2006				
March 31	Debenture Redemption Fund Policy A/c	Dr.	2,885	
	To Debenture Redemption Fund A/c			2,885
	(Transfer of accumulated interest on the policy to Debenture Redemption Fund A/c)			
2006				
March 31	12% Debenture A/C	Dr.	50,000	
	To Debentureholder A/c			50,000
	(Amount due on redemption)			
2006				
March 31	Debenture A/c	Dr.	50,000	
	To Bank			50,000
	(Payment made for the amount due)			
2006				
March 31	Debenture Redemption Fund A/c	Dr.	50,000	
	To General Reserve A/c			50,000
	(Transfer of the balance of Debenture Redemption Fund A/c to General Reserve)			

Ledger Account
12% Debentures Account

Dr Cr

		Rs.			Rs.
31.3.2004	To Balance c/d	50,000	1.4.2003	By Bank	50,000
31.3.2005	To Balance c/d	50,000	1.4.2003	By Bank b/d	50,000
31.3.2006	To Balance c/d	50,000	1.4.2003	By Bank	50,000

Debenture Redemption Fund Policy Account

		Rs.			Rs.
1.4.2003	To Bank	15,705	31.3.2004	By Balance c/d	15,705
1.4.2003	To Balance b/d	$\boxed{15,705}$	31.3.2005	By Balance c/d	31,410
		31,410			31,410
1.4.2005	To Balance b/	31,410	31.3.2006	By Bank	50,000
	To Bank	15,705	31.3.2006		
31.3.2006	To Debenture Redemption Fund A/c	2,885			
		50,000			50,000

Debenture Redemption Fund

		Rs.			Rs
31.4.2004	To Balance c/d	15,705	31.3.2004	By Profit and Loss Appropriation A/c	15,705
31.3.2005	To Balance c/d	31,410	1.4.2004	By Balance b/d	15,705
			31.3.2005	By Profit and Loss Appropriation A/c	15,705
		31,410			31,410
31.3.2006	To General Reserve A/c	50,000	1.4.2005	By Balance b/d	31,410
			31.3.2006	By Profit and Loss Appropriated A/c	15,705
			31.3.2006	Debenture Redemption Fund Policy A/c	2,885
		50,000			50,000

REDEMPTION OUT OF THE PROCEEDS OF FRESH ISSUE OF SHARES OR DEBENTURES

Debenture may be redeemed from the funds raised by the issue of fresh shares or debentures, Accounting entries are to be passed for fresh issue of shares debentures apart from entries for redemption. The following entries will be passed.

1. On issue of fresh shares or debentures-

Bank	Dr.	with the amount raised by fresh issue
To Share Capital A/c		
To Debentures A/c		

2. On Redemption of old debentures-

(a)	Debentures A/c	Dr.	with the nominal value of the debentures
	To Debentureholder A/c		
(b)	Debentureholders A/c	Dr.	with the amount paid
	To Bank		

Notes:

(1) Working capital remains intact as the new share capital or debenture takes the place of old debentures.

(2) If the fresh issue is made at a premium or a discount the entry should be passed accordingly.

(3) If the debentures are redeemed at a premium, Premium on Redemption of Debentures A/c should be credited at the time of issue by debiting Loss on issue of debentures A/c and before the payment is made, the same should be transferred to Debenture holders A/c.

(4) The creation of Debenture Redemption Reserve may not be necessary in this case since the additional capital or debentures raised for the purpose of redemption of debentures replaces the existing debentures.

REDEMPTION OUT OF SALE PROCEEDS OF ASSETS OF THE COMPANY

When debentures are redeemed out of the sale of the asset of the company, the accounting treatment is as follows:

(i) On sale of assets

Bank	Dr.	(with sale proceeds)
To Respective Assets A/c		

The profit or loss on sale of the asset will be transferred to profit and loss account.

The entries for redemption of debentures will be the same as in 7 above.

Note: Debenture Redemption reserve account to the extent of 50% of the face value of the debentures issued may be maintained as per the SEBI Guidelines.

Illustration 5 (When Debentures are redeemed out of the proceeds of fresh issue of shares or debentures).

The following is the Balance Sheet of Good Luck Ltd. as on 1st April 2006:

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Asset:	
Authorised Capital		Land and Building	2,00,000
1,00,000 Equity Shares		Plant and Machinery	2,00,000
of Rs.10 each 10,00,000		Furniture and Fixtures	10,000
50,000 Equity shares of		Current Assets,loans	
Rs.10 each fully paid-up	5,00,000	and Advances:	
Reserves and surplus:		A. Current Assets	
Profit & Loss A/c	50,000	Stock in Trade	1,70,000
Secured Loans:		Sundry Debtors	2,00,000
1,000 12% Debentures of		Cash at Bank	20,000
Rs.100 each fully paid-up	1,00,000	B.Loans and Advances:	Nil
Current Liabilities and Provisions:			
Creditors	1,50,000		
B.Provisions	Nil		
	8,00,000		8,00,000

The Debenture trust Deed provides that the company may redeem the debentures at a premium of 5% at any time before the maturity. In order to exercise this option, the directors decided to issue 10,000 equity shares of Rs.10 each at Rs.11 on this day and to redeem the debentures. All the shares were duly subscribed and the debentures were redeemed.

Show the journal entries in the books of the company. Also prepare the balance sheet after the redemption of debentures.

Solution:

Journal Entries

Date	Particulars		Dr Rs	Cr Rs
2006				
April 1	Bank A/c	Dr	1,10,000	
	To Equity Share Capital A/c			1,00,000
	To Securities Premium A/c			10,000
	(Allotment of 10,000 equity shares Of Rs.10 each issued at a Premium of Re.1/- per share as per Board's resolution dated…)			
	12% Debentures A/c	Dr	1,00,000	
	Premium on Redemption of Debenture A/c	Dr	5,000	
	To Debenture holders A/c			1,05,000
	(Amount due on redemption of debentures at premium of 5%)			
	Debenture holders A/c	Dr	1,05,000	
	To Bank A/c			1,05,000
	(Payment made for the amount due)			
	Securities premium A/c	Dr	5,000	
	To Premium on Redemption of Debentures A/c			5,000
	(writing off premium on Redemption of Debentures against the securities Premium A/c)			

Balance sheet of Good luck ltd, as at 1st April,2006
(After Redemption of Debentures)

Liabilities	Rs	Assets	Rs
Share Capital:		Fixed Assets:	
Authorised Capital		Land and Building	2,00,000
1,00,000 Equity shares		Plant and Machinery	2,00,000
Of Rs.10 each	10,00,000	Furniture and Fixture	10,000

Issued, subscribed and Paid-up capital-60,000 Equity shares of Rs.10 Each fully paid-up	6,00,000	Current Assets:	
		Stock in trade	1,70,000
		Sundry Debtors	2,00,000
		Cash at Bank	25,000
Reserves and Surplus:			
Securities Premium Account	5,000		
Profit and Loss A/c	50,000		
Current Liabilities:			
Creditors	1,50,000		
	8,05,000		8,05,000

Notes:

(1) In this case, additional equity shares capital raised for the purpose of redemption of debentures replaces the debentures. As such transfer to general Reserve out of profits of the company is not required.

(2) As section 78 permits the writing off of premium on redemption of debentures against securities premium Account, the same has been written off against the Securities premium Account.

2.9 LET US SUM UP

Redemption of Preference shares and Debentures refers to the discharge of the liability in respect of Debentures/Preference shares. Debentures can be redeemed at any time either at par or at a premium or at a discount without any legal formalities to be complied with. The prospectus inviting applications for the debentures/preference shares generally contains the terms of redemption.

2.10 LESSON-END ACTIVITIES

1 A Company issues early in 2002, 13% Rs.20,00,000 debentures at Rs.96, but redeemable at Rs.103. Redemption will be carried out by annual drawings of Rs.4,00,000 (face value) commencing at the end of 2006. What do you recommend as the amount to be charged to the profit and loss account, apart from that of interest?

2 Redemption of 10,000 preference shares of Rs.100 each was carried out by utilization of reserves and by issue of 4,000 equity shares of Rs.100 each at Rs.125. How much should be credited to capital redemption reserve account? In the above case, the redemption was carried out of reserves and out of the issue of 4,000 shares of Rs.100 each @Rs.95. what is the amount of capital redemption reserve account that is required?

3 A company having free reserves of Rs.30,000 wants to redeem rupees one lakh preference shares. Calculate the face value of fresh issue of shares of Rs.10 each to be made at a premium of 10%.

4 P. Ltd issued Rs.10,00,000 Debentures at a discount of 5%; the debenture holders have an option of converting the amount into Rs.10 equity shares at a premium of 10%. A debenture holder holding Rs.40,000 debentures wishes to exercise the option. How many shares will he get?

5 Calculate the amount of discount to be written off each year on the debentures of Rs.50,00,000 issued on 1.1.2006 at a discount of 5% repayable in annual drawings of Rs.10,00,000 each year. Account period ends on 31st December.

6 Ess Ltd pays interest on its 12% Debentures on 30th September and 31st March. To redeem the debtures it has maintained a sinking fund which stood on 31st December, 2005 at Rs.2,70,000 represented by 6% Government Loan of the nominal value of Rs.3,00,000 (interest payable on the same dates as for debentures),

On 1st January, 2006, the company purchased Rs.1,00,000 of its debentures @96 raising the necessary funds by selling Government Loan @92.5(to the nearest 100). What is the nominal value of Government loan sold and what is the profit and loss on the sale?

(Note: Every Rs.100 of Debentures requires Rs.99 i.e. Rs.96 plus Rs.3 for interest. Every Rs.100 of Government loan will yield Rs.94 i.e. the price stated plus Rs.1.50 interest for 3 months)

7 Bhalla and Co., Ltd., has an authorized equity capital of Rs.20,00,000 divided into shares of Rs.100 each. The paid-up capital was Rs,12,50,000. Besides this, the company had 9% Preference shares of Rs.10 each for Rs.2,50,000. Balance on other accounts were- Securities Premium Rs.3,40,000, profit and loss account Rs.72,000 and General reserve Rs.3,40,000. Included in the Sundry Assets were investments of the face value of Rs.30,000 carried in the books at a cost of Rs.34,000.

The Company decided to redeem the preference shares at 10% premium partly by the issue of equity shares of the face value of Rs.1,20,000 at a premium of 10%. Investments were sold at 105% of their face value. All preference shareholders were paid off except 3 holding 240 shares.

Give necessary journal entries bearing in mind that the Directors wanted a minimum reduction in free reserves, while effecting the above transactions. Working should form part of your answer.

References

1) M.C. Shukla, T.S. Grewal & S.C.Gupta- Advanced accountancy

2) R.L. Gupta & M Radhaswamy – Company Accounts

3) S.P. Jain & K.L. Narang – Company Accounts

4) J.R. Monga- Fundamentals of Corporate Accounting

UNIT - III

3.0 AIMS AND OBJECTIVES

i) To know the Meaning, definition of Profit and loss Account and Balance sheet.

ii) To study the preparation and presentation of Final Accounts.

iii) To understand the interpretation of the various expressions used in the Final Accounts.

3.1 FINAL ACCOUNTS OF COMPANIES

Final accounts of a company consists of the following two statements

1. Balance sheet as at the end of the accounting period disclosing the financial position of the company
2. Profit and loss account for the period disclosing the results of the operations of the company.

A company is under legal obligation to keep proper books of account and to prepare its final accounts every year in the prescribed manner. There is no such obligation upon sole proprietorship or partnership firms to prepare final accounts, but companies have a statutory obligation to prepare final accounts under section 210 of the Companies Act. A brief mention as to the legal provisions is given below.

Section 209:Books of accounts should be maintained on accrual basis and according to the double entry system of book keeping.

Section 210:This deals with the presentation of final accounts of a joint stock company.

Section 211:this deals with the form and contnts of balance sheet and profit and loss account.

Section 212:Disclosure of certain particulars in the balance sheet of a holding company in respect of its subsidiaries

Section 214:This deals with the rights of the holding companies representatives.

Section 215:As per this section the balance sheet and profit and loss acounbt of the company shall be authencitated by not less than two directors of the company or secretary/manager of the company.

3.1.2 PREPARATION AND PRESENTATION OF FINAL ACCOUNTS

At every general meeting of the company held in pursuance of section 166,the board of directors of the company shall lay before the company

a. A balance sheet at the end of the period specified in sub section 3 of section 210

b. A profit and loss account for that period

In case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting.

The profit and loss account shall relate

In case of the first ANNUAL GENERAL MEETING OF THE COMPANY, to the period beginning with the incorporation of the company and ending with the day which shall not precede that day of the meeting by more than nine months.

In the case of any subsequent annual general meeting of the company to the period beginning with the day immediately after the period for which the account was last submitted and ending with the day which shall not precede the day of the meeting by more than six months

The period to which the account afore said relates is referred to as “financial year” or it may be less than or more than a calendar year. But it shall not exceed fifteen months.

3.1.3 FORM AND CONTENTS OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNT:

Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and shall subject to the provisions of this section,be in the form set out in para 1 of schedule 6 or as near there to as circumstances admit.This provision shall not be applied to insurance or banking company or company generating electricity.

Every profit and loss account of the company shall give a true and fair view of the profit and loss account of the company for the financial year and shall,subject as afore said, comply with the requirements of part 2 of schedule 6.

The central government may by notification in the official gazette exempt any class of companies from compliance in the public interest.

The balance sheet and the profit and loss account of the company shall not be treated as not disclosing a true and fair view of the state of affairs of the company.

For the purposes of the section, except where the context otherwise requires any reference to a balance sheet or profit and loss account shall include any notes there on or documents annexed there to giving information required by this act.

SCHEDULE VI TO THE COMPANIES ACT, 1956
(See Section 211)

HORIZONTAL FORM Of Balance sheet

Balance Sheet of .... (name of the company) ....

As at ....(date as at which it is made out)

Figures for the P.Y. (Rs.)	L I A B I L I T I E S	Figures for the C.Y. (Rs.)	Figures for the P.Y. (Rs.)	A S S E T S	Figures for the C.Y. (Rs.)
	SHARE CAPITAL Authorised ..... Shares of Rs....... each Issued ..... Shares of Rs....... each Subscribed ..... Shares of Rs....... each Rs. .... per share called up Less: Unpaid calls Add: Forfeited shares RESERVES AND SURPLUS 1. Capital Reserves 2. Capital Redemption Reserve 3. Share Premium Account 4. Other Reserves Less: Debit balance in profit and loss account, if any 5. Balance in the profit and loss accounts after			FIXED ASSETS 1. Goodwill 2. Land 3. Buildings 4. Leaseholds 5. Railway Sidings 6. Plant and Machinery 7. Furniture and Fittings 8. Development of Property 9. Patents, trademarks and designs 10. Livestock 11. Vehicles etc. INVESTMENTS 1. Investments in Govt. or Trust Securities 2. Investments in shares, debentures or bonds 3. Immovable properties 4. Investments in the capital of partnership firms	

	providing for proposed allocation namely Dividend Bonus or Reserves 6. Proposed additions to Reserves 7. Sinking Funds <u>SECURED LOANS</u> 1. Debentures 2. Loans and Advances from Banks 3. Loans and Advances from Subsidiaries 4. Other Loans and Advances <u>UNSECURED LOANS</u> 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 <u>CURRENT LIABILITIES & PROVISIONS</u> A. <u>Current Liabilities</u> 1. Acceptances 2. Sundry Creditors i. Total outstanding dues of small scale industrial undertaking(s). ii. Total outstanding dues of creditors			5. Balance of unutilised monies raised by Issue <u>CURRENT ASSETS, LOANS & ADVANCES</u> A. <u>Current Assets</u> 1. Interest accrued on investments 2. Stores and spare parts 3. Loose tools 4. Stock-in-trade 5. Works-in-progress 6. Sundry debtors : a. Debts outstanding for a period exceeding 6 months b. Other debts Less: Provision 7. a. Cash balance on hand b. Bank balances With Scheduled Banks c. With Others B. <u>Loans and Advances</u> 8. Advances and Loans a. To subsidiaries b. To partnership firms in which the co./its subsidiary is a partner 9. Bills of Exchange 10. Advances recoverable in cash or in kind or for value to be received; e.g., Rates, Taxes, Insurance, etc. 11. Balances with Customs, Port	

	other than small scale industrial undertaking(s). 3. Subsidiary companies 4. Advance payments and unexpired discounts 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 Provident Fund Scheme 12. For Insurance, pension and similar staff benefit schemes 13. Other provisions			Trust, etc. (where payable on demand). MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted) 1. Preliminary Expenses 2. Expenses including commission/ brokerage on underwriting or subscription of shares or debentures 3. Discount allowed on issue of shares or debentures 4. Interest paid out of capital during construction 5. Development expenditure not adjusted 6. Other items (Specifying nature) PROFIT AND LOSS ACCOUNT (Debit Balance)	
	Total			Total	

3.2 CONTINGENT LIABILITIES

(Foot Note)

1. Claims against the company not acknowledged as debts
2. Uncalled liability on shares partly paid
3. Arrears of fixed cumulative dividends

4. Estimated amount of contracts remaining to be executed on capital account and not provided for
5. Other money for which the company is contingently liable

Requirements as to Balance Sheet

Under each of the heads in the above balance sheet of the companies, detailed notes are to be given on various matters. These requirements are listed as under :

3.3 SHARE CAPITAL

1. The 'issued capital' and 'subscribed capital' must be distinguished into various classes of capital; viz. preference and equity, and the particulars specified hereunder must be given separately for each of them.
2. Shares allotted as fully paid, pursuant to a contract, for consideration other than cash, should be separately shown; e.g., shares issued to promoters, or for the purchase of a running business etc.
3. Shares allotted as fully paid-up by way of bonus shares, should be separately disclosed. The source from which the bonus shares are issued must also be specified; e.g., by capitalisation of reserves or profits or from share premium account, etc.
4. Terms of redemption or conversion, if any, in case of redeemable preference shares must be stated, together with the earliest date of redemption or conversion.
5. Particulars of any option on unissued share capital should also be specified.
6. Preference shares should also be classified into different categories, if any.
7. Unpaid calls must be shown separately in respect of following:
    a. By directors.
    b. By others.
8. In case of forfeited shares, amount originally paid-up should be shown. Any profit on reissue of forfeited shares should be transferred to capital reserve.
9. In case of subsidiary companies, the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated.
10. Any capital profit on reissue of forfeited shares should be transferred to Capital Reserve.

The auditor is not required to certify the correctness of such shareholdings as certified by the management.

3.3.1. Reserves and Surplus

1. The item ‘Share Premium Account’ shall include the details of its utilisation in the year of its utilisation in the manner provided in S. 78.
2. In case of ‘other reserves’, the nature and the amount of each reserve must be specified; e.g., General Reserves, Dividend Equalisation Reserve etc.
3. The balance in the profit and loss account, should be the balance after providing for all proposed allocations namely for dividend, bonus or reserves.
4. The debit balance in the profit and loss account should be shown as a deduction from the uncommitted reserves, if any.
5. Additions and deductions in the reserves since last balance sheet must be shown under each of the specified heads.
6. The word ‘fund’ in relation to any ‘reserve’ must be used only where such reserve is specifically represented by earmarked investments.

3.3.2 Secured Loans

1. Loans from directors and managers must be shown separately, under each sub-head.
2. Interest accrued and due on secured loans should be included under appropriate sub-heads under the head "Secured Loans".
3. The nature of security must be specified in each case.
4. Where loans have been guaranteed by managers and/or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head.
5. In case of debentures, the terms of redemption or conversion, if any, of debentures issued must be stated together with earliest date of redemption or conversion.
6. Particulars of redeemed debentures which the company has power to reissue should be given.
7. Where any of the company’s debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the company’s books shall be stated.

3.3.3 Unsecured Loans

1. Loans from Directors; or Manager should be separately shown.
2. Interest accrued and due on unsecured loans must be included under the appropriate sub-heads under the head "Unsecured Loans".
3. Where loans have been guaranteed by the managers and/or directors a mention thereof should be made and also the aggregate amount of such loans under each head.
4. Short-term loans are defined to include those loans which are due for not more than 1 year as on the date of the balance sheet.
5. Maximum amount raised through ‘Commercial Paper’ and outstanding balance at year end to be disclosed as per RBI stipulations.

3.3.4 Current Liabilities and Provisions

1. Advance payments/unexpired discounts are that portion for which value has still to be given; e.g. in case of following companies. Newspapers, Fire insurance, Theatres, Clubs, Banking companies, Steamship companies, etc.
2. Current account balances with directors, and manager, shall be shown separately.
3. The name(s) of the small scale undertaking(s) to whom the company owes a sum exceeding Rs. 1,00,000/- together with interest which is outstanding for more than 30 days are to be disclosed.
4. Investor's Education and Protection Fund shall be credited by unpaid dividend, unpaid application money received for allotment of securities and due for refund, unpaid matured deposits/debentures and interest on these unpaid amounts.

3.3.5 Contingent liabilities

1. These are to be shown by way of a footnote and their amounts do not form part of the total of the balance sheet.
2. In case of arrears of fixed cumulative dividends, the period for which the dividends are in arrears or if there is more than one class of shares, the dividends on each of such class are in arrears, shall be stated separately. The amount shall be stated before deduction of income tax except that in the case of tax free dividends the amount shall be shown free of income-tax and the fact that it is so shown must be stated.
3. The amount of any guarantee given by the company on behalf of the directors or other officers of the company should be stated.

The contingent liabilities with their general nature and amount of each such contingent liability, if material, should be stated.

3.3.6 Fixed Assets

1. The fixed assets must be classified and distinguished as far as possible between the heads given in the balance sheet.
2. Under each head, the following details have to be separately given:
   a. Original cost of the asset.
   b. Additions thereto during the year.
   c. Deductions therefrom during the year.
   d. Total depreciation written off or provided up to the end of the year.
3. Where the fixed asset was purchased from a foreign country, and as a result of a change in the exchange rate after such purchase, there is an increase or reduction in the liability of the company in terms of rupees, for making payment towards the whole or part of the cost of the asset or for the repayment of the moneys borrowed in foreign currency for such purchase of an asset, the amount by which the liability has increased or reduced, must be added to or deducted from the cost of the asset, as the case may be, and the resultant figure will be treated as the cost of the asset.

4. Where the original cost of the asset cannot be ascertained without unreasonable expense or delay, the valuation shown by the books must be given. Such valuation shall be the net amount at which the asset stood in the company's books at the commencement of the Companies Act, 1956, after deduction for depreciation etc.

5. Where any sum has been written off on a reduction of capital or revaluation of assets, every balance sheet subsequent to such reduction or revaluation must show the reduced figures and the date of the reduction. For a period of five years, the amount of the reduction made shall also be stated.

6. Similarly, where sums have been added by writing up the asset, each subsequent balance sheet, should show the increased figures with the date of the increase. For a period of five years, the amount of the increase shall also be stated.

7. Depreciation written off or provided should be allocated under the different heads of assets and deducted in arriving at the value of the fixed assets.

3.3.7 Investments

1. The nature of investment and the mode of valuation for example at cost or market value shall be stated.
2. The investments shall be distinguished between quoted and unquoted investments and where quoted, the market value must be shown.
3. Investments in shares, debentures or bonds must be classified into fully paid or partly paid and into different classes of shares.
4. Investments in subsidiaries must be separately stated.
5. Investments must also be classified into trade investments and other investments. "Trade investment" means an investment by a company in the shares or debentures of another company, not being its subsidiary, for the purpose of promoting the trade or business of the first company.
6. A separate schedule of investments, showing the names of bodies corporate (showing separately the bodies corporate under the same management) in whose shares or debentures, investments have been made, should be annexed. The schedule also should show all the investments whether existing or not, made subsequent to the date as at which previous balance sheet was made out. In case of investment company (principal business of acquisition of shares, debentures, etc.), investments existing on the date as at which the balance sheet was made out may be given.
7. In regard to the investments in the capital of partnership firms, the names of the firms, names of all other partners, total capital and share of each partner shall be given.
8. All unutilised monies out of the issue must be separately disclosed in the Balance Sheet of the company indicating the form in which such unutilised funds have been invested.

