Corporate Accounting

V. Rajasekaran
R. Lalitha

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CORPORATE ACCOUNTING

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CORPORATE ACCOUNTING

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Delhi • Chennai • Chandigarh

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Dedicated to the lotus feet of
My Parents

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Preface

With the kind blessings of the Lord Almighty, this book is placed in the hands of readers. The favourable response to our previous publications—*Financial Accounting* and *Cost Accounting*—has driven us to write this book, *Corporate Accounting*.

The content of this book has been designed in such a way that it is not only suitable for elementary level (undergraduate) students but also for students of advanced level (honours, post graduate, professional courses such as CA, ICWA, CS and MBA). It also addresses the syllabi of all universities across India.

For a clear and better understanding of the concepts of corporate accounting, this book is structured around the corporate accounting principles comprising the following chapters:

Accounting for Share Capital; Understanding of Shares; Redemption of Preference Shares; Acquisition of Business; Profit Prior to Incorporation; Issue and Redemption of Debentures; Company Final Accounts; Valuation of Goodwill and Shares; Amalgamation of Companies; Accounts of Insurance Companies; Double Account System and Cash Flow Statement.

Each chapter begins with "learning objectives" and the content of each chapter is based on these learning objectives. The entire chapter is conceived and fragmented into several objectives and presented in a graded and logical sequence.

We have included all concepts relating to each topic. All topics are covered and explained in detail and the difficult areas are given point-wise. It is written in a simple and lucid style such that even students with no background of the subject are able to understand with ease.

As the accounting treatment for corporate entities is completely different from other forms of business enterprises, utmost care has been taken to analyse the subject matter in consonant with the provisions of The Companies Act, 1956, accounting practices recommended by The Institute of Chartered Accountants of India through Accounting Standards (Revised), guidelines issued by SEBI and notifications issued by the Income Tax Department and the Ministry of Company Affairs in appropriate areas to enrich the technical authenticity to a high degree. Information is up to date and accurate.

The Banking Regulation Act is strictly adhered to while dealing with the chapter "Banking Companies", and provisions of IRDA Act and regulations are complied with for the chapter "Accounting for Insurance Companies". While dealing with the accounting procedure for electricity companies, provisions of The Indian Electricity Act 1910 and The Electricity (Supply) Act 1948 and The Indian Electricity Rules 1956 are strictly followed. In a nutshell, every possible effort has been made to provide latest authentic information with accuracy.

The main features of the book are as follows.

As we are well aware of the difficulty level of the students, that is, incomprehensible and easily comprehensible topics, the problems are solved step by step explaining the intricacies involved. Our experience of more than three decades in the field of teaching coupled with their research experience in educational technology have been translated into words. All doubts that may arise among students are conceived in advance and explained clearly while solving problems. For instance, where and how are the figures arrived at and where such figures should be taken to are marked with asterisks for easy understanding. Sufficiently large number of problems have been worked out. Once the students go through all the solved problems, they gain full confidence on the subject, as each concept is self-explanatory.

Summary: At the end of each chapter, the entire content is given in a summarized form to help the students recapitulate quickly.

Key Terms: To enrich the accounting terminology of the students, all the vital terms associated with each chapter are explained precisely in a lucid and simple language.

Question Bank: On the basis of the research findings on "evaluation techniques" and "tests and measurements" by us, this section—Question Bank—is another feather in the cap of this book.

Objective Type Questions constituting of various categories, such as True or False; Fill in the Blanks; Multiple Choice Questions, are framed for each chapter. In this category, all the relevant and maximum possible number of questions (nearly 1,000 such questions) along with answers are provided. It is a self-assessment device, which is a unique, rare and special feature, exclusively crafted with utmost care for the students. The objective type of questions enhances conceptual clarity for concerned topics among the students.

In addition to this, Small Answer Type Questions and Essay Type Questions have been provided in sufficiently large numbers in separate sections.

Exercises: This section is given in two parts. One for the undergraduate level students and the other for advanced level (comprising B.Com. (Hons), M.Com., CA, CS, ICWA and MBA) students.

- Questions are provided model-wise to facilitate the students refer the main part of text (Illustrations) in case of any impediment while solving the problems.
- Questions are selected from the repeated questions of question papers of reputed universities. On the basis of such questions, new questions are framed and their answers provided.
- For professional courses, questions are scrutinized from the Inter and Final examinations conducted by the respective institutes.

To err is human. Some errors might have occurred in the text unintentionally. If readers find errors in the text, they are welcome to bring them out. Suggestion for further improvement may also be made at rajasekaranpv@gmail.com.

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We are greatly indebted to Raza Khan of Pearson Education for reposing high confidence in us. But for his valuable guidance, this book would not have seen the light of the day. We also appreciate the efforts of the editorial team, particularly Anshul Yadav and Dhiraj Pandey who took personal interest towards the betterment of the scripts and to Vamanan Namboodiri for taking utmost care in the production of this book.

We express our gratitude to the eminent authors who have already enriched *Corporate Accounting*; of course, without infringing upon their copyright.

Last but not the least, we thank the kind-hearted support and encouragement of our family members—Renuka Devi, Vasanth, Parul, Riddhima, Bhagya Shree, Sathyan and Manuraj.

RAJASEKARAN
LALITHA

Corporate Accounting (Company Accounts)—Issue of Share Capital 1

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Define and explain the concept of joint stock company.
2. Enlist the characteristics of joint stock company.
3. Understand the different kinds of companies.
4. Distinguish between a private limited and a public limited company and appreciate the privileges of a private limited company.
5. Understand the important terms and documents associated with the Formation (floatation) of Companies.
6. Explain the meaning of share, different classes of shares and their salient features.
7. Understand how a company is managed (management).
8. Record the transactions relating to the issue of shares, starting from allocation of shares till forfeiture and re-issue of forfeited shares under different varying conditions.
9. Record the transactions relating to sweat equity shares, employees' stock option and employee stock purchase scheme.
10. Explain the process of buy back shares, surrender of shares, issue of shares for consideration other than cash, issue of bonus shares, right issue.
11. Portray various items in the balance sheet.
12. Understand SEBI Guidelines relating to issue of share capital with special reference to bonus shares.

To meet the ever-increasing demand of consumers, different forms of organizations have come into existence. Students might have understood the pros and cons of sole proprietorship and partnership form of business organizations. Those forms were unable to meet the requirements and needs of consumers. This was due to insufficient money, man power and technology. Their resources are limited. As a result, a new form of business organization, known as "company", has come into existence. This new concept has resulted in the formation of joint stock companies—an important form of business organization to exploit the needed wealth (money), technology so as to satisfy the needs of customers globally. What is a joint stock company? What is "share" and "share capital"? What are the various classes of shares? How is a company managed? How will a new company be floated? What are the important statutory books needed? How shares are issued? What is the accounting treatment for issue of shares under varying conditions? What is meant by sweat equity and employees' stock option? Why are shares forfeited and how are they reissued? What is bonus share? What is meant by a rights issue? Answering to all such questions and other related matters is the aim of this chapter.

1.1 DEFINITION

According to the Companies Act 1956, "a company is a company formed and registered under this Act or an existing Company formed and registered under any of the defined laws (Act or Acts relating to companies before the Indian Companies Act, 1866, the Companies Act 1882, the Indian Companies Act, 1913 or any law governing companies in the State of Jammu and Kashmir before the commencement of Central Laws Act, 1968 and Portuguese Commercial Code)" .

But this definition does not expose the real concept and nature of a company. Let us see some other definitions.

Justice Marshall has defined a company as, "A Corporation is an artificial being, invisible, intangible and existing only in the contemplation of law."

According to Lord Justice Hanay, "A company is artificial person created by law with a perpetual succession and a Common Seal."

"A company is an association of persons who contribute money or money's worth to the common stock and employ it for some common purpose".

All these definitions expose the following characteristics:

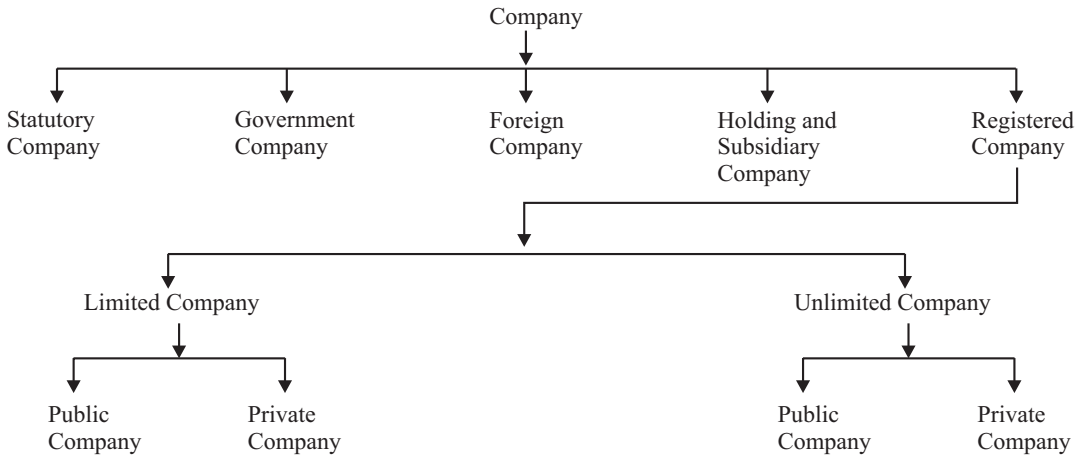
1.2 CHARACTERISTICS OF A COMPANY

The characteristics of a company are:

1. **Artificial legal person:** Company is created by law. Hence, it is treated as artificial legal person. It is not a natural person. Its very existence is through law.
2. **Separate legal entity:** Its legal existence is different from that of its members. Hence, it is not affected by changes in its membership. This means that change in members does not affect a company.
3. **Perpetual entity:** A company has a perpetual entity. A company continues to be in existence despite change of members, death or insolvency of its members.
4. **Liability is limited:** Member's liability is limited. To explain, the liability of every shareholder of a company (member) is limited to the amount he has fully paid on the shares allotted to him and nothing beyond that amount.
5. **Divorce between ownership and management:** In companies, management is separated from ownership. Though the shareholders contribute the necessary capital, the Board of Directors are entrusted with the overall responsibility to run the company.
6. **Voluntary association of persons:** It is a voluntary association of persons for a common purpose to earn profit.
7. **Transfer of shares:** The shareholders contribute the capital by way of subscription of shares. These shares can be transferable to any third person in public limited companies.
8. **Common seal:** As already said, company is an artificial person. It cannot sign the documents directly. For this, a company is provided with a legal arm "common seal". So, common seal has to be affixed in all documents in addition to it, the authorized person has to sign on behalf of the company. This process solves the problem of signing the document.
9. **Permitted activities:** A company can carry on only the permitted activities mentioned at the time of registration of the company.

1.3 KINDS OF COMPANIES (OR) TYPES OF COMPANIES

Companies in India may be classified as depicted in the following:



1.3.1 Statutory Companies

These companies are created by special acts passed by State Legislature or Parliament, e.g., Life Insurance Corporation, Reserve Bank of India. These companies are accountable to the State Legislature or Parliament.

1.3.2 Government Company

As per Section 617 of the Companies Act, 1956, "a Government Company means any company in which not less than 51% of the paid-up capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government Company".

1.3.3 Foreign Company

A foreign company is one that has its incorporation outside India but has business operations in India.

1.3.4 Holding Company

According to Section 4 (4) of the Companies Act, 1956, a company is deemed to be a holding company if the other company is its subsidiary company. A company becomes a subsidiary company when the other company controls 51% or more of its paid-up share capital, has right to appoint directors on its board or is a subsidiary of another subsidiary company.

1.3.5 SUBSIDIARY COMPANY

According to Section 4 (1), a company shall be deemed to be a subsidiary of another if, but only if,

(a) That the other controls the composition of its board of directors; or

(b) That the first-mentioned company is **any other** company, holds more than half in nominal value of its equity share capital

(c) That the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

Example:

Company B is a subsidiary of Company A, and Company "C" is a subsidiary of Company "B". Company C is a subsidiary of company A, by virtue of Clause (c) above. If Company D is a subsidiary of Company C, Company D will be a subsidiary of Company B and consequently also of Company A, by virtual of Clause (c) above, and so on.

(d) In case of a body corporate which is incorporated outside India, a subsidiary or holding company of the body corporate under the law of such country shall be deemed to be a subsidiary or holding company within the meaning and for the purpose of this Act whether the requirements of the section are fulfilled or not.

1.3.6 Registered Company

Companies that are registered under the Companies Act, 1956 are called registered companies.

Public company: Under Section 3 (1) (iv) of the Companies Act, "public company" means a company which

(a) Is not a private company
(b) Has a minimum paid-up capital of 5 lakh rupees or such higher paid-up capital; as may be prescribed
(c) Is a private company which is a subsidiary of a company which is not a private company

After Companies **(Amendment)** Act, 2000, a public company cannot be registered with a capital of less than ₹ **5** lakh. A company's name ends with "limited".

A public company may be a listed company or an unlisted company:

1.3.7 Listed Company

A listed company is a public limited company. Its securities are listed in any recognized stock exchange for trading purpose.

Unlisted company: An unlisted company is also a public limited company. But its securities are not listed on any recognized stock exchange for trading purpose.

1.3.8 Private Company

Under Section 3 (1) (iii), "private company" [means a company which has a minimum paid-up capital of 1 lakh rupees or such higher paid-up capital as may be prescribed and by its articles]—

(a) Restricts the right to transfer its shares, if any;
(b) Limits the number of its members to 50 not including—
  (i) Persons who are in the employment of the company; and
  (ii) Persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased; and
(c) Prohibits any invitation to the public to subscribe for any shares in, or debentures of, the company; and
(d) Prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives.
(e) The name of private company ends with "Private Limited".

1.3.9 Limited Company

In limited companies, liability of shareholders is limited (i) by shares or (ii) by guarantee.

(i) Companies limited by shares are the most popular ones. In this, liability of a member is limited to the amount of shares, fully paid-up.

(ii) In companies limited by guarantee, the liability of the member is limited to the amount he guaranteed voluntarily to meet out the deficiency of assets of the company when it is wound up.

1.3.10 Unlimited Company

In unlimited companies, liability of shareholders is unlimited. In general and in practice such companies do not exist.

1.3.11 Distinction between Private Company and Public Limited Company

At this stage, one should be able to understand the differences between a private company and a public limited company, which is shown in the following tabular column:

Basis of Distinction	Private Company	Public Company
1. Number of members	Minimum: 2 Maximum: 50.	Minimum: 7 Maximum: No limit.
2. Name	Two words: "Private Limited" as part of name (at the end).	One word: "Limited" as part of name (at the end).
3. Prospectus	Prospectus cannot be issued in private company	Prospectus must be issued in public companies.
4. Allotment (Minimum subscription)	Shares are allotted to as per the director's wish. No minimum subscription arises here.	Shares are allotted only if minimum subscription level is reached.
5. Transfer of shares	Transfer of shares is restricted.	No restriction on transfer of shares in public companies.
6. Bye laws	Special Articles of Association are necessary	Bye laws role is almost NIL. "Table A" in the Act will serve the purpose.
7. Commencement of business	Business can be commenced after Certificate of Incorporation is issued.	In addition, Certificate of Commencement of Business should be obtained to commence business.
8. Statutory Meeting	Statutory Meeting need not be held in private companies.	Statutory Meeting must be held in public companies and Reports have to be sent to its members.
9. Managerial remuneration	In private companies, managerial remuneration is not restricted.	In public companies, management remuneration is strictly in accordance with Companies Act rules.
10. Subscription of shares	Any invitation to the public to subscribe to any shares or debentures of the company is prohibited.	No such prohibition in public companies.
11. Minimum paid-up capital	The minimum paid-up capital is ₹ 1,00,000 in private companies.	₹ 5,00,000 is the minimum paid-up capital in public companies.
12. Acceptance of deposits	In private companies, deposits from persons other than its members, directors' relatives are not accepted.	In public companies, no such restrictions prevail to accept deposits.

1.4 PRIVILEGES OF A PRIVATE LIMITED COMPANY

The following are the privileges and exemptions of a private limited company:

1. Even two persons can float a private limited company.
2. Two signatories to the Memorandum will be sufficient.
3. It cannot and need not issue prospectus.
4. As soon as it receives the Certificate of Incorporation, it can commence business.
5. It need not wait till the receipt of Certificate of Commencement of Business to allot shares.
6. Provisions relating to 'Minimum Subscription' will not apply to private limited companies.
7. To make a quorum, only two members are sufficient.
8. Only two directors will be enough.
9. Directors need not be insisted to take up qualification shares.
10. The public cannot inspect the profit and loss account.
11. Directors need not retire by rotation.
12. A single resolution will be enough to appoint directors.
13. It can grant loans to its directors without the sanction of the Central Government.
14. Restrictions on managerial remunerations do not apply to private companies.
15. A private company need not hold a statutory meeting. Statutory report need not be filed.
16. A person can be a manager or a managing director for more than two private companies.
17. New shares need not be issued to the existing shareholders of the company in the first instance.
18. Restrictions on investments or loans in the same group of companies do not apply for private companies.

1.5 DOCUMENTS

Now, let us discuss some of the documents that are to be prepared and filed with the Registrar of Companies:

1.5.1 Memorandum of Association

This is the most important document to be filed with the Registrar of Companies, while floating a company. It contains the following six clauses:

(i) **Name:** The name of the Company with "Limited" in case of public limited company or "Private Limited" in case of private limited company.

(ii) **Place:** The State in which the registered office of (situation) the company is to be situated.

(iii) **Objects:** The objects of the company should be clearly stated. Only those stated in this clause can be pursued by the company.

(iv) **Capital:** Authorized capital and its divisions into various classes (shares).

(v) **Liability:** A statement declaring that the liability of the members is limited.

(vi) **Declaration:** A declaration of association stating that the company has been formed by the signatories to the Memorandum of Association.

It lays down the limits or framework within which a company has to work.

The Memorandum of Association must be printed, divided into paragraphs, each numbered consecutively. It must be signed by Atleast Seven persons who each agree to take one share at least.

1.5.2 Articles of Association

It contains the rules and regulations to run the company's business.

- A private company has to prepare its own Articles of Association.
- In case of a public limited company, it need not prepare it. Provisions of Table A of the Companies Act will serve the needed purpose.
- Articles include issue of shares, forfeiture of shares, election of directors, maintenance of books, division of profit, conduct of meetings, etc. In short, the Table A contains model articles which have to be complied with.
- It contains a declaration to the effect that all the requirements of the Act for incorporation have been complied with.
- In case of a private company, there is list of persons who are to act as first directors of the company. In the absence of the list, signatories to the Memorandum will act as directors.
- The written consent of such persons to act and to take qualification shares, if any. (This requirement does not apply to private company). In the absence of the list, signatories to the Memorandum will have to act as directors.
- The situation of Registered Office (Notice of the address) has to be intimated to the Registrar within 30 days after registration (incorporation).

1.5.3 Certificate of Incorporation

- The Registrar, after perusal of the documents—the Memorandum of Association and the Articles of Association—gets satisfied that the requirements the Companies Act have been duly complied with, will issue a certificate. This is called "Certificate of Incorporation".
- The Registrar will enter the company's name in the Registrar. The company comes into existence.
- A private company can commence business as soon as it receives this certificate. However, a public limited company will have to get one more certificate—the Certificate of Commencement of Business—to commence its business.