3.3.8 Current Assets, Loans and Advances

1. If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realisation in the ordinary course of the business at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated.
2. In case of stores and spare parts, stock-in-trade and work-in-progress, the mode of valuation shall be stated. Amount in respect of raw materials should be stated separately wherever practicable.
3. In case of investment in shares, debentures, etc. classified under current assets as a stock-in-trade information as per paras 5 and 6 above under ‘Investment' shall also be given separately.
4. In regard to sundry debtors particulars should be given separate in respect of :
   a. debts considered good and in respect of which 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.

A separate disclosure should also be made in respect of following:

d. debts due by —
   i. directors or other officers of the company
   ii. directors or other officers of the company jointly with any other person
   iii. firms in which any director is partner
   iv. private companies in which any director is a director or a member

e. debts due from other companies under the same management within the meaning of sub-section (1B) of S. 370 together with the names of such cos.

f. the maximum amount due by directors or other officers of the company at any time during the year.

The term "Sundry Debtors" has been defined to include "the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations". It does not, however, include amounts which are in the nature of loans or advances.

The provision for bad and doubtful debts under the head ‘sundry debtors’ should not exceed the amount of debts stated to be considered bad or doubtful. Any surplus of such provision should be shown as reserve for bad or doubtful debts under the head ‘Reserves and Surplus’ on the liabilities side.

5. In regard to 'bank balances', the following particulars should be given :
   a. the balance lying with scheduled banks on current accounts, call accounts and deposit accounts;
   b. the names of the bankers (other than scheduled banks) and the balances lying with each such banker on current accounts, call accounts and deposit accounts, and the maximum amount outstanding at any time during the year from each such banker; and
   c. the nature of the interest, if any, of any director or his relative in each of the banks, referred to in (b) above.

6. In regard to loans and advances, all instructions regarding 'Sundry Debtors' would apply to "Loans and Advances" also.

   The amounts due from other companies under the same management within the meaning of S. 370(1B) shall be given with the names of such companies.

   The maximum amount due from every one of such companies at any time during the year must also be stated.

   Current accounts with directors and managers should be shown separately.

3.3.9 Miscellaneous expenditure

1. The debit balance of profit and loss account should be shown as a deduction from the free or uncommitted reserves, if any.
2. While showing "interest paid out of capital during construction", the rate of interest shall be stated.

3.3.10 Other general instructions

1. If the required information cannot be given conveniently in the given form in the balance sheet itself, it may be furnished in separate schedules annexed to and forming part of the balance sheet.
2. Except in the case of the first balance sheet, the corresponding amounts for the immediately preceding financial year for all items shall also be shown.
3. Paise can also be given in addition to rupees, if desired.
4. Dividends declared by subsidiary companies after the date of the balance sheet should not be included unless they are in respect of the period which closed on or before the date of the balance sheet.
5. Any reference to benefits expected from contracts to the extent executed shall not be made in the balance sheet but shall be made in the Board's Report.

6. A small-scale industrial undertaking has the same meaning as assigned to it under clause (j) of sec. 3 of the Industries (Development and Regulation) Act, 1951.
7. The figures in the balance sheet may be rounded off as under:
   - Less than Rs. 100 crores : to the nearest hundreds or thousands or decimal thereof
   - Between Rs. 100 crore or more, but less than Rs. 500 crores : to the nearest hundreds, thousands, lakhs or millions or decimal thereof
   - Rs. 500 crores or more, to the nearest hundreds, thousands, lakhs, millions or crores or decimal thereof.

B. VERTICAL FORM

<table>
<tr><td colspan="4">Name of the company</td></tr>
<tr><td colspan="4">Balance Sheet as at</td></tr>
<tr><td></td><td>Sch. No.</td><td>Figures as at the end of the current financial year (Rupees)</td><td>Figures as at the end of the previous financial year (Rupees)</td></tr>
<tr><td>I. Sources of funds
1. Shareholders' Funds :
a. Capital
b. Reserves and surplus
2. Loan funds
a. Secured loans
b. Unsecured loans

TOTAL ....

II. Application of funds
1. Fixed assets :
a. Gross block
b. Less: Depreciation
c. Net block
d. Capital work-in-progress
2. Investments:
3. Current assets, loans and advances
a. Inventories
b. Sundry debtors
c. Cash and bank balances</td><td></td><td></td><td></td></tr>
</table>

d. Other current assets e. Loans and advances Less : Current liabilities and provisions f. Liabilities g. Provisions Net current assets 4. a. Miscellaneous expenditure to the extent not written off or adjusted b. Profit and loss account TOTAL			

Notes :

1. Details under each of the above items shall be given in separate Schedules. The Schedules shall incorporate all the information required to be given under A Horizontal Form read with notes containing general instructions for preparation of balance sheet. The Schedules, referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet.
2. The figures in the balance sheet may be rounded off to the nearest '000' or '00' as may be convenient or may be expressed in terms of decimals of thousands.
3. A footnote to the balance sheet may be added to show separately contingent liabilities.

PART - IV

3.4 BALANCE SHEET ABSTRACT AND COMPANY'S GENERAL BUSINESS PROFILE

1. REGISTRATION DETAILS:

Registration No

State code

Balance sheet date

Date month year

2.Capital raised during the year(amount in rs.thousands)

Public issue

Rights issue

Bonus issue

Private placement

3.position of mobilization and deployment of funds (amount in rs.thousands)

Total liabilities

Total assests

Sources of funds

Paid up capital

Reserves and surplus

Secured loans

Unsecured loans

Application of funds

Net fixed assets

Investments

Net current assets

Misc. expenditure

Accumulated losses

4 Performance of company(amount in Rs.thousands)

Turnover

Total Expenditure

Profit / loss before tax

Profit/ loss after tax

Earning per share in rs

Dividend rate %

5.Generic names of three principal products/ services of company(as per monetary terms)

Item code number
(itc code)

Product
description

Item code number
(itc code)

Product
description

Item code number
(itc code)

Product

description

Note: for ITC code of products please refer to the publication Indian trade classification based on harmonized description and coding system by Ministry of Commerce Directorate General of Commercial intelligence & Statistics, Kolkatta 700 001.

3.5 SCHEDULE VI TO THE COMPANIES ACT, 1956

3.5.1. TREATMENTS OF SPECIAL ITEM WHILE PREPARING THE FINAL ACCOUNTS

3.5.2 Provisions and reserves:

The expression "provision" shall mean any amount return of or retained by way of providing for depreciation, renewals or decrease in the value of assets or retained for known liability.few examples of provisions are provision for depreciation, provisions for repairs and renewals, bad and doubtful debts, fluctuations in investments, contingent liability and taxation etc. Provisions are definitely a charge against profits and as such they should be shown in the profit and loss account proper. Provisions made in the excess of the required amount will be regarded as reserves and not as provisions.A reserve therefore by implication represents undistributed profits and reserves are appropriation of profits and not charge against the profits.

3.5.3 DISTINCTION BETWEEN PROVISIONS AND RESERVES:

1) Provisions are created for specific purpose while reserve is created for probable losses.
2) Provision is a charge against profit while reserves are an appropriation of profit.
3) Provision cannot be distributed as profit while reserves can be distributed.
4) Provision cannot be invested while reserves can be invested in securities
5) Provision is made because of legal necessity while reserve is a matter of financial prudence.
6) Provision is deducted from the concerned head of account while the reserve is shown separately under reserves and circulars.

3.5.4 TYPES OF RESERVES

3.1.1. Revenue reserve: A reserve created out of profits by debiting profit and loss appropriation account.

3.1.2. Revenue reserves are profits retained to strengthen the financial position of the company.

3.1.3. Revenue reserves may be

a. General reserve which is created by setting aside a portion of the profit every year for unforeseen contingency

b. A specific reserve is created by settin aside a porion of profit for the specific purpose

3.5.5 Provision and Depreciation:

Part II schedule VI of the companies Act, 1956 requires that the profit and loss Account must disclose the amount provided for depreciation, renewals or diminution in value of fixed assets. If such provision is not made by means of a depreciation charge, the method adopted for making such provision should be stated, But where no provisions is made for depreciation, the fact no provision, has been made, must be stated and the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act, is also to be stated by way of a note.

Section 205(2) of the companies Act, 1956 states that depreciation should be provided either:

(a) to the extent specified in section 350;

(b) in respect of each item of depreciation asset for such an amount as is arrived at by dividing 95 percent of the original cost to the company by the specified period in respect of such assets; or

(c) on any other basis approved by the central Government which has the effect of writing off by way of depreciation 95 percent of the original cost of the company of each such depreciation assets on the expiry of the specified period;

or

(d) as regards ant other depreciable asset for which no rate of depreciation has been laid down by this Act or any rules made there under, on such basis as may be approved by the Government by any general order published in the official Gazette or any special order in any particular case:

Provided that if any of the aforesaid assets is sold, discarded, demolished or destroyed, the excess (if any) of the written down value of such asset over its sale proceeds or, as the case may be, its scrap value; must be written off in the financial year in which the asset is sold, discarded, demolished or destroyed.

Depreciation may be provided either on the written –down value at the rates specified in schedule XIV of the Act or on straight line basis. In straight line basis , depreciation may be calculated by dividing 95% of the original cost of the asset by its specified period. it means the number of years at the end of which atleast 95% of the original costs of that asset will have been provided by way of depreciation if depreciation were to be calculated in accordance with the provision of section 350.

The amount of depreciation charged on the asset every year is debited to the profit and loss Account and the provision for depreciation Account which is allowed to accumulated from year to year. The accounting entries required for this will be as follows:

(1) When depreciation is charged on assets:

Depreciation A/c Dr (With the amount of depreciation)
To Provision for depreciation A/c

(2) When depreciation is taken to the profit and loss Account :

Profit and loss A/c Dr (with the amount of depreciation)
To Provision for Depreciation A/c

The net effect of the above two entries will be:

Profit and loss Account Dr (with the amount of depreciation)
To provision for depreciation A/c

Notes:

(1) if any asset is sold, discarded, demolished or destroyed, the proportionate amount of depreciation relating to the asset must be transferred from the provision for depreciation Account to the Asset Disposal Account. For this the entry will be:

Provision for Depreciation A/c Dr (with the proportionate of depreciation)
To Asset Disposal A/c

(2) When the excess of the written down value of the asset sold; discarded demolished or destroyed over the sale proceeds or scrap value is written off the following entry is required:

Profit and loss Account Dr (with the loss)

To Asset Disposal a/c

This entry will be reversed if the sale proceeds of the asset sold are greater than its written down value. But the excess of sale proceeds over the original cost of the asset is capital profit and should be credited to capital Reserve.

(3) if depreciation appears in the trial balance as a debit balance, it implies that the credit has already been given to provision for Depreciation Account.

(4) If any asset is purchased during the accounting period, depreciation may be provided for the full year and in such a case a note may be given to this effect. However, according to accounting principles, depreciation should be provided only for the period the asset was in use.

(5) Depreciation relating to past years should be treated as appropriation of profits and not charge against profits.

(6) Any charge in the method of providing for depreciation should be disclosed along with the quantum of effect on the profit/loss of the company.

3.5.6 Provision for Repairs, Renewals and Replacements:

While considering the question of depreciation, a clear distinction should be made between the cost of upkeep in the shape of repairs and small renewals and the cost of large renewals or the entire replacement of the asset concerned.

(a) Cost of Repairs and Renewals: The cost of upkeep should be charged to revenue in addition to the necessary provision for depreciation. The current expenditure by way of repairs is necessary to preserve the life of the asset to the extent of its normal estimated life. Actually speaking, this is based upon which the rate of depreciation is determined; otherwise the rate of depreciation would have been much higher. As a consequence, it is essential that the cost of current repairs should be charged to revenue.

It is also important to consider whether it is necessary to provide for future expenditure on repairs during the early years of the life of an asset. It is a recognized fact that the expenditure on repairs in the early years of the life of an asset is much less as compared to the subsequent years of its life. Where large sums are involved , the best method is to estimate the total expenditure by the number of years of its estimated life. this average estimated expenditure on repairs is debited every year to the profit and loss account and credited to either “Provision for Repairs and Renewals Account” or to “ Provision for Maintenance Account” The actual expenditure on repairs as and when it is incurred is debited to Provision for Repairs and Renewals account and credited to bank. Thus, the following two entries are required:

1. When provision is made for repairs an renewals-
   Profit and loss A/c Dr (with the average estimated expenditure)
   To Provision for Repairs and Renewals A/c

2. When actual expenditure is incurred on repairs-
   (i) Repairs and renewals A/c Dr (with the actual expenditure as and when made)
   To Bank
   (ii) Provision for Repairs and Renewals A/c Dr (with the actual expenditure as and when made)
   To Bank

(ii) Provision for Repairs and Renewals A/c Dr (transfer of the total sum to the provision at the end of the year)
To Repairs and renewals A/c

The balance of the provision for Repairs for Renewals Account will be carried forward and shown on the liabilities side of the Balance sheet under the head "Reserves and Surplus". But it may so happen that the provision for Repairs and Renewals Account may show temporarily a debit balance owing to excessive expenditure in any particular year. In such a case, it has to seen whether this excessive expenditure is likely to be recouped out of the provisions to be made during the subsequent years. if so, such a debit balance can be carried forward otherwise, it must be written off against the revenue of that particular year. For this the entry will be-

Profit and loss A/c Dr (with the excess amount)
To Provision for Repairs and Renewals A/c

If the estimated repairs prove exact at the end of the life of the asset, there will be no balance left in the provisions for Repairs and Renewals Account. But usually, there will be some balance left in the provision for Repairs and Renewals Account which should be transferred to the profit and loss Account.

Illustration:1

Okay ltd. estimated its expenditure on repairs of machinery over a period of 10 years at Rs.1,00,000 and decided to raise a Provision for Repairs and Renewals Account by debiting its Profit and loss Account with a uniform figure every year. The actual repairs in the 1^{st},2^{nd} and 3^{rd} years were respectively Rs.3,000, Rs.4,500 and Rs.7,000

Write up the provision for Repairs and Renewals Account.

Solution :

Dr — Provision for Repairs and Renewals Account — Cr

		Rs			Rs
1st year	To Bank	3,000	1st year	By Profit and Loss A/c	10,000
	To Balance c/d	7,000			
		10,000			10,000
2nd Year	To Bank	4,500	2nd year	By Balance b/d	7,000
	To Balance c/d	12,500		By Profit and Loss A/c	10,000
		17,000			17,000
3rd Year	To Bank	7,000	3rd year	By Balance b/d	12,500
	To Balance c/d	15,500		By Profit and Loss A/c	10,000
		22,500			22,500

Notes:

(1) The balance of this account will be shown every year in the balance sheet on the liabilities side under the head "Reserve and Surplus".

(2) The annual amount to be debited to profit and loss Account every year will be

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

(3) Although, a provision of Rs.10,000 will be made every year in the profit and loss Account of the company, for the purpose of determining the next profit for calculation of managerial remuneration the excess of provision over actual expenditure has to be added back to the profits.

(b) Cost of Replacement and provision for Replacement: Replacement of an asset represents the complete exhaustion of the capital invested in the asset. It involves the expenditure of large sums for the replacement of the asset. The annual charge of depreciation spreads this cost equitably over the life of the asset.

An important point to be noted here is that where the cost of replacement of the asset is estimated to exceed the original cost of the asset, it raises the question as to whether depreciation should be calculated on the original cost of the asset or on the replacement cost of the asset (i.e the amount required to replace the asset by a new one).

Since one of the important objects of providing for depreciation is to collect funds for replacement cost of the asset, it seems quite logical that the depreciation should be charged on the replacements cost of the asset. But this principle cannot be followed in practice due to the restrictions imposed by the companies Act, 1956.

According to the companies Act, 1956, depreciation has to be calculated on the original cost of the asset. Part III of Schedule VI of the companies Act further states that where any amount written off or retained by way of providing for depreciation in excess of the amount which is necessary for the purpose, the excess shall be treated as a reserve and not as a provision. Besides, depreciation is also not admissible on replacement cost basis under the income-tax Act, 1961.

Under the circumstances, if it is not possible for the company to raise further capital required to meet the excess expenditure on replacement of the asset, the company may decide to create a reserve called “Replacement Reserve” out of the profits of the company for the excess amount over the original cost of the asset. Such a Reserve is an appropriation of profits and not a charge against profit and therefore, should be shown below the line. “Replacement Reserve Account” should be shown as accumulated profits on the liabilities side of the balance sheet under be head “Reserve and Surplus” .

Providing for depreciation every year has the effect of generating funds within the business of the company with a view to replacing the asset at the end of its useful life. These funds may be used within the business of the company, the same does not ensure that cash will be available, when required, to replace the asset, as the funds may be represented by other business asset which may not be readily realized.

In order to ensure that the cash is readily available at the time of replacement of the asset. it is desirable that the funds should be invested outside the business of the company. This can be done in the following two ways:

(i) By investing the funds every year in readily convertible securities known as the sinking Fund or Depreciation Fund Method.

(ii) By taking out an insurance policy.

(vi) Provision for taxation and Advance payment of Tax:

Under clause 3(vi) of profit and loss Account of a company must set out the “amount of charge for income tax and other taxation on profits, including where practicable, with Indian income-tax, any taxation on profits, including where practicable, with Indian Income tax, any taxation imposed elsewhere to the extent of the relief, if any, from Indian Income tax and distinguishing where practicable between income-tax and other taxation.

A company is liable to pay income-tax or tax on profits under the income-tax Act, 1961 and such tax is treated as charge against the profits of the accounting year, although the profits are assessed and actual liability for tax is determined in the following year. The estimated amount of tax is debited to the Profit and loss account proper i.e. above the line and is credited to "provision for Taxation Account" which is shown on the liabilities side of the Balance sheet under the head "Current liabilities and provisions", the accounting entry is required for this will be as follows:

Profit and Loss A/c Dr. (with the estimated amount of
To Provision for Taxation tax liability)

While making the estimate of provision for taxation, due consideration should be given to the following points:

ii) Whether the net profit has been determined after deducting depreciation according to Income tax Act and managerial remuneration.
iii) Whether Income tax has been computed at the rates prescribed.
iv) Whether profit sur tax is payable or not.
v) Whether capital gains tax is payable or not.
vi) Whether penalty is payable under any tax laws.
vii) Whether rebates are available for double taxation.
viii) Whether investment allowance, extra shift allowance, etc if any, have been duly deducted or not in estimating the tax liability.
ix) Whether adjustment has been made for the last year's actual tax liability or not.

Accounting entry for Advance Tax payment:

Advance payment of tax A/c Dr. (With the amount of advance
To Bank A/c tax paid)

Until and unless the actual tax liability is determined and adjusted against advance payment of tax, "Advance payment of Tax account" will show a debit balance which may be shown in the Balance sheet either on the assets side under the head "Current Assets, Loans and Advances", or alternatively, on the liabilities side as a deduction from "Provision for taxation account" under the head "Current Liabilities and Provisions".

When the profits of the company are assessed at a subsequent date and the actual tax liability is determined. Advance Payment of Tax account relating to the period concerned is closed by transfer to Provision for taxation Account. For this, the accounting entry will be as follows:

Provision for taxation A/c Dr. (with the amount of advance
To Advance payment of Tax a/c payment of tax)

If the actual tax liability is more or less than the provision made in the previous year, the difference has to be adjusted through the appropriation section of the Profit and loss account (i.e. below the line) by debiting or crediting the provision for taxation account. The accounting entry for this will be as follows:

a) If the actual tax liability more than the provision made last year
Profit and Loss appropriation A/c Dr. (with the difference)
To Provision for taxation A/c

b) If the actual tax liability is less than the provision made last year

Provision to Taxation A/c Dr. (with the difference)
To Profit and loss appropriation A/c

If the advance payment of tax made for the previous year is less than the actual tax liability, the difference has to be treated as the liability for taxation until it is paid and should be shown on the liabilities side of the Balance sheet under the head "Current Liabilities". In such a case, the balance of the provision for taxation account for the previous year may be transferred to "Liabilities for Taxation Account". The Accounting entry for this will be as follows:

Provision for taxation Dr. (with the net liability)
To Liabilities for taxation A/c

In case of payment

Liabilities for taxation A/c Dr. (with the amount paid)
To Bank

On the other hand, if the advance payment of tax made for the previous year is more than the actual tax liability, the balance left in the Advance payment of tax account has to be shown as an asset on the asset side of the Balance sheet under the head "Current Assets, Loans and advances" and a refund claim has to be furnished for the same. On receipt of the refund claim, the accounting entry will be as follows:

Bank A/c Dr. (with the amount of refund)
To Advance Payment of Tax A/c

Illustration 2

The Trial balance of simplex Ltd as at 31st march, 2008 shows the following items:

	Dr.	Cr.
Provision for income tax account		60,000
Advance payment of Tax	1,10,000	

You are also given the following information:

1) Advance payment of tax account includes Rs.70,000/- for 2006-07
2) Actual tax liability for 2006-07 amounts to Rs.786,000/- and no effect for the same has so far been given in accounts.
3) Provision for income-tax has to be made for 2007-08 for Rs.80,000/-

Prepare the various ledger accounts involved and also show how the relevant items will appear in the balance sheet of the company.

Solution

Provision for income tax account

Dr.			Cr.	
31.3.2008	To Advance payment of Tax A/c	70,000	By Balance b/d	60,000
	To Liabilities for Taxation A/c	6,000	By Profit and loss appropriation A/c	16,000
		76,000		76,000
31.3.2008	To Balance c/d	80,000	By Profit and loss A/c	80,000

Advance payment of tax a/c

31.3.2008	To Balance b/d	1,10,000	By provision for Income tax a/c	70,000
			By Balance c/d	40,000
		1,10,000		1,10,000

Liabilities for taxation account

31.3.2008	To Balance C/d	6,000	By Provision for Income tax A/c	6,000
		6,000		6,000

3.6 MANAGERIAL REMUNERATION

The remuneration payable to the directors of a company, including any managing or whole-time director, shall be determined, in accordance the provisions given below either by the articles of the company, or by a resolution (special resolution if the articles so require), passed by the company in general meeting and the remuneration payable to any such director determined as per the said provisions shall be inclusive of the remuneration payable to such director for services rendered by him in any other capacity. However, any remuneration for services will not be so included if the services are of a professional nature and in the opinion of the Central Government, the director possesses the requisite qualifications.

A director may receive remuneration by way of fees for attending each meeting of the Board or of any committee thereof (Sitting Fees).

A director who is in whole time employment of the company or a managing director may be paid remuneration either by way of a monthly payment or at a specified percentage of net profits of the company or partly by one and partly by the other. Such remuneration cannot exceed 5 % of the net profits of the company, except with the approval of the Central Government in case of one director and 10 % for all such directors.

The total managerial remuneration payable by a public company or a private company which is a subsidiary of a public company to its directors and its manager in any financial year must not exceed 11 % of the net profits of the company calculated in accordance with the provisions of section 349, 350 and 351.

In the case of a director who is neither in the whole-time employment of the company nor a managing director may be paid remuneration either by way of a monthly, quarterly or annual payment with the approval of the Central Government or by way of commission if the company by special resolution authorises such payment. Such special resolution to in sub-section (4) shall not remain in force for a period of more than five years; but may be renewed, from time to time, by special resolution for further periods of not more than five years at a time. Remuneration payable to such directors cannot exceed :-

a. if the company has a managing or whole-time director or a manager, one per cent, of the net profits of the company;

b. in any other case, three percent of the net profits of the company.

If any director earns remuneration from a company in excess of the above limits without prior approval of the Central Government, he shall refund the excess to the company and until such repayment, hold the money in trust with him.

The Company cannot waive recovery of such sum due from the director unless approved by the Central Government.

No approval of the Central Government is required in case the remuneration is within the limits mentioned in Schedule XIII to the Companies Act, 1956.

No director of a company who is in receipt of any commission from the company and who is either in the whole-time employment of the company or a managing director shall be entitled to receive any commission or other remuneration from any subsidiary of such company.

The above provisions pertaining to remuneration do not apply to a private company unless it is a subsidiary of a public company.

Provision for increase in remuneration to require Government sanction
In the case of a public company, or a private company which is a subsidiary of a public company, any provision relating to the remuneration of any director or any amendment thereof, which purports to increase or has the effect of increasing, whether directly or indirectly, the amount of remuneration shall not have any effect unless :-

i. is within the limits specified in Schedule XIII, where Schedule XIII is applicable ; or

ii. approved by the Central Government

and the amendment shall become void if, and in so far as, it is disapproved by the Government.

Increase in remuneration of managing director on reappointment or appointment after Act to require government sanction
In the case of a public company, or a private company, which is a subsidiary of a public company, if the terms of any re-appointment or appointment of a managing or whole-time

director, purport to increase or have the effect of increasing, whether directly or indirectly, the remuneration which the managing or whole-time director or the previous managing or whole-time director, as the case may be, was receiving immediately before such appointment, the or appointment shall not have any effect unless :-

i. is within the limits specified in Schedule XIII, where Schedule XIII is applicable ; or
ii. approved by the Central Government

and the amendment shall become void if, and in so far as, it is disapproved by the Government.

3.7 DIRECTOR CANNOT TO HOLD OFFICE OR PLACE OF PROFIT

Except with the previous consent of the company accorded by a special resolution :-

i. No director of a company can hold any office or place of profit in that company
ii. No partner or relative of such a director (i.e. a director holding an office or place of profit in the company), no firm in which such a director or relative is a partner, no private company of which such a director is a director or member, and no director, or manger of such a private company can hold any office or place of profit carrying monthly remuneration in excess of the prescribed amount (Rs. 10000/-).

However, the above restrictions are not applicable to the office of managing director, manager, banker, or trustee for the holders of debentures of the company either :-

i. in the company ; or
ii. in any subsidiary of the company, unless the remuneration received from such subsidiary in respect of such office or place is paid over to the company or its holding company.

The special resolution required for the above purpose may be passed at the first general meeting after the appointment. Such special resolutions will required at subsequent re-appointments also on a higher remuneration not covered by the earlier special resolution.

However, if the monthly remuneration is not less than Rs. 20000/- per month, the special resolution mentioned above has to be obtained prior to the appointment and in addition to the special resolution, approval of the Central Government will also be required for the appointment.

If any office or place of profit under the company or a subsidiary thereof is held in contravention of the above provisions, the director, partner, relative, firm, private company or, manager shall be deemed to have vacated his office, with effect from the day following the date of general meeting mentioned above. Such person will also be liable to refund to the company any remuneration received, or the monetary equivalent of any perquisites or advantage enjoyed by him, in respect of such office or place of profit. The company will not be able to waive recovery of such amounts, except with the approval of the Central Government.

Any office or place in a company shall be deemed to be an office or place or profit under the company for these provisions :-

a. in case the office or place is held by a director, if the director holding it obtains from the company anything by way of remuneration over and above the remuneration to which he is entitled as such director, whether as salary, fees, commission, perquisites, the right to occupy free of rent any premises as a place of residence, or otherwise;

b. in case the office or place is held by an individual other than a director or by any firm, private company or other body corporate, if the individual, firm private company or body corporate holding it obtains from the company anything by way of remuneration whether as salary, fees, commission, perquisites, the right to occupy free of rent any premises as a place of residence, or otherwise.

None of the above provisions apply to a director appointed by the Central Government u/s 408 of the Companies Act, 1956

3.8 COMPENSATION FOR LOSS OF OFFICE

Payment may be made by a company, except in the cases specified below and subject to the limit specified, to a managing director or a director holding the office of manager or in the whole time employment of the company, by way of compensation for loss of office, or as consideration for retirement from office, or in connection with such loss or retirement.

However, such payment cannot be made by the company to any other director.

No payment shall be made to a managing or other director in the following cases :-

a. where the director resigns his office in view of the reconstruction of the company, or of its amalgamation with any other body corporate or bodies corporate, and is appointed as the managing director, manager or other officer of the reconstructed company or of the body corporate resulting from the amalgamation;

b. where the director resigns his office otherwise than on the reconstruction of the company or its amalgamation as aforesaid;

c. where the office of the director is vacated

d. where the company is being wound up, whether by or subject to the supervision of the Court or voluntarily, provided the winding up was due to the negligence or default of the director;

e. where the director has been guilty of fraud or breach of trust in relation to, or gross negligence in or gross mismanagement or, the conduct of the affairs of the company or any subsidiary or holding company thereof;

f. whether the director has instigated, or has taken part directly or indirectly in bringing about, the termination of his office.

Any such payment made to a managing or other director shall not exceed the remuneration which he would have earned if he had been in office for the unexpired residue of his term or for three years, whichever is shorter, calculated on the basis of the average remuneration actually earned by him during a period of three years immediately proceeding the date on which he ceased to hold the office, or where he held the office for a lesser period than three years, during such period.

No such payment shall be made to the director in the event of the commencement of the winding up of the company, whether before, or at any time within twelve months after, the date on which he ceased to hold office, if the assets of the company on the winding up, after deducting the expenses thereof , are not sufficient to repay to the share-holders the share capital (including the premiums, if any) contributed by them.

These provisions do not prohibit the payment to a managing director or a director holding the office of manager, of any remuneration for services rendered by him to the company in any other capacity.

Payment to director for loss of office in connection with transfer of undertaking or property
No director of a company shall, in connection with the transfer of the whole or any part of any undertaking of property of the company, receive any payment, by way of compensation for loss of office, or as consideration for retirement from office, or in connection with such loss or retirement

a. from such company; or

b. from the transferee of such undertaking or property or from any other person, unless particulars with respect to the payment proposed to be made by such transferee or person (including the amount thereof) have been disclosed to the members of the company and the proposal has been approved by the company in general meeting.

Where a director of a company receives payment of any amount in contravention of the above provisions, the amount shall be deemed to have been received by him in trust for the company. Payment to director for loss of office, etc., in connection with transfer of shares
No director of a company shall, in connection with the transfer to any persons of all or any of the shares in a company, being a transfer resulting from-

i. an offer made to the general body of shareholders;

ii. an offer made by or on behalf of some other body corporate with a view to the company becoming a subsidiary of such body corporate or a subsidiary of its holding company;

iii. an offer made by or on behalf of an individual with a view to his obtaining the right to exercise, or control the exercise of, not less than one-third of the total voting power at any general meetings of the company; or

iv. any other offer which is conditional on acceptance to a given extent;

receive any payment by way of compensation for loss of office, or as consideration for retirement from office, or in connection with such loss or retirement,-

a. from such company; or
b. from the transferees of the shares or from any other person except as provided below.

It shall be the duty of the director concerned to take all reasonable steps to secure that details with respect to the payment proposed to be made by the transferees or other person (including the amount thereof) are sent with, any notice of the offer made for their shares which is given to any shareholders.

If :-

a. any such director fails to take reasonable steps as aforesaid; or
b. any person who has been properly required by any such director to include the said details in the aforesaid notice fails so to do;

he shall be punishable with fine which may extend to two hundred and fifty rupees.

If-

a. the above provisions are not complied with ; or
b. the making of the proposed payment is not, before the transfer of any shares in pursuance of the offer, approved by a meeting, called for the purpose ,of the concerned shareholders

any sum received by the director on account of the payment shall be deemed to have been received by him in trust for any persons who have sold their shares as a result of the offer made, and the expenses incurred by him in distributing that sum amongst those persons shall be borne by him and not retained out of that sum.

If at a meeting called for the purpose of approving any payment, a quorum is not present and, after the meeting has been adjourned to a later date, a quorum is again not present, the payment shall, be deemed to have been approved.

3.9 DIRECTORS WITH UNLIMITED LIABILITY IN LIMITED COMPANY

In a limited company, the liability of the directors or of any director or of the manager may ie generally limited to the amount of investment in shares of that company. However, if so provided by the memorandum, it may become unlimited.

In a limited company in which the liability of a director or manager is unlimited, the directors, and the manager of the company, and the member who proposes a person for appointment, to the office of director or manager, shall add to that proposal a statement that the liability of the person holding that office will be unlimited and before the person accepts the office or acts therein, notice in writing that his liability will be unlimited, shall be given to him.

If any director, manager or proposer makes default in adding such a statement, or if any promoter, director, manager or officer of the company makes default in giving such a notice, he shall be punishable with fine which may extend to one thousand rupees and shall also be liable for any damage which the person so appointed may sustain from the default; but the liability of the person appointed shall continue to remain unlimited.

3.10 SPECIAL RESOLUTION OF LIMITED COMPANY MAKING LIABILITY OF DIRECTORS UNLIMITED

A limited company may, if so authorised by its articles, by special resolution, alter its memorandum so as to render unlimited the liability of its directors or of any director or of its manager.

However no alteration of the memorandum making the liability of any of the officers unlimited shall apply to such officer, if he was holding the office from before the date of the alteration, until the expiry of his then term, unless he has accorded his consent to his liability becoming unlimited.

To sum up the discussion on managerial remuneration, the following rates should be remembered.

	Maximum Limit
1. Overall Managerial remuneration (inclusive of fee for attending meetings)	11% of Net Profit
2, If the company has one managing Director or whole time director	5% of the Net profit
3. If the company has more than one Managing Director or whole time	10% of the Net profit

Director (for all of them)	
4. Remuneration of part time directors Where the company has no Managing director (for all of them)	3% of the Net profit
5. Remuneration of part time director Where the company has one or more Managing director (for all of them)	1% of the Net profit
6. Remuneration to the manager	5% of the Net profit

Please note that the Companies Act has only prescribed the maximum limit and hence the companies are at liberty to fix the remuneration within the limit.

If nothing is mentioned in the problem as to whether the managerial remuneration is to be calculated on the net profits of the company before charging such remuneration or after charging such remuneration, it is always to be assumed that the remuneration has to be calculated on the net profits before charging such remuneration.

3.11 DETERMINATION OF NET PROFIT FOR CALCULATION OF MANAGERIAL REMUNERATION

Section 349 and 350 of the Companies Act contain the provisions relating to the manner of determination of net profits for the purpose of calculating the managerial remuneration. All these provisions are based on sound accounting principles and practice.

The Provisions of the above sections require that in computing net profits of a company in any financial year for the purpose of calculating managerial remuneration the following points should be considered.

8.1.1 Credit shall be given for-

Bounties and subsidies received from any Government or its Agencies

3.12 CREDIT SHALL NOT BE GIVEN FOR THE FOLLOWING SUMS-

a) profits, by way of premium, on shares or debentures of the company which are issued or sold by the company.

b) Profits on sales by the company of forfeited shares.

c) Profits of capital nature including profits from the sale of undertaking or any of the undertakings of the company, or any part thereof.

d) Profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets.

8.1.3. The following sums shall be deducted-

a) All the usual working charges

b) Director's remuneration

c) Bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician, or person employed or engaged by the company, whether on a whole time or on a part time basis.

d) Any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits

e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf.

f) Interest on mortage, debentures, unsecured loans etc

g) Expenses on repairs

h) Depreciation to the extent specified in Sectin 350

8.1.4 The following sums shall not be deducted

a) Income tax and super tax payable by the company

b) any compensation, damages or payment s made voluntarily

c) Loss of capital nature including loss on sale of undertakings.

It is important to note here that the above provisions do not apply to Private company, unless it is subsidiary of a public company.

Illustration 3

The following particulars are extracted from the Profit and loss Accouts of Hema Ltd for the year ended 31st March 2006

i) Remuneration paid to

   a) Managing Director Rs.75,000

   b) Whole time Director Rs.60,000

ii) Provisions for bonus Rs.5,50,000 and for gratuity Rs.50,000, this includes provision for above Directors-Bonus Rs.5,0000 and gratuity Rs.6,000.

iii) Provision for doubtful debts made during the year Rs.30,000

iv) Surplus on sale of building credited in the Profit and Loss account Rs.1,50,000. This includes a short term capital gain of Rs.1,30,000.

v) Loss on sale of machinery debited in Profit and Loss Account,Rs.7,000 (representing difference between sale price Rs.1,43,000 and written down value of Rs.1,50,000.

vi) The company has made donations of Rs.50,000 to charitable institutions and contributed Rs.4,00,000 to an approved research association for research related to the company's business.

vii) Provision for Income tax Rs.8,00,000 and for surtax Rs.60,000 made in the accounts.

viii) The net profit as per Profit and Loss accounts is Rs.16,00,000. The company had suffered losses in the earlier years . The aggregate amount of such brought forward losses (after adjustments required to be made under Section 349) works out to Rs.2,50,000/

You are required to calculate the net profit for the purpose of computing managerial remuneration.

Solution

	Rs.
Profit as per Profit and loss account	16,00,000
Add: Items not deductible:	
Managerial remuneration charged in the profit and loss A/c	1,46,000
Provisions for doubtful debts	30,000
Provisions for income tax	8,00,000
	25,76,000
Short term capital gain	1,30,000
Past losses	2,50,000
	3,80,000
Net profit for calculation of managerial remuneration	21,96,000

Illustration 4

The following is the Profit and loss Account of Harini Ltd for the year ended 31st March 2006

	Rs.		Rs.
To Salaries and Wages	1,50,000	By Gross profit	40,00,000
To Repairs to Fixed Assets	50,000	By Profit on sale of machinery	
To General expenses	40,000	(Cost Rs.8,00,000 and Written	
To Compensation for breach		down value Rs,4,00,000)	4,00,000
of contract	25,000	By subsidy from Government	1,00,000
To Depreciation	2,40,000		
To Loss on sale of investment	35,000		
To Expenditure on scientific			
Research (cost of setting			
Up a new laboratory)	2,50,000		
To Debenture interest	75,000		
To Interest on unsecured			
Loans	15,000		
To Provision for Income tax	16,00,000		
To Proposed dividends	10,00,000		
To Balance C/d	10,70,000		
	45,50,000		45,50,000

Calculate the overall managerial remuneration under Section 198

Solution		**Rs.**
Net Profit as per Profit and loss Account		10,70,000
Add: Items not to be deducted under Section 349 and 350		
	Rs.	
Loss on sale of investment	35,000	
Expenditure on Scientific research	2,50,000	
Provision for income tax	16,00,000	
Proposed dividend	10,00,000	28,85,000
		39,95,000

Less: Capital profit on sale of machinery	
i.e. sale price Rs.(4,00,000+4,50,000)-Cost price	
8,50,000-8,00,000	50,000
Net Profit under Section 198 for managerial remuneration	39,05,000

Maximum overall managerial remuneration @11% on Rs,39,05,000
= 4,29,550

Illustration 5

(Calculation of maximum remuneration where there is a managing director)

From the following particulars of R.P.Ltd., calculate the maximum remuneration payable to the Managing Director and other part time directors of the company.

	Rs.
Net profit before provisions for income tax and managerial Remuneration, but after depreciation and provisions for repairs	86,84,100
Depreciation provided in the books	32,00,000
Repairs for machinery provided for during the year	2,50,000
Actual expenditure incurred on repairs during the year	1,50,000

Solution	**Rs.**
Net profit as stated	86,84,100
Excess provision made for repairs and machinery (Rs.2,50,000 – 1,50,000)	1,00,000
Net profit for the purpose of calculating managerial remuneration	87,84,100
Managing Directors @ 5% on Rs.87,84,100	4,39,205
Part time directors @ 1% on Rs.87,84,100	87,841
Total managerial remuneration	5,27,046

Illustration:6

M.E Ltd have authorized capital of Rs.50 lakhs, divided into 5,00,000 equity shares of Rs.10 each. Their books show the following balances as on 31.3.06:

	Rs		Rs
Stock	6,65,000	Bank Current account	20,000
Discount and rebates	30,000	Cash in Hand	8,000
Carriage inwards	57,500	Debenture interest	
Patterns	3,65,000	(for ½ year to 30.9.2005)	20,000
Rates,taxes and insurance	55,000	Interest banks (Dr)	91,000
Furniture and fixtures	1,50,000	Preliminary Expenses	10,000
Materials Purchased	12,32,500	Calls-in-arrears	10,000
Wages	13,05,000	Equity Share Capital	
Coal and Coke	63,000	(2,00,000 share of Rs.10	
Freehold Land	12,50,000	each)	20,00,000
Plant and machinery	7,50,000	8% Debentures	5,00,000
Engineering tools	1,50,000	Bank Overdraft	7,57,000
Goodwill	3,75,000	Sundry Creditors (for	
Sundry Debtors	2,66,000	goods)	2,40,500
Bills receivable	1,34,500	Sales	36,17,000
Advertisement	15,000	Rents (cr)	30,000
Commission and brokerage	67,500	Transfer fees	6,500
Business expenses	56,000	Profit and loss A/c (Cr)	67,000
Repairs	46,500		
Bad debts	25,500		

The Stock (valued at cost or market value whichever is lower) as an 31.3.06 was Rs.7,08,000.

Outstanding Liability for wages Rs.25,000 and Business expenses Rs.25,000.

Dividend declared @8% on paid-up capital.

To Charge depreciation: Plant and Machinery @ 15% Engineering Tools @ 20%. Patterns @ 10% and furniture and fixture @ 10%. Provide 2% on debtors as doubtful debts after writing off Rs.21,500 as bad debts. Write off Preliminary expenses RS.5,000 and create Debenture Redemption Reserve RS.50,000. Provide RS.1,30,000 for income-tax.

Prepare Profit and loss Account for the year ended 31.3.06 and Balance Sheet, as on that date, in accordance with the Companies Act, 1956, giving as much information as necessary, Ignore Previous year’s figures.

Solution:

Profit and loss Account of M.E ltd.
For the year ended 31st Mar,06

Dr	Rs		Rs Cr
To Opening Stock	6,65,000	By Sales	36,17,000
To Materials Purchased	12,32,500	By Closing Stock	7,08,000
To Carriage inwards	57,500	By Rent	30,000
To Wages	13,30,000	By Transfer Fees	6,500
To Coal and Coke	63,000		
To Discount and rebates	30,000		
To Rates,taxes and insurance	55,000		
To Advertisement	15,000		
To Commission and brokerage	67,500		
To Business expenses	81,000		
To Repairs	46,500		
To Bad debts	47,000		
To Debenture Interest	40,000		
To Interest-Banks	91,000		
To Preliminary expenses	5,000		
To Depreciation on Plants and Machinery 1,12,500; Engineering Tools 30,000; Patterns 37,500; Furniture and Fixtures 15,000	1,95,000		
To Provision for Doubtful Debts	4,890		
To Provision for Income-tax	1,30,000		
To Profit for the year c/d	2,05,610		
	43,61,500		43,61,5000
To Debenture Redemption Reserve-transfer	50,000	By Balance as per last year	67,000
To Proposed Dividend	1,59,200	By Profit for the year b/d	2,05,610
To Corporate Dividend Tax @ 12.5 %	19,900		
To Balance c\d	43,510		
	2,72,610		2,72,610

Balance Sheet of M.E ltd. as at 31st March, 2006

Liabilities	Amount	Assets	Amount
Share Capital:		Fixed Assets:	
Authorized Capital		Goodwill	3,65,000
5,00,000 Equity shares		Freehold Land at cost	12,50,000
of RS.10 each	50,00,000	Plant and	
Issued and Subscribed		Machinery** 7,50,000	
Capital		Less: Depreciation 1,12,500	6,37,500
2,00,000 Equity shares		Furniture and	
Of Rs.10 each , fully		Fixtures** 1,50,000	
Called-up 20,00,000		Less: Depreciation 15,000	1,35,000
Less: Calls-		Patterns* 3,75,000	
in arrears 10,000	19,90,000	Less: Depreciation 37,500	3,37,500
Reserves and Surplus:		Engineering	
Debenture Redemption		Tools* 1,50,000	
Reserve	50,000	Less: Depreciation 30,000	1,20,000
Profit and Loss Account	43,510		
Secured Loan:		Investments:	
8% Debentures		Current Assets, loans	
(repayable after 10 years)	5,00,000	And Advances:	
Interest due and payable	20,000	A. Current Assets:	
Bank overdraft**	7,57,000	Stock-in Trade	
Unsecured Loans		(Valued at cost or market	
Current Liabilities and		value whichever is lower)	7,08,000
Provision:		Sundry Debtors 2,44,500	
A. Current Liabilities:		Less: Provision	
Sundry Creditors		For Doubtful Debts 4,890	2,39,610
(for goods)	2,40,500	Cash in Hand	8,000
Outstanding wages	25,000	Bank Balance in Current A/c	20,000
Outstanding expenses	25,000	B.Loans and Advances:	
B.Provisions:		Bills Receivable	1,34,500
Provision for income-tax	1,30,000	Miscellaneous Expenditure:	
Proposed Dividend	1,59,200	Preliminary expenses	5,000
Corporate Dividend Tax	19,900		
	39,60,110		39,60,110

Note: As the rate of dividend is 8% Transfer to Statutory reserve as per Section 205 2(a) is not essential.

Balance Sheet of M.E ltd. as at 31st March, 2006

	Schedule No	Figure as at the end of Current financial year		
I.Sources of Funds		Rs	Rs	Rs
1.Shareholder's funds:				
(a) Capital	1	19,90,000		
(b) Reserves and Surplus	2	93,510	20,83,510	
2. Loan funds:				
(a) Secured loans	3	12,77,000		
(b) Unsecured loans		-	12,77,000	33,60,510
II. Application of funds:				
1. Fixed assets:				
(a) Gross Blocks	4	30,40,000		
(b) less depreciation		1,95,000	28,45,000	
(c) Net blocks			-	28,45,000
(d) Capital work-in –progress				
2. Investments				
3. Current Assets, loans and Advances:				
(a) Inventories valued at cost				
or market value whichever		7,08,000		
is lower		2,39,610		
(b)Sundry debtors		28,000		
(c) Cash and bank balances				
(d) Other current assets		1,34,500	11,10,110	
(e) Loans and advances				
Less: Current liabilities and				
Provisions:	5	2,90,500		
(a)Liabilities		3,09,100	5,99,600	5,10,510
(b) Provisions				
Net current assets				
4.(a) Miscellaneous expenditure				
(to the extent not written of or				
adjusted)				5,000
Preliminary expenses				
(b)Profit and loss Account				33,60,510
Total				

Schedules:

1.Shareholder's Funds:

Capital	
Authorised 5,00,000 equity shares of Rs.10 each	50,00,000
Subscribed and paid-up	
2,00,000 equity shares of Rs.10 each	20,00,000
Less: Calls-in arrears	10,000
Amount as per balance sheet	19,90,000

2.Reserves and Surplus

Debenture Redemption Reserve	50,000
Surplus as per Profit and loss A/c	43,510
Amount as per Balance sheet	93,510

3.Loan Funds:

Secured loans	
8% Debentures	5,00,000
Interest accrued and due	20,000
Bank overdraft	7,57,000
Amount as per Balance sheet	12,77,000

4.Fixed Assets

Particulars	Value given	Depreciation	Written down Value on 31.3.06
Good will	3,65,000	-	3.65,000
Land	12,50,000	-	12,50,000
Plant and Machinery	7,50,000	1,12,500	6.37,000
Furniture and Fixtures	1,50,000	15,000	1,35,000
Patterns	3,75,000	37,500	3,37,500
Engineering tools	1,50,000	30,000	1,20,000
	30,40,000	1,95,000	28,45,000

5.Current liabilities and provisions		
Current liabilities		
Sundry Creditors	2,40,500	
Outstanding Wages	25,000	
Outstanding Business expenses	25,000	2,90,500
Provisions:		
Proposed Dividend	1,59,200	
Corporate dividend tax	19,900	
Taxation	1,30,000	3,09,100
		5,99,600

3.13 LET US SUM UP

Companies have no statutory obligation to prepare final accounts as required under Section 210 of the Companies Act. In addition to general principles, a joint stock company must conform to certain legal provisions as given in the Companies Act,1956 in respect of forms and contents of the final accounts. It may be remembered that the provisions of the Companies Act, 1956 do not apply to Insurance, Banking and electricity companies, which are governed by special Acts relating to such companies.