1.5.4 Prospectus

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

- A public limited company has to issue a prospectus (or prepare a statement in lieu of prospectus) signed by every director before its publication and file a copy with the Registrar in order to get the Certificate of Commencement of Business.
- Its main objective is to invite the public to subscribe for the shares and debentures of the company.
- The prospectus must be dated and it should be issued within 90 days of that date.
- Main clauses in prospectus:
  - Capital—Authorized, issued, subscribed and paid-up capital
  - Share amount of instalments—Time gap between instalments to pay share amount
  - Particulars of issue—At par, At premium, At discount
  - Underwriting commission
  - Commission to brokers on sale of shares
  - Preliminary expenses

- The prospectus serves as a basis of contract between the company and the person who opts to buy shares.
- The Registrar may refuse to register a prospectus, if
  - It does not show the date
  - It does not comply with the requirements of Section 56
  - It does not contain the expert's consent, when his opinion is permissible and is inserted
  - It does not contain the consent in writing of directors, and copy of documents mentioned in Section 60 (1)
  - It does not comply with the provisions of Section 60 (2)

1.5.5 Certificate of Commencement of Business

The Certificate of Commencement of Business will be issued by the Registrar, if the following conditions are fulfilled:

1. A copy of prospectus or a statement is lieu of prospectus has to be filed by the company with the Registrar.
2. The minimum number of shares which have to be paid in for cash has been subscribed and allotted.
3. Every director has paid on the shares held by him.
4. The secretary or anyone director has to certify and declare that the requirements of the Companies Act have been complied with.

On perusal and satisfaction, the Registrar issues a certificate called the Certificate of Commencement of Business.

A public limited company can commence business only after getting this certificate.

1.6 SHARE CAPITAL

Company raises "Capital" by issue of shares, because it being an artificial person cannot have a capital of its own. Such capital raised by issue of shares is called "share capital". Share capital is mentioned in the Memorandum of Association of Company. Share capital of a company is divided into small units of a fixed amount. These units are called "shares".

Types of share capital: The share capital of a company may be divided into the following categories

1.6.1 Authorized Capital (Nominal/Registered Capital)

This is the nominal value of shares which the company is authorized to issue by its Memorandum of Association. This is the maximum amount of capital any company is allowed to have. This amount is stated in the "Capital Clause" of the Memorandum of Association at the time.

On registration, an ad valorem duty is paid on the amount of authorized capital. The company can issue shares only to that much amount. It cannot issue shares beyond the authorized (capital) amount. The share capital (total amount) has to be divided into shares of small denomination such as ₹ 10, 50, 100 of various classes. This amount cannot be enhanced without altering the Capital Clause of the Memorandum of Association. The entire amount need not be issued at a single instance.

1.6.2 Issued Capital

The capital (part of authorized) offered to the public for subscription is called "issued capital". This includes shares offered to vendors for subscription other than cash. Issued capital can never be more than nominal

capital. The shares may or may not be fully subscribed by the public. Difference between issued capital and nominal capital is termed as "unissued capital". This can be offered to the public later at any time.

1.6.3 Subscribed Capital

It is the nominal value of shares subscribed by the public. Shares issued for public may or may not be fully subscribed. If all the shares are fully subscribed by the public, issued capital will be the same as the subscribed capital.

The balance of issued capital not subscribed by the public is known as "unsubscribed capital".

1.6.4 Called-up Capital

This is the part of the subscribed capital which has been called-up. The Board of Directors may decide to call the entire amount of the face value of the share of part by part in two or more calls. It is not necessary to call for the entire amount on shares subscribed by the shareholders at one and the same time.

1.6.5 Paid-up Capital

The amount of called-up capital that has been actually paid by the shareholders is known as "paid-up capital". If all the called-up capital has been received, then paid-up capital will equal to the called-up capital. That part of called-up capital which has not received is termed as "calls-in-arrears."

Paid-up Capital = Called-up Capital – Calls-in-Arrear

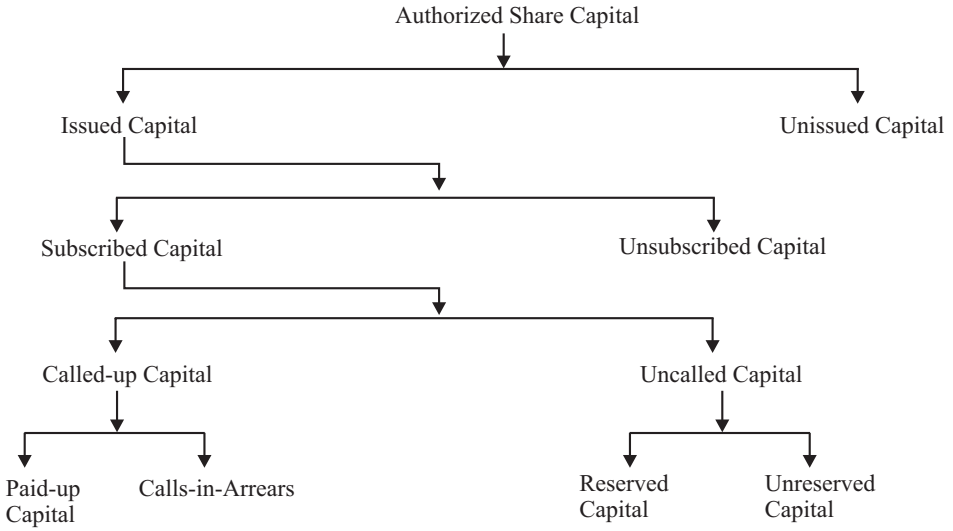
1.6.6 Uncalled Capital

This is the remaining part of the issued capital which has not yet been called.

1.6.7 Reserve Capital

Sometimes, the company, by a special resolution, may decide to keep a certain portion of the uncalled capital till liquidation. That portion is called reserve capital.

The different types of share capital may be depicted schematically as:



The different types of share capital can best be explained by the following illustration.

Illustration 1.1

A limited company has been incorporated with an authorized capital of ₹ 50,00,000 divided into 5,00,000 shares of ₹ 10 each. It offered 4,00,000 shares for subscription by the public and out of these, 3,50,000 shares were subscribed for. The directors called for an amount of ₹ 8 per share and received the entire amount except a call for ₹ 5 per share on 1,000 shares. Determine the amount of different categories of 'share capital".

Solution

		Number of Shares	Amount per Share (₹)	Total (₹)
1.	Authorized Capital (Given):	5,00,000	10	50,00,000
2.	Issued Capital (Given):	4,00,000	10	40,00,000
3.	Unissued Capital: (5,00,000 – 4,00,000)	1,00,000	10	10,00,000
4.	Subscribed Capital	3,50,000	10	35,00,000
5.	Unsubscribed Capital: 4,00,000 – 3,50,000 (Issued) (Subscribed)	50,000	10	5,00,000
6.	Called-up Capital:	3,50,000	8	28,00,000
7.	Uncalled Capital:	3,50,000	2[10 – 8]	7,00,000
8.	Paid-up Capital: (3,50,000 × ₹ 8) – (10,000 × ₹ 5)	3,50,000	$\left\{\frac{3,50,000 \times 8}{1,000 \times 5}\right\}$	27,95,000
9.	Calls-in-Arrears:	1,000	5	5,000

1.7 DIFFERENCES BETWEEN "CAPITAL RESERVE" AND "RESERVE CAPITAL"

The following table shows the differences between "reserve capital" and "capital reserve":

Reserve Capital	Capital Reserve
1. It is that portion of uncalled share capital, which shall be capable of being called up except in the event and for the purpose of winding up of the company.	It includes all reserves except revenue reserves. It arises due to revaluation of fixed assets.
2. It is not disclosed in the balance sheet of a company.	It is disclosed on the liability side of the balance sheet under the head "Reserves and Surplus".
3. It can be used only at the time of winding up of the company.	It can be used at anytime during the life of the company.
4. It is that part of amount which has never been called up.	It is the amount which has already been realized on revaluation of fixed assets of the company.

1.8 SHARES OF A COMPANY

1.8.1 Meaning

Total capital of company is divided into units of small value. Each such unit it called a "share". A share is a fractional part of the share capital of a company. By purchasing a share, one attains ownership rights in a company. Such persons who part away money through shares are known as shareholders. They, thus, become part owners of the company. "A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place and of interest in the second, but also consisting of mutual covenants entered into by all the shareholders in terms of the Act and the Articles."

1.8.2 Classes of Shares

According to Section 86 of the Companies Act, 1956, share capital of a company formed after 1 April 1956 shall be of only two kinds: (i) preference shares and (ii) equity shares.

1.8.2.1 Preference Share

U/S 85 of the Companies Act, 1956, a preference share is one which fulfils the following conditions:

1. That it carries a preferential right to dividend to be paid either as a fixed amount or an amount calculated by a fixed rate.
2. That with respect to capital it carries or will carry, on the winding up of the company, the right to repayment of capital before anything is paid to equity shareholders.

In simple words, these preference shareholders have (i) the right to receive dividend and (ii) to return of capital in preference to other shareholders.

A fixed rate of dividend payable is mentioned before the name, i.e., prefixed. For example, 12% reference shares mean that dividend is payable on these shares at the rate of 12% p.a.

The rights are shown in the Articles of Association.

1.8.3 Types or Kinds of Preference Shares

1.8.3.1 On the Basis of Dividend Right

On the basis of dividend right, preference shares are classified into:

1. Cumulative preference shares
2. Non-cumulative preference shares

1. **Cumulative preference shares:** The holders of these shares have a right to receive the arrears of dividend. They are entitled to receive the arrears of dividend before any dividend is paid on equity shares. For example, if dividend has not been paid for the accounting years 2008–09 and 2009–10 on 15% cumulative preference shares and the company wants to distribute dividend on equity shares for the year 2010–11, divid on preference shares for three years, i.e., 2008–09; 2009–10; 2010–11 at 15% p.a., 45% for three years in all, will have to be first paid on preference shares before any dividend is paid on equity shares for the year 2010–11. Unless specifically mentioned otherwise, preference shares shall be construed to be cumulative.
2. **Non-cumulative preference shares:** The holders of these shares will not have rights to receive any arrears of dividend. In the above example, if the preference shares are non-cumulative, the company will pay 15% preference dividend only for 2010–11 before paying dividend on equity shares. They are not entitled to receive arrears for the years 2008–09 and 2009–10. Hence, for non-cumulative preference shares, dividends for the previous years do not accumulate. If no dividend is declared in a year, the right to receive such dividend for that year expires automatically.

1.8.3.2 On the Basis of Participation in Surplus Profits

On the basis of participation in surplus profits, preference shares are classified into:

1. Participating preference shares
2. Non-participating preference shares

1. **Participating preference shares:** In addition to a fixed dividend right, these shareholders have a right to participate in the surplus profits after the equity shareholders have been paid dividend. In the event of winding up of the company, these shareholders have the right to receive a pre-determined portion of surplus after the equity shareholders have been paid off.
2. **Non-participating preference shares:** These shares are entitled to get only a fixed rate of dividend. They are not entitled to have any right in surplus profit. Unless specified otherwise, the preference shares are generally non-participating.

1.8.3.3 On the Basis of Recovery of Capital

On the basis of recovery of capital, preference shares are classified into:

1. Redeemable preference shares
2. Irredeemable preference shares (Non-redeemable)

1. **Redeemable preference shares:** A company may issue shares on the condition that the company will repay after a fixed period or even earlier at company's discretion. The repayment on these shares is called redemption. This is governed by Section 80 of the Companies Act, 1956. Now, only this category of preference shares can be issued by a company.
2. **Non-redeemable preference shares:** In this category of shares, the amount of capital will never be paid back before winding up of the company. According to Section 80 (5A), no company limited by shares shall issue irredeemable preference shares for preference shares redeemable after the expiry of 20 years from the date of issue.

1.8.3.4 On the Basis of Conversion into Equity Shares

On the basis of convertibility, preference shares may be classified into:

1. Convertible preference shares
2. Non-convertible preference shares

1. **Convertible preference shares:** These shares give the rights to the holders to get them converted into equity shares at their option as per the stipulated terms and conditions of their issue.
2. **Non-convertible preference shares:** If a preference share cannot be converted into equity shares, such a share is called non-convertible preference share. Unless otherwise stated, preference shares are non-convertible.

1.8.3.5 Guaranteed Preference Share

In case, even if there is no profit, dividend will have to be distributed to some kind of shares. This is called "guaranteed preference share." However, such a guarantee is not to be given by the company but by someone else.

1.9 EQUITY SHARES

According to Section 85 of the Companies Act, 1956, "An equity share is a share which is not a preference share".

Holder of equity shares is entitled to:

(i) Dividend

(ii) Repayment of capital only after the claims of preference shares are paid off.

According to Section 86 (A), equity share capital may be (i) with voting rights or (ii) with differential rights to voting, dividend or otherwise in accordance with such rules and subject to such conditions as may be prescribed.

Generally, equity shareholders control the affairs of the company.

1.9.1 Distinction Between Preference Share and Equity Share

The following table gives the differences between preference share and equity share:

Basis of Distinction	Preference Share	Equity Share
1. Right to dividend (Preference)	Dividend on preference shares is paid first.	Only if there is profit and that too after paying to preference shares, are the dividend is paid.
2. Rate of dividend	Rate of dividend is pre-determined and fixed in Articles of Association.	Rate of dividend is not pre-determined and is also not fixed.
3. Refund of capital	On dissolution of the company, preference share capital is returned (refunded) first.	Only if there is any balance, that the capital may be refunded.
4. Right to vote	In general, they do not have right to vote.	They have full right to vote.
5. Management participation	They have no role in management participation.	They have right to participate in management.

1.10 MANAGEMENT OF COMPANIES

The internal management of companies is governed by the Articles of Association and the Memorandum of Association. The provisions of the law enshrined in the Companies Act, 1956 set the framework within which the activities of the company will have to be carried on. The said Act and the Memorandum and Articles express explicitly the duties and powers of the shareholders, directors, managing director and other persons associated with the affairs of the company. The relevant provisions envisaged in Table A of the First Schedule to the Companies Act are applicable, in case if the Articles are silent on any issue.

1.10.1 Shareholders

By subscribing for shares issued, the shareholders are the real owners of the company, as they contribute to the capital. Since the number of shareholders is sufficiently very large comprising different geographical locations, it will be a difficult task to manage the affairs of the company on a day-to-day basis. This necessity resulted in the separation of management and ownership. Hence, the management is entrusted with the directors (who are not owners). Then, do you think that the real owners are powerless or mere puppets in the affairs of the company? The answer is an emphatic, No. They can show their power in Annual General Body Meeting. In such a meeting, shareholders consider the annual accounts, the balance sheet, directors' report, audited accounts, etc. By passing a resolution (since they have voting rights), they approve and adopt all such important and crucial matters. Shareholder elect directors, appoint auditors, declare dividends, etc. All such matters are finalized only by the shareholders in general meeting. Even any amendment of articles or memorandum requires a resolution to be passed by the shareholders in such

meeting. Any ratification or approval can also be made possible only by the needed resolution passed by them in general meeting. General meeting is the place where the shareholders can show their might.

1.10.2 Board of Directors

There are a number of provisions, in respect of the directors, in the Companies Act. Managerial powers and control are entrusted with the Board of Directors. Generally, directors are elected by the shareholders. Board of Directors constitute more than two directors. Directors have to act in unison, i.e., the directors should act as a board. The Board has enormous powers. A meeting of the Board of Directors must be held once in every three calendar months as per the provisions of the Companies Act. The quorum is two directors or one-third of the total number, whichever is higher. They have to take any decisions at such meeting by way of resolutions. The directors are trustees for the company's property. They have to act for the benefit of the company alone. The directors should be cautious and diligent in exercising their powers. Generally, they are not responsible for any loss suffered by the company. But, if the directors are guilty of gross negligence or breach of trust, they must compensate the company for its losses.

Subject to Section 289 of the Companies Act, resolutions may also be adopted by circulation. However, according to Section 292, the following must be adopted only by the Board at its meeting:

1. The power to make calls
2. The power to issue debentures
3. The power to borrow moneys otherwise than on debenture
4. The power to invest company's funds
5. The power to make loans

Only at its meeting are specific powers delegated to individual directors. (But in general, individual directors have no powers.)

1.10.3 Managing Director

A managing director is "a director who, by virtue of an agreement with the company or of a resolution passed by the company in general meeting or by its Board, or, by virtue of its memorandum or articles of association, is entrusted with substantial powers of management which would not otherwise be exercisable by him, and includes a director occupying the position of a managing director, by whatever name called."

Appointment of a managing director (new or re-appointment) must be approved by the Central Government.

A managing director cannot act as such for more than two companies. In case of a second company, unanimous approval of the Board of Directors of that company is essential.

The powers and allied matters relating to managing director are explained in the provisions of the Companies Act.

1.10.4 Manager

A manager is "an individual … who, subject to the superintendence, control and director of the Board of Directors, has the management of the whole, or substantially the whole of affairs of the company, and includes a director or any other person occupying the position of a manager, by whatever name called, and whether under a contract of service or not". Generally, a manager is appointed by the Board of Directors. A company may have either the manager or the managing director. However, with the approval of the Central Government, a company may have two managing directors.

1.11 GENERAL MEETINGS OF THE COMPANY

The next item a student of corporate accounting should comprehend is "general meetings of the company". In general, there are three kinds of meetings of the company:

1. Statutory meeting
2. Annual general meeting
3. Extraordinary general meeting

1.11.1 Statutory Meeting

Every public company limited by shares and limited by guarantee and having share capital must hold a general meeting of its members within a period of not less than one month and more than six months from the date of commencement of business. At least 21 days before the day of the meeting, the Board has to forward to every member a report known as the statutory report along with the notice of the meeting. This meeting is termed statutory meeting.

The statutory report must state:

(i) The number of shares allotted; fully or partly paid; cash and other than cash; total amount received in cash
(ii) An abstract of receipts and payments made up to date within seven days of the report
(iii) An account or estimate of the preliminary expenses including commission and discount in respect of shares and debentures
(iv) Names, addresses and occupations of its directors, auditors, managers and secretary
(v) Contract for getting approval at the meeting
(vi) The arrears, if any, due on calls from directors, managers, etc.

In addition to the auditors, at least two directors must certify the statutory report. A copy of statutory report has to be filed with the registrar. A company cannot alter the terms of contract mentioned in the prospectus before the statutory meeting.

A private company is not required to hold a statutory meeting. After the first meeting, it may get adjourned from time to time. Due notice is the prime requirement to pass any resolution.

1.11.2 Annual General Meeting

The first general meeting must be held within 18 months of the incorporation of the company. Thereafter, it must be held every year but the interval between two annual general meetings must not be more than 15 months. The registrar is empowered to extend the time by 3 months. The meeting will be held, generally, at the place where the registered office is situated. It must not be held on public holidays. It must be held during normal business hours.

The following is the usual agenda:

1. Consideration of annual accounts, and the reports of directors
2. Election of directors
3. Appointment of auditors
4. Deciding rate of dividend

All these matters are passed by simple majority resolution. All other matters can be taken up for discussion but they should be given proper prior notice, i.e., at least 21 days in advance.

If any default is made in convening the meeting, the Central Government may intervene on the appeal of any one member. In such a case also, a notice of 21 days is necessary. This is the statutory provision.

1.11.3 Extraordinary General Meeting

Other than the statutory meeting and the annual general meeting, any general meeting of the company is called as an extraordinary general meeting.