3.14 LESSON END ACTIVITIES

1. Who is responsible for maintenance of Books of Account? Briefly explain the provisions of company law regarding maintenance of proper Books of account.
2. Explain and illustrate how the following items are to be shown in the Balance sheet of a Company to comply with the requirements of Companies Act, 1956.
   a) Share Capital
   b) Secured Loans
   c) Fixed capital expenditure
   d) Current liabilities
3) What are the statutory requirements relating to profit and loss account of a joint stock company in regard to the following matters?
   a) Raw materials consumed
   b) Foreign exchange earnings
   c) Miscellaneous expenditure
   d) Payment made to managerial personnel

4) Write short notes on :
   a) Miscellaneous expenditure to the extent not written off
   b) Provisions for taxation and dividend
   c) Rights issue
   d) Auditor's report
   e) Directors Report
5) What are the various heads under which profits are usually appropriated by companies and for what reasons?
6) "Published accounts conceal much more than they reveal" Critically examine the statement/
7) What do you understand by the concept of true and fair disclosure in the accounts of a company?
8) State how the matters given below will be dealt with while preparing the profit and loss account for the year ended 31st march 2006
   a) A company whose profit runs into lakhs of rupees and has large inventories finds at the end of March 2006 that the stock sheets, for 31.3.2005 were over cast by Rs.10,000/
   b) The provision of tax at the end of 31.3.2005 stood at Rs.1,50,000 during 2005-06 the tax liabilities were settled for Rs.1,37,000. Provision required in respect of 2005-06 is Rs.41,000/
   c) Government imposed penalty of Rs.30,000 for non-payment of P.F.dues in time.
9) State how you will treat the following while preparing the final accounts of the company concerned for the year ending 31st march 2006.
   a) Land and Buildings (Cost Rs.5,00,000 depreciation provided Rs.80,000) sold for Rs.7,50,000.
   b) It was discovered in September 2005 that the purchase invoice of Rs.50,000 dated 11.2.2004 was not entered in the book at all; accounts for 2003-04 were passed at the AGM in August, 2005.
   c) While preparing the accounts for 2004-2005 closing stock was valued at market price Rs.6,20,000 instead of cost which was Rs.6,50,000
10) A company acquires plant and machinery on 1st October 2005, it paid Rs.30,00,000 to the supplier and incurred transport charges of Rs.1,00,000 installation charges of Rs.1,00,000 in addition to repairs of Rs.1,40,000 because of accidental damage during transit. Depreciation according to Schedule XIV is 15% and its life is estimated at 15 years. The accounts are closed on 31st march each year. What is the figure at which the asset will be capitalized and what is the depreciation charge for the first year?

3.15 REFERENCES

1. Gupta R.L & Radhaswamy M. “Corporate Accounts” Theory method and application- 13^{th} revised edition 2006, Sultan chand & Co.,, New delhi.
2. S.P.Jain & K.L Narang, “ Advanced Accounting “, Kalyani publications, New delhi.
3. Reddy & Murthy, “Financial accounting”, Margham publications, Chennai 2004
4. J.R. Monga – Fundamentals for Corporate Accounting

UNIT - IV

4.0 AIMS AND OBJECTIVES

1) To understand Meaning of Goodwill and the necessity for valuation of Good will.
2) To understand the Types of goodwill and the valuation
3) To understand the factors affecting valuation of goodwill
4) To understand the Valuation of Shares and the various types of valuation.

4.1 INTRODUCTION:

Goodwill may be defined as the value of the reputation of a business house in respect of profits expected in future over and above the normal level of profits earned by undertakings belonging to the same class of business. In other words, goodwill is the present value of a firm's anticipated super normal earnings. The term 'super normal earnings' means the excess of earnings attributable to operating tangible and intangible assets(other than goodwill) over and above the normal rate of return earned by representative firms in the same degree. In his "A dictionary for Accountants", kohler defines goodwill as "the current value of expected future income in excess of a normal return on the investment in net tangible assets….".

4.2 FEATURES OF GOODWILL

a) Goodwill can be sold only with the entire business or it cannot be sold in part or in isolation except on admission or retirement of a partner when a new partner compensate the old partners or the retiring partner gives up his rights in favour of remaining partners.

b) Goodwill is valuable only if it s capable of being transferred from one person to another.

c) Goodwill represents a non physical value over and above the physical assets.

d) Goodwill cannot have an exact cost as its value fluctuates from time to time due to internal or external factors which ultimately affect the fortune of the company.

e) The value of goodwill is based on subjective judgement of the valuer.

4.3 NEED FOR VALUATION OF GOODWILL:

In the case of **partnership**, the necessity of valuation goodwill arises in connection with the following:

(1) When there is a change in the profit-sharing ratio among the partners;

(2) When a new partner is admitted;

(3) When a partner retires or dies; and

(4) When the firm sells its business to a company or is amalgamation with another firm.

In the case of a **joint stock company**, the need for evaluation goodwill may arise in the following cases;

(1) When the business or a company is to be sold to another company or when the company is to be amalgamated with another company.

(2) When stock exchange quotations not being available, shares have to be valued for taxation purpose-gift tax, etc.;

(3) When a large block of shares, so as to enable the holder to exercise control over the company concerned, has to be bought or sold; and

(4) When the company has previously written off goodwill and wants to write it back.

(5) When the company is being taken over by the government.

4.4 FACTORS AFFECTING GOODWILL

The valuation of goodwill depends upon the circumstances of each case. Each business has its own peculiar characteristics and its special set of circumstances and these factors make it difficult to lay down a general formula which will cover all cases

The factors leading to goodwill are the following:

(1) Special locational advantages;

(2) Special commercial advantages such as long-term contract for supply of raw materials at a low price or for sale of finished goods at remunerative prices;

(3) Advantages because of prior entry specially if later is very difficult;

(4) Advantages enjoyed by it because of certain patents available to it;

(5) Technical Know-how possessed by the firm;

(6) The research and development effort; and

(7) Above all,the advantages enjoyed by the superiority of its man-power specially management; this is superior products, better exploitation of markets, new products and new markets,etc.

4.5 FACTORS HAVING A BEARING ON VALUATION;

In addition to what has already been stated, in a valuation, consideration of the following factors is also necessary:

(a) Nature of the industry, its history and the risks to which it is subjected to ;

(b) Prospects of the industry in the future;

(c) The company's history-its past performance and its record of past profits and dividends;

(d) The basis of valuation of assets of the company and their value;

(e) The ratio of liabilities to capital;

(f) The nature of management and the chance for its continuation;

(g) Capital Structure or gearing;

(h) Size, location and reputation of the company's products;

(i) The incidence of taxation;

(j) The number of shareholders;

(k) Yield on shares of companies engaged in the same industry, which are listed in the stock-exchanges;

(l) Composition of purchase of the products of the company; and

(m) Size of block of shares offered for sale since for large blocks very few buyers would be available and that has a depressing effect on the valuation. Question of control, however, may become important, when large blocks of shares are involved.

To put the above in different words, the factors would be:

(i) Profitability: Profitability of a concern is the chief factor in valuation of goodwill. one who pays for goodwill looks to the future profit. The profits that are expected to be earned in future are extremely important for valuation of goodwill. the following are the important factors that have a bearing on future profits and, therefore, the value of goodwill:

(a) Personal skill in management;

(b) Nature of business;

(c) Favorable location

(d) Access to suppliers;

(e) Patents and trade marks protection;

(f) Exceptionally favorable contracts; and

(g) Capital requirements and arrangement of capital.

N.B: A very careful estimate of the profits expected to be earned by the firm and the amount of capital employed to earn such profits, has to be made;

(ii) General reputation which the firms or the company and its management enjoys;

(iii) Yield expected by investors in the industry to which the firm or company belongs.

4.6 DETERMINATION OF FUTURE MAINTAINABLE PROFIT

Determination of future maintainable profits is based on past record is a delicate and complicated task as it involves not only the objective consideration of the available financial information but also subjective evaluation of many other factors, such as capabilities of the company's management, general economic conditions, future Government policies. etc.. Guiding principles can be laid down only in respect of the former and the valuer will have to give due consideration to the other matters according to his reading of the situation in each individual case. The steps necessary to arrive at the future maintainable profits of the company are: (a) calculation of past average taxed earnings; (b) Projection of the future maintainable taxed profits; and (c) adjustments of preferred rights.

(a) Calculation of past average earnings: In order to calculate the past average earnings. it is necessary to decide upon the number of years whose results should be taken for averaging; select these years and adjust their profits to make them acceptable for averaging.

The number of years to be selected must be large enough so as to cover generally the length of a business cycle; an average for a shorter period might not be suitable. but it should not go too far back, e.g., results in the 80's will have no bearing on the results expected in the 90's. In inflationary conditions, that are present today, it is considered that a relatively shorter period may be more representative since it reveals more recent results. Similarly, for companies having steady and gradual growth, average of a shorter period is more useful. In some unusual circumstances, average of still shorter period or even only one year's profit may be more significant in estimating future earnings, such as where a change in the business or a change in trading conditions forces the valuer to discard earlier years and to rely upon one year only or to select certain normal years and exclude others. In all these matters, a sound reasoning would alone aid the valuer. whether a 3 yearly, 5 yearly or longer average would reflect the correct future earnings of a company mostly depends upon the nature of the individual case.

The followings are some items which generally require adjustment in arriving at the average of the past earnings:

(i) Elimination of material non recurring items such as loss of exceptional nature through strikes, fires, floods and theft, etc., profits or loss of any isolated transaction not being part of the business of the company, lump sum compensation of retiring allowances, damages and costs in legal actions, abnormal repair charges in a particular year, etc.

(ii) Elimination of income and profits and losses from non-trading assets.

(iii) Elimination of any capital profit or loss or receipt or expense included in the profit and loss account.

(iv) Adjustments for any interest, remuneration, commission, etc., foregone or overcharged by directors and other managerial personnel.

(v) Adjustments for any matters suggested by notes, appended to the accounts or by Qualifications in the Auditor’s report, such as provision for taxation and gratuities, bad debts, under or over provision for depreciation, inconsistency in valuation of stock, etc..

(vi) Taxation: According to the opinion of the valuer, the tax rates may be such as were ruling for the respective years or the latest ruling rate may be deducted from the average profit. However, the consensus of opinion is for adjusting tax payable rather than tax-paid because so many short-term reliefs and tax holidays might have reduced the effective tax burden.

(vii) Depreciation: it is a significant item that calls for careful review. The valuer may adopt book depreciation provided he is satisfied that the rate was realistic and the method was suitable for the nature of the company and they were consistently applied from year to year. But imbalances do arise in cases where consistently written down value method was in use and heavy expenditure in the recent past has been madein rehabilitating or expanding fixed assets, since the depreciation charges would be unfairly heavy and would prejudice the seller. Under such circumstances, it would be desirable to readjust depreciation suitably as to bring a more equitable charge on the profits meant for averaging.

In averaging past earnings, consideration is to be given to the trend of profits earned. It is indeed imperative that estimation of maintainable profits be based only on the available record. i.e., the record of past earnings, but indiscrete use of past results may lead to an entirely fallacious and unrealistic result.

In this regard, three situations may have to be faced. where the past profits of a company are widely fluctuating from year to year, an average fails to aid future projection. in such cases, a study of the whole history of the company and of earnings of a fairly long period may be necessary. if the profits of a company do not show a regular trend, upward or download, an average of the cycle can usefully be employed for projection of future earnings. In some companies, profits may record a distinct rising or falling trend from year to year; in these circumstances, a simple average fails to consider a significant factor, namely, trend in earnings. The shares of a company which record a clear upward trend of past profits would certainly be more valuable than those of a company whose trend of past earnings indicates a static or doem-trend. In such cases, a weighted average, giving more weight to the recent years than to the past, is appropriate. A simple way of weighting is to multiply the profits by the respective number of the years arranged chronologically so that the largest weight is associated with the most recent past year and the least for the remotest. (similarly, if net worth is under consideration, the respective years average net worth may also be weighted in a similar way).

(b) Projection of future maintainable taxed profits: Projection is more a matter of intelligent guesswork since it is essentially an estimation of what will happen in the risky an uncertain future. The average profit earned by a company in the past could be normally taken as the average profit that would be maintainable by it in the future, if the future is considered basically as a continuation of the past. If future performance as the company is viewed as departing significally from the past, then appropriate adjustments will be called for before accepting the past average profit as the future maintainable profit of the company. These are stated below:

(i) Discontinuance of a part of the business;
(ii) Under-utilization of installed capacity;
(iii) Expansion Programmes;
(iv) Major change in the policy of the company; and
(v) Adjustment for rehabilitation and replacement.

(c) Adjustments of Preferred rights: In arriving at the average profits and their future projection, all charges including interest on debentures and other borrowings are of course deducted. But the dividend on preference shares should also be considered after the estimate of future profits has been arrived at. Dividends payable to preference shareholders, according to the terms of their issue, should be deducted from the maintainable profit.

4.7 NORMAL RATE OF RETURN:

Normal rate of return is the rate of return that the investors in general expect on their investments in a particular industry. This rate differs from industry to industry. The normal rate of return is required to be adjusted in the light of certain circumstances, i.e.,

(i) Risk attached to the investment: If a business is having more risk the risk of return should also be more. Risk may be due to high borrowings or by the mature of business.
(ii) Period of investment: The longer the period of investment, the higher is the rate of return
(iii) Higher bank rate: An increase in bank rate gives higher expectations to the investors.
(iv) Boom period: When there is a boom in the industry, the investors have higher expectations and the normal rate of return is to be increased.

4.8 CAPITAL EMPLOYED

The goodwill of a business depends on the amount of capital employed also. the term 'capital employed' for the valuation of goodwill should be calculated from the point of view of shareholders. Capital employed may be expressed as the aggregate of share capital and reserves less the amount of non-trading assets and fictitious assets and deducting all liabilities. For this purpose, the amount of debentures or loans should also be excluded from capital employed. Of course any profit or loss on revaluation of assets should be taken into account.

It is considered desirable to use average capital employed in place of ' capital employed' because the capital must be such as may fairly represent the capital investment throughout the year. Average capital employed is the end of the year. But if the current year's profit is not disturbed during the year itself the average capital employed is to be ascertained by deducting half the profit from capital employed at the end. This is appropriate for goodwill to be ascertained by reference to current year's profit and current year's capital employed.

Illustration 1

Exe Ltd. gives you the following summarized balance sheet as at 31st March, 2006:

11% Preference share capital	5,00,000	Fixed Assets:		
Equity share capital	20,00,000	Cost	50,00,000	
Reserves and surplus	25,00,000	Depreciation	30,00,000	20,00,000
10% loans	27,00,000	Capital work-in-progress		40,00,000
Current liabilities and provisions	15,00,000	6% Government securities		5,00,000
		Current Assets		25,00,000
		Underwriting commission		2,00,000
	92,00,000			92,00,000

The company earned a profit of Rs.9,00,000 after tax @ 50% in 2005-2006. The capital work in progress represents additional plant equal to half the capacity of the present plant it will be immediately operational, there being no difficulty in sales. With effect form 1st April,2006 , two additional part-time directors are being appointed at Rs.75,000 p.a. Ascertain the future maintainable profit and the capital employed, assuming the present replacement cost of fixed assets is Rs.1,00,00,000 and the annual rate of depreciation is 10% an original cost.

Solution:

Future Maintainable Profit:

		Rs
After-tax profit at present		9,00,000
Add. Tax		9,00,000
Depreciation-10% of Rs.50,00,000		5,00,000
Present profit before depreciation and tax		23,00,000
less: Interest of Investments (non-trading income)		30,000
		22,70,000
Add: Increase in profit since sales will increase by 50%		11,35,000
		34,05,000
less: Depreciation @ 10% on Rs.1,00,00,000	10,00,000	
on Rs. 40,00,000	4,00,000	
	14,00,000	
Annual remuneration	1,50,000	15,50,000
		18,55,000
less: Tax @ 50%		9,27,500
Future Maintainable Profit		9,27,500

Capital Employed:

Fixed Assets-Present Replacement cost		1,00,00,000
Depreciation (adjusted)		60,00,000
		40,00,000
Additions to plant		40,00,000
		80,00,000
Current Assets		25,00,000
		1,05,00,000
less: 10% loans	27,00,000	
Current liabilities and provisions	15,00,000	42,00,000
Alternatively:		63,00,000

		Rs
Preference share capital		5,00,000
Equity share capital		20,00,000
Reserves and surplus-At present	25,00,000	
Profit on Revaluation	20,00,000	45,00,000
		70,00,000
less: Non-trading assets, Investments	5,00,000	
Underwriting Commission	2,00,000	7,00,000
Capital Employed		63,00,000

4.9 METHODS OF VALUING GOODWILL:

There are basically two methods of valuing goodwill: (i) Simple Profit method;
(ii) Super profit method.

4.10 SIMPLE PROFIT METHOD:

Goodwill is sometimes valued on the basis of a certain number of years' purchase of the average profits of the past few years. While calculating average profits for the purpose of valuation of goodwill certain adjustments are made. Some of them are the following:

(a) All actual expenses and losses not likely to occur in the future are added back to profits;

(b) Expenses and losses expected to be borne in future are deducted from such profits;

(c) All profits likely to come in the future are added: and

(d) Even actual profits not likely to recur are deducted

After having adjusted profit in the light of future possibilities, average profits are estimated and then the value of goodwill is estimated by a particular number, representing ascertained and then the average is multiplied by a particular number, representing the number of years' purchase. if goodwill is to be valued at 3 years' purchase of the average profits which come to Rs.20,000, the goodwill will be Rs.60,000. i.e., 3*Rs.20,000.

This method has nothing to recommend itself since goodwill is attached to profits over and above what one can earn by starting a new business and not to total profits. it ignores the amount of capital employed for earning the profits. However, it is usual to adopt this method for valuing the goodwill of the goodwill of the practice of a professional person such as a chartered accountant or a doctor.

4.11 SUPER PROFIT METHOD

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

(1) A normal rate of return for representative firms in the industry.

(2) The fair value of capital employed.

(3) Estimated future maintainable profit.

Example:

In the Illustration no.1 given above, suppose the investors are satisfied with 12% return, then normal profit will be Rs.7,56,000 i.e., 12% of Rs.63,00,000. The future maintainable profit being rs.9,27,500, super profit will be Rs.1,71,500.

There are three methods of calculating goodwill based on super profit which are as under:

(a) (i) Purchase of Super Profit Method:

Goodwill as per this method is: Super profit * A certain number of years. Under this method, an important point to note is that the number of years of purchase as goodwill will differ from industry to industry and from firm to firm. Theoretically, the number of years is to be determined with reference to the probability of a new business catching up with an old business. Suppose it is estimated that in four years time a business, if Started de novo, will be earning about the same profits as an old business is earning now, goodwill will be equivalent to four times the super profits. In the example given above, goodwill will be Rs.6,86,000. i.e., 4* Rs.1,71,500.

(**ii) Sliding Scale Valuation of Super Profit :**

This method is a variation of the purchase method. This has been advocated by A.E. Cutforth and is based upon the theory that the greater the amount of Super Profit, the more difficult it would be to maintain. In this method the super profit is divided in to two or three divisions. Each of these is multiplied by a different number of years purchase, in descending order from the first division. For example, if super profit is estimated at Rs.2,25,000. Goodwill be calculated as follows:

	Rs
First Rs.75,000 say 5 years	3,75,000
Second Rs.75,000 say 4 years	3,00,000
Third Rs.75,000 say 3 years	2,25,000
Total goodwill	9,00,000

(b) Annuity Method of Super Profit:

Goodwill as per this method is: Super profit* Annuity of re.1 at the normal rate of return for the stated number of years. Goodwill in this case is the discounted value of the total amount calculated as per purchase method. The idea behind super profit method is that the amount paid for goodwill will be recouped during the coming few years. But in this case, there is a heavy loss of interest. hence, properly speaking what should be paid now is only the present value of super profits paid annually at the proper rate of interest.Tables show that the present value @ 12% oe Re.1 received annually for four years is 3.037. In the above illustration, the value of goodwill under this method will be Rs.5,20,845. i.e 3.37*1,71,500.

(c) Capitalisation of super profit:

In this method, the amount of super profit is capitalized at the normal rate of return. in other words, this method tries to find out the amount of capital needed for earning the super profit. the formula is:

$$\frac{\text{Average Annual super profit} * 100}{\text{Normal rate of return}}$$

In the example given above, the value of goodwill will be Rs.14,29,167 i.e..

$$\frac{1{,}71{,}500*100}{12}$$

There is also another method of capitalization frequently used. under this method adjusted average profits are capitalized on the basis of normal rate of return and from such a value, the net assets of the business are substracted to arrive at the value of goodwill.

In the illustration given above, value of total business will be Rs.77,29,167 or say Rs.77,29,200. Therefore goodwill will be 14,29,200. i.e., Rs.77,29,200 less Rs.63,00,000.

This method puts a very large value on goodwill. Really it is useful only when the future maintainable profit is less than the normal profit. it then determines the proper value of the firm.

Suppose the total net tangible assets of a company is Rs.50,00,000. the normal rate of return in the concerned industry is 14%; and the company earns the profit of Rs.8,40,000. The total value of the business will be Rs.60,00,000, i.e

$\frac{8{,}40{,}000*100}{14}$ In that the goodwill be Rs.10lakhs. The normal profit being Rs.

7,00,000, the super profit will be Rs.1,40,000; goodwill, therefore, will be more than seven years purchase. This is too high since it is not expected that super profits will continue for as long as seven years.

Suppose on the other hand, that the future maintainable profit is Rs.6,30,000. In that case the total value of business will be Rs.45 lakhs, i.e., $6{,}30{,}000*\frac{100}{14}$

There is naturally no goodwill since the actual profit is less than the normal profit. However, it will be improper to pay Rs.50 lakhs for the business since then the earning will not be 14%. The proper value of the business is Rs. 45lakhs.

Illustration 2

A Ltd. proposed to purchase the business carried on by M/s. X & Co. Goodwill for this purpose is agreed to be valued at three years purchase of the weighted average profits of the past four years. The appropriate weights to be used are:

2002-03	1	2004-05	3
2003-04	2	2005-06	4

The profit for these years are 2002-03 – Rs. 1,01,000: 2003-04 –Rs. 1,24,000: 2004-05 – Rs.1,00,000 and 2005-06 – Rs. 1,40,000.

On a scrutiny of the accounts the following matters are revealed:

(i) On 1st December, 2004 a major repair was made in respect of the plant incurring Rs. 3,00,000 which was charged to revenue. The said sum is agreed to be capitalized for goodwill calculation subject to adjustment of depreciation of 10% p.a.on reducing balance method.

ii) The closing stock for the year 2003-04 was overvalued by Rs.12,000.

iii) To cover management cost an annual charge of Rs. 24,000 should be made for the purpose of goodwill valuation.

Compute the value of goodwill of the firm.

Solution:

Calculation of Adjusted Profits

.		Rs
Profits-2002-03		1,01,000
Less: Management expenses		24,000
Adjusted Profits -2002-03		77,000
Profits-2003-2004		1,24,000
Less: Over-valuation of closing stock	12,000	
Management expenses	24,000	36,000
Adjusted Profits-2003-2004		88,000
Profits-2004-2005		1,00,000
Add: over- valuation of opening stock	12,000	
Major repairs of plant to be treated		
As capital expenditure	30,000	42,000
		1,42,000
Less: Depreciation on capital expenditure		
@ 10% p.a for 4 months from		
December 1,2004 to mar 31, 2005		

$\frac{30{,}000 * 10 * 4}{100 * 12}$	1,000
	1,41,000
Less: Management expenses	24,000
Adjusted profits-2004-2005	1,17,000
Profits-2005-2006	1,40,000
Less: 10% depreciation on Rs.29,000 (book value Rs.30,000-Rs.1,000- Capital expenditure)	2,900
	1,37,100
Less: Management expenses	24,000
Adjusted Profits-2005-2006	1,13,100

Calculation of Average profits

Year ended 31st march	**Profits** Rs	**weight**	**Product**
2002-2003	77,000	1	77,000
2003-2004	88,000	2	1,76,000
2004-2005	1,17,000	3	3,51,000
2005-2006	1,13,100	4	4,52,400
			10,56,400

Average profits = 10,56,400/10 = 1,05,640
Goodwill at three years purchase = Rs.1,05,640 x 3
= Rs.3,16,920

Illustration:3

From the following information ascertain the value to goodwill of X ltd. under super profit method.

Balance sheet as on 31st march, 2006

Liabilities	Rs	Assets	Rs
Paid-up capital:		Goodwill at cost	50,000
5,000 shares of Rs.100 each		Land and buildings at cost	2,20,000
fully paid	5,00,000	Plant and machinery at cost	2,00,000
Bank overdraft	1,16,700	Stock in trade	3,00,000
Sundry creditors	1,81,000	Book debts less provision	

Provision for taxation	39,000	for bad debts	1,80,000
Profit and loss appropriation Account	1,13,300		
	9,50,000		9,50,000

The Company commenced operations in 2000 with a paid-up capital of Rs. 5,00,000. Profits for recent years(after taxation) have been as follows:

Year ended 31st march	Rs
2002	40,000
2003	88,000
2004	1,03,000
2005	1,16,000
2006	1,30,000

The loss in 2002 occurred due to a prolonged strike.

The income-tax paid so far has been at the average rate of 40%. But it is likely to be 35% from April 2006 onwards. Dividends were distributed at the rate of 10% on the paid up capital in 2003 and 2004 and the rate of 15% in 2005 and 2006. The market price of share is ruling at Rs. 125 at the end of the year ended 31st March 2006. Profits till 2006 have been ascertained after debiting Rs. 40,000. As remuneration to the director, the company has approved a remuneration of Rs. 60,000 with effect from 1st April, 2006. The company has been able to secure a contract at an advantageous price thereby it can save materials worth Rs.40,000 per annum for the next five years

Valuation of Goodwill of X ltd.

Solution:

(i) Capital employed:		Rs
Land and building at cost		2,20,000
Plant and Machinery		2,00,000
Stock in trade		3,00,000
Sundry Debtors		1,80,000
		9,00,000
Less: Sundry Liabilities:		
Bank overdraft	1,16,700	
Sundry Creditors	1,81,000	
Provision for taxation	39,000	3,36,700

	Capital employed at the end of the year		5,63,300
Add back:			
	Dividend paid for the year	75,000	
less:	Half of the year	65,000	10,000
	Average Capital employed		5,73,300

(ii) Normal rate of Return:

Average Dividend for the last 4 years 12.5%
Market price of shares on 31st March Rs.125

Normal Rate of Return : 12.5 x100 /125

Note:
It may be more appropriate to relate the normal rate of return to the dividend paid in the last two years since price is related to dividend expected in future and, for that, the most recent experience is relevant.

In that case,the normal rate of return will be 15 x 100/125 = 12%

(iii) Normal profit on average capital employed :

@ 10% on Rs.5,73,300	57,330
@ 12% 0n Rs.5,73,300	68,796

(iv) Future maintainable Profit- Weighted Average:

Year ended 31st march	Profit Rs	Weight	Product Rs
2003	88,000	1	88,000
2004	1,03,000	2	2,06,000
2005	1,16,000	3	3,48,000
2006	1,30,000	4	5,20,000
		10	11,62,000
Average Annual profit (After tax)			1,16,200
Average Annual Profit (before tax)			
1,16,200x100/60			1,93,667
Adjustments:			
(i) Increase in remuneration		-20,000	
(ii) Saving in cost of materials		+40,000	20,000
			2,13,667
Less: Taxation @ 35%			74,783
Future maintainable Profit			1,38,884

(v) Super Profits	Normal rate 12% Rs	Normal Rate 10% Rs
Average Maintainable Profits	1,38,884	1,38,884
Normal Profit on capital employed	68,796	57,330
Super Profit	70,088	81,554
Goodwill at 5 years purchase of super profits	3,50,440	4,07,770
Goodwill at 3 years purchase	2,10,264	2,44,662

Note:
Three to five years purchase of super profits can be taken as fair value of goodwill. thus, depending on the assumptions regarding the normal rate of return and the number of years purchase, goodwill may range between Rs.2,10,264 and Rs.4,07,770 .

4.12 VALUTION OF SHARES

The valuation of shares is necessitated because of the non availability of market price for a proprietary company and even if it is available the price doesnot reflect the true or intrinsic value of shares.

The necessity for valuation of shares arises inter alia in the following circumstances:

(i) Assessments under the wealth Tax or Gift Tax Acts.

(ii) Purchase of a block of shares which may or may not give the holder thereof a controlling interest in the company.

(iii) Purchase of a shares by employees of the company where the retention of such shares is limited to the period of their employment.

(iv) Formulation of schemes of amalgamation, absorption, etc.

(v) Acquisition of interest of dissenting shareholders under a scheme of reconstruction.

(vi) Compensating shareholders on the acquisition of their shares by the Government under a scheme of rationalization.

(vii) Conversion of shares, say, preference into equity.

(viii) Advancing a loan on the security of shares.

(ix) Resolving a deadlock in the management of a private limited company on the basis of the controlling block of shares being given to either of the parties.

Normally, the price prevailing on the stock exchange is accepted. However, valuation by expert is called for when parties involved in the transactions/deal/scheme, etc., fail to arrive at a mutually acceptable value or the agreements or Articles of Association, etc., provide for valuation by experts. For isolated transactions of relatively small blocks of shares which are quoted on the stock exchanges, generally ruling stock exchange price provides the basis. Thus,
valuation by a valuer becomes necessary when:

(i) Shares are unquoted,

(ii) Shares relate to provide limited companies.

(iii) Courts so direct.

(iv) Articles of Association or relevant agreements so provide.

(v) Large block of shares is under transfer.

(vi) Statutes so require.

4.13 METHODS OF VALUATION OF SHARES

As stated earlier, principally two basic methods are used for share valuation: one on the basis of net assets and the other on the basis of earning capacity or yield.

4.13.1. Net Assets Basis or Intrinsic Value Method

The method relating to asset may take various forms depending upon circumstances:
(i) Break –up value method (or liquidation value method);
(ii) Appraised value method: and
(iii) Book value method.

Depending on the circumstances of the case, goodwill may not be included. Goodwill comes in for distinct consideration only when the number of shares involved is large giving to the holder a measure of control. Normally, earning represents the result of application of all assets of every description in the business, whether it is plant and machinery or goodwill or patent or know-how; for a small number of shares in a going concern, earning is the only appropriate basis.

Valuation on the basis of assets is generally not recommended for a going concern, because, there the predominant factor is yield: but for certain types of companies, for example, investment companies, assets basis valuation may be acceptable since yield itself will depend almost wholly on the assets position. In case of a company in respect of which no realistic yield or earning capacity is discernible, because of highly uneven past results, valuation only on assets basis may be acceptable.

For a company which shows consistent loss over a number of immediate past years and which has no apparent prospect of recovery, the appropriate method would be the break-up value method. According to Sidney, an authority in share valuation, the realizable value of assets, for arriving at the break-up value, should be discounted at rates varying from 20% to 33 1/3% for taking care of realization losses and expenses.

Book value method does not have any practical application except to disclose the unexpired costs of asset of a going concern which were acquired in the course of the company's operations. But statutes like the Gift Tax Act, Wealth Tax Act, etc., have in fact adopted book value method for valuation of unquoted equity shares for companies other than an investment company. Book value of assets does help the valuer in determining the useful employment of such assets and their state of efficiency. In turn, this leads the valuer to the determination of rehabilitation requirements with reference to current replacement values.

In all cases of valuation on assets basis, except book value basis, it is important to arrive at current replacement and realization value. It is more so in case of assets like patents, trademarks, know-how,etc., which may possess values substantially more or less than those shown in the books.

4.14 THE MECHANISM OF ASSET VALUATION

(i) Arrive at the current replacement costs of assets for valuation based on appraisal or, in the case of a firm which is not a going concern, determine the net reliasable value for break-up valuation and deduct there from all liabilities in the books of account and such other liabilities which have not been recorded but are likely to rank for payment, and the amount payable to preference shareholders. The approach should be conservative. Under provision for taxation, liabilities on account of gratuities arrears of preference dividends, etc., are instances, of what may not appear in books.

(ii) If circumstances suggest existence of goodwill from a study of the profit record, particular advantages, etc., the same should be evaluated with reference to any method appropriate for the purpose, i.e purchase of net profit or purchase of gross earning or by reference to super profit, etc., for addition to the result obtained in (i) above

(iii) The result, as arrived at, shall represent the asset value for the whole undertaking; to arrive at value per share, the same should be dividend by the number of equity shares in the company provided all shares are equally paid-up. If the company has equity shares of varying fully paid-up values, the total value should first be allocated to the different paid-up value groups and each such allocation would be divided by the number of shares in each of such groups.

(ii) Yield Basis

Yield basis valuation may take the form of valuation based on rate and productivity factor.
(a) Valuation Based on Rate Return

Rate of returns to the returns which a shareholder earns on his investment. It may be classified into (a) Rate of dividend and (b) Rate of earning.

Valuation based on rate of dividend: This method of valuation is suitable for small blocks of shares because small shareholders are usually interested in dividends. The value of a share according to this method is ascertained as follows:

$$\text{Value of share} = \frac{\text{Possible rate of dividend}}{\text{Normal rate of dividend}} \times \text{Paid up value per share}$$

OR

$$= \frac{\text{Dividend (in rupees) per share}}{\text{Normal rate of dividend}} \times 100$$

$$\text{Possible rate of dividend} = \frac{\text{Total profit available for dividend}}{\text{Total paid up equity capital}} \times 100$$

(a) In other words, dividend on equity shares should be calculated by deducting from the maintainable profits

(2) Taxation;

(3) Transfers to reserve;

(4) Transfers to debenture redemption fund;

(5) Preference dividend, and

(b) By dividing the remaining by the number of shares.
Valuation based o rate of earning: This method of valuation of shares is suitable for valuing large blocks of company's shares because they are more interested in company's earnings rather than what the company distributes in the form of dividends.

$$\text{Value of share} = \frac{\text{Rate of earning}}{\text{Normal rate of earning}} \times \text{Paid up value of share}$$

$$\text{Rate of earning} = \frac{\text{Actual profit earned} \times 100}{\text{Capital employed}}$$

Rate of earning is calculated by taking into account the total capital employed including long time borrowings. Since the total capital is taken into account the profit figure should be before debenture interest, preference dividend but after income tax. This is quite appropriate when the divided is much more than the rate of earning on capital.

Valuation based on price earning ratio: This method is suitable for ascertaining the market value of shares which are quoted on a recognized stock exchange. According to this method, the shares are valued on the basis of earning per share multiplied by price earning ratio. Thus,

$$\text{Market value of share} = \text{Price Earning ratio} \times \text{Earning per share}$$

$$\text{Earning per share} = \frac{\text{Profit available for equity shareholders}}{\text{Number of equity shares}}$$

$$\text{Price earning ratio} = \frac{\text{Market value per share}}{\text{Earnings per share}}$$

OR

$$\text{Price earnings ratio} = \frac{100}{\text{Normal rate of return}}$$

Capitalization factor: The value of a share according to yield basis can also be ascertained by finding out the capitalization factor or the multiplier. The capitalization factor will be ascertained by dividing 100 by the normal rate return. The profit available is capitalized by multiplying it with the capitalization factor. The value of equity share is obtained by dividing the capitalized value by the number of equity shares.

(b)Valuation Based on productivity Factor

Productivity factor is a concept of relative earning power. It represents the earning power in relation to the value of assets employed for such earnings. This gives a ratio which is applied to the net worth of the business as on the valuation date to arrive at the projected earning figure for the company. This projected earning after necessary adjustments (discussed later) shall be multiplied by the appropriate capitalization factor to arrive at the value of the company's business. The total value is divided by the number of equity shares to ascertain the value of each share.

The productivity factor valuation is really a method for arriving at a reliable figure of future profits. The steps are the following:

(i) Take a number of years whose results are relevant to the future. Determine net worth of the business at the commencement and close of each of the accounting years under consideration and find out the average net worth for each year by adding the opening and closing net worth and dividing the result by 2; and, in turn, arriving at the average net worth of the business during the period under study.

(ii) Determine the net worth of the business on the valuation date.

(iii) Ascertain the average, weighted, if necessary, adjusted profit earned during the years under consideration.

(iv) Find out the percentage that (iii) bears to (i); that represents the productivity factor i.e $\dfrac{\text{Average (weighted) profit x 100}}{\text{Average (weighted) networth}}$

(v) Apply the productivity factor as obtained in (iv) above to the net worth on the valuation date to find out the projected income in future.

(vi) Adjust the projected taxed income for factors like appropriations for provision for replacement and rehabilitation of plant and equipment, tax, dividends on preference shares, under utilization of productive capacity, effects of restrictions on monopoly, etc.

(vii) Determine the normal rate of return for the company, having particular regard to the nature and size of the undertaking.

(ix) Apply the multiplier obtained in (viii) above to the adjusted projected taxed income to arrive at the capitalized value of the undertaking.

(x) Divide the result in (ix) above by the number of equity shares to arrive at the value per share.

In this context, it may be noted that vary often companies have non-trading assets like investments and sometimes idle assets in their balance sheets. The income from non - trading asset does not reflect the earning power of the company and consequently that part of income should be taken out of consideration in determining the average maintainable profit. Also, the value of non-trading and idle assets, after proper determination, should be excluded in the determination of networth at each stage. But non-trading assets should be added to the value of undertaking as obtained in (ix) above.

4.15 DETERMINATION OF NORMAL RATE OF RETURN AND CAPITALIZATION FACTOR:

This obviously has a tremendous bearing on the ultimate result, but unfortunately it is subjective and, therefore, valuers differ more widely in this area than any other in the whole valuation process. As a general rule, the nature of investment would decide the rate of return, companies, investment in which is more risky would call for a larger rate of return, and, consequently they will have a lower capitalization factor and lower valuation than companies with assured profits. For investments in Government securities, the risk is least and, consequently, an investor would be content with a very low rate of return. In a logical order, we find mortgage debentures, being riskier than government paper, require slightly higher rate of return. Preference shares are less risky than equity shares
but more risky than mortgage debenture; preference shares rank in between debentures and equity shares in the matter of return. Equity shares are exposed to highest risks and, consequently, the normal rate of return is highest in case of equity shares, though equity shares of progressive and soundly managed companies, provide a safeguard against inflation – equity share prices are likely to rise sufficiently high to counteract the effect of a rise in prices.

The above also applies to companies and industries and the normal rate of return will always depend on the attendant risk. In this respect, net tangible asset backing is relevant. The higher net tangible asset backing for each share , greater would be the confidence of the investor. Normally, 2 to 3 times backing is considered satisfactory. This ratio should be reviewed carefully to ascertain whether shares are inadequately covered or too much covered which may indicate over capitalization in the form of idle funds or inadequate use of productive resources. Symptoms suggesting idle assets would be holding of large cash and bank balances, high current ratio, unutilized land, plant and machinery, etc. The normal rate of return should be increased suitably in either case. Further, if any disabilities attach to the concerned share such as the share being party paid, the normal rate of return would be higher.

If the concerned company has special features, the normal rate of return will have to be suitably modified. Thus, the following additional factors are to be considered:

(i) Restrictions on transfer of shares –The normal rate of return will be increased say, by ½%.

(ii) Disabilities attached to shares will also cause the normal rate of return to go up e.g. if shares are partly paid-up, the investors will expect a high yield (say by ½% higher) than in case of fully paid shares.

(iii) Dividend performance –stability in dividend will decrease the normal rate.

(iv) Financial prudence on the part of the company's management also affects the normal rate of return. A company which distributes only a part of the profit will attract investors without offering high yield.

(v) Net asset backing is important from the point of view of safety. The poor net asset backing will increase the normal rate since the investors consider themselves unsafe.

4.16 FAIR VALUE OF SHARES

The fair value of a share is the average of the value of shares obtained by the net asset method and the one obtained by yield method. Under net assets method, the value of an equity share is arrived at by valuing the assets of a company and deducting therefrom all the liabilities and claims of preference shareholders and dividing the resultant figure by the total number of equity shares with the same paid up value. Under yield method, the value of an equity share is arrived at by comparing the expected rate of return with the normal rate of return. If the expected rate of return is more than normal rate of return, the market value of the share is increased proportionately.

The fair value of shares can be calculated by using the following formula:

$$\text{Fair value of share} = \frac{\text{value by net assets method + Value by yield method}}{2}$$

Or (Intrinsic value + Yield value)/ 2

This method is also known as dual method of share valuation. This method attempts to minimize the demerits of both the methods. This is of course, no valuation but a compromised formula for bringing the parties to an agreement. However it is recognized in Government circles for valuing shares of investment companies for wealth tax purposes.

4.17 SPECIAL FACTORS FOR VALUATION OF SHARES

Valuation of equity shares must take note of special features in the company or in the particular case. These are briefly stated below:

4.17.1. Importance of the size of the block of shares:

Valuations of the identical shares of a company may vary quite significantly at the same point of time on a consideration of the size of the block of shares under negotiation. It is common knowledge that the holder of 75% of the voting power in a company can alter even the provisions of the articles to suit himself; a holder of voting power exceeding 50% and than less than 75% can substantially influence the operations of the company even to alter the articles of association or comfortably pass a special resolution.

Even persons holding less than 50% of the total voting strength in a public limited company may control the affairs of the company, if the shares carrying the rest of the voting power are widely scattered; such shareholders rarely combine to defeat a determined block. Usually a person holding 10 to 15% of the total voting powers is in a position to have his way in the company- even to change the provisions of the articles of association or pass any special resolution.

The above analysis is associated with the concept of the controlling interest, which according to most authorities carries a separate value to the tune of additional 10to 20% of the value of shares otherwise obtained.

4.17.2 Restricted transferability:

Along with principal considerations of yield and safety of capital, another important factor is the easy exchangeability or liquidity. Shares of reputed companies generally enjoy the advantage of easy marketability which is of great significance to the holder. At the time of need, he may get cash in exchange of shares without being required to hunt out a willing buyer, or without being required to go through a process of protected negotiation and valuation. Generally quoted shares of good companies are preferred for the purpose. On the other hand, holders of shares of unquoted public companies or of private companies do not enjoy this advantage; therefore, such shares, however good, are discounted for lack of liquidity at rates which may be determined on the basis of circumstances of each case. The discount may be either in the form of a reduction in the value otherwise determined or an increase in the normal rate of return. Generally, the articles of private companies contain provisions for offering shares to one who is already a member of the company and this necessarily restricts the ready market for the shares. These shares are also discounted for limited transferability. But exceptions are also there; by acquisition of a small back, if one can extend his holding in the company to such an extent as to effectively control the company, the share values may not be depressed in that deal.

4.18 DIVIDENDS AND VALUATION

Generally companies paying dividends at steady rates enjoy greater popularity and the prices of their shares are high while shares of companies with unstable dividends do not enjoy confidence of the investing public as to the returns they expect to get and consequently they suffer in valuation. For companies paying dividends at unsteady rates, the question of risk also becomes great and it depresses the price. The question of risk may be looked upon from another angle. A company which pays only a small proportion of its profit as dividend and thus builds up reserves is less risky than the one which has a high pay out ratio. The dividend rate is also likely to fluctuate in the latter case. Investors, however, do not like a company whose pay-out ratio is too small.

Shares are generally quoted high immediately before the declaration of dividend if the dividend prospect is good; or immediately after the declaration of dividend (if it is satisfactory) to take care of the dividend money that the prospective holder would get.

4.19 BONUS AND RIGHT ISSUES

Share values have been noticed to go up when bonus or right issues are announced, since they indicate an immediate prospect of gain to the holder although, in the ultimate analysis, it is doubtful whether really these can alter the valuation. Bonus issues are made out of the accumulated reserves in the employment of the business, which in no way contribute to the increased earning capacity of the business and ultimately depress the dividend rate since the same quantum of profit would be distributed over a larger number of shares. However, a progressive company generally picks up the old rate of dividend after a short while but this is no way a result of bonus; it is the contribution of nature growth potential of the company. However, in the case of right issues, the existing holders are offered the shares forming part of the new issue; more funds flows into the company for improving the earning capacity. Share values will naturally depend on the effectiveness with which new funds will be used.

4.20 VALUATION OF PREFERENCE SHARES:

These are valued on yield basis in a going concern. Compared to Equity shares, the rate of return in preference shares would be generally, lower because of greater safety. With fluctuations in the normal rate of return in respect of preference shares,the value of preference share will fluctuate but in the opposite direction, i.e., if the normal rate of return increase, the value tends to diminish. For instance,12%preference shares of rs.100 each would be valued at Rs.85.72 when the expected rate of return is 14% (i.e., 12/14x100). The same share would be valued at Rs.120 if the expected rate of return is 10% (i.e.,12/10x100). In case the 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 preference share calculated.

As stated earlier, a valuer must exercise his own judgement in valuing preference shares, because of the diminishing real value of the fixed preference dividend.This is considered to be a handicap for sellers in an inflationary economy. The yield based Valuation of preference shares would hold good only if:

(i) the dividend on the share has been paid regularly and it is reasonably expected that it would continue to be paid; and

(ii) that investment is adjudged by the criteria that the total assets of the concern are equal to 4 or 5 times the preference capital.

Preference shares may have certain additional rights, for example, the right to get an additional share of profits or the right to get the share converted into equity shares at a certain rate. The right to get an additional share of profit will probably increase the market value of the share depending upon the size of the total profit and conditions under which the additional dividend will come to preference share holders. Total yield per share will have to be worked out and on that basis the market value will be ascertained by the formula:

$$\frac{\text{Total yield per share}}{\text{Normal rate of yield}} \times 100$$

The right to get the preference share converted into equity share will be valuable only if the equity share of the company commands good value in the market. As against this, there will also be the possibility that wholesale conversion into equity shares may depress the dividend on these shares and thus bring down their price. The price of such a right will be roughly equal to the difference in the market value of an equity share and the conversion price. Suppose holders of preference shares of Rs.100 have a right to convert their holding into equity shares at the end of 3 years at Rs.130 per equity share and the market value of the equity share at the time is likely to be Rs.160 which is not likely to be affected by the conversion. The right of conversion in the circumstances would be ultimately worth Rs.30 (Rs.160 minus Rs.130). Taking 12% as the proper rate of interest, the present value of such a right (discounting it @ 12% for 3 years) would be Rs.21.36. The preference share therefore will command a value based upon its yield plus Rs.21.36.

Illustration:4

From the following figures calculate the value of a share of Rs.10 on (i) dividend basis, and (ii) return on capital employed basis, the market expectation being 12%.