This meeting is called by the directors if there is any urgent business that has to be done before the next general meeting.

Only special matters can be transacted in this type of meeting.

Extraordinary general meeting may also be called by the Board at the request of members (written requisition). The meeting must be called within 21 days of the deposit of the requisition to be held on a day not later than 45 days from such date. The notice should contain the matter to be transacted in the meeting.

In case the Board does not convene the meeting within 45 days of the requisition, the concerned members (requisitionists) may hold the meeting within 3 months of the date of requisition. However, all the statutory formalities should be adhered to strictly in the same manner as that of regular meetings.

The National Company Law Tribunal may order a meeting of the company to be held either on its own accord or on the application of a director or a member entitled to note.

1.12 QUORUM

The quorum for the general meetings of the company is FIVE persons personally present for public companies and TWO persons for private companies. However, the articles can fix a higher number than this.

1.13 VOTING

The followig is the procedure of voting:

- Every member present in the meeting has ONE VOTE.
- Voting is by show of hands.
- The chairman or five members present in person or proxy or members representing 10% of the paid-up capital or member(s) holding shares of not less than ₹ 50,000 may demand a poll in public companies.
- In a private company, poll may be demanded by one member present in person or proxy if not more than seven such members are personally present. If more than seven members are personally present, two members present in person or proxy may demand a poll.
- In case if there is a poll, proxies can be used.

1.14 RESOLUTIONS

According to the Companies Act, there are three types of resolutions:

1. Ordinary resolution
2. Special resolution
3. Resolution requiring special notice

1. **Ordinary resolution:** Resolution passed by a simple majority is called an ordinary resolution.
2. **Special resolution:** A special resolution is one (i) in regard to which the intention to propose the resolution as special resolution is specifically mentioned in the notice of the meeting, and (ii) which is passed if the votes cast for it are not less than three times the votes cast against it.

3. **Resolution requiring special notice:** This resolution is passed by the members at a general meeting by a simple or three-fourths majority. Besides, a notice of the intention to move the resolution (which requires special notice) should be given to the company not less than 14 days before the meeting at which it is to be moved. The company must immediately give notice to the members of the intention to move such a resolution.

1.15 FLOATING OF A COMPANY (FORMING A NEW COMPANY)

In general, promoters indulge in promoting a company, as they are well versed in the procedure. Irrespective of the involvement of a promoters or somebody else, the procedure to be followed will remain the same. which is explained as follows:

Stage I: Investigation: First, one has to thoroughly analyse and make an intensive survey to ascertain whether the business they are going to venture will be a propositious one.

Stage II: If such investigation injects a hopeful result, then a document called "Memorandum of Association" has to be prepared. It is an important document and its contents are described earlier in this chapter.

Stage III: Next, another important document called "The Articles of Association" has to be drafted. Its important clauses are also explained earlier in this chapter. It is nothing but rules and regulations for the conduct of the business of the company.

Stage IV: Competent persons should be chosen well in advance for the post of Managing Director of the company and an agreement should be entered into with him.

Stage V: List of persons who have agreed to become the first directors of the company, their written consent, their qualification shares, etc. have to be finalized and reduced to writing in standardized formats.

Stage VI: A declaration stating that all the provisions and requirements of the Companies Act have been complied with should be prepared. This should be signed by any one of the following persons:

(i) An advocate of the Supreme Court or High Court

(ii) An attorney or a pleader entitled to appear before a High Court

(iii) A secretary or a chartered accountant, who is engaged in the formation of the company

(iv) A person named as a director in the Articles of the Company

While preparing the above documents, care should be taken to see that no provision of requirements of The Companies Act should be left out. All the above documents should be sent to the Registrar of Companies with required fees.

Stage VII: The Registrar will peruse all the documents. He has to verify whether all the requirements of The Companies Act have been complied with. Then he will enter the company's name in the Registrar. The Registrar will issue a certificate at this stage, known as "Certificate of Incorporation". The company comes into EXISTENCE now.

Stage VIII: In order to get one more certificate—The Certificate of Commencement of Business—public limited company has to issue a prospectus (or prepare a statement in lieu of prospectus) signed by all directors and file a copy with the Registrar. (Contents of a prospectus are described earlier in this chapter). The company raises capital by inviting the public to subscribe for the shares and debentures of the company through "prospectus". The Companies Act, the Central Government, SEBI and the Reserve Bank of India impose several rules and regulations for the issue of prospectus by the companies. All such rules must be duly complied with.

1.16 MINIMUM SUBSCRIPTION

At this stage, one has to understand the meaning of "minimum subscription". Let us discuss it.

Minimum subscription means the amount which, in the opinion of the Board of Directors, is the minimum to be raised by the issue of shares so as to provide for the following:

(i) The price of any property purchased or agreed to be purchased
(ii) All preliminary expenses, including underwriting commission and brokerage
(iii) Repayment of money borrowed, if any, for the above purpose
(iv) Working capital
(v) Any other expenditure

For any new company issuing shares for the first time, this should be strictly adhered to. In case the newly incorporated companies are unable to raise the minimum subscription amount, it will not be able to get Certificate of Commencement of Business. The time limit to raise the minimum subscription is 120 days from the date of first issue of prospectus. If the company fails to do so, it has to refund the entire amount received from application within the next 10 days, i.e., within 130 days from the date of issue of prospectus.

Norms imposed by SEBI: If a company does not receive 90% of the issued amount from public subscription PLUS accepted development from underwriters or from other sources in case of under-subscribed issues, within 60 days from the date of closure of the issue, the company must refund the subscription amount in full. This condition is applicable to all the public and rights issue of shares.

The prospectus not only stipulates the minimum amount (minimum subscription) but also sets the minimum period for which the company will continue to receive application for shares. This minimum period is known as keeping the subscription LIST open. Subscription list must be kept open for at least 3 days. It should not open before the beginning of the fifth day from the date of issue of prospectus. The moneys received from applicant of shares, should be kept in a scheduled bank, until the minimum subscription level is reached. The ulterior motive in imposing so many restrictions is to ensure that only companies with sufficient capital are permitted to commence business.

Only after all such rules, regulations and provisions of The Companies Act are duly complied with, that the Registrar will issue the Certificate of Commencement of Business. After obtaining this certificate, a public limited company can commence its business.

The other import terms such as application money, allotment, calls, call-in-arrears, forfeiture and re-issue of forfeited shares are all explained in the forthcoming pages, while "accounting treatment" is discussed.

1.17 ISSUE OF SHARES

The shares of a company may be issued in two ways:

1. For cash
2. For consideration other than cash

1.17.1 Issue of Shares for Cash

1.17.1.1 Stage I—Application for Shares

This is the first stage for the issue of share capital. The prospectus invites the public to subscribe to its share capital. The prospective investors have to submit their application for shares (in the prescribed format) with the stipulated amount called "application amount". This should not be less than 25% of the issue price of the share. For example, if the issue price of a share is ₹ 10, application amount should not be less than

₹ 2.50 per share. Suppose if an investor wants to subscribe for 1,000 shares, then he will send the application form duly filled in and ₹ 2,500 has to be remitted in a scheduled bank mentioned in the prospectus.

1.17.1.1.1 Receipt of Applications

On receipt of applications, the company will make the needed entries in its Book.

Accounting Treatment:

Journal Entry for Receipt of Application Money

Bank A/c	Dr.	…	… { Total Amount Received on Application to be Entered in Amount Column }
To Share Application A/c			
(Receipt of Application Money in Respect of … Shares @ ₹… per Share).			

[Note and Remember: Whenever cash is received by the company, the (cash A/c) bank A/c should be debited.

Then, note for what purpose it is received. Here, it is received as share application. Hence that account, i.e., share application A/c, should be credited.]

1.17.1.1.2 Stage I—Transfer of Application Money

Situation 1: When all the shares applied for have been allotted:

In this case, i.e., Shares applied = Shares allotted, share application A/c has to be closed by transferring share application money to share capital A/c.

Accounting Treatment:

Share Application A/c	Dr.	…	{ Number of Shares Allotted × Application Money per Share }
To Share Capital A/c		...	
(Application Money on… Shares Allotted [Transferred to Share Capital]			

[There two entries fall under Stage I]

1.17.1.2 Stage II—Allotment

1.17.1.2.1 Amount Due on Allotment

If the par value of share is called up by the company, letters of allotment are sent to applicants to whom shares have been allotted. They will be requested to pay a part of the remaining value of shares after application amount. This amount is known as allotment money.

Accounting Entry for Amount Due on Allotment:

Share Allotment A/c	Dr.	…	{ Number of Shares Allotted × Allotment Amount per Share }
To Share Capital A/c		...	
(Amount Due on the Allotment of…….Shares @ ₹……per Share)			

1.17.1.2.2 Accounting Entry for Receipt of Allotment Amount

When Allotment Amount is Received

Bank A/c	Dr.	…	
To Share Allotment A/c		...	
(Allotment Money Received on…. Shares @ ₹… per Share).			

[**Note:** Cash Received – Debit the Bank A/c Purpose – Share Allotment → Credit the Share Allotment A/c]

[These two entries fall under Stage II]

1.17.1.3 Stage III—Call on Shares

The balance amount on the face value of shares after deducting the money received on application and allotment shall be asked by the Board of Directors to pay the allottees in a single payment or in more than one instalment. Each such instalment is known as a "call". Any number of calls—first call, second call, third call and final call—may be made to get the remaining value of shares. Following two conditions are important:

1. Call amount should not be less than 25% of issue price of shares
2. There should be at least an interval of one month between the makings of two calls or as provided in the Articles of Association.

Accounting Treatment:

1.17.1.3.1 Call Amount Due

Share—Call A/c	Dr.	…	{Number of Shares × Call Amount per Share}
To Share Capital A/c		...	
(— Call Due in Respect of …. of Shares @ ₹—Each)			
(If it is first call, fill with the words **I** call A/c, in case of second call **II** call A/c and so on)			

1.17.1.3.2 Receipt of Call Amount

Bank A/c	Dr.	…	{Number of Shares × Call Amount per Share}
To Share–Call A/c		...	
(Receipt of … Call on—Shares @ ₹—Each)			
[These two entries fall under Stage III]			

These six entries in three stages form the basis of accounting entries

1.18 ACCOUNTING TREATMENT FOR ISSUE OF SHARES FOR CASH

The whole process of issue of shares (i.e., from the receipt of application till the money received on final call) is divided into three stages, for the sake of convenience of passing entries, as follows:

Stage I: (a): On Receipt of Application Money:

Entry:		…	{Number of Shares Application × Amount per Share}
Cash A/c Bank A/c	Dr.	...	
To Share Application A/c			
(Application Money Received on….Application @ ₹—Each)			

Note: Students should keep in mind that whenever money is received by the company→Bank A/c → to be debited. The source (or purpose for) from which is received → that A/c → to be credited. Here, share application A/c. Though this is not a rule or accounting principle, it is a short cut method to remember.

(b): On Transfer of Application Money to Share Capital:

Entry: … { Number of Shares Allotted × Application Money per Share }

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

(Application Money Received Transferred to Share Capital A/c)

Stage II: (a) On Allotment Money Due:

Entry: … { Number of Shares Allotted × Allotment Money per Share }

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

(Allotment Money DUE on…. Shares @ ₹… per Share)

(b) On Receipt of Allotment Money:

Entry: … { Number of Shares Allotted × Allotment Money per Share }

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

(Allotment Money Received)

Stage III: (a) On Call Money Due:

Entry: … { Number of Shares × Call Money per Share }

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

(b) On Receipt of Call Money:

Bank A/c	Dr.	…	{ Number of Shares × Call Money per Share }
To Share Call A/c		...	

(Call Money Received)

Important note:

Generally, call money is received by the company in more than one instalment. Then in such cases, for every call (by prefixing the call number), this entry has to be repeated.

For instance, if call money is made in two instalments, then Call Money Due on First Call (first instalment) is to be recorded as:

Share First Call A/c	Dr.	…	
To Share Capital A/c			…
When money is received on first call,			
Bank A/c	Dr.	…	
To Share First Call A/c			…

Then, second instalment, i.e., Call Money Due on Second and Final Call

Share Second and Final Call A/c	Dr.	…	
To Share Capital A/c			…
When money is received on second call:			
Bank A/c	Dr.	…	
To Share Second & Final Call A/c			…

[And so on…., if third call is made]

[These THREE STAGES are the foundation or cornerstone on which all the other transactions are inserted or added, which are described then and there in course of solving problems. Students have to understand and master these steps which will facilitate the task of understanding this chapter with ease.]

Illustration 1.2

On 1 January 2010, Pappu & Co. Ltd. was incorporated with an authorized capital of ₹ 20,00,000 divided into shares of ₹ 10 each. It offered to the public for subscription of 50,000 shares payable as follows:

On Application	₹ 4 per Share
On Allotment	₹ 3 per Share
On First Call	₹ 2 per Share
On Second & Final Call	Re 1 per Share

Shares were fully subscribed. Application money was received on 15 January 2010. The directors made the allotment on 15 February 2010.

Journalize the above transactions in the books of Pappu & Co. Ltd.

Solution

In the Books of Pappu & Co. Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
15 January 2010	**Stage I**: (a) On Receipt of Application Money:			
	Bank A/c (50,000 × ₹ 4) Dr.		2,00,000	
	To Share Application A/c			2,00,000
	(Application Money Received on 50,000 @ ₹ 4 per Share)			
	(b) On Transfer of Application Money to Share Capital:			
	Share Application Dr.		2,00,000	
	To Share Capital A/c			2,00,000
	(Entire Application Money Received Transferred to Share Capital A/c)			
15 February 2010	**Stage II**: (a) On Share Allotment Amount DUE:			
	Share Allotment A/c (50,000 × ₹ 3) Dr.		1,50,000	
	To Share Capital A/c			1,50,000
	(Allotment Money Due on 50,000 Shares @ ₹ 3 per Share)			
15 February 2010	(b) On Receipt of Allotment Money:			
	Bank A/c Dr.		1,50,000	
	To Share Allotment A/c			1,50,000
	(Allotment Money Received Entirely)			
	Stage III: [***Note:*** Now, you have to note how many calls have been made. Here 2 calls are made. So for each call, entries have to be passed separately]			

	(a) On Share First Call Amount DUE:			
	Share First Call A/c (50,000 × ₹ 2)	Dr.	1,00,000	
	To Share Capital A/c			1,00,000
	(First Call Money Due on 50,000 Shares @ ₹ 2 per Share)			
	(b) On Receipt of First Call Amount:			
	Bank A/c	Dr.	1,00,000	
	To Share First Call A/c			1,00,000
	(First Call Money Received Entirely)			
	(c) On Share Second & Final Call Amount DUE:			
	Share Second and Final Call A/c	Dr.	50,000	
	To Share Capital A/c			50,000
	(Second and Final Call Money Due on 50,000 Shares @ ₹ 1 per Share)			
	(d) On Second & Final Call Money Received:			
	Bank A/c	Dr.	50,000	
	To Share Second and Final Call A/c			50,000
	(Second and Final Call Money Received Entirely)			

Note: If in the problem shares are specifically mentioned such as "equity shares", then in the entries "equity" should be prefixed. Generally, shares denote equity shares. If "preference shares" are given in the problem, then the word "preference" should be prefixed to the word "share" in journal entries.

Stage 2: There are three entries:

(a) On transfer of application money to share capital A/c (Situation 1: When shares are allotted for all the A/c applicants)

(b) On allotment money due

(c) On receipt of allotment amount

Stage 3: There are mainly two entries (if there is only one call):

(a) Share call amount due

(b) On receipt of share call money

Important note: Students should be thorough with these BASIC ENTRIES.

Illustration 1.3

Model : Only one call

Good Luck Ltd. Company was incorporated on 1 January 2010 with an authorized capital of ₹ 5,00,000 divided into shares of ₹ 10 each.

It offered to the public for subscription 40,000 shares payable as follows:

On Application	₹ 3 per Share
On Allotment	₹ 4 per Share
On First and Final Call	₹ 3 per Share

(1 month After Allotment)

The shares were fully subscribed by the public and the application money was duly received on 15 January 2010. The directors made the allotment on 1 February 2010.

Pass the journal entries in the books of Good luck Ltd. Company, assuming that amount due have been received within 15 days of making the allotment and call.

Solution

NOTE:

1. In this problem nothing is mentioned regarding the class of shares issued. In such cases, they are always treated as equity shares.
2. Hence, the word "equity" should be prefixed to "share" while recording entries. (In case it is preference shares, then instead of equity, preference shares should be written.)

Now, make journal columns and remember the explained set of entries in three stages and record one by one as follows:

Books of Good Luck Company

Journal

Date	Particulars	L.F.	Debit Amount ₹	Credit Amount ₹
15 January 2010	**STAGE I:** (a) On Receipt of Application Money:			
	Bank A/c Dr.		1,20,000	
	To Equity Share Application A/c			1,20,000
	(Money Received on Applications for 40,000 Equity Shares @ ₹ 3 per Share. 40,000 × ₹ 3 = ₹ 1,20,000)			
1 February	(b) On Transfer of Application Money:			
	Equity Share Application A/c Dr.		1,20,000	
	To Equity Share Capital A/c			1,20,000
	(Transfer of Application Money on 40,000 Equity Shares to Share Capital A/c)			
1 February	**STAGE II:** (a) On Allotment Due:			
	Equity Share Allotment A/c Dr.		1,60,000	
	To Equity Share Capital A/c			1,60,000
	(Amount Due on the Allotment of 40,000 Equity Shares @ ₹ 4 per Share) (40,000 × ₹ 4 = ₹ 1,60,000)			
15 February	(b) On Receipt of Allotment Money:			
	Bank A/c Dr.		1,60,000	
	To Equity Share Allotment A/c			1,60,000
	(Allotment Money Duly Received)			
1 March	**STAGE III:** (a) On Call Money Due:			
	Equity Share Call A/c Dr.		1,20,000	
	To Equity Share Capital A/c			1,20,000
	(Call Money Due on 40,000 Shares @ ₹ 3 per Share)			
	40,000 × ₹ 3 = ₹ 1,20,000			
	Note: Since there is only one call in this problem, call number need not arise.			

15 March	(b) On Receipt of Call Money: Bank A/c Dr. To Equity Share Call A/c (Call Money Received on 40,000 Shares @ ₹ 3 per Share)		1,20,000	 1,20,000

Illustration 1.4

Model: More than one calls

Fortune Ltd. on 1 January 2010 was incorporated with an authorized capital of ₹ 10,00,000 divided into shares of ₹ 100 each.

If offered to the public for subscription 9,000 shares payable as follows:

On Application	₹ 25 per Share
On Allotment	₹ 25 per Share
On First Call	₹ 25 per Share
On Second and Final Call	₹ 25 per Share

Shares were fully subscribed for by the public and all money on allotment, first call and final call were received duly.

Pass necessary entries in the books of the company.

Solution

Note:

1. Students have to enter one more entry, for the second and final call. This should be made in Stage III after entry for first call has been made.
2. In this problem also, it is given as shares only. Automatically, it should be treated as equity shares.

Books of Fortune Ltd.