Year ended 31st march	**capital employed** Rs.	**profit** Rs.	**Dividend (%)**
2003	5,00,000	80,000	12
2004	8,00,000	1,60,000	15
2005	10,00,000	2,20,000	18
2006	15,00,000	3,75,000	20

Solution:

(i)Valuation of share on dividend basis:

The dividend rate on the simple average is 65/4 or 16 x1/4%. But since the dividend has been rising it would be better to take the weighted average which come to 17.6% - thus:

Year ended 31st March	**Rate**	**weight**	**product**
2003	12	1	12
2004	15	2	30
2005	18	3	54
2006	20	4	80
		10	176

Dividing 176 by, we get 17.6%

The value of the share on the basis of dividend (weighted average) should be

$$\frac{17.6}{12} \text{x} 10 = \text{Rs.}14.67$$

(ii) Valuation of share on return on capital employed basis:

The return on capital employed for each year and its weighted average is as follows:

Year ended 31st march	**Return on capital** employed %	**weight**	**Product**
2003	16	1	16
2004	20	2	40
2005	22	3	66
2006	25	4	100
		10	222

Weighted average is 22.2%

The value of the share should be:

$$\frac{22.2}{12} \times 10 = \text{Rs.}18.50.$$

Illustration:5

Balance sheet of Diamond ltd. as on 30.6.2006

Liabilities	Rs
Share Capital:	
2,000,shares of Rs.100 each	2,00,000
General Reserve	40,000
Profit and loss account	32,000
Sundry creditors	1,28,000
Income Tax reserve	60,000
	4,60,000
Assets:	
Land and Buildings	1,10,000
Plant and machinery	1,30,000
Patents and trade marks	20,000
Stock	48,000
Debtors	88,000
Bank Balance	52,000
Preliminary expenses	12,000
	4,60,000

The expert valuer valued the land and buildings at Rs.2,40,000; goodwill at Rs.1,60,000; and Plant and machinery at Rs.1,20,000. Out of the total debtors, it is found that debtors of Rs.8,000 are bad. The profits of the company have been as follows:

	Rs
31.3.2004	92,000
31.3.2005	88,000
31.3.2006	96,000

The company follows the practice of transferring 25% of profits to general reserve. Similar type of companies earn at 10% of the value of their shares. Ascertain the value of shares of the company under:

(i) Intrinsic Value Method;
(ii) Yield value Method;
(iii) Fair Value Method;

Solution:

Diamond Ltd.

Valuation of shares:

(i) Intrinsic value method:

Assets	**Rs**
Land and buildings	2,40,000
Goodwill	1,60,000
Plant and machinery	1,20,000
Patents and trade marks	20,000
Stock	48,000
Debtors less bad debts	80,000
Bank balance	52,000
	7,20,000
Less:	
Liabilities:	
Sundry creditors	1,28,000
Net assets	5,92,000

Intrinsic value of shares (each share) $= \dfrac{\text{Net Assets}}{\text{No.of Shares}}$

$= \dfrac{\text{Rs.}5{,}92{,}000}{2{,}000} = \text{Rs.}296.$

(ii) Yield value method:

	Rs
Total profit of last three years	2,76,000
Less: Bad debts	8,000
	2,68,000

Average profit $= \dfrac{\text{Rs.}2{,}68{,}000}{3} =$ 89,333

Add: Decrease in depreciation on plant and machinery say @10% on Rs.1,30,000	13,000
Average profit	77,833
Less: Transfer to reserve @ 25% of Rs.77,833	19,458
Profit available for dividend	58,375

$$\text{Rate of dividend} = \frac{Rs.58,375}{2,00,000} \times 100 = 29.187\%$$

$$\text{Yield value of each share} = \frac{\text{Rate of Dividend}}{\text{Normal rate of return}} \times \text{paid-up value of each share}$$

$$= \frac{29.187}{10} \times 100 = Rs.291.87$$

(iii)Fair value method:

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

$$= \frac{Rs.296 + Rs.291.87}{2} = Rs.293.93$$

Illustration:6

The balance sheet of super sound ltd. as at 31st March,2006 is given below:

Liabilities	**Rs**	**Assets**	**Rs**
Share Capital:		Buildings	2,25,000
9,000 equity shares		Machinery	3,30,000
of Rs.100 each,		Stock	4,50,000
fully Paid-up	9,00,000	Sundry debtors	2,40,000
Profit and loss account	75,000	Bank	90,000
Bank overdraft	15,000		
Creditors	90,000		
Provision for taxation	1,65,000		
Provision for dividends	90,000		
	13,35,000		13,35,000

The net profits of the company after deducting usual working expenses but before providing for taxation were as under:

Year	Rs
2003-04	3,00,000
2004-05	3,60,000
2005-06	3,30,000

On 31st March, 2006, building was revalued at Rs.3,00,000.Machinery at Rs.3,75,000 and sundry debtors on the same date including Rs.10,000 as irrecoverable. Having regard to nature of the business, 10% return on net tangible capital invested is considered reasonable.

You are required to value the company's share ex-dividend. Valuation of goodwill may be based on three years purchase of annual super profits. Rate of depreciation on buildings is 20% and on machinery is 10%. The income-tax rate is ti be assumed at 35%. All workings should form part of your answer.

Solution:

In the books of super sound Limited

Calculated of value of Equity share:

	Rs	Rs
Goodwill- WN. (v)		2,72,800
Buildings (revalued value)		3,00,000
Machinery (revalued value)		3,75,000
Stock		4,50,000
Sundry Debtors		2,30,000
Bank		90,000
Total Assets:		17,17,800
Less: Liabilities:		
Bank Overdraft	15,000	
Creditors	90,000	
Provision for taxation	1,65,000	
Proposed Dividend	90,000	3,60,000
Net Assets		13,57,800

Value of an equity share = Net Assets/No.of Equity shares

= Rs.13,57,800/9,000= Rs.150.87

Working Notes:

(**i) Calculation of Average Capital Employed:**

Closing Capital Employed:

Assets

Building (revalued)	3,00,000
Machinery (revalued)	3,75,000
Sundry Debtors (less bad debts)	2,30,000
Stock	4,50,000
Bank	90,000
	14,45,000

Less: Liabilities

Bank overdraft	15,000	
Sundry Creditors	90,000	1,05,000
Closing Capital employed		13,40,000
Less: 50% of profit before tax		1,65,000
Average Capital employed		11,75,000

(ii) Calculation of normal rate of returns on average capital employed:

Average Capital Employed x NRR/100 = Rs.11,75,000 x 10/100= Rs.1,17,500

(iii) Calculation of future Maintainable Profits:

Average profits of last three years =Rs.3,00,000 + Rs.3,60,000+Rs.3,30,000

		Rs
Cumulative Profits		9,90,000
Less: Bad debts		10,000
		9,80,000
Average Profits=Rs.9,80,00/3 =		3,26,667
Less: Depreciation on revaluation of assets		
	Rs	
2% on Rs.75,000 =	1,500	
10% on Rs.45,000 =	4,500	6,000
		3,20,667.00
Less: Income tax @ 35%		1,12,233.45
Future maintainable Profit		2,08,433.55

(iv) Calculation of super Profits

= Future Maintainable Profit - Normal Rate of return
= Rs.2,08,433.55 - Rs.1,17,500 =Rs.90,933.55

(v) Calculation of Goodwill:

Super profits x 3years purchase =Rs.90,933.55 x3 =Rs.2,72,800.

Illustration:7

From the following particulars calculated the value of share of Z ltd. on yield basis:

Balance sheet of Z ltd. as on 31st march, 2006.

Liabilities	**Rs**	**Assets**	**Rs**
8,000 equity shares		Land and buildings	5,00,000
of Rs.100 each	8,00,000	Plant and machinery	6,00,000
4,000 9% preference		Patents	2,00,000
Shares of Rs.100 each	4,00,000	Sundry Debtors	3,00,000
10% Debentures	2,00,000	Work-in-progress	
Reserves	4,00,000	and stock	5,00,000
Sundry creditors	4,00,000	Cash at bank	1,00,000
	22,00,000		22,00,000

Land and buildings to be valued at Rs.9,00,000. The company's earnings were,

Year ended	**Profits before tax**	**Tax paid**
31st march	Rs	Rs
2002	3,00,000	80,000
2003	4,00,000	1,60,000
2004	1,00,000	40,000(strike)
2005	5,00,000	2,30,000
2006	5,50,000	3,00,000

The company paid managerial remuneration of Rs.60,000 per annum but itwill become Rs.1,00,000 in future. There has been no change in capital employed. The company paid dividend ofRs.9 per share and it will maintain the same in future. The company proposes to build up a plant rehabilitation reserve. Dividend rate in this type of company is fluctuating and the asset backing of an equity share is about 1-1/2 times.
The equity shares with an average dividend of 8% sell at par. (tax rate is assumed to be 40%)

Solution:

Average maintainable profits in future.2003-2004 not considered because of low profits for abnormal reasons:

Year ended 31st March	Profits Rs	weight Rs	Product
2002	3,00,000	1	3,00,000
2003	4,00,000	2	8,00,000
2004	-	-	-
2005	5,00,000	3	15,00,000
2006	5,50,000	4	22,00,000
		10	48,00,000

	Rs
Weighted average:	4,80,000
Adjustment:	
Less: Increase in managerial remuneration	40,000
	4,40,000
Less: Tax @40%	1,76,000
Profit available for distribution	2,64,000
Less: Rehabilitation Reserve (12.5% estimated)	33,000
	2,31,000
Less: Dividend on preference shares	36,000
Profit available for distribution to equity shareholders	
	1,95,000

Rs.195,000 capitalised at 8%=Rs.1,95,000x100 =Rs.24,37,500

The value of equity share will be = $\frac{\text{Rs.24,37,500}}{8,000}$ = 304.69

=Rs.305.00 (Approximately)

Altermatively:

Assets backing per equity share:		Rs
Total Asset as per balance sheet		22,00,000
Add: Increase in value of land and buildings		4,00,000
		26,00,000
Less: Sundry Creditors	4,00,000	
10% Debentures	2,00,000	
9% Preference shares	4,00,000	10,00,000
Net assets available for equity shareholders		16,00,000
Equity share capital		8,00,000

Asset backing	2times
Normal dividend rate	8.0%
Less: For higher dividend rate (9%) and stability (say)	0.5%
Less: For higher asset backing 2 times as compared to 1.5times) (say)	
Adjusted normal rate of return	0.5%
	7.00

Capital employed:

Equity share capital	8,00,000
9% preference share capital	4,00,000
10% Debentures	2,00,000
Reserves	4,00,000
Increase in value of land and buildings	4,00,000
	22,00,000
Profit after tax	2,64,000
Add: Debenture interest (after effect of income tax)	12,000
Profit earned	2,88,000

Rate of earning: $\frac{\text{Rs.2,88,000}}{\text{Rs.22,00,000}} \times 100 = 13.09\%$

(since the capital employed includes the amount of debentures, debenture interest after the effect of income tax has been adjusted.)

alue of share:

on actual dividend basis = 9/7 x100 = Rs.129(appx)

on earning basis = 13.09/7 x100 = Rs.187

Illustration:8

Year ended 31st March	Average networth (excluding investmant) Rs	Adjusted taxed profit Rs
2004	18,50,000	1,80,000
2005	21,20,000	2,00,000
2006	21,30,000	2,30,000

The aforesaid figures relate to a company which has Rs.10,00,000 on equity shares of Rs.100 each and Rs.3,00,000 in 9% preference shares of Rs.100 each. The company has investments worth Rs.2,50,000 (at market value) on the valuation date the yield in respect of which has been excluded in arriving at the adjusted tax profits figures. It is usual for similar type of companies to set aside 25% of the taxed profit for rehabilitation and replacement purpose. On the valuation day the net worth (excluding investment) amounts to Rs.22,00,000. The normal rate of return expected is 9%. The company paid dividends consistently within a range of 8 to 10% on equity shares over the previous seven years and the company expects to maintain the same. Compute the value of each equity share on the basis of productivity.

Solution:

Since both profits and net worth of the company are showing a steady growth, it would be reasonable to attach due weightage to them foe valuation purposes.

Year ended 31st march	Average Networth Rs	Adj.taxed Profit Rs	Weight factors	Weighted Networth Rs	Profit Rs
2004	18,50,000	1,80,000	1	18,50,000	1,80,000
2005	21,20,000	2,00,000	2	42,40,000	4,00,000
2006	21,30,000	2,30,000	3	63,90,000	6,90,000
			6	1,24,80,000	12,70,000
weighted average				20,80,000	2,11,667

Productivity Factor = $\frac{\text{Rs.2,11,667}}{\text{Rs.20,80,000}}$ x 100 =10.18%

	Rs
Net worth on valuation date = Rs.22,00,000	
Projected future maintainable profit = 10.18% of Rs.22,00,000	2,23,960
less: Rehabilitation and replacement @ 25%	55,990
	1,67,970
less:Preference Dividend	27,000
	1,40,970
Rs.1,40,970 capitalised @ 9 rate of return would be	15,66,334
Add: Value of investments	2,50,000
Value of 10,000 equity shares	18,16,334

Therefore, the value of each equity share would be = $\frac{18,16,334}{10,000}$ = Rs.181.63

Illustration:9

From the following balance sheet of M.P products ltd. Find out the values of equity shares and preference shares:

Balance sheet of M.P Products ltd.

Liabilities	**Rs**	**Assets**	**Rs**
20,000 equity shares of Rs.10 each	2,00,000	Goodwill	25,000
		Machinery	1,60,000
8% 1,000 preference shares of Rs,100 each	1,00,000	Furniture	5,000
		Stock	80,000
Reserves	30,000	Debtors	1,50,000
Profit and loss account	10,000	cash	2,000
Sundry creditors	60,000	Preliminary expenses	3,000
proposed preference dividend	8,000		
other liabilities	12,000		
overdraft	5,000		
	4,25,000		4,25,000

Goodwill is valued at Rs.15,000. Stock is overvalued by Rs.10,000, Machinery is Undervalued by Rs.15,000.

Solution:

		RS
Net Assets:		
Goodwill		15,000
Machinery		1,75,000
Furniture		5,000
Stock		70,000
Debtors		1,50,000
Cash		2,000
		4,17,000
Less: Liabilities		
Creditors	60,000	
Proposed preference dividend	8,000	
overdraft	5,000	
Other liabilities	12,000	85,000
		3,32,000
Less:Preference share capital		1,00,000
Net Assets for equity shareholders		2,32,000

Intrinsic Value of equity shares: Rs.2,32,000 / 20,000 =Rs.11.60 per share.

Intrinsic value of preference shares:

Rs.100 + proposed dividend Rs.(8,000 /1,000= Rs.8) = Rs.108 per share.

If they are participating preference shares, the excess of net assets less preference share capital over the paid -up value of equity shares will be distributed over equity shares and preference shares converting them to equivalent number of same paid-up values. The share is to be added to the paid up amount of the respective shares. The total excess may also be distributed in the ratio of equity capital and prefernce capital. Participating shares in this connection are taken to mean that they participate in surplus in liquidation pari-passu with equity shares. In reality, the articles of association will govern the situation.

Assuming the preference shares in illustration above are participating shares. Determine the values of equity shares and preference shares, assuming they rank Pari-passu.

	Rs
Net assets less preference share capital (as above)	2,32,000
less: Equity share capital	2,00,000
	32,000

Equivalent number of equity and preference shares:

20,000 equity shares equivalent to	20,000 shares of Rs.10 each
1,000 preference shares equivalent to	10,000 shares of Rs.10 each
	30,000 shares of Rs.10 each

Surplus per share of Rs.10 = $\frac{\text{Rs.}32{,}000}{30{,}000}$ = Rs.1.07

Hence the value of equity shares: Rs.10 + Rs.1.07 = Rs.11.07 per share.

Value of preference shares : Rs.100 + Rs.8 + (Rs.1.07x10)=Rs.118.70

or, the surplus of Rs.32,000 may be dividend between equity capital and preference capital in the ratio of 2:1, i.e., Rs.21,333 and Rs.10,667 respectively.

Values of shares:

Equity : $\frac{2{,}00{,}000 + 21{,}333}{20{,}000} = \frac{2{,}21{,}333}{20{,}000} = 11.07$

Preference: $\frac{1{,}00{,}000 + 10{,}667 + 8{,}000}{1{,}000} = \frac{1{,}18{,}667}{1{,}000} = 118.67$

4.21 LET US SUM UP

Share forms the basis of ownership in the Company and the people who contribute the money. The valuation of Goodwill and Shares has to be done when there is no market price as in the case of Proprietary company and where for special reasons, the market price does not reflect the true or intrinsic value of shares/Goodwill. This problem does not arise if the shares are quoted on the stock exchange as it provide a ready means of ascertaining the value placed on such shares by buyers and sellers. The valuation depends on the purpose the nature of business, demand and supply, the government policy, past performance of the company, growth prospects of the company and many other related factors.

4.22 LESSON-END ACTIVITIES

1. Explain the factors that affect the valuation of goodwill and shares.
2. Ramesh runs a general store. His net assets on 31st Marchm2006m amounted to Rs.20,00,000. After paying a rent of Rs.20,000 a year and salary of Rs.10,000 to the manager, he earns a profit of Rs.1,50,000. His landlord is interested in acquiring the business. 8% is considered to be a reasonable return on capital employed. What can Ramesh expect as payment for Goodwill?
3. Sita Ltd., is desirous of selling its business to another company and has earned an average profit in the past of Rs. 60,000 per annum. It is considered that such average profit fairly represents the profit likely to be earned in the future except that (a) Director's fee Rs.4,000 charged against such profits will not be payable by the purchasing company whose existing board can easily cope with the additional administrative work at the present fees payable to the directors. (b) Rent at Rs.8,000 p.a. which had been paid by the vendor company will not be charged in future, since the purchasing company owns its own premises and can supply the accommodation necessary for the staff and equipment of the vendor company. The value of the net tangible assets of the vendor company at the beginning of the year i.e. 12 months before the date of purchase, was Rs.7,30,000. It was considered that a reasonable return on capital invested, for the type of company was 8%. The profit of the vendor company and goodwill existed and was to be paid for on the basis that vendor company was a continuing enterprise. Calculate the value of goodwill.
4. Renga Co Ltd., is to be absorbed by Ram Co Ltd and in order to decide upon the purchase consideration, it is necessary, amongst other things, to value the good will attaching to the business of Ranga Co Ltd., The two companies agree that the basis of the calculation of goodwill shall be three years purchase of the average annual

super profits, the net profits being averaged over five years and subject to whatever adjustments you, as the accountant for making the valuation, consider necessary. The profits of Ranga Co Ltd., for the last five years ending 31st March (before charging income tax @40% on income) are as follows: 2002 Rs.5,00,000 2003 Rs.6,50,000 2004 Rs.4,50,000 2005 Rs.5,50,000 and 2006 Rs. 7,50,000. The Directors of Renga Co Ltd., (3 in number) will be appointed to the Board of Ram Co. ltd on absorption and it is considered that their services have been (and will be in the future) worth Rs.50,000 each per annum. There has never been made any charge against the profits of Ranga Co Ltd., for such services. The average capital invested in tangible assets over the period is Rs.18,00,000. And it is considered that the normal return to be expected from the particular type of business carried on by Ranga Co Ltd.,is 10%. Calculate the goodwill of Ranga Co Ltd.,

5. It is provided in the Articles of Association that on the death of a shareholder, his shares shall be purchased by the remaining shareholders at a price to be settled by the Auditors. On the basis of the last balance sheet. It is further provided that for this purpose, goodwill was to be of the value of three years' purchase of the average annual profits for the last four years. The last balance sheet is as follows:

Liabilities	Rs.	Assets	Rs.
Capital		Goodwill	1,00,000
20,000 shares of		Investment at cost	
Rs.10 each fully	2,00,000	(market value Rs1,25,000	
Paid	1,50,000		
Reserve	1,00,000	Stock at cost	2,50,000
Debentures	2,00,000	Debtors	1,50,000
Sundry Creditors	1,50,000	Cash	35,000
Profi & Loss A/c	35,000		
	6,85,000		6,85,000

The profits for the last four years were (after tax) Rs.15,000, 20,000, 25,000 and 40,000 respectively.

You are required to state with details of working the price which should be paid per share.

4.23 REFERENCES

1. Gupta R.L & Radhaswamy M. "Corporate Accounts" Theory method and application- 13th revised edition 2006, Sultan chand & Co.,, New delhi.
2. S.P.Jain & K.L Narang, " Advanced Accounting ", Kalyani publications, New delhi.
3. Reddy & Murthy, "Financial accounting", Margham publications, Chennai 2004

UNIT - V

5.0 AIMS AND OBJECTIVES

i) To know the Meaning, definition of Liquidation of companies.

ii) To study the modes of winding up

iii) To study the procedure to prepare Statement of affairs & Liquidators' final statement.

5.1 INTRODUCTION

A company comes into being through a legal process and also comes to an end by the same legal process. Liquidation is the legal procedure by which the company comes to an end. Thus, a company being a creation of law cannot die a natural death. A company, when found necessary, can be liquidated. Insolvency proceedings are not applicable to a company as are applicable to an individual or partnership firms. For liquidation of limited company liquidation proceedings are applied. But it may be mentioned that the insolvency of a company is not a necessary condition for its liquidation; a solvent company can also be liquidated.

If you cannot pay your business debts when they become due, or if the assets of your business are less than your debts, your business is insolvent.

Liquidation (or "winding up") is a process by which a company's existence is brought to an end.

Unless you pay those debts quickly, then the insolvency will lead to bankruptcy or winding up. Bankruptcy applies to individuals such as sole traders and those that have given personal guarantees for loans. Winding up and liquidation apply to companies.

5.1.1 Avoiding bankruptcy and winding up

To keep your business solvent you should bear the following in mind:

- Do not allow your debts to exceed your assets.
- Keep an eye on your cashflow.
- Choose the right business structure.
- Implement good credit-control structures.
- Take care before offering personal guarantees for business loans.

If your assets – e.g. stock, buildings, machinery or debts owed to you - equal the amount of loans and debts that you owe then you are in a situation where all of your capital could be wiped out.

Your creditors effectively own your business and if the value of the assets fall further your creditors could realise that their money is at risk and want it back. This would make you insolvent, as you wouldn't be able to pay them all.

To avoid this you need to make sure that your capital is maintained. You should try to keep your own capital up by holding back profits where possible. Do not be tempted to take on loans that would increase your borrowing far above your own investment in the business.

Even though you are making profits and have enough capital you can still become insolvent if you cannot make payments on time. You need to make sure you have a good cashflow so that you can pay debts on time. A common problem is to take on too much debt while chasing new business. This is known as overtrading. Careful planning and forecasting will help you to avoid this. See our guide on how to avoid the problems of overtrading

5.2 MODES OF WINDING UP OR LIQUIDATION

Section 425(1) of the Companies Act provides that a company can be liquidated in any of the following three ways:

(i) Compulsory winding up by the court;

(ii) Voluntary winding up by the members or creditors;

(iii) Winding up under the supervision of the court.

Generally (unless the contrary appears), the provisions of the Act with respect to winding up apply to winding up of a company whether it be by the court or voluntary or subject to the supervision of the court [Section 425 (2)].

Liquidations are also classified according to whether the company is solvent or insolvent.

5.2.1 Solvent and insolvent liquidations

If the company is insolvent, this means it is unable to pay its debts as they fall due. In this situation there is potential conflict between creditors (those to whom money is owed), as there will be insufficient assets for all creditors to be paid in full.

The law attempts to maintain an equality between creditors, so the assets are distributed proportionately according to the size of each creditor’s claim. However, the law gives priority to secured creditors (those with a charge over some of the company’s property as security for the debt). In addition, a number of rules exist to prevent one or more creditors from gaining an unfair advantage.

5.2.2 Winding up Under Supervision of the Court

Your company can also be wound up by compulsory liquidation under a court order. If there are sufficient assets, the official receiver will call a first meeting of creditors to appoint an insolvency practitioner as liquidator. When a company is being wound up voluntarily, the court under Section 522 of the Companies Act, at any time after a company has passed a resolution for voluntary winding up, may make an order that voluntary winding up shall continue but subject to the supervision of the Court. Such an order is passed by the Court on the application of any creditor or contributory or liquidator or the company itself when the liquidator under voluntary winding up is prejudiced or is negligent in collecting the assets of the company or the resolution for winding up was obtained by fraud. The liquidator will continue to exercise all powers but powers will be exercisable subject to any restrictions or conditions laid down by the court. This type o winding up is made to safeguard the interest o the creditors and contributors or members of the company.

5.2.3. Contributory

According to Section 428 of the Companies Act, 1956, a contributory is “every person liable to contribute to the assets of a company in the event of its being wound up, and includes a holder of fully paid-up shares, and also any person alleged to be contributory”. A contributory can be either a preset member or a past member. A present member is that member whose name is included in the register of member when the shares held by him if the amounts is needed to make the payment to the legal claimants. In the case of a company limited by guarantee, he is liable for the amount undertaken to be contributed by him in the event of the company being wound up.

The holders of fully paid up shares are also treated as contributories even though they are not to contribute to the assets of the company because it is necessary to complete a list of all the members of the company so that the court may be able to know, not only those who will contribute but also who will share the surplus assets, if any. The present members are included in “A” List of contributories. It may be remembered that a contributor’s liability is legal and not contractual as he cannot set off his debts against his liability for unpaid amount on shares held by him even if there is an express agreement to do so.

On the other hand, past members are those members who ceased to be shareholders (except by death) within one year of the winding up of the company and can be called upon to pay if the present contributories are not able to pay the liabilities of the company. As regards past members, section 426 of the companies Act provided as follows:

(a) A past members is not liable to contribute in respect of any liability of the company contracted after he ceased to be a member of the company.

(b) A past member is not liable to contribute if he ceased to be a member of the company for one year or upward before the commencement of the winding up.

(c) A past member is liable to contribute only if it appears to the court that present members are unable to make the contributions required to be made by them in pursuance of the Companies Act.

(d) In the case of a company limited by shares, no contribution is required from any past member excluding the amount)if any) unpaid on the shares in respect of which he is liable as such member.

(e) In the case of a company limited by guarantee, no contribution is required from any past member excluding the amount undertaken to be contributed by him in the event of the company being wound up.

The past members are included in “B” list contributories.

5.2.4 Fraudulent Preference.

Fraudulent preference takes place when one creditor is preferred to another creditor in the matter of payment of his dues. The object of the Companies Act is pari passu distribution amongst creditors; so it has been provided in Section 531 that every transfer of property or money made within 6 months before the commencement of the winding up, which amounts to fraudulent preference, is invalid.

Voluntary transfer. All voluntary transfers, made by the company within a period of one year before the presentation of a petition for winding up or the passing of a resolution for voluntary winding up, are void as against the liquidator.

5.3 EMPLOYEES AND OFFICERS

According to Section 444, a winding up order operators as a notice of discharge to the employees and officers of the company, except when the business of the company is being continued. A voluntary winding up also operates as a notice of discharge.

5.4 INTEREST ON LIABILITIES

Interest on liabilities is payable upto the date of actual payment if the company is solvent. But if the company is insolvent, interest on liabilities is payable up to the date of commencement of insolvency proceedings.

5.5 LIQUIDATOR

In case of compulsory winding up, the official liquidator attached to each High Court will become the liquidator after the winding up order is passed. The company must submit a Statement of Affairs to such liquidators within 21 days of the passing of the winding up order. This statement shows assets at realizable values and liabilities at values expected to rank and shows surplus or deficiency as per list H. The Official Liquidator must convene a meeting of the creditors within 2 months of the winding up order to ascertain whether they like to appoint a “Committee of Inspection”. The committee so appointed should not have more than 12 members, made up of equal number representing creditors and contributories. In case of voluntary winding up, the voluntary liquidator is appointed by a resolution in general meeting of the company and/or of the creditors. The general duties of the liquidator are to take into his custody or under his control all the property of the company and its effects and actionable claims and pay the right claimants.

5.6 CREDITORS’ VOLUNTARY LIQUIDATION (CVL)

If your company becomes unable to pay its debts and no **arrangement** or period of **administration** is likely to save it then you, as director, can propose a **creditors' voluntary liquidation (CVL)**.

The amounts realized from the assets not specifically pledged and the amounts contributed by the contributories must be distributed by the liquidator in the following order:

(1) Expenses of winding up including the liquidator’s remuneration.

(2) Creditors,(i.e., debentures etc.) secured by a floating charge on the assets of the company..

(3) Preferential creditors (they are unsecured even if they enjoy priority).

(4) Unsecured creditors.

(5) The surplus, if any, amongst the contributories, (i.e. preference shareholders and equity shareholders) according to their respective rights and interests.

5.7 ORDER OF PAYMENT

(a) Preference shareholders. Preference shareholders get the priority over the equity shareholders as regards the payment of their capital and the dividend payable upto the date of the winding up. The holders of cumulative preference shares are entitled to arrears of dividend if there is a surplus after the return of the amount of the equity share capital or if the Articles state that arrears of preference dividend are to be paid before anything is paid to equity shareholders. In the latter case the arrears of dividend must be paid even by contributions from equity shareholders if equity shares are party paid.

(b) Equity Shareholders. Any surplus left after making the payment of the preference shareholders is distributed among equity shareholders pari passu if all shares are equally paid up. But if the shares are called in unequal proportions, the liquidator should see that the capital contribution by the shareholders should be the same. For example, a company has issued equity shares of Rs.10 each, but if the shares of some shareholders have been called up Rs.7 per share and those of other shareholders Rs.5 per share. Further, if the amount realized from the sale of he assets is not sufficient to pay the liabilities and the cost of the winding up, the liquidator will make a call of Rs.2 per share on those shareholders who have paid Rs.5 per share to bring their capital contribution equal to other shareholders. A further call, if necessary, would be made equally on all equity shareholders. In case of surplus of assets, the shareholders who have paid Rs.7 per share will get preference of rs.2 per share and if still there is a surplus, all equity shareholders will be entitled to pari passu distribution.

It may be remembered that calls-in-advance will have priority on repayment over the paid up share capital of that class.

Preferential creditors are paid out of the proceeds of the assets not specifically pledged, surplus from the assets specifically pledged and amount contributed by the contributories after retaining the amount necessary for the payment of legal expenses ,cost of winding up and liquidator’s remuneration but before making any payment to other claimants. It must be remembered that preferential creditors are in the nature of unsecured creditors who have priority of claims over other unsecured creditors not because of any security held by them but because of Section 530 of the Companies Act.

5.8 THE PREFERENTIAL CREDITORS

(a) All revenues, taxes , cess and rates, whether payable to the Government or local authority, due and payable by the company within 12 months before the date of commencement of winding up.

(b) All wages or salaries (including commission earned) of any employee in respect of services rendered to the company and due for a period not exceeding four months within the said twelve months before the relevant date such sum may be specified by the Government in the Official Gazette in respect of each claimant. Such sum has been specified as Rs.20,000 w.e.f.from March,1997.

Salaries due to an officer like director, maneger, secretary, assistant secretary, branch manager etc. are not preferential.

(c) All accrued holiday remuneration becoming payable to an employee on account of the termination of his employment before or on account of winding up.

Note. Persons who advance money for the purpose of making preference payments under (b) and (c) above will be treated as preferential creditors.

(d) Unless the company is being wound up voluntarily for the purpose of reconstruction or amalgamation, all contributions payable during the 12 months previous to the winding up, by the company as the employer of any person, under Employees’ State Insurance Act,1948 or any other law for the time being in force.

(e) All sums due as compensation under Workmen’s compensation Act,1923 unless the winding up is for reconstruction or amalgamation.

(f) All sums due to an employee from a provident fund, pension fund, gratuity fund, or any other fund maintained for the welfare of the employees.

(g) The expenses of any investigation held under section 235 or 237 in so far as they are payable by the company.

The forgoing preferential creditors rank equally among themselves and must be paid in full unless the assets are not sufficient to meet their claims, in which case they shall abate proportionately.

5.9 DUE TO WORKERS

In order to protect the interest of workers, Section 529 has been amended by the Companies (Amended) Act, 1985.As per this amendment the legitimate dues of the workers will rank pari passu with secured creditors in the event of the liquidation of the company. Dues ton workers will be above even the dues to government. The security of every secured creditors, according to this amendment, shall be deemed to be subject to a pari passu charge in favour of workmen to the extent of workmen's portion therein. As per Section 2 (s) "workman means any person (including an apprentice) employed in any industry to any skilled or unskilled, manual, supervisory, technical or clerical work for hire or reward. The terms of employment may be express or implied. It includes any person who has been dismissed, discharged or retrenched in connection with, or as a consequence of an industrial dispute or whose dismissal, or discharge, or retrenchment has led to that dispute."

The following persons are specified excluded from the definition of workman.

(1) A person who is subject to the Army Act, 1950, or the Air Force Act,1950 or the Navy (Discipline) Act, 1934.

(2) A person who is employed in the police service or as an officer or other employee of a prison.

(3) A person who is employed mainly in a managerial or administrative capacity.

(4) A person who is employed in a supervisory capacity and draws wages exceeding Rs.1600 per month or exercise functions mainly of a managerial nature"

Section 529A added in the Companies Act in 1985 makes provision for overriding preferential payment. This Section gives priority in payment to workmen's dues and debts due to secured creditors to the extent they could not be paid because of the former, ranking pari passu with the latter as provided in section 529. The unpaid amount of dues to workmen and Secured creditors after making payment as per section 529 shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

5.10 WHAT ARE THE CONSEQUENCES OF LIQUIDATING A COMPANY?

The main consequences of the company being liquidated are as follows:

- The company no longer has the power to dispose of its property.
- The company may carry on business only for the limited purpose of completing the liquidation process.
- The powers of the company directors come to an end when a liquidator is appointed.
- A liquidation order operates as a notice of dismissal to all of the company's employees. Note, however, that if an employee is on a fixed-term contract and is required under this contract to be given a period of notice, then a liquidation order will breach this and the employee will be entitled to damages.
- When an application is made for a court-ordered liquidation, the court may stay or restrain any proceedings against the company as the court sees fit. When a liquidator is appointed, no person can begin or continue legal proceedings against the company or in relation to its property, unless the liquidator agrees or the court permits it.

5.11 FORM OF STATEMENT OF AFFAIRS

Statement as to the affairs of …..ltd., on the ….day of …..19…… being the date of the winding up order appointing Provisional Liquidator or the date directed by the official Liquidator as the case may be showing assets of estimated realizable values and liabilities expected to rank.

	Assets not specially pledged (as per list A) Balance at Bank Cash in hand Marketable Securities Bills Receivable Trade Debtors Loans & Advances Unpaid Calls Stock-in-trade work-in-progress _______________ Freehold Property, Land & Buildings Leasehold Property Plant& Machinery Furniture Fittings, Utensils etc. Livestock	Estimated Realizable Value Rs

Other Property, viz..

* Asset specially pledged (as per List 'B')	(a) Estimated realizable values Rs	(b) Due to Secured Creditors Rs	(c) Deficiency ranking as unsecured Rs	(d) Surplus carried to last column Rs
Freehold Property				

Estimated Surplus from assets specially pledged
Estimated total assets available for preferential creditors,
Debenture holders secured by a floating charge, and unsecured
creditors (carried forward).

SUMMARY OF GROSS ASSETS

Gross realizable value of assets specially pledged
Other Assets
GrossAssets

Liabilities

(to be deducted from surplus or added to
deficiency as the case may be)
Secured Creditors (as per list 'B') to the extent to which
claims are estimated to be covered by assets specially
Pledged item (a) or (b) whichever is less
(Insert in 'Gross Liabilities' column only)
Preferential Creditors (as per list 'C')
Estimatedbalanceofassetsavailablefordebentureholders
Secured by a floating charge and unsecured Creditors)**
Debenture holders secured by a floating charge (as per list 'D')
Estimated Surplus/ Deficiency as regards Debenture holders
Unsecured Creditors (as per list 'E')
Estimated unsecured balance of claims of creditors partly
secured on specific asset, brought from preceding page
Trade Accounts
Bills payable
Out standing Expenses

Contingent Liabilities (state nature)

	Estimated Surplus/Deficiency as regards Creditors (being difference between Gross Assets and Gross Liabilities Issued and Called-up Capital: Rs Preference Shares of ………each Called-up (as per list 'F') Equity Shares of …….each ………..Called-up (as per list 'G') Estimated Surplus / Deficiency as regards Members (as per list 'H')	

* Notes:

1. All assets specially mortgaged, pledged, or otherwise given as security should be included under this head. In the case of goods given as security, those in possession of the company and those not in possessions, should be separately set out.
2. The figures must be read subject to the following:

(a) There is no unpaid capital liable to be called up or the nominal amount of unpaid capital liable to be called up is Rs…..estimated to produce Rs…… which is not charged in favour of Debenture holders.

(b) The estimates are subject to cost of the winding up and to any surplus or deficiency on trading pending realization of assets.

5.11.1 Procedure of Preparation of Statement of Affairs:

For the preparation of statement of Affaires, the following points are worth-noting:

(1) First of all, take all assets which are not specifically pleadged. These assets are taken at their realizable values and not at book values because creditors for their payment are concerned with the realizable values of the assets. It may be noted that calls in arrears are also treated as an asset not specifically pledged to the extent of estimated realizable amount, but uncalled capital is not shown as an asset.

(2) Add to the realizable value of the assets not specifically pledged, any surplus from assets specifically pledged.

(3) From the total as obtained by adding (1) and (2) first deduct the amount of preferential creditors, then the amount of creditors having a floating charge (e.g. debentures)and the result will be surplus or deficiency as regards debenture holders.

(4) Deduct the amount of unsecured creditors from the figure as obtained in (3) above the resultant figure will be either surplus or deficiency as regards unsecured creditors.

(5) Add the amount of paid up share capital to the figure as obtained in (4) above; the result will be either surplus or deficiency as regards members or contributories.

(6) Any likely expenditure on liquidation should be ignored. A note may simply be given that deficiency or surplus as shown by the statement of affaires is subject to the cost of liquidation.

(7) Any unrecorded asset or liability should be shown both in the statement of Affairs and the deficiency or surplus Account to make double entry complete.

(8) Personal guarantee given by any party including the guarantees given by the directors for loans raised by the company should be ignored while preparing the Statement of affairs.

5.11.2. Lists to be attached to the Statement of Affairs:

The following lists are attached to the statement of Affairs;

List A gives a complete list of assets not specially pledged in favour of secured creditors. Creditors having a floating charge on the assets are considered as having assets not specifically pledged with them; so such assets are included in this list.

List B gives the list of assets which are specifically pledged in favour of fully secured and partly secured creditors.

List C gives the list of preferential Creditors.

List D gives the list of debenture holders and other creditors having a floating charge on the assets.

List E gives the names, addresses and occupations of unsecured creditors and the amount due.

List F gives the names and number and value of shares held by various preference shareholders.

List G gives the names and holdings of equity shareholders.

List H shows how Deficiency or surplus in the Statement of Affairs has been arrived at, i.e. , it explains the reasons responsible for the surplus or deficiency. According to the law, the period covered by Deficiency or surplus must commence on a date not less than 3 years before the winding up order, or if the company has not been incorporated for the whole of that period, the date of incorporation of the company, unless the official Liquidator otherwise agrees.

Illustration:1

Shri. Govindan is appointed liquidator of a company in voluntary liquidation on july,2002, and the following balance are extracted from the books of that date:

	Rs		Rs
Capital:		Machinery	30,000
16,000 shares of Rs.5 each	80,000	leasehold Properties	40,000
Provision for Bad Debts	10,000	stock in Trade	1,000
Debentures	50,000	Book Debts	60,000
Bank Overdraft	18,000	Investments	6,000
Liabilities foe purchases	20,000	Calls in Arrear	5,000
		Cash in hand	1,000
		Profit and loss Account	35,000
	1,78,000		1,78,000

The Machinery is Valued at Rs.60,000; the leasehold Properties at Rs.73,000; Investments at Rs.4,000; Stock in Trade at Rs.2,000 ; Bad debts are Rs.2,000 ; Doubtful debts are Rs.4,000 , estimated to realize Rs.2,000. The Bank Overdraft Is secured by deposit of title deeds of leasehold Properties. Preferential Creditors for taxes and wages Rs.1,000. Telephone rent owing is Rs.80. You are required to make out (1) Statement of Affairs as regards creditors and contributors and (2) Deficiency or Surplus Account.

Solution:

STATEMENT OF AFFAIRS OF SHRI.GOVINDAN
As on July 1,2002

Assets	Estimated Realisable Value
	Rs
Asset not Specifically Pledged (as per list A)	
Cash in hand	1,000
Trade Debtors	56,000
Calls in Arrear	5,000
Investments	4,000
Stock	2,000
Machinery	60,000
	1, 28,000
Asset Specifically Pledged (as per list B)	
Estimated Due to Deficiency Surplus	

	Realizable Value Rs	secured creditors Rs	ranking as unsecured Rs	carried to last column Rs	
Leasehold Property	73,000	18,000	___	55,000	
Estimated Surplus from assets Specifically pledged					55,000
Estimated total assets available for preferential creditor, debentureholders secured by a floating charge, and unsecured creditors					1,83,000
Summary of Gross Assets				Rs	
Gross realizable value of assets specifically pledged				73,000	
Other assets				1,28,000	
Gross Assets				2,01,000	

Gross Liabilities Rs	Liabilities	Rs	
18,000	Secured creditors (as per List B) to the extent to which claims are estimated to be covered by assets specially pledged		
1,000	Preferential Creditors(as per list C)		1,000
	Estimated balance of assets available for debentureholders Secured by a floating charge, and unsecured creditors		1,82,000
50,000	Debentureholders secured by a floating charge (as per list D)		50,000
	Estimated surplus as regards debenture holders		1,32,000
	Unsecured Creditors (as per list E)		
	Liabilities for purchases	20,000	
	Telephone Rent outstanding	80	
20,080			20,080
89,080	Estimated surplus as regards creditors (being the difference between gross assets and Gross liabilities)		1,11,920
	Issued and called up capital (as per list G)		80,000
	Estimated surplus as regards contributions(as per List H)		31,920

SURPLUS ACCOUNT (LIST H)

					Rs
Items reducing surplus:					
Excess of capital and liabilities over assets, i.e, Profit and Loss Account					35,000
Estimated losses now written off for which provision has been made for the purpose of preparing the statement:					
				Rs	
Investments (Rs.6,000-Rs.4,000)				2,000	
Preferential creditors for taxes and wages				1,000	
Telephone rent outstanding				80	3,080
					38,080
Items Contributing to surplus:					
Machinery (Rs.60,000- Rs.30,000)				30,000	
Leasehold Properties (Rs.73,000-Rs.40,000)				33,000	
Stock (Rs.2,000-Rs.1,000)				1,000	
Debtors: Provision for Bad debts			10,000		
Less: Bad Debts		2,000			
Doubtful Debts		2,000	4,000	6,000	70,000
Surplus as shown by the Statement of Affairs					31,920

5.12 LIQUIDATOR'S REMUNERATION

The liquidator normally gets the remuneration I the form of commission which is usually based as a percentage on the value of assets realized and amount paid to unsecured creditors. In calculating the liquidator's remuneration, the following points
May be noted:

(1) Commission on assets given as securities to secured creditors. The Liquidator gets commission on the surplus from such assets left after making the payment of secured creditors because he make an effort of realizing the surplus of such assets from secured creditors. However, if he sells the assets himself, he gets commission on the total proceeds of such assets.

(2) Cash and bank Balance. If the liquidator is to get a commission on assets realized, he also gets a commission on cash and bank balance unless otherwise stated.

(3) Unsecured Creditors. If the liquidator is to get a commission on amount paid to unsecured creditors, unsecured creditors will also include preferential creditors for the purpose of calculation of remuneration unless otherwise stated. If the amount available is sufficient to make the full payment of unsecured creditors, the commission is calculated as follows:

Liquidators
Remuneration = <u>Amount due to Unsecured creditors X % of commission on creditors</u>
100

If the amount available is not sufficient to make the full payment of unsecured creditors, the commission is calculated as below:

<u>Amount available for unsecured creditors X % of commission</u>
100+ % of Commission

For example, if the amount due to unsecured creditors is Rs.5,00,000 and the amount available for unsecured creditors before charging commission on amount paid to unsecured creditors is rs.2,06,000. Suppose 3% commission is to be paid on the amount paid to unsecured creditors, the commission in this case will be calculated as below:

$$\frac{\text{RS.2,06,000 X 3}}{100+3} = \frac{\text{Rs.2,06,000 X 3}}{103} = \text{Rs.6,000.}$$

Illustration:2

The following particulars relate to a limited company which has gone into voluntary liquidation. You are required to prepare the liquidator's Final Account allowing for his remuneration @ 2% on the amount realized on assets and 2% on the amount distributed to unsecured creditors other than preferential creditors:

	Rs
Unsecured Creditors	2,24,000
Preferential Creditors	70,000
Debentures	75,000
The assets realized the following sums:	
Cash in hand	20,000
Land and Buildings	1,30,000
Plant and machinery	1,10,500
Fixtures and Fittings	7,500

The liquidation expenses amount to Rs.2,000. A call of Rs.2 per share on the partly Paid 10,000 equity shares was made and duly paid except in case of one shareholder owing 500 shares.

Solution:

In the books of …..Ltd. (in Liquidation)

LIQUIDATOR'S FINAL STATEMANT OF ACCOUNT

Rs	Rs	Rs	Rs
To Assets realized:			
To Cash in hand 20,000		By Liquidation Expenses:	2,000
To Land and Buildings 1,30,000			
To Plant and Machinery 1,10,500		By Liquidator's Remuneration	
To Fixtures and Fittings 7,500	2,68,000	2% on Rs.2,68,000 5,360	
		2% on Rs.1,32,000 2,640	8,000
To Calls (9,500 shares @ Rs.2 each)	19,000		
		By Debenture holders	75,000
		By Preferential Creditors	70,000
		By Unsecured Creditors (58.93% of Rs.2,24,000)	1,32,000
	2,87,000		2,87,000

Notes:

(1) Shareholders will not get anything as the amount is not sufficient even to make the payment of the unsecured creditors.

(2) Since the amount is not sufficient to make the full payment of the unsecured creditors, the commission payable to the liquidator on the paymenet made to the unsecured creditors is to be calculated as follows:

	RS	RS
Total of the receipts side		2,87,000
Less: Liquidation Expenses	2,000	
Liquidator's Remuneration on assets realized	5,360	
Payment to Debenture holders	75,000	
Payment to Preferential Creditors	70,000	1,52,360
Amount available for Unsecured Creditors & Liquidator's Remuneration		1,34,640

Therefore, liquidator's Commission on payment to unsecured Creditors is

$$RS.2,640 = \frac{2}{102} X\ Rs.1,34,640$$

Illustration:3

ou are asked by a liquidator of a company to prepare a statement of account to be laid before a meeting of the shareholders from the following:

BALANCE SHEET OF THE COMPANY

As on date of liquidation 1-1-2002

	Rs		Rs
Share capital:		Fixed Assets	4,00,000
4,000 Equity Shares of Rs.100 each called Rs.80	3,20,000	Book debts	3,00,000
1,000 Preference Shares of Rs.100 each called Rs.70	70,000	Loss-to-date	1,00,000
Secured Loan From Bank on: Building and Machinery	1,50,000		
Trade Creditors	2,60,000		
	8,00,000		8,00,000

The assets realized as follows: 1-4-2002- Book debts Rs.1,00,000, expenses paid Rs.4,000 ; 1-6-2002- Fixed Assets (final)Rs.3,00,000, Book Debts Rs.1,00,000. 1-8-2002 –Book debts (final) Rs.50,000. The liquidator is entitled to 5% on collections from book debts and 2% on the amount paid to equity shareholders. Prepare the statement on the assumption that disbursements are made in accordance with law, as and when cash is available.

Solution:

In the books of the company (In liquidation)
LIQUIDATOR'S STATEMENT OFACCOUNT
From 1-1-2002 to 1-8-2002

Date	Receipt	Rs	Date	Payment	Rs
1-4-02	To Realisation of Assets: Book Debts	1,00,000	1-4-02	By Liquitator's Remuneration(5% On Rs.1,00,000)	5,000
				By Liquidation Expenses	4,000
				By Balance c/d	91,000
		1,00,000			1,00,000
1-4-02	To Balance b/d				
1-6-02	To Realisation of Assets: Book debts	91,000	1-6-02	By Liquitator's Remuneration 5% on Rs.1,00,000 5,000 2% on rs.5,882 118	5,118
	Surplus from Securities	1,00,000			
		1,50,000		By Trade creditors	2,60,000
				By Refund of capital to Preference Shareholders on 1000 preference Shares @ Rs.70 per Share	70,000
				Equity Shareholders @ Rs.1.47 per share on 4,000 shares	5,882
		3,41,000			3,41,000
1-8-02	To Realisation of Assets: Book debts (final)	50,000	1-8-02	By Liquitator's Remuneration: 5% on Rs.50,000 2,500 2% on Rs.46,569 931	3,431
				By Refund of capital to Equity shareholders On 4,000 Equity Shares @ RS.11.64 Per share	46,569
		50,000			50,000

Note: The balance in hand on 1st April,2002 has to be carried forward since the position as regards Bank has not yet crystallized.