Journal

Date	Particulars	L.F.	Debit Amount ₹	Credit Amount ₹
2010	**Stage I:** (a) On Receipt of Application Money: Bank A/c. Dr. To Equity Share Application A/c (Money Received on Applications for 9,000 Equity Shares @ ₹ 25 per Share.) [9,000 × ₹ 25 = ₹ 1,75,000]		1,75,000	 1,75,000
	(b) On Transfer of Application Money to Share Capital A/c: Equity Share Application A/c Dr. To Equity Share Capital A/c (Transfer of Application Money to Share Capital A/c on 9,000 Equity Shares)		1,75,000	 1,75,000

	Stage II: (a) On Allotment Money Due: Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Amount Due on Allotment of 9,000 Equity Shares @ ₹ 25 per Share)		1,75,000	1,75,000
	(b) On Receipt of Allotment Money: Bank A/c Dr. To Equity Share Allotment A/c (Allotment Money Received)		1,75,000	1,75,000
	Stage III: (a) (i) On First Call Money Due: Equity Share First Call A/c Dr. To Equity Share Capital A/c (First Call Money Due on 9,000 Equity Shares @ ₹ 25 Each)		1,75,000	1,75,000
	(a) (ii) On Receipt of First Call Money: Bank A/c Dr. To Equity Share First Call A/c (First Call Money Received)		1,75,000	1,75,000
	*(b) (i) On Second & Final Call Money Due: Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Second & Final Call Money Due on 9,000 Shares @ ₹ 25 Each)		1,75,000	1,75,000
	(b) (ii) On Receipt of Second & Final Call Money: Bank A/c Dr. To Equity Share Final Call A/c (Second & Final Call Money Received)		1,75,000	1,75,000

***Note:** If there is more than one call, then for each such call two more entries have to be repeated as shown above—Stage III b (i) & (ii). That is the only difference between Model 1 and Model 2.

1.18.1 Combined Account

Sometimes a combined account for share application and share allotments is recorded.

There are four entries, if they are recorded separately (as in previous two illustrations, i.e., Stage I (1) and Stage II (a), (b) and (c). Now, in case of combined account it has to be recorded as follows:

Stage I: On Receipt of Application Amount:

Bank A/c Dr. …

To Share Application and Allotment A/c …

(Money Received on Applications for … Shares @ ₹… per Share)

Stage II: (a) Transfer of Application Money and Allotment Due:

Share Application and Allotment A/c Dr … { Number of Shares Alloted × Application Money per Share + Allotment Amount per Share }

To Share Capital A/c ...

(b) On Receipt of Allotment Amount:

Bank A/c Dr. …

To Share Application and Allotment A/c …

(Allotment Money Received)

Illustration 1.5

Model: Combined account for share application and share allotment

Same figures as in Illustration 1.3.

Solution

Books of Fortune Ltd.

Journal

Date	Particulars	L.F.	Debit Amount ₹	Credit Amount ₹
	Stage I:			
	Bank A/c Dr.		1,75,000	
	To Equity Share Application & Allotment A/c			1,75,000
	(Money Received on Applications for 9,000 Equity Shares @ ₹ 25 per Share.)			
	Stage II: (a) On Transfer of Application & Allotment Money:			
	Equity Share Application & Allotment A/c Dr.		1,75,000	
	To Equity Share Capital A/c			1,75,000
	(Transfer of Application and Allotment Money on 9,000 Shares to Share Capital)			
	(b) On Allotment Money Received:			
	Bank A/c Dr.		1,75,000	
	To Equity Share Application & Allotment A/c			1,75,000
	(Allotment Money Received)			
	Stage III: (a) (i) On First Call Money Due:			
	Equity Share First Call A/c Dr.		1,75,000	
	To Equity Share Capital A/c			1,75,000
	(First Call Money Due on 9,000 Shares @ ₹ 25 per Share)			
	(a) (ii) On Receipt of First Call Money:			
	Bank A/c Dr.		1,75,000	
	To Equity Share First Call A/c			1,75,000
	(First Call Money Received)			

	(b) (i) On Second & Final Call Money Due: Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Second & Final Call Money Due on 9,000 Shares @ ₹25 per Share)		1,75,000	1,75,000
	(b) (ii) On Receipt of Second & Final Call Money: Bank A/c Dr. To Equity Share Final Call A/c (Second & Final Call Money Received)		1,75,000	1,75,000

1.19 OVER-SUBSCRIPTION

When the number of shares applied for is more than the number of shares offered for issue, such a situation is called over-subscription. As per SEBI Guidelines, all applications have to be categorized according to the number of shares applied for and then allotment has to be made in marketable lots on a proportionate basis.

Here, only accounting treatment for oversubscription is dealt with. There are three alternatives to deal with oversubscribed shares.

1.19.1 Alternative 1

The directors may decide:

(i) to fully accept some applications

(ii) to reject those in excess of the needed number

That means, some applicants may not be allotted any shares. Regret letters will be sent to them and the money will be refunded for such rejected applications.

Journal Entry

Share Application A/c	Dr.	…	{Number of Application Rejected × Application/Money per Share}	
To Bank A/c		...		
(Refund of Excess Application Money on…. Shares @ ₹… per Share)				
(This is Just the Reverse Entry of Application Money Received)				

1.19.2 Alternative 2

The Board of Directors can make a proportionate distribution of shares available for allotment among the applicants. This is usually made on the basis of the ratio between the number of shares to be allotted and the number of shares applied for. This method is known as pro-rata allotment.

To illustrate, in case if application for 1,00,000 shares are invited and received shares are 1,50,000. Under pro-rata allotment, two shares will be allotted for every three shares applied for.

1,00,000:1,50,000

= 2:3

The excess application money of 50,000 shares will be adjusted towards the amount due on the allotment of 1,00,000 shares.

Journal Entry

Stage I: 1. On Receipt of Application Money:

Bank A/c	Dr.	…	{Number of Application Rejected × Application Amount per Share}
To Share Application A/c		...	

Stage I: (c) (a) On Adjustment of Application Money:

Share Application A/c	Dr.	…	{Number of Shares Allotted × Application Money per Share}
To Share Capital A/c		...	
To Share Allotment A/c			

Stage II: (a) On Share Allotment Due:

Share Allotment A/c	Dr.	…	
To Share Capital A/c		…	

(b) On Receipt of Allotment Money

Bank A/c	Dr.	…	{Shares Allotment Due Excess Application Money}
To Share Allotment A/c		...	

1.19.3 Alternative 3

The Board of Directors can opt for this alternative which is a combination of the above-mentioned two alternatives.

(a) Some shares are rejected

(b) The remaining shares are allotted on a pro-rata basis

To illustrate, for 1,00,000 shares invited, 1,50,000 applications are received. Board of Directors decided

(a) To reject 25,000 shares outright

(b) Make a pro-rata allotment of remaining excess shares, i.e., 25,000

That means, 1,00,000 applicants are to be allotted 1,25,000 shares—4 shares are allotted for every 5 applicants (1,00,000:1,25,000 = 4:5.)

Hence, money on 25,000 shares will be refunded.

Application money received on another 25,000 shares will be adjusted towards the amount due on the allotment of shares allotted.

Journal Entry

(a) Bank A/c	Dr	…	{Number of Application Received × Application Money per Share}
To Share Application A/c		...	
(b) Share Application A/c	Dr.	…	[Application Money Received]
To Share Capital A/c		…	{Number of Shares Allotted × Application Money per Share}
To Share Allotment A/c		…	[Excess Application Money]
To Bank A/c		…	{Number of Shares Rejected × Application Money per Share}
(c) Share Allotment A/c	Dr.	…	{Number of Shares Allotted Application Money per Share}
To Share Capital A/c		...	

(d) Bank A/c Dr. … {Amount Due on Allotment Excess / Application Moey Already Adiusted}
To Share Allotment A/c
...

Illustration 1.6

Model: Over-subscription—Excess applications rejected completely

X Co. Ltd. invited applications for 50,000 shares of ₹ 10 each payable:

On Application ₹ 3

On Allotment ₹ 2

And the balance when required

60,000 shares were applied for. The directors accepted applications for 50,000 shares and rejected the remaining applications. Allotment money was received on 49,000 shares.

You are required to pass the necessary journal entries, make the ledger accounts and show these items in the balance sheet of the company.

Solution

Note:

1. Excess applications were rejected outright. First alternative (i.e.) application money on rejected ones have to be refunded.
2. 50,000 Shares were allotted. But money for allotment was received only for 49,000 shares. Hence, 'On allotment due': 50,000 × ₹ 2 = ₹ 1,00,000 has to be recorded and on receipt of allotment, 49,000 × ₹ 2 = ₹ 98,000 has to be recorded.
3. Here, ledger accounts and balance sheet are to be prepared in addition to journal entries.
   First, journal entries have to be passed in the books of the company. Then, from these journal entries, ledger accounts have to be prepared and finally from the available figures, the balance sheet has to be drawn up.

Step 1: Passing of Entries:

Journal Entries in the Books of X Co. Ltd.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		1,80,000	
	To Equity Share Application A/c (Application Money Received on 60,000 Shares @ ₹ 3 per Share) 60,000 × ₹ 3			1,80,000
	(b) On Transfer of Application Money to Share Capital:			
	Share Application A/c Dr.		1,50,000	
	To Share Capital A/c			1,50,000
	(50,000 Shares Allotted and Money on Them Transferred to Share Capital A/c) 50,000 × ₹ 3 = ₹ 1,50,000			
	(c) On Refund of Rejected Applications:			
	Share Application A/c Dr.		30,000	
	To Bank A/c			30,000
	(Refund of Application Money on 10,000 Shares Rejected) 10,000 × ₹ 3			

	Stage II: (a) On Allotment Money Due:			
	Share Application A/c Dr.		1,00,000	
	To Share Capital A/c			1,00,000
	(Amount Due on 50,000 Shares @ ₹ 2 per Share)			
	50,000 × ₹ 2 = ₹ 1,00,000			
	(b) On Receipt of Allotment Amount:			
	Bank A/c Dr.		98,000	
	To Share Allotment A/c			98,000
	(Allotment Money Received on 49,000 Shares @ ₹ 2 per Share)			
	49,000 × ₹ 2 = ₹ 98,000			

Step 2: Preparation of Ledger Accounts:

1. Share Application Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	1,50,000		By Bank A/c	1,80,000
	To Bank A/c	30,000			
		1,80,000			1,80,000

2. Share Capital Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	2,50,000		By Share Application A/c	1,50,000
				By Share Allotment A/c	1,00,000
		2,50,000			2,50,000
				By Balance b/d	2,50,000

3. Bank Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Application A/c	1,80,000		By Share Application A/c	30,000
	To Share Allotment A/c	98,000			2,48,000
		2,78,000		By Balance c/d	2,78,000
	To Balance b/d	2,48,000			

4. Share Allotment Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	1,00,000		By Bank A/c	98,000
				By Balance c/d	2,000
		1,00,000			1,00,000
	To Balance b/d	2,000			

5. Balance Sheet as at…

Dr. **Cr.**

Liabilities		₹	Assets	₹
Share Capital:			*	
50,000 Shares of ₹ 10, Each: ₹			Cash at Bank	2,48,000
+				
Called up (₹ 3 + 2):	2,50,000			
*LESS: Share Allotment Due:	2,000	2,48,000		
		2,48,000		2,48,000

Illustration 1.7

Model: Pro-rata allotment of shares

Green Co. Ltd invited applications for 10,000 shares of ₹ 20 each payable as follows:

On Application ₹ 5

On Allotment ₹ 6

And the balance when required

Applications were received for 15,000 shares. The directors decided to allot on pro-rata basis.

Pass necessary journal entries.

Solution

Books of Green & Co. Ltd

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		75,000	
	To Share Application A/c			75,000
	(Money Received on Application for 15,000 Shares @ ₹ 5 per Share) [15,000 × ₹ 5 = ₹ 75,000]			
	(b) On Adjustment of Application Money:			
	Share Application A/c Dr.		75,000	
	To Share Capital A/c			50,000
	To Share Allotment A/c			25,000
	(Out of ₹ 75,000 Received on Application, ₹ 50,000 is Transferred to Share Capital; Excess ₹ 25,000 is Adjusted with Share Allotment)			
	Stage II: (a) On Allotment Money Due:			
	Share Allotment A/c Dr.		60,000	
	To Share Capital A/c			60,000
	(Allotment Money Due on 10,000 Shares @ ₹ 6 per Share) 10,000 × ₹ 6			

	(b) On Receipt of Allotment Money: Bank A/c Dr. To Share Allotment A/c (Allotment Money Received Allotment Due – Excess Application Money (₹ 60,000 – ₹ 25,000)		35,000	35,000

Illustration 1.8

Model: Partly rejected and partly pro-rata allotment

A public limited company invited applications for 1,00,000 shares of ₹ 10 each payable as:

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

Applications for 1,50,000 shares were received. Applications for 20,000 shares were rejected outright. Remaining applicants were allotted 1,00,000 shares on pro-rata basis. The excess amount on application was adjusted towards the amount due on allotment. All the shareholders paid the amount duly. Journalize the transactions.

Solution

Step 1: Excess Money (Application) to Be Adjusted Towards Allotment Money Is Arrived as Shown in the Following:

(a) Number of Applications Received: 1,50,000
Application Fee/Share: ₹ 3

		₹
∴ Amount Received on 1,50,000 Shares @ ₹ 3 per Share (1,50,000 × ₹ 3)	=	4,50,000
(b) Less: Amount Transferred to Share Capital (1,00,000 × ₹ 3)	=	3,00,000
(c) Excess Application Money [(a) – (b)]	=	1,50,000
(d) Less: Rejected & Refunded (20,000 × ₹ 3)	=	60,000
(e) Excess Application Money to Be Adjusted towards Allotment Money [(c) – (d)]	=	90,000

Step 2: Allotment Money Due:

(a) Number of Shares × Allotment Money Due 1,00,000 × ₹ 4	=	4,00,000
(b) Less: Excess Application Money Already Adjusted to Allotment Money: (Ref: Step 1 (e))	=	90,000
(c) Actual Allotment Money to Be Received & Credited to Bank A/c [Step 2: (a) – (b)] {Allotment Due – Excess Application Money}	=	3,10,000

Step 3:

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		4,50,000	
	To Share Application A/c			4,50,000
	(Application Money Received on 1,50,000 Shares @ ₹ 3 Each)			
	(b) On Transfer of Share Application Money to Share Capital			
	Share Application A/c Dr.		3,00,000	
	To Share Capital A/c			3,00,000
	(Application Money on 1,00,000 Shares @ ₹ 3 per Share Transferred to Share Capital Account)			
	(c) On Rejected Application Refunded:			
	Share Application A/c Dr.		60,000	
	To Bank A/c			60,000
	(Money Refunded on 20,000 Shares Which Are Rejected) 20,000 × ₹ 3			
	Stage II: (a) On Allotment Money Due:			
	Share Allotment A/c Dr.		4,00,000	
	To Share Capital A/c			4,00,000
	(Allotment Money Due on 1,00,000 Shares @ ₹ 4 per Share)			
	(b) On Excess Money Adjusted to Allotment A/c:			
	Share Application A/c Dr.		90,000	
	To Share Allotment A/c			90,000
	(Excess Application Money Adjusted with Allotment A/c) [Ref: Step 1 (e)]			
	(c) On Receipt of Allotment Money			
	Bank A/c Dr.		3,10,000	
	To Share Allotment A/c			3,10,000
	(Share Allotment Money Received After Refund & Adjustment) [Ref: Step 2 (c)]			
	Stage III: (a): On Call Money Due:			
	Share Call A/c Dr.		3,00,000	
	To Share Capital A/c			3,00,000
	(Call Money Due on 1,00,000 Shares @ ₹ 3 per Share)			
	(b): On Receipt of Call Money:			
	Bank A/c Dr.		3,00,000	
	To Share Call A/c			3,00,000
	(Call Money Received)			

1.20 UNDER–SUBSCRIPTION

All the shares offered by a company, at times, may not be taken by the public. In such a situation, the number of shares applied for is less than the number of shares offered by the company to the public. Such a situation is called "under-subscription" of shares.

This is subject to the condition that minimum subscription should have been received by the company. As per statutory provisions, shares can be issued for subscription only after minimum subscription has been received.

Accounting Treatment:

Journal entities are to be made on the basis of shares APPLIED (NOT ON THE BASIS OF SHARES ISSUED). Hence, no special treatment is required.

If the number of shares applied for is less than 90% of the minimum subscription, the issue devolves if not under-written.

1.20.1 Distinction Between Under-subscription and Over-subscription

The following table gives the differences between under-subscription and over-subscription:

Basis of Distinction	Under–subscription	Over–subscription
1. Number of shares applied	Number of shares applied is less than the shares offered for subscription.	Number of shares applied is more than the shares offered for subscription.
2. Acceptance of application	All the applications are accepted.	All applications are not accepted. Some may be rejected. Some may be on pro-rata basis.
3. Allotment of shares	All the subscribers are allotted shares, i.e., full allotment.	Excess shares are allotted on pro-rata basis.
4. Refund of application money	As all applications are accepted, question of refund of money does not arise.	Application money for rejected shares, refund of money takes place.
5. Minimum subscription	Sometimes, the company may face the problem of minimum subscription	No such problem arises in this case.

Illustration 1.9

Model: Under-subscription

Vas & Co. Ltd. offered 20,000 shares of ₹ 50 each to the public as:

On Application	₹ 20
On Allotment	₹ 15
On Call	₹ 15

The public applied for 18,000 shares only. All money due received.

Pass journal entries.

Solution

In the Books of Vas & Co. Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		3,60,000	
	To Share Application A/c			3,60,000
	(Application Money Received on 18,000 Shares @ ₹ 20 per Share) 18,000 × ₹ 20			
	(b) On Transfer of Share Application Money to Share Capital Account:			
	Share Application A/c Dr.		3,60,000	
	To Share Capital A/c			3,60,000
	(Application Money Transferred to Share Capital A/c)			
	Stage II: (a) On Share Allotment Due:			
	Share Allotment A/c Dr.		2,70,000	
	To Share Capital A/c			2,70,000
	(Amount Due on Allotment @ ₹ 15 on 18,000 Shares)			
	(b) On Receipt of Allotment Money:			
	Bank A/c Dr.		2,70,000	
	To Share Allotment A/c			2,70,000
	(Money Received on Allotment)			
	Stage III: (a) Amount Due on Share Call:			
	Share Call A/c Dr.		2,70,000	
	To Share Capital A/c			2,70,000
	(Amount Due on 18,000 Shares @ ₹ 15)			
	(b) On Receipt of Call Amount:			
	Bank A/c Dr.		2,70,000	
	To Share Call A/c			2,70,000
	(Amount Received on Call)			

1.21 CALLS-IN-ARREARS

Sometimes, shareholders may fail to pay the amount due on CALLS. The amount not received on calls (as per terms and conditions) by the company is termed "calls-in-arrears".

An interest (5% p.a.) is charged on calls-in-arrears till such amount is paid. The directors are empowered to waive the interest charge. This amount is shown as deduction from the called-up-capital to arrive at the paid-up share capital in the balance sheet.

Accounting Treatment:

The following are the two methods for dealing with calls-in-arrears:

1. Without opening calls-in-arrear account
2. By opening calls-in-arrear account

1.21.1 Without Opening Calls-in-Arrear Account

If a separate account for calls-in-arrear is not opened, amount received from the shareholders is credited to the relevant call account. As such, various call accounts will show debit balance equal to the total unpaid amount of each such call.

On a later date, if the calls-in-arrear is received, bank A/c is debited and the respective call account is credited.

1.21.2 By Opening Calls-in-Arrear Account

Accounting Treatment: For calls-in-arrear:

(a) On Non-receipt of Call Money:				What Amount Should Enter ↓
Calls-in-Arrear A/c	Dr.	…		{With the Amount Not Paid}
To Relevant Call A/c			...	
(b) On Receipt of Calls-in-Arrear on a Later Date				
Bank A/c	Dr.	…		{With the Amount Calls in Arrear Received}
To Call-in-Arrears A/c			...	
(c) On Interest Due on Calls-in-Arrears:				
Sundry Members A/c	Dr.	…		{With the Amount of Interest Due}
To Interest on Calls-in-Arrear			...	
(d) On Receipt of Interest on Calls-in-Arrear:				{With the Amount of Interest Received}
Bank A/c	Dr.	…		
To Sundry Members A/c.			...	
(e) On Transfer of Interest to P&L A/c				
Interest on Calls-in-Arrear A/c	Dr.	…		{With the Amount of Interest}
To Profit & Loss A/c			...	

Illustration 1.10

Model: Calls-in-arrear

Raj Ltd. issued 20,000 equity shares of ₹10 each payable: ₹3 on Application; ₹2.50 on Allotment; ₹2 on I call and the balance on final call. All the shares are fully subscribed and paid except a shareholder having 200 shares could not pay the final call. Journalize these transactions.

Solution

Books of Raj Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		60,000	
	To Equity Share Application A/c			60,000
	(Money Received on Applications for 20,000 Shares @ ₹3 per Share)			

	(b) On Transfer of Application Money:				
	Equity Share Application A/c	Dr.		60,000	
	To Equity Share Capital A/c				60,000
	(Transfer of Application Money to Share Capital)				
	Stage II: (a) On Allotment Money Due:				
	Equity Share Allotment A/c	Dr.		50,000	
	To Equity Share Capital A/c				50,000
	(Allotment Money Due on 20,000 Shares @ ₹ 2.50 per Share)				
	(b) On Receipt of Allotment Money:				
	Bank A/c	Dr.		50,000	
	To Equity Share Allotment A/c				50,000
	(Allotment Money Received)				
	Stage III:				
	(a) On First Call Due:				
	Equity Share First Call A/c	Dr.		40,000	
	To Equity Share Capital A/c				40,000
	(First Call Money Due on 20,000 shares @ ₹ 2 Share)				
	(b) On Receipt of First Call Money:				
	Bank A/c	Dr.		40,000	
	To Equity Share First Call A/c				40,000
	(First Call Money Received)				
	(c) On Second & Final Call Due:				
	Equity Share Final Call A/c	Dr.		50,000	
	To Equity Share Capital A/c				50,000
	(Final Call Money Due on 20,000 Shares @ ₹ 2.50				
	[10 – (3 + 2.50 + 2)]				
	(d) On Receipt of Final Call:				
	Bank A/c (19,800 × ₹ 2.50)	Dr.		49,500	
	Calls-in-Arrears A/c (200 × ₹ 2.50)	Dr.		500	
	To Equity Share Final Call A/c				50,000
	(Final Call Money Received Except on 200 Shares)				

1.22 CALLS-IN-ADVANCE

When a company accepts money, paid in advance for calls, for which they are not yet DUE, such amount is called "calls-in-advance".

For this, the Articles should permit to do so.

Entry:

Bank A/c Dr. ...

To Calls-in-Advance A/c ...

This amount is adjusted when the respective call is made.

Entry:

Calls-in-Advance A/c Dr. ...

To Call A/c ...

It may occur at the time of pro-rata allotment also. In such a case, if surplus application money is treated as calls-in-advance, interest will be paid with effect from the date of allotment only.

Usually, 6% interest is allowed on calls-in-advance. Such interest is a charge against profit. Balance of calls-in-advance A/c is shown as a separate item on the liabilities side of the balance sheet, under the head "Current Liabilities".

Illustration 1.11

Model: Calls-in-advance

Jasemine & Co. Ltd. issued to the public 1,00,000 shares of ₹10 each payable as:

On Application	₹3
On Allotment	₹3
On First & Final Call	₹4

All the shares were subscribed for and all money due was received. A shareholder who paid for 1,000 shares paid the call money along with allotted money.

Pass the necessary journal entries in the books of Jasemine Ltd.

Solution

Note: Paid call money along with allotted money means that it was paid in advance.

This calls-in-advance was paid along with allotment money. So, when money paid on allotment, this has to be credited.

When the money is paid on call, this has to be adjusted with that.

In the Books of Jasemine & Co. Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		3,00,000	
	To Share Application A/c			3,00,000
	(Application Money Received on 1,00,000 Shares @ ₹3 per Share)			
	(b): On Transfer of Application Money:			
	Share Application A/c Dr.		3,00,000	
	To Share Capital A/c			3,00,000
	(Share Application Money Transferred to Share Capital A/c)			
	Stage II: (a) On Allotment Money Due:			
	Share Allotment A/c Dr.		3,00,000	
	To Share Capital A/c			3,00,000
	(Allotment Money Due on 1,00,000 Shares @ ₹3 per Share)			
	(b) On Receipt of Allotment Money:			
	Bank A/c Dr.		3,04,000	
	To Share Allotment A/c			3,00,000
	To Calls-in-Advance A/c			4,000
	(Allotment Money Received + Call Money on 1,000 Shares @ ₹4 Received in Advance)			

	Stage III: (a) On Call Money due:			
	Share First & Final Call A/c Dr.		4,00,000	
	To Share Capital A/c			4,00,000
	(Call Amount Due on 1,00,000 Shares @ ₹ 4 per Share)			
	(b) Call Money (On Receipt of):			
	Bank A/c Dr.		3,96,000	
	Calls-in-Advance A/c Dr.		4,000	
	To Share First & Final Call A/c			4,00,000
	(Call Money Received and Calls-in-Advance—1,000 Share @ ₹ 4 Transferred to Call A/c)			

Illustration 1.12

Model: Computation of interest on calls-in-advance and calls-in-arrear

X Ltd. issued 50,000 shares of ₹ 10 each payable as:

On Application	₹ 2 (1 January 2010)
On Allotment	₹ 3 (1 April 2010)
On First Call	₹ 3 (1 June 2010)
On Second & First Call	₹ 2 (1 August 2010)

Applications were received for 45,000 shares and the directors made allotment in full. X, one shareholder, to whom 50 shares were allotted, paid the entire balance on his shareholdings with allotment money and Y, another shareholder, did not pay allotment and first call money on 100 shares but for which he paid with final call.

You are required to calculate the amount of interest paid and received on calls-in-advance and calls-in-arrear on 1 August 2010.

Solution

1. Calculation of Interest on Calls-in-Advance:

   X—To whom 50 shares were allotted paid in advance. He paid both calls money in advance along with allotment.

   (i) Number of Shares: 50 × First Call Money: ₹ 3

   50 × ₹ 3 = ₹ 150 for 2 months (April to June):

		₹
Interest = ₹ 150 × $\frac{2}{12}$ × $\frac{6}{100}$	=	1.50

   (ii) For Second Call Money:

   Number of Shares = 50 × Second Call Money

   = ₹ 2 = ₹ 100

   Period (April to August) = 4 months

Interest = ₹ 100 × $\frac{4}{12}$ × $\frac{6}{100}$	=	2.00
∴ Interest on Calls-in-Advance	=	3.50

2. Calculation of Interest on Calls-in-Arrear:

   Y—To whom 100 shares were allotted did not pay in due date.

   He paid allotment money and first call only along with final call.

(i) 100 Shares–allotment money–after 4 months.

$\therefore$ Interest on Arrears = $(100 \times ₹3) \times \frac{4}{12} \times \frac{5}{100}$ = ₹5.00

(ii) Interest on First Call Money:

100 Shares × ₹3 × $\frac{2}{12} \times \frac{5}{100}$ = ₹2.50

$\therefore$ Interest on Calls-in-Arrear = ₹7.50

Illustration 1.13

Model: Calls-in-arrear and calls-in-advance

On 1 January 2010, X Ltd. makes an issue of 20,000 equity shares of ₹10 each payable as:

On Application	₹2
On Allotment	₹3
On First & Final Call	₹5 (three months after allotment)

Applications were received for 25,000 shares. The directors made in full to the applicants demanding ten or more shares and rejected and returned money to the applicants for 5,000 shares. One shareholder Mr. A, who was allotted 50 shares, paid first and final call with allotment money. Another shareholder Mr. B did not pay allotment money on his 100 shares but he paid with first and final call. Directors have decided to charge and allow interest, as the case may be.

Journalize the transactions.

Solution

Working:

1. Calculation of Interest on Calls-in-Advance:
   Mr. A Paid for 50 Shares Call Money Along with Allotment
   Amount: 50 × ₹5 = ₹250; Period: 3 months or $\frac{3}{12}$; r = 6%

$\therefore$ Interest on Call-in-Advance = ₹250 × $\frac{3}{12} \times \frac{6}{100}$ = ₹3.75

2. Calculation of Interest on Calls-in-Arrear:
   Mr. B Paid for 100 Shares Allotment Money Only on Call Date.
   Number of Shares: 100 × 3 = ₹300; Period: 3 months; r = 5%

$\therefore$ Interest on Call-in-Arrear = 300 × $\frac{3}{12} \times \frac{5}{100}$ = ₹3.75

In the Books of X Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		50,000	
	To Equity Share Application A/c			50,000
	(Application Money Received on 25,000 Equity Shares @ ₹2 per Share)			

	(b) On Transfer of Application Money:			
	Equity Share Application A/c Dr.		40,000	
	To Equity Share Capital A/c			40,000
	(Application Money Transferred to Share Capital A/c on 20,000 Shares @ ₹ 2)			
	Stage II: (a) On Allotment Money Due:			
	Equity Share Allotment A/c Dr.		60,000	
	To Equity Share Capital A/c			60,000
	(Allotment Amount Due on 20,000 Shares @ ₹ 3 per Share)			
	(b) On Rejected & Refunded Applications:			
	Equity Share Application A/c Dr.		10,000	
	To Bank A/c			10,000
	(5,000 Shares Were Rejected and Applications Money Refunded @ ₹ 2)			
	(c) On Allotment Money Received:			
	Bank A/c Dr.		59,950	
	Calls-in-Arrear A/c Dr.		300	
	To Equity Share Allotment A/c			60,000
	To Calls-in-Advance A/c (OR)			250
	Bank A/c Dr.		59,950	
	To Equity Share Allotment A/c			59,700
	To Calls-in-Advance A/c			250
	(Allotment Money Received)			
	Stage III: (a) First & Final Call Money Due:			
	Equity First & Final Call A/c Dr.		1,00,000	
	To Equity Share Capital A/c			1,00,000
	(First & Final Call Money Due on 20,000 Shares @ ₹ 5 per Share)			
	(b) On Receipt of First & Final Call Money:			
	Bank A/c Dr.		1,00,050	
	To Equity First & Final Call A/c			99,750
	To Calls-in-Arrear A/c			300
	(Share–100 Shares Allotment @ ₹ 3) (20,000 × 5 = 1,00,000 – Advance = 50 × 5)			
	(c) On Calls-in-Advance			
	Calls-in-Advance A/c Dr.		250	
	To Equity First & Final Call A/c			250
	(On 50 Shares First & Final Call Received in Advance Along Allotment)			
	(d) Interest on Calls-in-Advance:			
	Interest on Call-in-Advance A/c Dr.		3.75	
	To Sundry Members (A) A/c			3.75
	(Interest on ₹ 250 @ 6% for 3 months Allowed)			

	(e) On Interest Paid on Call-in-Advance:			
	Sundry Members A/c Dr.		3.75	
	To Bank A/c			3.75
	(Interest on Call-in-Advance Paid)			
	(f) On Interest: Call-in-Arrear:			
	Sundry Members A/c Dr.		3.75	
	To Interest on Call-in-Arrear A/c			3.75
	(Interest on ₹ 300 @ 5% for 3 months)			

Illustration 1.14

Model: Comprehensive—Allotment of shares

'A' Ltd. invited applications for 50,000 shares of ₹ 10 as follows:

On Application	₹ 3
On Allotment	₹ 2
On First and Final Call	₹ 5

Applications were received for 1,00,000 shares. It was decided

1. To refuse allotment to the applicants for 10,000 shares
2. To allot 50% to Mr. P. who has applied for 20,000 shares
3. To allot in full to Mr. Q. who has applied for 10,000 shares
4. To allot balance of the available shares pro-rata among the other applicants
5. To utilize excess application money in part payment of allotment and final call

Pass necessary journal entries in the books of 'A' Ltd.

Solution

Working Notes:

1 Mr. P: Shares Applied for: 20,000

Shares Allotted: 50%: 10,000

Application Money Received: 20,000 × ₹ 3	=	₹ 60,000
Out of this, for Application Money: 10,000 × ₹ 3	=	₹ 30,000
Excess Application Money	=	₹ 30,000
To Be Adjusted on Allotment = 10,000 × ₹ 2	=	₹ 20,000
Calls-in-Advance	=	₹ 10,000
(to Be Adjusted on Calls)		

2. Mr. Q: Shares Applied for and Allotted Were for 10,000 Shares

Hence, No Adjustment on Allotment and Call.

3. Balance: 1,00,000 – (10,000 + 20,000 + 10,000) = 60,000 Shares

For 60,000 Shares Applied for, 30,000 Shares will be Allotted on Pro-rata Basis.

Shares Applied (Balance) for	=	60,000 Shares
Shares Allotted 30,000 Shares (50,000 – (10,000 + 10,000))		
Application Money Received (60,000 × ₹ 3)	=	₹ 1,80,000
Application Money Adjusted 30,000 Shares @ ₹ 3}	=	₹ 90,000

∴ Excess Application Money = ₹ 90,000

Adjustment Money Allotted 30,000 Shares @ ₹ 2} = ₹ 60,000

Calls-in-Advance = ₹ 30,000

Total Calls-in-Advance = ₹ 10,000 + ₹ 30,000 = 40,000

↓

Ref: Working 1

In the Books of A Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money			
	Bank A/c Dr.		3,00,000	
	To Share Application A/c			3,00,000
	(Application Money Received on 1,00,000 Shares @ ₹ 3 per Share)			
	(b) For Rejecting & Refunding:			
	Share Application A/c Dr.		3,00,000	
	To Bank A/c			3,00,000
	(10,000 Shares Were Rejected Outright and Application Money Refunded)			
	(c) On Transfer to Share Capital:			
	Share Application A/c Dr.		1,50,000	
	To Share Capital A/c			1,50,000
	(Application Money Transferred to Share Capital A/c on 50,000 Shares @ ₹ 3)			
	Stage II: (a) On Allotment Money Due:			
	Share Allotment A/c Dr.		1,00,000	
	To Share Capital A/c			1,00,000
	(Allotment Money Due on 50,000 Shares @ ₹ 2 per Share)			
	(b) On Transfer of Excess Application Money to Allotment & Calls			
	Share Application A/c Dr.		1,20,000	
	To Share Allotment A/c			80,000
	To Calls-in-Advance A/c			40,000
	(Excess Application Money Transferred to Share Allotment A/c & Call-in-Advance A/c)			
	(c) Allotment Money of Q:			
	Bank A/c Dr.		20,000	
	To Share Allotment A/c			20,000
	(Allotment Money Received from Q for Whom 10,000 Shares are Allotted in Full)			

	Stage III: (a) Share Call Money Due:			
	Share First and Final Call A/c Dr.		2,50,000	
	To Share Capital A/c			2,50,000
	(Share Call Money Due on 50,000 Shares @ ₹ 5 per Share)			
	(b): On Receipt of Call Money			
	Bank A/c Dr.		2,10,000	
	To Share First & Final Call A/c			2,10,000
	(Call Money Received After Adjustment of Calls-in-Advance Money) (₹ 2,50,000 – ₹ 40,000)			

1.23 ISSUE OF SHARES FROM THE STANDPOINT OF ISSUE PRICE

Shares of a company may be issued in any of the following ways:

1. Issue of shares at par
2. Issue of shares at premium
3. Issue of shares at discount

The accounting treatment will differ in each approach. Let us discuss one after one as follows:

1.23.1 Issue of Shares at Par

If the issue price of a share is equal to the face value of the share, such issue is said to be an issue at par.

Example: Assume that the issue price is ₹ 10 per share and the applicant will have to pay only ₹ 10 i.e., the face value of share ₹ 10

Shares are said to have been issued at par when an applicant has to pay a total sum equal to the face value of a share, i.e., issue price is ₹ 10 and the face value is also equal to ₹ 10

The accounting treatment (i.e., journal entries to be passed in case of issue of shares at par) is discussed in the previous illustrations; hence, it is not repeated here.

1.23.2 Issue of Shares at Premium

Sometimes shares may be issued at an amount higher than the face value.

Example: When a share of ₹ 10 is issued at ₹ 12, it is said to have been issued at a premium of ₹ 2. (Issue price – Face value, i.e., ₹ 12 – 10 = ₹ 2). Premium is the excess of issue price over face value of the share.

According to Section 78 of the Companies Act, when shares are issued at a premium, the premium amount is to be credited to a separate account called "securities premium account". This is to be done so because it is not treated as a part of share capital. It is a capital gain to the company. Securities premium account has to be used only for the following purposes:

(a) To write off preliminary expenses of the company
(b) To issue fully paid bonus shares to the members
(c) To write off the expenses of, or the commission paid or discount allowed, on any issue of shares or debentures of the company
(d) To pay premium on the redemption of preference shares or debentures of the company

In case the company wants to utilize the securities premium account for any other purpose, it will have to obtain permission from the Court to do so.

Journal Entries

Case 1: When Premium Amount is Included in Application Money:

(i) On Receipt of Application Money with Premium:

Bank A/c Dr. … {Number of Applications × Application Money Including Premium}

To Share Application A/c …

To Bank A/c …

(Application Money Received on … Applications @ ₹ … per Share Including Premium @ ₹ … per Share)

(ii) On Transfer of Application Money:

Share Application A/c Dr. …

To Securities Premium A/c ... {Number of Shares × Premium Amount per Share}

To Share Capital A/c ... {Number of Shares × Premium Amount per Share}

Illustration 1.15

Model: Issue of shares at premium, premium along with application

X Ltd issued 5,000 shares of ₹ 10 each at a premium of ₹ 2 per share payable as follows:

₹ 4 on Application Along with Premium ₹ 2

₹ 3 on Allotment

Balance when Required

All the shares were applied for and duly allotted. Pass necessary journal entries in the books of X Ltd.

Solution

Note:

1. Issue is fully subscribed.
2. Shares are issued at premium.
3. Premium is included in application money.

Bearing the above in mind, the necessary entries are made as:

In the Books of X Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money: Bank A/c Dr. To Share Application A/c (Application Money Received on 5,000 Shares @ ₹ 4 per Share Including Premium)		20,000	20,000

	(b) On Transfer of Application Money:			
	Share Application A/c Dr.		20,000	
	To Share Capital A/c			10,000
	To Securities Premium A/c			10,000
	(Application Money Transferred to Share Capital A/c & Securities Premium A/c)			
	Stage II: (a) On Share Allotment Due:			
	Share Allotment A/c Dr.		15,000	
	To Share Capital A/c			15,000
	(Allotment Money Due on 5,000 Shares @ ₹ 3 per Share)			
	(b) On Receipt of Allotment Amount:			
	Bank A/c Dr.		15,000	
	To Share Allotment A/c			15,000
	(Allotment Money Received)			

Case 2: When Premium Amount is Included in Allotment Money:

Generally, the premium amount is received along with allotment money.