5.13 RECEIVER FOR DEBENTURE HOLDERS

The terms of issue of debentures may give express power to the debenture holders to appoint a receiver on failure of the company to pay them their interest or the instalment On the due date of liquidation of the company. In case of liquidation, debenture Holders may appoint an independent person as receiver to take over the assets specifically or generally charged in their favour. The receiver will realize such assets and after meeting his expenses, remuneration and making payment to claimants entitled to get payment in priority to the debenture holders, he will make payment to the debenture holders. The receiver will hand over the surplus, if any, to the liquidator of the company so that the latter may make the payment to the claimants who are to get the payment after the debenture holders. Thus, if a receiver is appointed by the debenture holders to protect their interest, two statements of accounts namely Receiver's Statement of Account and liquidator's Final Statement of Account will have to be prepared.

Illustration:4

The following is the balance sheet of A ltd. As at 30th Sep,2002:

Liabilities	Rs	Assets	Rs
Share capital:		Land And Buildings	1,20,000
Issued: 11% Pref.shares of Rs.10 each	1,00,000	Sundry Current Assets	3,95,000
		Profit and loss Account	38,500
10000 equity shares of Rs.10 each, fully paid-up	1,00,000	Debenture Issue Expenses Not Written off	2,000
5000 equity shares of Rs.7.50 per share paid-up	37,500		
13% Debentures	1,50,000		
Mortgage Loan	80,000		
Bank Overdraft	30,000		
Creditors for trade	32,000		
Income-tax Arrears: (assessments concluded In july 2002)			
Assessment year			
2000-01 21,000			
2001-02 5,000	26,000		
	5,55,000		5,55,000

Mortgage loan was secured against land and buildings. Debentures were secured by a floating charge on all the other assets. The company was unable to meet the payments And therefore the debenture holders appointed a receiver and this was followed by a Resolution for members voluntary winding up. The Receiver for the Debenture holders Brought the land and buildings to auction and realized Rs.1,50,000.He also took charge of sundry assets of the value of Rs.2,40,000 and realized Rs.2,00,000. The liquidator realized Rs.1,00,000 on the sale of the balance of sundry current assets. The bank overdraft was secured by a personal guarantee of two of the directors of the company and on the Bank raising a demand, the directors paid off the dues from their personal resources. Costs incurred by the Receiver were Rs.2,000 and by the liquidator was to receive 3% fee on the value of assets realized by him. Preference shareholders had not been paid dividend for period after 30th September,1996 and interest for the last half-year was due to the debenture holders.

Prepare the accounts to be submitted by the Receiver and the liquidator.

Solution

RECEIVER'S STATEMENT OF ACCOUNT

Liabilities	Rs	Assets	Rs
Sundry Assets Realised	2,00,000	Cost of the Receiver Payment of Preferential Creditors	2,000
Surplus Realised from Mortgage:		Income Tax raised within 12 months	26,000
Sale proceeds of land and buildings 1,50,000		Payment of Debentureholders:	
less:Applied to discharge of mortgage loan 80,000	70,000	Principal 1,50,000	
		Interest for 1/2year@13% p.a. 9,750	1,59,750
		Surplus handed over to the liquidator	82,250
	2,70,000		2,70,000

LIQUIDATORS FINAL STATEMENT OF ACCOUNT

Liabilities	Rs	Assets	Rs
Surplus received from The Receiver	82,250	Cost of Liquidation	2,800
Sundry Assets realized by the Liquidator	1,00,000	Liquidator,s Remuneration (3% of assets realized)	3,000
Amount realized from Contributories: From holders of 5,000 party paid shares @ Rs.2.17 per share (1)	10,850	Payment of Unsecured Creditors: Creditors for Trade 32,000; Payment of amount due to Directors for Bank Overdraft 30,000	62,000
		Payment of Preference Shareholders Principal 1,00,000; Arrears of Dividends For 2 years @ 11% p.a. 22,000	1,22,000
		Equity Shareholders to get: Return of money to holders of 10,000 shares fully paid up @ 33 paise per share	3,300
	1,93,100		1,93,100

Working Note:

(1) Calculation of Amount Payable by Partly Paid Shareholders:

	Rs.	Rs.
Amount available before call from partly paid shareholders		1,82,250
Less: Amount payable to various claimants:		
Cost of Liquidator		2,800
Liquidator’s remuneration		3,000
Unsecured creditors		62,000
Preference shareholders	1,22,000	1,89,800
Deficiency		(-) 7,550

Add: Total amount receivable from Party Paid shareholders on the basis of notional call of Rs.2.50 per share on 5,000 shares	12,500
Net Surplus after notional call	4,950
Number of shares deemed fully paid(10000+5000)	15,000

Refund on each fully paid share (Rs.4,950+15,000) =33 paise

Call on party paid share = Rs.2.50 –Re.0.33 =Rs.2.17.

The Companies (Second Amendment) Act 2002 (India's new corporate insolvency law) is now operational and the Sick Industrial Companies (Special Provisions) Act 1985 has been repealed by the Sick Industrial Companies (Special Provisions) Repeal Act 2003.

- Companies Act 1956 as amended by the Companies (Second Amendment) Act 2002.
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI)

  With the passing of the Second Amendment, a new National Company Law Tribunal (NCLT) has been established. The Tribunal will be empowered:
- To consider revival and rehabilitation of companies.
- With jurisdiction relating to the winding up of companies. The Tribunal stands in the stead of the High Court and pending liquidation applications are being transferred from the High Court to the Tribunal.
- The jurisdiction previously exercised by the Company Law Board. The Board has been abolished.

In India now, procedures for the reorganization and liquidation of companies are contained in the same Act. The Second Amendment is an attempt to create a balance between reorganization and liquidation.

The Second Amendment seeks to provide a quick, convenient and timely procedure for dealing with the affairs of a sick industrial company. A sick industrial company is defined as an industrial company that has, at the end of a financial year, accumulated losses equal to 50% of the average net worth of the company in the four preceding financial years, or which has been unable to pay creditors as debts have fallen due in three consecutive quarters.

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The Board of Directors apply to the NCLT and prepare a scheme for the revival and rehabilitation of the company. The application and scheme must be accompanied by a statement by the company's auditor.

The NCLT may make inquiries about the financial state of the company and its prospects. They may require an Operating Agency (a group of experts) to assist. The NCLT can make an order putting a scheme in place or ordering that the company be liquidated. Creditors may also put forward a scheme.

Approval of a scheme requires consent by all parties providing financial assistance within 60 days. However, a non-reply is taken as a consent. Every party providing financial assistance has a right of veto. This right of veto cannot be overridden by a Court.

In a rehabilitation, the debtor remains in possession of the entity.

Where the NCLT comes to the conclusion that the sick industrial company cannot be revived and that it is just and equitable for the company to be wound up, the Tribunal shall order the winding-up of the company.

A levy is charged on each company to establish a rehabilitation and revival fund for sick industrial companies.

SARFAESI provides for the enforcement of security interests in movable (tangible and intangible, including accounts receivable) and immovable property without the intervention of the court and by way of a simple, expeditious and cost effective process. SARFAESI also enables the establishment of asset reconstruction companies.

Role played by Government

Given that the Second Amendment now allows the emergence of a private sector insolvency profession in India, the Government bureaucracy is looking at ways of regulating this profession.

Role played by private sector practitioners

Under the 1956 Act as it was before the passing of the Second Amendment, an Official Liquidator was attached to every High Court. This court officer undertook all liquidations. The Second Amendment allows for private sector practitioners to be appointed from a panel of Chartered Accountants, Cost Accountants, Lawyers and Company Secretaries. Thus, a private sector insolvency profession is just starting to emerge in India.

5.14 ROLE PLAYED BY THE COURT

With the passing of the Second Amendment, the National Company Law Tribunal (NCLT) has been established to deal with reorganization and liquidation of sick industrial companies. The Tribunal consists of a President and not more than 62 Judicial and Technical members. The President of the NCLT is to be a former judge or a person qualified for appointment as a High court judge. Benches of the tribunal dealing with reorganization and liquidation matters will consist of three members, including one judicial member and one technical member. Judicial members are judges or lawyers (of at least 15 years standing) and the technical members are accountants.

There is also a National Company Law Appellate Tribunal (NCLAT) that hears appeals from orders made by the NCLT.

In a significant step to build investors' confidence, the Department of Company Affairs (DCA) has shortened the time limit for liquidation of companies under the Companies Act, 1956 to seven months against the current 12 months.

Accordingly, official liquidators will take over possession of assets, books of accounts and other records of companies in liquidation within 15-30 days from the date of winding up order from the High Court concerned.

Time taken for valuation of the property will be 30 days from the date of completion of inventories. Completion of sale of assets will take 45 days from the date of valuation of properties. Handing over possession of property to buyers will take seven days from the date of payment of sale price, a DCA press release said.

Scrutiny of books and records of companies and submission of reports to the High Court in respect of transfer company under Section 394 (1) of the Companies Act will take 30 days.

5.15 LET US SUM UP

In law, **liquidation** refers to the process by which a company (or part of a company) is brought to an end, and the assets and property of the company redistributed. Liquidation can also be referred to as **winding-up** or **dissolution**, although dissolution technically refers to the last stage of liquidation. Liquidation may either be compulsory (sometimes referred to as a *creditors' liquidation*) or voluntary (sometimes referred to as a *shareholders' liquidation*, although some voluntary liquidations are controlled by the creditors, see below).

In finance, *liquidation* is also sometimes used as convenient shorthand for converting an asset to cash.

The main purpose of a liquidation where the company is insolvent is to collect in the company's assets, determine the outstanding claims against the company, and satisfy those claims in the manner and order prescribed by law. The liquidator must determine the company's title to property in its possession. Property which is in the possession of the company, but which was supplied under a valid retention of title clause will generally have to be returned to the supplier. Property which is held by the company on trust for third parties will not form part of the company's assets available to pay creditors. Before the claims are met, secured creditors are entitled to enforce their claims against the assets of the company to the extent that they are subject to a valid security interest. In most legal systems, only fixed security takes precedence over all claims; security by way of floating charge may be postponed to the preferred creditors.

Claimants with non-monetary claims against the company may be able to enforce their rights against the company. For example, a party who had a valid contract for the purchase of land against the company may be able to obtain an order for specific performance, and compel the liquidator to transfer title to the land to him, upon tender of the purchase price. After the removal of all assets which are subject to retention of title arrangements, fixed security, or are otherwise subject to proprietary claims of others, the liquidator will pay the claims against the company's assets. Generally, the priority of claims on the company's assets will be determined in the following order:

1. Firstly, the costs of the liquidation are met out of the company's remaining assets
2. Secondly, the preferred creditors under applicable law are paid
3. Thirdly, in many legal systems, the claims of the holders of a floating charge will be paid; other claims may also fit into this layer
4. Fourthly, if there is anything left, the unsecured creditors are paid out pari passu in accordance with their claims. In many jurisdictions, a portion of the assets which would otherwise be caught by a floating charge are reserved for the unsecured creditors.
5. In the very rare instances where the unsecured creditors are repaid in full, any surplus assets are distributed between the members in accordance with their entitlements.

5.16 LESSON-END ACTIVITIES

1. What do you mean by liquidation of a company?describe the different modes of winding up?

2. Bring out clearly the distinction between a winding – up by the court and a members voluntary winding – up.
3. Give a proforma of the statement of affairs and the deficiency/ surplus account with imaginary figures which complies with the requirements of the Indian companies act, 1956.
4. What do you mean by the term “ contributory” ? Describe the various types of contributaries.
5. Explain the circumstances under which a liquidator would have to make a call on partly paid shares.
6. Shri Chopra is appointed liquidator of moon company limited in voluntary liquidation on 1st July, 2002. Following balances are extracted from the books on that date:

Capital	Rs	Machinery	Rs
24,000 shares of Rs. 5 each	1, 20,000	Leasehold properties	45,000
Reserve for bad Debts	15,000	Stock in trade	1,500
Debentures	75,000	Book debts	90,000
Bank overdraft	27,000	Investments	9,000
Liabilities for purchase	30,000	Calls- in- arrear	7,500
		Cash in hand	1,500
		Profit and loss account	52,500
Total	2, 67,000		2, 67,000

7. The following particulars relate to a limited company which has gone into voluntary liquidation. You are required to prepare the liquidator's final account allowing for his renumeration @ 3% on the amount realized and 2% on the amount paid to the unsecured creditors

Secured creditors(security realized Rs.54,000)	46, 000
Unsecured creditors	2,83,698
Preferential creditors	8, 000
Debentures having a floating charge on the assets	1, 00, 000

Expenses of liquidation amounted to Rs. 3, 000

A call of Rs. 2 per share on the partly paid equity shares were duly paid except in case of one shareholder owning 400 shares.

5.17 REFERENCES

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2. S.P.Jain & K.L Narang, " Advanced Accounting ", Kalyani publications, New delhi.
3. Reddy & Murthy, "Financial accounting", Margham publications, Chennai 2004
4. J.R. Monga – Fundamentals for Corporate Accounting

MODEL QUESTION PAPER I

TOTAL MARKS 100

ALL QUESTIONS CARRY EQUAL MARKS

ANSWER ALL QUESTIONS

1) What do you mean by a ‘share’ and what are the types of shares? Distinguish between a Equity share and Preference share?

2) The Nagpur Chemical Works Ltd., issued for public subscription 1,00,000, Equity shares of Rs.100/- each at a premium of Rs.20/-per share payable as under:

   On application, Rs.20 per share, On allotment Rs.50 per share(including premium), On first call Rs.20 per share and on final call Rs.30, per share.

   Applications were received for 1,50,000 shares. The shares were allotted pro rata to the applicants for 1,20,000 shares, the remaining applications being rejected. Money over-paid on application was utilized towards sums due on allotment.

   Ram Lal to whom 4,000 shares were allotted, failed to pay allotment and call money and Krishnan kumar, to whom 5,000 shares were allotted failed to pay the two calls. These were subsequently forfeited after the second call was made. All the forfeited shares were sold to Mohit as fully paid up shares at Rs.80/- per share.

   Pass the necessary Journal entries and also prepare the Balance sheet, after the transactions are complete.

3) E ltd had allotted 10,000 shares to applicants for 14,000 shares on a pro rata

   Basis. The amount payable was Rs.2/- on application, Rs.5/- on allotment (including premium of Rs.2/- each), Rs.3/.- on first call and Rs.2/- on final call. V failed to pay the first cal and final call on his 300 shares. All the shares were forfeited and out of these 200 shares were re-issued @Rs.9/- per share. What is the amount credited to capital reserve?

4) The Balance sheet of Hari & Hema Ltd., as at 31st December,2001 inter alia include the following:

		Rs.
50,000 8% Preferebce shares of Rs.100 each Rs.70 paid up		35,00,000
100,000 Equity shares of Rs.100 each fully paid up	1,00,00,000	
Securities Premium	5,00,000	
Capital Redemption reserve	20,00,000	
General Reserve	50,00,000	

   Under the terms of their issue, the preference shares are redeemable on March 31, 2002 at a premium of 5%. In order to finance the redemption, the company makes a right issue of 50,000 equity shares of Rs.100 each at Rs.110/- per share, Rs.20 being payable on application, Rs.35 (including premium) on allotment and the balance on January 1st, 2003. The issue was fully subscribed and allotment made on March 1, 2002. The moneys due on allotment were received by March 30, 2002.

The preference were redeemed after fulfilling the necessary conditions of Section 80 of the Companies Act, 1956. The company decided to make the minimum utilization of general reserve.

You are asked to pass the necessary journal entries and show the relevant extracts from the Balance Sheet as on 31st March, 2002 with the corresponding figures as on 31st December,2001.

5) The Balance Sheet of Producers ltd. as at 31st march 2006 is as follows:

Liabilities	Rs	Assets	Rs
Share Capital:		Fixed Assets:	
Authorised capital		Plant and Machinery	190000
40000 equity shares		Furniture and Fixtures	20000
of Rs.10 each	400000	Investments	60000
1000 8% Preference shares		Current Assets, loans and	
of Rs.100 each	100000	Advances:	
	500000	A. Current Assets:	
Issued and subscribed Capital:		Stock	130500
25000 Equity Shares of		Debtors	49550
Rs.10 each fully Paid	250000	Cash at Bank	4950
1000 8% Preference shares		B. Loans And Advances	
Of Rs.100 each fully Paid-up		Prepaid Expenses	1000
Reserves and Surplus:			
Securities premium Account	9000		
Profit and Loss Account			
Current Liabilities and Provisions			
A. Current Liabilities:			
Sundry Creditors	22500		
B. Provisions:			
Provisions for taxation	19500		
	456000		456000

In order to redeem its Preference shares, the company issued 5,000 equity shares of Rs.10 each at a premium of 10% and sold its investment of Rs.70800. Preference shares were redeemed at a premium of 10%.

Show the necessary journal entries in the books of the company and prepare the balance sheet of the company immediately after redemption of Preference shares.

6) A Company issues early in 2002, 13% Rs.20,00,000 debentures at Rs.96, but redeemable at Rs.103. Redemption will be carried out by annual drawings of Rs.4,00,000 (face value) commencing at the end of 2006. What do you recommend as the amount to be charged to the profit and loss account, apart from that of interest?

   Redemption of 10,000 preference shares of Rs.100 each was carried out by utilization of reserves and by issue of 4,000 equity shares of Rs.100 each at Rs.125. How much should be credited to capital redemption reserve account? In the above case, the redemption was carried out of reserves and out of the issue of 4,000 shares of Rs.100 each @Rs.95. what is the amount of capital redemption reserve account that is required?

7) Give a proforma of the statement of affairs and the deficiency/ surplus account with imaginary figures which complies with the requirements of the Indian companies act, 1956. What do you mean by the term " contributory" ? Describe the various types of contributaries. Explain the circumstances under which a liquidator would have to make a call on partly paid shares.

8) What are the consequences of liquidating a company?

9) Explain the factors that affect the valuation of goodwill and shares.

10) It is provided in the Articles of Association that on the death of a shareholder, his shares shall be purchased by the remaining shareholders at a price to be settled by the Auditors. On the basis of the last balance sheet. It is further provided that for this purpose, goodwill was to be of the value of three years' purchase of the average annual profits for the last four years. The last balance sheet is as follows:

Liabilities	Rs.	Assets	Rs.
Capital		Goodwill	1,00,000
20,000 shares of		Investment at cost	
Rs.10 each fully	2,00,000	(market value Rs1,25,000	
Paid			1,50,000
Reserve	1,00,000	Stock at cost	2,50,000
Debentures	2,00,000	Debtors	1,50,000
Sundry Creditors	1,50,000	Cash	35,000
Profi & Loss A/c	35,000		
	6,85,000		6,85,000

The profits for the last four years were (after tax) Rs.15,000, 20,000, 25,000 and 40,000 respectively.

You are required to state with details of working the price which should be paid per share.

MODEL QUESTION PAPER - II

TOTAL MARKS 100

ALL QUESTIONS CARRY EQUAL MARKS

ANSWER ALL QUESTIONS

1) X ltd issued for public subscription 20,000 equity shares of Rs.10/- each at a premium of Rs.2 per share payable as under:

   Rs.2 per share on application; Rs.5 per share (including premium) on allotment; Rs.2 per share on first call: Rs.3 per share on final call.

   Applications for 30,000 shares were received. Allotment was made pro-rata to the applicants for 24,000 shares, remaining applications being rejected. Money over paid on application was utilized towards sums due on allotment. Shri Y to whom 800 shares were allotted failed to pay the allotment money, first and second calls. These shares were subsequently forfeited after the second call was made. All these forfeited shares were reissued to Shri D as fully paid up at Rs.8 per share.

   Give necessary journal entries to record the above transactions.

2) H ltd was registered with an authorized capital of Rs.10,00,000/- divided into 1,00,000 equity shares of Rs.10/- each out of which 50,000 equity shares were offered to the public for subscription. The shares were payable as under:

   Rs. 3/- per share on application

   Rs.2/- per share on allotment

   Rs. 2/- per share on 1st call

   Rs.3/- per share on 2nd and final call

The shares were fully subscribed for and the money was duly received.

Show the journal and cash book entries

3) The following particulars relate to a limited company which has gone into voluntary liquidation. You are required to prepare the liquidator's final account allowing for his renumeration @ 3% on the amount realized and 2% on the amount paid to the unsecured creditors

Secured creditors(security realized Rs.54,000)	46, 000
Unsecured creditors	2,83,698
Preferential creditors	8, 000
Debentures having a floating charge on the assets	1, 00, 000

   Expenses of liquidation amounted to Rs. 3, 000

   A call of Rs. 2 per share on the partly paid equity shares were duly paid except in case of one shareholder owning 400 shares.

4) Give a proforma of the statement of affairs and the deficiency/ surplus account with imaginary figures which complies with the requirements of the Indian companies act, 1956.

5) What are the various Modes of winding up or Liquidation, explain them?

6) From the following balance sheet of M.P products ltd. Find out the values of equity shares and preference shares:

Balance sheet of M.P Products ltd.

Liabilities	**Rs**	**Assets**	**R**
20,000 equity shares		Goodwill	25,000
of Rs.10 each	2,00,000	Machinery	1,60,000
8% 1,000 preference		Furniture	5,000
shares of Rs,100 each	1,00,000	Stock	80,000
Reserves	30,000	Debtors	1,50,000
Profit and loss account	10,000	cash	2,000
Sundry creditors	60,000	Preliminary expenses	3,000
Proposed preference			
Dividend	8,000		
Other liabilities	12,000		
Overdraft	5,000		
	4,25,000		4,25,000

Goodwill is valued at Rs.15,000. Stock is overvalued by Rs.10,000, Machinery is Undervalued by Rs.15,000.

7) The balance sheet of super sound ltd. as at 31st March,2006 is given below:

Liabilities	**Rs**	**Assets**	**Rs**
Share Capital:		Buildings	2,25,000
9,000 equity shares		Machinery	3,30,000
of Rs.100 each,		Stock	4,50,000
fully Paid-up	9,00,000	Sundry debtors	2,40,000
Profit and loss account	75,000	Bank	90,000
Bank overdraft	15,000		
Creditors	90,000		
Provision for taxation	1,65,000		
Provision for dividends	90,000		
	13,35,000		13,35,000

The net profits of the company after deducting usual working expenses but before providing for taxation were as under:

Year	Rs
2003-04	3,00,000
2004-05	3,60,000
2005-06	3,30,000

On 31st March, 2006, building was revalued at Rs.3,00,000.Machinery at Rs.3,75,000 and sundry debtors on the same date including Rs.10,000 as irrecoverable. Having regard to nature of the business, 10% return on net tangible capital invested is considered reasonable.

You are required to value the company's share ex-dividend. Valuation of goodwill may be based on three years purchase of annual super profits. Rate of depreciation on buildings is 20% and on machinery is 10%. The income-tax rate is ti be assumed at 35%. All workings should form part of your answer.

8) Harini overseas Ltd had an issue 1,000, 12% redeemable preference shares of Rs.100/- each, repayable at a premium of 10%. These shares are to be redeemed now out of the accumulated reserves, which are more than the necessary sum required for redemption. Show the necessary entries in the books of the company, assuming that the premium on redemption of shares has to be written off against the company's Securities Premium Account.

9) A Company has decided to increase its existing share capital by making rights issue to the existing shareholders in the proportion of one new share for every two old shares held. You are required to calculate the value of the right if the market value of share at the time of announcement of right issue is Rs.240/- . The company has decided to give one share of Rs.100/- each at a premium of Rs.20/- each.

10) Explain in detail the treatments of special items while preparing the final accounts of a Company.

THIS IS THE CORRECT FORM CORRECTED UPTO UNIT V