Accounting Treatment: Journal entry:

When securities premium is to be collected on allotment, either of the following two approaches may be adopted by a company:

Approach 1: On allotment money becomes due, share capital account will be credited with the total amount becoming due on account of share capital & securities premium A/c will be credited with the total amount of securities premium becoming due and with the total of these two, share allotment A/c will be debited as:

Share Allotment A/c Dr.
To Share Capital A/c
To Securities Premium A/c

On Receipt of Allotment Money:

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

Approach 2: This is commonly used by companies.

On allotment money becomes Due:

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

Note: Securities premium is not considered in this approach

On Receipt of Allotment Money:

Bank A/c Dr.
To Share Allotment A/c
To Securities Premium A/c

Illustration 1.16

Model: Premium included in allotment

X Ltd. offered 10,000 shares of ₹ 10 each at ₹ 12, payable as follows:

On Application ₹2
On Allotment ₹5 (Including Premium)
The balance When Required
All the shares were applied for and duly allotted.
Pass necessary journal entries.

Solution

In the Books of X Ltd.,
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		20,000	
	To Share Application A/c			20,000
	(Application Money Received on 10,000 Shares @ ₹2 per Share)			
	(b) On Transfer of Application Money to Share Capital A/c			
	Share Application A/c Dr.		20,000	
	To Share Capital A/c			20,000
	(Share Application Money Transferred to Share Capital A/c)			
	Stage II: (a) On Allotment Money Due (Approach 2 is Followed):			
	Share Allotment A/c Dr.		30,000	
	To Share Capital A/c			30,000
	(Allotment Money Due on 10,000 Shares @ (₹5 – ₹2): ₹3 per Share			
	(b) On Receipt of Allotment Money:			
	Bank A/c Dr.		50,000	
	To Share Allotment A/c			30,000
	To Securities Premium A/c			20,000
	(Allotment Money Received on 10,000 Shares @ ₹3 per Share and Securities Premium @ ₹2 per Share)			

Note: Sometimes, securities premium will be collected on a call. Journal entry will be similar to the case (b) mentioned above. In the place of allotment, insert the word call in the entries while entering call money due and call amount received.

Illustration 1.17

Model: Premium included in call

'A' Ltd. issued 5,000 shares of ₹10 each at ₹12 (at a premium of ₹2 per share) payable as follows:

₹2 on Application

₹3 on Allotment

₹ 7 on First and Final Call (Including Premium)

All the shares were applied for and duly allotted. All money was duly received.

Pass the necessary journal entries in the books of 'A' Ltd.

Solution

In the Books of 'A' Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		10,000	
	To Share Application A/c			10,000
	(Application Money on 5,000 Shares @ ₹ 2 per Share)			
	(b) On Transfer of Application Money:			
	Share Application A/c Dr.		10,000	
	To Share Capital A/c			10,000
	(Application Money Transferred to Share Capital A/c)			
	Stage II: (a) Allotment Money Due:			
	Share Allotment A/c Dr.		15,000	
	To Share Capital A/c			15,000
	(Allotment Money Due on 5,000 Shares @ ₹ 3 per Share)			
	(b) On Receipt of Allotment Money:			
	Bank A/c Dr.		15,000	
	To Share Allotment A/c			15,000
	(Allotment Money Received)			
	Stage III: (a) On Call Money Due:			
	Share First and Final Call A/c Dr.		25,000	
	To Share Capital A/c			25,000
	(Call Money Due on 5,000 Shares @ ₹ 5 per Share)			
	(b) Call Money Received Along with Premium:			
	Bank A/c Dr.		35,000	
	To Share First & Final A/c			25,000
	To Securities Premium Account			10,000
	(Call Money Received on 5,000 Shares @ ₹ 5 Premium Received on 5,000 Shares @ ₹ 2)			

1.23.3 Issue of Shares at a Discount

When shares of a company are issued at a price less than its face value (nominal value), it is known as "shares issued at a discount".

Example: When a share of the face value of ₹ 10 is issued at ₹ 9, it is issued at a discount of Re 1.

The excess of face value over the issue price (₹ 10 – ₹ 9 = Re 1) represents the discount on issue of shares.

Generally, a company issues forfeited shares at a discount.

According to Section 79 of the Companies Act, a Company can issue only if the following conditions are satisfied:

(a) The issue of shares at a discount is authorized by an ordinary resolution passed by the company at its general meeting and sanctioned by the Company Law Board.

(b) The resolution must specify the maximum rate of discount at which the shares are to be issued. The rate must not exceed 10% of the nominal value of shares unless the Company Law Board is of the opinion that a higher rate of discount may be allowed in special circumstances of the case.

(c) The shares are of a class, which has already been issued.

(d) At least one year must have elapsed since the company was entitled to commence the business.

(e) The shares are issued within two months from the date of receiving sanction from the Company Law Board.

In a nutshell:

(i) No new company can issue shares at a discount

(ii) A new class of share cannot be issued at a discount

Accounting Treatment:

Journal Entry

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

(Amount Due on Allotment of … Shares @ ₹ … per Share and Discount on Issue Brought into Account)

"Discount on the issue of shares account" is a loss to the company. It is shown on the asset side of the company's balance sheet under "Miscellaneous Expenditure".

It is written off by charging to the "Securities Premium Account" (or) it is charged to the P&L A/c over a period of time.

Illustration 1.18

Model: Shares issued at a discount

'Y' Ltd. issued 10,000 shares of ₹ 10 each at a discount of 10% as payable as follows:

On Application	₹ 2 per Share
On Allotment	₹ 5 per Share (Including Discount)
On First & Final Call	₹ 3 per Share

The shares were applied and allotted in full and all moneys were received duly.

Pass the journal entries.

Solution

In the Books of Y Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money			
	Bank A/c Dr.		20,000	
	To Share Application A/c			20,000
	(Amount Received on 10,000 Shares @ ₹ 2)			
	(b) On Transfer to Application Money:			
	Share Application A/c Dr.		20,000	
	To Share Capital A/c			20,000
	(Application Money Transferred to Share Capital A/c)			
	Stage II: (a) On Allotment Money Due:			
	Share Allotment A/c Dr.		40,000	
	Discount on Issue of Shares A/c Dr.		10,000	
	To Share Capital A/c			50,000
	(Allotment Money Due on 10,000 Shares @ ₹ 4 per Share and Discount @ ₹ 1 per Share)			
	(b) On Receipt of Allotment Money:			
	Bank A/c Dr.		40,000	
	To Share Allotment A/c			40,000
	(Allotment Money Received on 10,000 Shares)			
	Stage III: (a) On Call Money Due:			
	Share First and Final Call A/c Dr.		30,000	
	To Share Capital A/c			30,000
	(Call Money Due on 10,000 Shares @ ₹ 3 per Share)			
	(b) On Receipt of Call Money:			
	Bank A/c Dr.		30,000	
	To Share First & Final Call A/c			30,000
	(Call Money Received on 10,000 Shares @ ₹ 3 per Share)			

1.24 CASH BOOK

In practice, when shares are issued, all cash transactions are recorded in cash book. In such a case, cash transactions are not recorded in journal. Only transactions, other than cash transactions are recorded in the journal.

If questions are asked with specific instructions such as:

Make entries in the cash book and journal, then all transactions relating to cash/bank are to be recorded in the cash book (with bank columns only), and other non-cash transactions are to be recorded in the journal.

This is explained in the following illustration:

Illustration 1.19

Model: Preparation of cash book

VRS Ltd. offered 10,000 shares of ₹ 10 each payable as:

On Application	₹ 2
On Allotment	₹ 3
On First Call	₹ 3
On Second & Final Call	₹ 2

All the shares were applied for and duly allotted and all money was received duly.

Make entries in the cash book and the journal.

Solution

First, cash book is to be prepared.

An easy way to prepare cash book:

Remember the three stages explained in journalizing the transactions, discussed so far. Only, "On Amount Received" should be taken into account for respective items and entered on the debit side of "Cash book". Amount returned by the company has to be entered on the credit side of the cash book. Then it is balanced.

CASH BOOK (Bank Column)

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
*1	To Share Application A/c (10,000 Shares @ ₹ 2)	20,000		By Balance c/d	1,00,000
*2	To Share Allotment A/c (10,000 Shares @ ₹ 3)	20,000			
*3	To Share First Call A/c (10,000 Shares @ ₹ 3)	30,000			
*4	To Share Final Call A/c (10,000 Shares @ ₹ 2)	20,000			
		1,00,000			1,00,000
	To Balance b/d	1,00,000			

Now, other transactions:

In the Books of VRS Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
*1	**Stage I:** (a) On Receipt of Application Money *[1] (Entered in Cash book) (b) On Transfer to Application Money: Share Application A/c Dr. To Share Capital A/c (Application Money Received on 10,000 Shares @ ₹ 2 per Share Transferred to Share Capital A/c)		20,000	20,000

	Stage II: (a) On Allotment Money Due:				
	Share Allotment A/c	Dr.		30,000	
	To Share Capital A/c				30,000
	(Allotment Money Due on 10,000 Shares @ ₹ 3 per Share)				
	(b) On Receipt of Allotment Money:				
*2	*[2] (Entered in Cash book)				
	Stage III: (a) On Call Money Due:				
	Share First Call A/c	Dr.		30,000	
	To Share Capital A/c				30,000
	(Amount Due on 10,000 Shares on First Call @ ₹ 3 per Share)				
	(b) On Receipt of First Call Money:				
*3	*[3] (Entered in Cash book)				
	(c) On Final Call Money Due:				
	Share Final A/c	Dr.		20,000	
	To Share Capital A/c				20,000
	(Amount Due on 10,000 Shares on Final Call @ ₹ 2 per Share)				
	(d) On Receipt of Final Call Money:				
*4	*[4] (Entered in the Cash book)				

For easy comprehension, all cash transactions are shown with *1, *2, *3, *4 marks. Now, refer the cash book to understand its preparation.

1.25 MORE THAN ONE TYPE OF SHARES

In case more than one type of shares are issued by the company simultaneously, the accounting treatment does not differ from those described so far. But, the various accounts should be prefixed with the type of share issued. To illustrate, if a limited company issues two different classes of shares namely preference shares and equity shares, then each entry should be prefixed as equity share application A/c, equity share allotment A/c, etc in case of equity shares and preference share application A/c, preference share allotment A/c in case of preference shares.

Illustration 1.20

Model: Two classes of shares

Shree Ltd. offered to the public 20,000 equity shares and 25,000 preference shares of ₹ 20 each payable as follows:

Particulars	Equity Shares	Preference Shares
	₹	₹
On Application	6	8
On Allotment	8	6
On First & Final Call	6	6

The public applied for 22,000 equity shares and 10,000 preference shares.

Applications for preference shares were accepted in full.

For equity shares, 1,000 applications were rejected outright. 16,000 shares were accepted in full and the remaining shares were allotted on pro-rata basis.

All money duly received except the amount due on call on 2,500 equity shares and 1,000 preference shares.

Pass necessary entries in the cash book and journal.

Solution

Note:

1. Two classes of shares are given in the question. Hence, entries should be shown separately and each should be prefixed with "equity" or "preference", as the case may be.
2. In case of equity shares, it is over-subscribed.
3. In case of preference shares, it is under subscribed.
4. Treatment of Over-subscription (Equity Shares):
   (i) Number of Over-subscribed Equity Shares
   = Number of Shares Subscribed – Number of Shares Issued
   = 22,000 – 20,000
   = 2,000 Shares
   (ii) Applications Rejected = 1,000 Shares
   (iii) Application Money Refunded = 1,000 × ₹ 6 = ₹ 6,000
   (iv) Calculation of Surplus Application Money:

		₹
Amount Received on Application: 22,000 × 6	=	1,32,000
Less: Amount Transferred to Capital: 20,000 × 6	=	1,20,000
		12,000
Less: Rejected & Refunded	=	6,000
∴ {Excess Application Money to Be Adjusted with Allotment A/c}	=	6,000

5. In this question, both cash book and journal are asked. Care should be taken to enter all cash transactions in cash book and non-cash transactions in journal.
6. In case of preference shares, it is a case of under-subscription. Hence, care should be taken while recording preference share transactions, i.e., each time it is to be multiplied with the number of shares subscribed—10,000—and not with number of shares issued—25,000.
7. This is a typical illustration comprising all features, i.e.,
   (i) Two classes of shares are given
   (ii) Equity shares are over-subscribed
   (iii) Preference shares are under-subscribed
   (iv) Calls-in-arrears
   (v) Cash book and journal

Cash Book (Bank Column Only)

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c (22,000 × ₹ 6)	1,32,000		By Equity Share Application A/c (Refund: 1,000 × ₹ 6)	6,000
	To Preference Share Application A/c (10,000 × ₹ 8)	80,000		By Balance c/d	5,39,000

	To Equity Share Allotment A/c (₹ 1,20,000 – ₹ 6,000) Ref: 4(iv)	1,14,000			
	To Preference Share Allotment A/c (10,000 × ₹ 6)	60,000			
	To Equity Share Call A/c (20,000 × 6 – 2,500 × 6)	1,05,000			
	To Preference Share Call A/c (10,000 × 6 – 1,000 × 6)	54,000			
		5,45,000			5,45,000
	To Balance b/d	5,39,000			

In the Books of Shree Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Equity Share Application A/c Dr. To Equity Share Capital A/c (Application Money Transferred to Share Capital A/c on 20,000 Shares @ ₹ 6)		1,20,000	1,20,000
	Preference Share Application A/c Dr. To Preference Share Capital A/c (Application Money Received on 10,000 Preference Shares Transferred to Preference Share Capital A/c)		80,000	80,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Allotment Money Due on 20,000 Shares @ ₹ 8 per Share)		1,60,000	1,60,000
	Preference Share Allotment A/c Dr. To Preference Share Capital A/c (Allotment Money on 10,000 Preference Shares @ ₹ 6 per Share)		60,000	60,000
	Equity Share Application A/c Dr. To Equity Share Allotment A/c (Excess Equity Application Money Adjusted with Allotment Money) [Ref: 4 (iv)]		6,000	6,000
	Equity Share Call A/c Dr. To Equity Share Capital A/c (Equity Call Money Due on 20,000 Equity Shares @ ₹ 6 per Share)		1,20,000	1,20,000
	Preference Share Call A/c Dr. To Preference Share Capital A/c (Preference Share Call Money Due on 10,000 Shares @ ₹ 6 per Share)		60,000	60,000

Illustration 1.21

Model: Shares at premium—All ledger accounts and balance sheet

Renu Ltd. issued 10,000 shares of ₹ 10 each at a premium of ₹ 2 as follows:

On Application	₹ 3
On Allotment	₹ 5 (Including Premium)
On First & Final Call	₹ 4

All shares were duly subscribed and money due was fully paid. Pass journal entries. Prepare necessary ledger accounts. Draw the balance sheet.

Solution

In the Books of Renu Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money			
	Bank A/c Dr.		30,000	
	To Share Application A/c			30,000
	(Money Received on 10,000 Applications @ ₹ 3 per Share)			
	(b) On Transfer to Application Money to Share Capital:			
	Share Application A/c Dr.		30,000	
	To Share Capital A/c			30,000
	(Application Money Received, Transferred to Share Capital A/c)			
	Stage II: (a) On Allotment Money Due:			
	Share Allotment A/c Dr.		50,000	
	To Share Capital A/c			30,000
	To Securities Premium A/c			20,000
	(Allotment Amount Due on 10,000 Shares @ ₹ 3 per Share + Premium Amount @ ₹ 2 per Share)			
	(b) On Receipt of Allotment Money:			
	Bank A/c Dr.		50,000	
	To Share Allotment A/c			50,000
	(Allotment Money Including Premium Received)			
	Stage III: (a) On Call Money Due:			
	Share First and Final Call A/c Dr.		40,000	
	To Share Capital A/c			40,000
	(Call Money Due on 10,000 Shares @ ₹ 4 per Share)			
	(b) On Receipt of Call Money:			
	Bank A/c Dr.		40,000	
	To Share First & Final Call A/c			40,000
	(Call Money Received on 10,000 Shares @ ₹ 4 per Share)			

Ledger Accounts

Bank A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Application A/c	30,000		By Balance c/d	1,20,000
	To Share Allotment A/c	50,000			
	To Share First & Final Call A/c}	40,000			
		1,20,000			1,20,000
	To Balance b/d	1,20,000			

Share Application A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	30,000		By Bank A/c	30,000
		30,000			30,000

Share Allotment A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	30,000		By Bank A/c	50,000
	To Securities Premium A/c	20,000			
		50,000			50,000

Securities Premium A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	20,000		By Share Allotment A/c	20,000
		20,000			20,000

Share First & Final Call A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	40,000		By Bank A/c	40,000
		40,000			40,000

Share Capital A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	1,00,000		By Share Application A/c	30,000
				By Share Allotment A/c	30,000
				By Share Final Call A/c	40,000
		1,00,000			1,00,000
				By Balance c/d	1,00,000

Balance Sheet as at …

Liabilities	₹	Assets	₹
SHARE CAPITAL: Authorized Capital	—	CURRENT ASSETS: Bank	1,20,000
Issued Capital: = (10,000 × ₹ 10)	1,00,000		
Subscribed Capital = (10,000 × ₹ 10)	1,00,000		
Called-up Capital = (10,000 × ₹ 10)	1,00,000		
Paid-up Capital = (10,000 × ₹ 10)	1,00,000		
RESERVE & SURPLUS:			
Securities Premium	20,000		
	1,20,000		1,20,000

Illustration 1.22

Model: Issue of shares at a discount—All ledger accounts and balance sheet

Parul Ltd. issued 1,00,000 shares of ₹ 10 each at a discount of 10% payable as:

On Application	₹ 3
On Allotment	₹ 4 (Excluding Discount)
On First & Final Call	₹ 2

80,000 shares were applied for and the shares have been duly allotted. All money due were received. Pass necessary journal entries. Prepare ledger accounts and the balance sheet.

Solution

Note:

1. This is a case of under-subscription.
2. Issue of share is at discount.
3. "Discount on issue of shares" should be shown in the balance sheet under the head, "Miscellaneous Expenditure".

In the Books of Parul Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		2,40,000	
	To Share Application A/c			2,40,000
	(Application Money on 80,000 Shares @ ₹ 3 Received)			
	(b) On Transfer of Application Money to Share Capital A/c:			
	Share Application A/c Dr.		2,40,000	
	To Share Capital A/c			2,40,000
	(Application Money Transferred to Share Capital A/c)			

	Stage II: (a) On Allotment Money Due				
	Share Allotment A/c	Dr.		3,20,000	
	Discount on Issue of Shares A/c	Dr.		80,000	
	To Share Capital A/c				4,00,000
	(Allotment Money Due on 80,000 Shares @ ₹ 4 & Adjustment on Discount 80,000 (₹ 10 – ₹ 9 × ₹ 1 = ₹ 80,000)				
	(b) On Allotment Money Received (Leave the Discount Amount):				
	Bank A/c	Dr.		3,20,000	
	To Share Allotment A/c				3,20,000
	(Allotment Money Received Excluding Discount)				
	Stage III: (a) On Call Money Due:				
	Share First and Final Call A/c	Dr.		1,60,000	
	To Share Capital A/c				1,60,000
	(Call Money Due on 80,000 Shares @ ₹ 2 per Share)				
	(b) On Receipt of Call Money:				
	Bank A/c	Dr.		1,60,000	
	To Share First & Final Call A/c				1,60,000
	(Call Money Received)				

Ledger Accounts

Bank Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Application A/c	2,40,000		By Balance c/d	7,20,000
	To Share Allotment A/c	3,20,000			
	To Share First & Final Call A/c	1,60,000			
	To Balance b/d	7,20,000			7,20,000

Discount on Issue of Shares A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	80,000		By Balance c/d	80,000
	To Balance b/d	80,000			80,000

Share Capital A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	8,00,000		By Share Application A/c	2,40,000
				By Share Allotment A/c	3,20,000
				By Discount on Issue of Shares A/c	80,000

				By Share Call A/c	1,60,000
				By Balance b/d	8,00,000
		8,00,000			8,00,000

Balance Sheet as at

Liabilities	₹	Assets	₹
SHARE CAPITAL:		CURRENT ASSETS:	
Authorized Capital	…..	Bank A/c	7,20,000
Issued Capital (1,00,000 Shares @ ₹ 10)	10,00,000	MISCELLANEOUS EXPENDITURE:	
Subscribed Capital (80,000 Shares × ₹ 10)	8,00,000	Discount on Issue of Shares	80,000
Called-up Capital (80,000 Shares × ₹ 10)	8,00,000		
Paid-up Capital (80,000 Shares × ₹ 10)	8,00,000		
	8,00,000		8,00,000

Illustration 1.23

Model: Issue of shares at premium—Over-subscription, calls-in-arrear

Shiva & Co. Ltd. offered 50,000 shares of ₹ 10 each at ₹ 12 payable as follows:

On Application	₹ 2
On Allotment	₹ 5 (Including Premium)
On First Call	₹ 2
On Final Call	₹ 3

The public applied for 65,000 shares. Applications for 40,000 shares were accepted in full, 10,000 were allotted to applicants of 20,000 shares and applications for 5,000 shares were rejected. All money was duly received except the first call on 100 shares and final call on 200 shares. Pass journal entries, prepare only necessary ledger accounts and show how these items will appear in the balance sheet of the company?

Solution

Calculation of Excess Application Money:

		₹
Money Received on 65,000 Applications @ ₹ 2	=	1,30,000
Less: Rejected & Refunded 5,000 × ₹ 2	=	10,000
	=	1,20,000
Less: Full Allotment 40,000 × ₹ 2		80,000
	=	40,000
Less: Partial Allotment 10,000 × ₹ 2		20,000
∴ Excess Application Money	=	20,000

In the books of Shiva & Co. Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money			
	Bank A/c Dr.		1,30,000	
	To Share Application A/c			1,30,000
	(Money Received on 65,000 Applications @ ₹ 2 per Share)			
	(b) On Transfer of Application Money to Share Capital Account:			
	Share Application A/c Dr.		1,00,000	
	To Share Capital A/c			1,00,000
	(Application Money on 50,000 Shares @ ₹ 2 Transferred to Share Capital A/c)			
	(c) On Rejection & Refund of Application Money:			
	Share Application A/c Dr.		1,00,000	
	To Bank A/c			1,00,000
	(Application Money was Refunded on Rejection of 5,000 Shares @ ₹ 2)			
	Stage II: (a) On Allotment Money Due:			
	Share Allotment A/c Dr.		2,50,000	
	To Share Capital A/c			1,50,000
	To Securities Premium A/c			1,00,000
	(Amount Due on Allotment of 50,000 Shares @ ₹ 3 and on Premium @ ₹ 2 on 50,000 Shares)			
	(b) On Adjustment of Excess Application Money:			
	Share Application A/c Dr.		20,000	
	To Share Allotment A/c			20,000
	(Excess Application Money Adjusted with Allotment by Transfer) (Ref: Working)			
	(c) On Receipt of Allotment Money:			
	Bank A/c Dr		2,30,000	
	To Share Allotment A/c			2,30,000
	(Allotment Money Received + Premium – Excess Application Money)(₹ 1,50,000 + ₹ 1,00,000 – ₹ 20,000)			
	Stage III: (a) On First Call Due:			
	Share First Call Account Dr.		1,00,000	
	To Share Capital A/c			1,00,000
	(First Call Money Due on 50,000 Shares @ ₹ 2 per Share)			
	(b) On Receipt of First Call Money:			
	Bank A/c Dr.		99,800	
	To Share First Call A/c			99,800
	(Call Money Received on 50,000 – 100 shares @ ₹ 2)			

	(c) Final Call Due:			
	Share Final Call A/c Dr.		1,50,000	
	To Share Capital A/c			1,50,000
	(Final Call Money Due on 50,000 Shares @ ₹ 3 per Share)			
	(d) On Receipt of Final Call Money:			
	Bank A/c Dr.		1,49,400	
	To Share Final Call A/c			1,49,400
	(Final Call Money Received on (50,000 – 200) Shares @ ₹ 3)			

Ledger Accounts

Bank A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Application A/c	1,30,000		By Share Application A/c	10,000
	To Share Allotment A/c	2,30,000		By Balance c/d	5,99,200
	To Share First Call A/c	99,800			
	To Share Final Call A/c	1,49,400			
		6,09,200			6,09,000
	To Balance b/d	5,99,200			

Share Capital A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	5,00,000		By Share Application A/c	1,00,000
				By Share Allotment A/c	1,50,000
				By Share First Call A/c	1,00,000
				By Share Final Call A/c	1,50,000
		5,00,000			5,00,000
				By Balance b/d	5,00,000

Securities Premium A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	1,00,000		By Share Allotment A/c	1,00,000
		1,00,000			1,00,000
				By Balance b/d	1,00,000

Balance Sheet of Shiva & Co. Ltd. as at…

Liabilities	₹	Assets	₹
SHARE CAPITAL:		CURRENT ASSETS:	
50,000 Shares of ₹10 Each Called-up Capital	5,00,000	Cash	5,99,200
Less: Calls Unpaid: ₹			
First Call: 200			
Final Call: 600	800		
	4,99,200		
RESERVE & SURPLUS:			
Securities Premium	1,00,000		
	5,99,200		5,99,200

Illustration 1.24

Model: Issue at a discount and calls-in-arrears and pro-rata allotment

VRV Ltd. issued 50,000 equity shares of ₹10 each at a discount of 10% payable as follows:

On Application	₹2
On Allotment	₹3
On First Call	₹2
On Final Call	₹2

Applications were received for 75,000 shares and the directors made pro-rata to the applicants for 60,000 shares by rejecting the remaining ones.

Mr. A, a shareholder, failed to pay allotment and first call money on 500 shares allotted to him.

Mr. B, another shareholder, did not pay the final call on 1,000 shares.

Journalize the above transactions, prepare important ledger accounts and draw the balance sheet of the company.

Solution

Working Notes:

		₹
1. Application Money Received = 75,000 Shares × ₹2	=	1,50,000
Amount Refunded on 15,000 Shares @ ₹2	=	30,000
		1,20,000
Money Transferred to Share Capital A/c (50,000 × ₹2)	=	1,00,000
∴ Excess Application Money to be Adjusted on Allotment	=	20,000

2. Calls-in-Arrears on Allotment:

$$(500 \text{ Shares} \times ₹3) - \left(500 \times \frac{60}{50} \times 2 - 500 \times 2\right)$$

$= ₹1,500 - (1,200 - 1,000)$

$= (1500 - 200) = ₹1,300$

3. Calls-in-Arrears on First Call: $500 \times 2 = ₹1,000$
4. Calls-in-Arrears on Final Call: $1,000 \times 2 = ₹2,000$

Books of VRV Ltd.
Journal

Dr. **Cr.**

Date	Particulars	L.F.	₹	₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		1,50,000	
	To Equity Share Application A/c			1,50,000
	(Money Received for 75,000 Shares @ ₹ 2 per Share)			
	(b) On Transfer to Capital:			
	Equity Share Application A/c Dr.		1,00,000	
	To Share Capital A/c			1,00,000
	(Application Money on 50,000 Shares @ ₹ 2 Transferred to Share Capital A/c)			
	(c) Rejected Application Money Refunded:			
	Equity Share Application A/c Dr.		20,000	
	To Bank A/c			20,000
	(Application Money on 10,000 Shares Rejected and Refunded @ ₹ 2 per Share)			
	Stage II: (a) On Allotment Money Due:			
	Equity Share Allotment A/c Dr.		1,50,000	
	Discount on Issue of Shares A/c Dr.		50,000	
	To Equity Share Capital A/c			2,00,000
	(Amount Due on Allotment of 50,000 Shares @ ₹ 3 and Discount Brought into Accounts)			
	(b) On Receipt of Allotment Money:			
	Bank A/c Dr.		1,29,000	
	Calls-in-Arrears A/c 500 × 2 Dr.		1,000	
	To Equity Share Allotment A/c			1,30,000
	(Allotment Money Received After Excess Application Money Adjusted) (₹ 1,50,000 – ₹ 20,000 & Arrears)			
	Stage III: (a) First Call Money Due:			
	Equity Share First Call A/c Dr.		1,00,000	
	To Equity Share Capital A/c			1,00,000
	(First Call Money Due on 50,000 Shares @ ₹ 2 per Share)			
	(b) On Receipt of First Call Money:			
	Bank A/c Dr.		99,000	
	Calls-in-Arrear A/c Dr.		1,000	
	To Equity Share First Call A/c			1,00,000
	(Money Received on First Call Except 500 Shares @ ₹ 2)			

	(c) Final Call Money Due:			
	Equity Share Final Call A/c	Dr.	1,00,000	
	To Equity Share Capital A/c			1,00,000
	(Final Call Money Due on 50,000 Shares @ ₹ 2 per Share)			
	(d) Final Call Money Received:			
	Bank A/c	Dr.	98,000	
	Calls-in-Arrears A/c	Dr.	2,000	
	To Equity Share Final Call A/c			1,00,000
	(Money Received on Final Call Except 1,000 Shares @ ₹ 2)			

Bank Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Application A/c	1,50,000		By Share Application A/c	30,000
	To Share Allotment A/c	1,29,000		By Balance c/d	4,46,000
	To Share First Call A/c	99,000			
	To Share Final Call A/c	98,000			
		4,76,000			4,76,000
	To Balance b/d	4,46,000			

Equity Share Capital A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	5,00,000		By Equity Share Application A/c	1,00,000
				By Allotment A/c	2,00,000
				By First Call A/c	1,00,000
				By Final Call A/c	1,00,000
		5,00,000			5,00,000
				To Balance b/d	5,00,000

Discount on Issue of Shares A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	50,000		By Balance c/d	50,000
		50,000			50,000
	To Balance b/d	50,000			

Balance Sheet of VRV Ltd. as at …

Liabilities		₹	Assets	₹
SHARE CAPITAL:			CURRENT ASSETS:	
CALLED–UP CAPITAL			Bank (Cash)	4,46,000
50,000 Shares @ ₹ 10 Each		5,00,000	MISCELLANEOUS EXPENDITURE	
PAID-UP CAPITAL:			Discount on Issue of Share	50,000
Less: Allotment Arrears:	1,000			
First Call Arrears:	1,000			
Final Call Arrear :	2,000	4,000		
		4,96,000		4,96,000

1.26 SHARES ISSUED FOR CONSIDERATION OTHER THAN CASH

At times, companies may issue shares for consideration other than cash. Example: For purchase of assets such as land, buildings, plant and machinery.

Here, the purchase of an asset against the issue of shares takes place. Two distinct transactions are involved in such instances. They are (1) purchase of an asset and (ii) issue of shares.

Accounting Treatment:

1. On Purchase of Assets:

Sundry Assets A/c (Individually)	Dr.	…	{With the Amount of Purchse Price}
To Vendor's A/c		...	

2. On Issue of Shares:

Case 1: Shares Issued at Par to the Vendor:

Vendor's A/c	Dr.	…	{With the Face Value of Shares Allotted}
To Share Capital A/c		...	

Case 2: Shares are Issued at Premium:

Vendor's A/c	Dr.	…	With Purchase Price
To Share Capital A/c		...	With Face Value
To Securities Premium A/c		...	With Premium Amount

Case 3: Shares are Issued at Discount:

Vendor's A/c	Dr.	…	With Purchase Price
Discount on Issue of Shares A/c	Dr.	…	With Discount Amount
To Share Capital A/c		...	With Face Value

Illustration 1.25

Model: Issue of shares other than cash

Bhagya Ltd. purchased assets for ₹ 7,20,000 from Kaveri & Co. payable in fully paid shares of ₹ 100 each. Pass journal entries in the books of Bhagya Ltd. if issue is

(a) At par
(b) At a premium of 20%
(c) At a discount of 10%

Solution

Number of Shares Issued on Each Occasion Has to be Calculated:

(a) At Par: Number of Shares to Be Issued $= \frac{\text{Purchase Price}}{\text{Issue Price}}$

$$= ₹\frac{7,20,000}{100} = 7,200$$

(b) At Premium:

Issue Price = 20% Premium

$$= \frac{20}{100} \times ₹100 = ₹20 \text{ (Premium)}$$

∴ Issue Price = ₹100 + ₹20 = ₹120

Number of Shares to Be Issued $= \frac{\text{Purchase Price}}{\text{Issue Price}}$

$$= \frac{₹7,20,000}{₹120} = 6,000$$

(c) At Discount:

Issue Price = 10% Discount

Discount $= \frac{10}{100} \times 100 = ₹10$

∴ Issue Price = ₹100 – ₹10

= ₹90

Number of Shares to Be Issued $= \frac{₹7,20,000}{₹90}$

$$= 8,000$$

In the Books of Bhagya Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	1. On Purchase of Assets: Sundry Assets A/c. Dr. To Kaveri & Co. (Purchase of Various Assets for ₹7,20,000 from Kaveri & Co.)		7,20,000	7,20,000
	2. (a) Issue at Par. Kaveri & Co. Dr. To Share Capital A/c (Fully Paid 7,200 Shares Were Issued @ ₹10 per Share to the Vendor)		7,20,000	7,20,000

	2. (b) At Premium:				
	Kaveri & Co.	Dr.		7,20000	
	To Share Capital A/c				6,00,000
	To Securities Premium A/c				1,20,000
	(6,000 Shares of ₹ 100 @ a Premium of 20% Issued to the Vendor)				
	2. (c) At Discount:				
	Kaveri & Co.	Dr.		7,20,000	
	Issue on Discount of Shares	Dr.		80,000	
	To Share Capital A/c				8,00,000
	(8,000 Shares of ₹ 100 Each Issued at a Discount of 10% to Vendors)				

1.27 FORFEITURE OF SHARES

Shareholders fail to pay any of the instalments due, allotment money or call money, at times. On such occasions, after giving due notice (clear 14 days) and after adhering the provisions in the Articles of Association, the directors can forfeit such shares.

As per SEBI Guidelines, the subscription money must be received within 12 months from the date of allotment. If the shareholders fail to comply with the notice, i.e., if they still do not pay the due with interest within the stipulated period, the directors can forfeit the shares after passing appropriate resolution.

*On forfeiture, cancellation of allotment of defaulting shares takes place. The shareholder's name is removed from the Register of Members.

Accounting Treatment:

Since allotment is to be cancelled on account of forfeiture, all entries relating to the shares forfeited (except those relating to premium already recorded) must be REVERSED.

1.27.1 Case 1—When Shares Issued at Par Forfeited

When the shares issued at par are forfeited, the journal entry will be:

Share Capital A/c	Dr.	...	[With the Amount Called up]
To Share Forfeited A/c		…	[With the Amount Received So Far]
To Share Allotment A/c and/or		...	[Unpaid but Called up]
To Share Call(s) A/c		…	[Unpaid but Called up]

Share capital is debited with the amount called up till the stage of forfeiture and NOT the nominal (face) value of shares. Shares forfeited amount is added to the paid-up capital under the heading "Share Capital" and shown on the liabilities side of the balance sheet till the forfeited shares are re-issued.

Illustration 1.26

Model: Forfeiture of shares (Issued at par)

VASU Ltd. issued 10,000 shares of ₹ 10 each at par payable as:

On Application	₹ 2
On Allotment	₹ 4

On First Call ₹2

On Second & Final Call ₹2

Mr. Z was allotted 100 shares.

Pass the necessary journal entries relating to forfeiture of shares in each of the following alternatives cases:

(a) If Mr. Z failed to pay allotment money and his shares are forfeited

(b) If Mr. Z failed to pay allotment money and first call money and his shares are forfeited

(c) If Mr. Z failed to pay both the calls and his shares are forfeited

Solution

Working Notes:

All transactions with respect to "forfeiture" are shown in Stage IV.

Case (a):

(i) For Forfeited Shares A/c:

Number of Shares Forfeited × Amount Already Received

= 100 × ₹2 (Application Money Only Received)

= ₹200

(ii) For Shares Allotment A/c:

Number of Shares Forfeited × Amount Unpaid

= 100 × ₹4 (Allotment Called up but Unpaid)

= ₹400

In the books of VASU Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
Case (a)	**Stage IV**			
	Share Capital A/c Dr.		600	
	To Share Forfeited A/c			200
	To Share Allotment A/c			400
	(100 Shares Forfeited on Non-payment of Allotment Money)			
Case (b)	Share Capital A/c Dr.		800	
	To Share Allotment A/c			400
	To Share I Call A/c			200
	To Share Forfeited A/c			200
	(100 Shares Forfeited for Non-payment of Allotment and First Call Money)			
	[Working Notes: (i) For Share Allotment A/c: Number of Shares Forfeited × Allotment Money 100 × ₹4 = ₹400 (ii) For Share I Call A/c: Number of Shares Forfeited × I Call Money 100 × ₹2 = ₹200			

	(iii) For Share Forfeited A/c: Number of Shares Forfeited × Amount Received 100 × ₹ 2 = ₹ 200]			
Case (c)	Share Capital A/c Dr.		1,000	
	To Share First Call A/c			200
	To Share Second Call A/c			200
	To Share Forfeited A/c			600
	(100 Shares Forfeited for Non-payment of Both Call Money)			
	[Working Notes: (i) For Share First Call A/c: Number of Shares Forfeited × I Call Amount 100 × ₹ 2 = ₹ 200 (ii) For Share Second Call A/c: Number of Shares Forfeited × II Call Amount 100 × ₹ 2 = ₹ 200 (iii) For Share Forfeited A/c: Number of Shares Forfeited × Amount Received So Far 100 × (₹ 4 + ₹ 2) = ₹ 600			

1.27.2 Forfeiture of Shares—Issued at Premium

1.27.2.1 Case 1—When Premium is Received

When shares originally issued as a premium, on which premium amount has been received fully, and later forfeited due to non-payment of allotment and or call money, the accounting treatment will be the same as that of shares issued at par. Hence, at the time of forfeiture, securities premium account is not debited.

Journal Entry:

Share Capital A/c	Dr.	…	[Amount Called up]
To Share Forfeited A/c		…	[Amount Received So Far]
To Share Allotment A/c		…	[Amount Called up but Unpaid]
To Share Call(s) A/c		…	[Amount Called up but Unpaid]

1.27.2.2 Case 2—When Premium is NOT Received

Where shares originally issued as premium on which premium amount has not been received (wholly or partially) and later forfeited, securities premium account is to be debited with the full amount of premium, along with the share capital A/c at the time of forfeiture.

Journal Entry:

Share Capital A/c	Dr.	…	[With the Amount Called up]
Securities Premium A/c	Dr.	...	[Number of Shares × Premium Amount]
To Share Forfeited A/c		...	[Number of Shares × Amount Already Received]
To Share Allotment A/c		…	[Number of Shares × Amount Received Including Premium]
To Share Call(s) A/c		…	[Number of Shares × Amount Not Received]

Important note: When calls-in-arrears A/c is maintained, calls-in-arrears is credited and NOT share allotment A/c or share call(s) A/c.

Illustration 1.27

Model: Forfeiture of shares, shares issued at a premium; Case 1: Premium is received

Khan & Co. Ltd. issued 10,000 shares of ₹ 10 each at ₹ 12 per share, payable as follows:

On Application	₹ 2
On Allotment	₹ 5 (Including Premium)
On First Call	₹ 3
On Second & Final Call	₹ 2

Mr. Joseph to whom 100 shares were allotted failed to pay both the calls. His shares were forfeited consequently. Pass journal entries. Prepare necessary ledger accounts and the balance sheet.

Solution

In the Books of Khan & Co. Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		20,000	
	To Share Application A/c			20,000
	(Application Money Received on 10,000 Shares @ ₹ 2 per Share)			
	(b) On Transfer of Application Money to Share Capital A/c:			
	Share Application A/c Dr.		20,000	
	To Share Capital A/c:			20,000
	(Application Money Transferred to Share Capital)			
	Stage II: (a) On Allotment A/c Due:			
	Share Allotment A/c Dr.		50,000	
	To Share Capital A/c			30,000
	To Share Premium A/c			20,000
	(Amount Due on Allotment of 10,000 Shares @ ₹ 3 on Account of Capital & @ ₹ 2 on Account of Premium)			
	(b) On Receipt of Allotment Amount:			
	Bank A/c Dr.		50,000	
	To Share Allotment A/c			50,000
	(Allotment Money Received)			
	Stage III:			
	(a) On Share First Call Due:			
	Share First Call A/c Dr.		30,000	
	To Share Capital A/c			30,000
	(First Call Money Due on 10,000 Shares @ ₹ 3 Each)			

	(b) On Receipt of First Call Amount:			
	Bank A/c Dr.		29,700	
	To Share First Call A/c			29,700
	(Amount Received on 9,900 Shares @ ₹ 3 Each)			
	(c) On Final Call Amount Due:			
	Share Final Call A/c Dr.		20,000	
	To Share Capital A/c			20,000
	(Final Call Amount Due on 10,000 Shares @ ₹ 2 per Share)			
	(d) On Receipt of Final Call Amount:			
	Bank A/c Dr.		19,800	
	To Share Final Call A/c			19,800
	(Amount Received on 9,900 Shares @ ₹ 2)			
	Stage IV:			
	Important note: As money on allotment was received, one can easily understand that premium is received. Accordingly entries are to be made as follows:			
	On Forfeiture:			
	Share Capital A/c Dr.		1,000	
	To Share First Call A/c			300
	To Share Final Call A/c			200
	To Share Forfeited A/c			500
	(100 Shares Were Forfeited for Non-payment of Both the Calls)			

Working Notes for Stage IV:

(i) For Share Capital A/c:

Number of Shares Forfeited × Amount Called up per Share

= 100 × ₹ 10 (Premium Should Not be Taken into Account)

= ₹ 1,000

(ii) For Share First Call A/c:

Number of Forfeited Shares × On First Call Amount (Not Paid)

= 100 × ₹ 3

= ₹ 300

(iii) For Share Final Call A/c:

Number of Forfeited Shares × On Final Call Amount (Not Paid)

= 100 × ₹ 2

= ₹ 200

(iv) For Share Forfeited A/c:

Number of Shares Forfeited × Amount Received So Far

= 100 × (₹ 2 on application + ₹ 3 on allotment (₹ 5 – ₹ 2 premium)

= 100 × ₹ 5

= ₹ 500

Bank Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Application A/c	20,000		By Balance c/d	1,19,000
	To Share Allotment A/c	50,000			
	To Share Final Call A/c	29,700			
	To Share Final Call A/c	19,800			
		1,19,500			1,19,500
	To Balance b/d	1,19,500			

Share Capital A/c

Dr. **Cr.**

Date	Particulars		₹	₹	Date	Particulars	₹
	To Sundries		₹			By Share Application A/c	20,000
	First Call	:	300			By Share Allotment A/c	50,000
	Final Call	:	200			By Share First Call A/c	30,000
	Forfeited Shares	:	500	1,000		By Share Final Call A/c	20,000
	To Balance c/d			1,19,000			
				1,20,000			1,20,000
						By Balance c/d	1,19,000

Share Forfeited A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	500		By Share Capital A/c	500
		500			500
				By Balance b/d	500

Balance Sheet of Khan & Co. Ltd.
as at ……..

Liabilities	₹	Assets	₹
SHARE CAPITAL:		CURRENT ASSETS	
Authorized Capital	…	Cash at Bank	1,19,500
Issued Capital: (10,000 Shares of ₹ 10 Each)	1,00,000		
Subscribed Capital: (9,900 Shares of ₹ 10 Each)	99,000		
Called-up Capital: (9,000 × ₹ 10)	90,000		
Paid-up Capital: (9,900 × ₹ 10)	99,000		

Shares Forfeited Account	500		
RESERVE & SURPLUS:			
Securities Premium Account	20,000		
	1,19,500		1,19,500

Illustration 1.28

Model: Forfeiture of shares issued at premium; premium money—Not received

Ansul Ltd. issued 10,000 shares of ₹ 20 each at ₹ 23 per share. The amount was payable as:

On Application	₹ 4
On Allotment	₹ 7 (Including Premium)
On First Call	₹ 7
On Final Call	₹ 5

The company is yet to make final call.

Diraj, a shareholder of 100 shares, failed to pay allotment and first call money and consequently his shares were forfeited.

Pass journal entries with respect to forfeiture of shares.

Solution

Note:

1. Forfeiture occurred due to non-payment of allotment money (and also call money). Hence, premium is not received.
2. So, share premium A/c has to be debited.
3. The entries up to Stage III—No change.
4. Only in Stage IV: For forfeiture of shares, care should be taken and the entry has to be made as follows:

Working Notes:

(i) For Share Capital:

Number of Forfeited Shares × Amount Called up

100 × ₹ 15 = ₹ 1,500

(ii) For Share Premium:

Number of Forfeited Shares × Premium per share

100 × ₹ 3 = ₹ 300

(iii) For First Call:

Number of Shares Forfeited × Amount Unpaid

100 × ₹ 7 = ₹ 700

(iv) For Share Allotment:

Number of Shares Forfeited × Amount Unpaid (Including Premium)

100 × ₹ 7 = ₹ 700

(v) For Share Forfeited: Number of Shares Forfeited × Amount Received So Far

100 × ₹ 4 = ₹ 400

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Share Capital A/c Dr.		1,500	
	Securities Premium A/c Dr.		300	
	To Share Forfeited A/c			400
	To Share Allotment A/c			700
	To Share First Call A/c			700
	(Diraj's 100 Shares Were Forfeited for Non-payment of Allotment Money and First Call Money)			

Illustration 1.29

Model: Forfeiture of shares issued at premium comprehensive

Sathyam & Co. Ltd. issued for public subscription 40,000 equity shares of ₹20 each at a premium of ₹4 per share payable as:

On Application ₹8
On Allotment ₹10 (Including Premium)
On Call ₹6

Applications were received for 60,000 shares. Allotment was made pro-rata to the applicants for 48,000 shares and the balance were rejected. Excess money on application was applied towards sums due to allotment.

Praveen, to whom 1,600 shares were allotted, failed to pay the allotment money and Nitin, to whom 2,000 shares were allotted, failed to pay the call money and consequently they are forfeited.

Journalize the above transactions in the books of Sathyam & Co. Ltd.

Solution

Basic Calculations:

Step 1: Amount Due on Allotment:
Number of Shares × Allotment Amount per Share
40,000 × ₹10 = ₹4,00,000

Step 2: Allotment Actually Due After Adjusting
Excess Application Money
Amount Due on Allotment – Excess Application Money Adjusted with Allotment

	₹
(₹4,00,000 – ₹64,000) =	3,36,000

Step 3: Allotment Amount Due from Praveen:
Allotment Money on Praveen's Share:
1,600 Shares × ₹10 (Including Premium) 16,000
Less: Excess Application Money (Pro-rata Allotment)
16,00 Shares × $\frac{48,000}{40,000}$ = 1,9200 Shares
Praveen Would Have Been Applied = 1,920 shares

	Excess: 1,920 Shares – 1,600 Shares = 320 × ₹ 8 2,560	
∴	Allotment Amount Due from Praveen:	13,440
Step 4:	Allotment Money Received:	
		₹
	Amount Actually Due on Allotment (Ref: Step 2)	3,36,000
	Less: Amount Not Paid by Praveen:	13,440
	Amount Received:	3,22,560
Step 5:	Balance on Shares Forfeited Account:	
	Amount Paid by Praveen	
	(Number of Shares That Would Have Been Applied × ₹ 8)	15,360
	(Ref: Step.3) (1,920 × ₹ 8)	
	Amount Paid by Nitin:	
	Add: 2,000 Shares (₹ 8 + ₹ 6) (Prem. Not Included) =	28,000
	Total Balance =	43,360

Books of Sathyam & Co.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: (a) On Receipt of Application Money:			
	Bank A/c Dr.		4,80, 000	
	To Equity Share Application A/c			4,80, 000
	(Application Money Received on 60,000 Shares @ ₹ 8 per Share)			
	(b) (i) On Transfer to Share Capital (ii) On Rejection to Bank A/c & (iii) Excess Application Money to Share Allotment)			
	Equity Share Application A/c Dr.		4,80, 000	
	To Equity Share Capital A/			3,20,000
	To Equity Share Allotment A/c			64,000
	To Bank A/c			96,000
	(Application Money Received on 12,000 Shares Rejected, on 40,000 Shares to Share Capital and Under Pro-rata Allotment to Share Allotment Account)			
	Stage II: (a) On Allotment Due:			
	Equity Share Allotment A/c Dr.		4,00,000	
	To Equity Share Capital A/c			2,40,000
	To Share Capital A/c			1,60,000
	(Amount Due on Allotment of 40,000 Shares @ ₹ 10 per Share Including Premium)			

	(b) On Receipt of Allotment Amount:				
	Bank A/c	Dr.		3,22,560	
	Calls-in-Arrears A/c	Dr.		13,440	
	To Equity Share Allotment A/c				3,36,000
	(Allotment Money Received Except 1,600 Shares)				
	Stage III: (a) On Call Money Due:				
	Equity Share Call A/c	Dr.		2,40,000	
	To Equity Share Capital A/c				2,40,000
	(Call Money Due on 40,000 Shares @ ₹ 6 per Share)				
	(b) On Receipt of Call Money:				
	Bank A/c	Dr.		2,18,400	
	Call-in-Arrears A/c	Dr.		21,600	
	To Equity Share Call A/c				2,40,000
	(Money Received on First Call Except 1,600 + 2,000 Shares @ ₹ 6 per Share)				
	Stage IV: Forfeiture:				
	Equity Share Capital A/c	Dr.		72,000	
	Securities Premium A/c	Dr.		6,400	
	To Forfeited Shares A/c				43,360
	To Equity Share Allotment A/c				13,440
	To Equity Share Call A/c				21,600
	(Forfeiture of 2,000 + 1,600 = 3,600 Shares)				

1.27.3. Forfeiture of Shares Issued at a Discount

When shares are issued at a Discount, at that time of issue, the Discount Account is debited.

Hence, now, i.e., at the time of forfeiture of shares which were originally issued at a discount, the Discount Account will be Credited. The account is cancelled thereby. Then the balance on "Discount on Issue of Shares Account" pertains only to the remaining shares forming part of share capital amount.

Journal entry for the shares issued at a discount are forfeited is:

Share Capital A/c	Dr.	...	[With the Amount Called Up]
To Shares Forfeited A/c		...	[With Amount Received Till]
To Discount on Issue of Shares A/c		...	[Discount on Forfeited Shares]
To Calls-in-Arrears A/c		...	[With the Amount NOT Paid]

Illustration 1.30

Model: Forfeiture of shares issued at a discount

Riddhima Ltd. issued 10,000 shares of ₹ 100 each to the public at 10% discount payable as:

On Application : ₹ 30
On Allotment : ₹ 40
On Call : ₹ 20

All money due were received except from one shareholder, to whom 100 shares were allotted, who failed to pay call money. His shares were forfeited.

Pass journal entries for forfeiture of shares:

Solution

In the Books of Riddhima Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Share Capital A/c (100 × ₹ 100)	Dr.		10,000	
	To Shares Forfeited A/c (100 × ₹ 70)				7,000
	To Discount on Issue of Shares A/c (100 × ₹ 10)				1,000
	To Calls-in-Arrears A/c (100 × ₹ 20)				2,000
	(Forfeiture of 100 Shares Issued at a Discount)				

1.28 RE-ISSUE OF FORFEITED SHARES

1.28.1 All Forfeited Shares are Re-issued

The directors of a company have been empowered to re-issue the shares that were forfeited.

The re-issue price: Forfeited shares may be re-issued at an amount less than that called previously but at the same time, the amount of discount should not be less than the amount previously received. To illustrate, a share of ₹ 10, on which ₹ 5 has been received till its forfeiture can be re-issued as fully paid up at an amount not less than (₹ 10 – ₹ 5) = ₹ 5. In case the share is re-issued as ₹ 7 paid up, an amount of not less than (₹ 7 – ₹ 5) = ₹ 2 should be received from the persons.

The loss incurred on re-issue (Paid up value – Re-issue Price) of forfeited shares is to be debited to "Shares Forfeited A/c".

Entry:

Bank A/c	Dr.	...	[With the Actual Amount Received]
Shares Forfeited A/c	Dr.	...	[With the Discount Made to New Shareholder]
To Share Capital A/c		...	[With the Amount Treated as Paid up on the Shares]

Balance, if any, in the forfeited share account is a capital profit. It will be transferred to capital reserve account.

Entry:

Shares Forfeited A/c	Dr.	...
To Capital Reserve A/c		...

Illustration 1.31

Model: Forfeiture of shares—Originally issued at par, re-issued at discount

X Ltd. forfeited 50 shares of ₹ 20 each fully called up, held by 'D' for non-payment of allotment money ₹ 6 per share and the final call of ₹ 9 per share. He paid the application money of ₹ 5 per share. Those shares were re-issued to 'A' for ₹ 16 per share.

Pass the entries for the forfeiture and re-issue of shares.

Solution

Journal of X Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
Stage IV	**Step 1:** On Forfeiture				
	Share Capital A/c (50 × ₹ 20)	Dr.		1,000	
	To Shares Allotment A/c (50 × ₹ 6)				300
	To Share Final Call A/c (50 × ₹ 9)				450
	To Share Forfeited A/c (500 × 5)				250*[1]
	(Forfeiture of 50 Shares Held by D)				
	Step 2: On Re-issue of Forfeited Shares :				
	Bank A/c (50 × ₹ 16)	Dr.		800	
	Share Forfeited A/c (50 × (₹ 20 – ₹ 16)	Dr.		200*[2]	
	To Shares Capital A/c				1,000
	(Forfeited Shares are Re-issued to A)				
	Step 3: On Transfer of Profit:				
	Share Forfeited A/c	Dr.		50	
	To Capital Reserve A/c				50
	(₹ 250*[1] – ₹ 200*[2]) = ₹ 50—A Capital Profit Transferred to Capital Reserve A/c)				

Illustration 1.32

Model: Forfeiture of shares—Originally issued at premium, re-issued at a discount

X Ltd. Forfeited 50 shares of ₹ 100 each at a premium of 20% to Gopal who had applied for 60 shares, for non-payment of allotment money of ₹ 50 per share (including premium) and the first and final call of ₹ 50 per share. These shares were re-issued to Saran credited as fully paid for ₹ 90 per share.

Give journal entries to record forfeiture and re-issue of shares assuming that the company follows the policy of adjusting excess application money towards other sums due on shares.

Solution

This is a case of over-subscription, shares issued at premium.

First, the amount due but not paid on allotment has to be calculated as follows:

Step 1:	Total Number of Shares Applied for	=	60 Shares
Step 2:	Total Money Paid on Application (60 × ₹ 20)	=	₹ 1,200
Step 3:	Excess Application Money (₹ 1,200 – (50 × ₹ 20)	=	₹ 200
Step 4:	Total Money Due on Allotment (50 × ₹ 50)	=	₹ 2,500
***[1]Step 5**:	Amount Due but Not Paid on Allotment (₹ 2,500 – ₹ 200)	=	₹ 2,300

In the Books of X Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Step 1: On Forfeiture of Shares:				
	Share Capital A/c (50 × ₹ 100)	Dr.		5,000	
	Securities Premium A/c (50 × ₹ 20)	Dr.		1,000	
	To Forfeited Shares A/c (60 × ₹ 20)				1,200
	*[1]To Share Allotment A/c (₹ 2,500 – ₹ 200)				2,300
	To Share First & Final Call A/c (50 × 50)				2,500
	(50 Shares Forfeited for Non-payment of Allotment Money)				
	Step 2: On Re-issue of Shares:				
	Bank A/c (50 × ₹ 90)	Dr.		4,500	
	Forfeited Shares A/c 50 × (100 – 90)	Dr.		500	
	To Share Capital A/c				5,000
	(50 Forfeited Shares Re-issued as Fully Paid up for ₹ 90 per Share)				
	Step 3: On Transfer of Profit on Re-issue:				
	Forfeited Shares A/c	Dr.		700	
	To Capital Reserve A/c				700
	(Profit on Re-issue Transferred to Capital Reserve A/c)				

Illustration 1.33

Model: Forfeiture of shares—Issued at premium, re-issued at discount

X Ltd. issued 10,000 shares of ₹ 10 each at ₹ 12 payable as follows:

On Application	₹ 2.50
On Allotment	₹ 4.50 (including Premium)
On First Call	₹ 2.00
On Final Call	₹ 3.00

All the shares were applied for and allotted. All money was received with the exception of first and final call on 100 shares held by Mr. A. These shares were forfeited and re-issued at ₹ 9 per share. Give the journal entries relating to forfeiture and re-issue of forfeited shares.

Solution

Journal of X Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
Stage IV	**Step 1:** On Forfeiture of Shares				
	Share Capital A/c	Dr.		1,000	
	To Share First Call A/c (100 × ₹ 2)				200
	To Share Final Call A/c (100 × ₹ 3)				300
	To Share Forfeited A/c (100 × ₹ 5)				500
	(100 Shares Forfeited for Non-payment of First Call and Final Call)				

	Step 2: On Re-issue of Forfeited Shares:			
	Bank A/c (100 × ₹ 9) Dr.		900	
	Forfeited Shares A/c (100 × Re.1) Dr.		100	
	To Share Capital A/c			1,000
	(100 Shares Re-issued @ ₹ 9 Credited as Fully Paid and the Discount (₹ 10 – ₹ 9) ₹ 1 per Share Debited to Forfeiture A/c			
	Step 3: On Transfer of Profit:			
	Shares Forfeited A/c Dr.		400	
	To Capital Reserve A/c			400
	(Profit on Forfeited Shares Transferred to Capital Reserve) (₹ 500 – ₹ 100)			

Illustration 1.34

Model: Forfeiture of shares—Originally issued at discount, re-issued at discount

X Ltd. forfeited 100 equity shares of ₹ 20 each, issued at a discount of 10%, for non-payment of first call ₹ 4 and second call ₹ 6 per share.

These shares were re-issued to Ram upon payment of ₹ 1,400 credited as fully paid.

The company maintains calls-in-arrears account.

Pass necessary journal entries with respect to forfeiture of 100 shares and their re-issue.

Solution

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
Stage IV	**Step 1:** On Forfeiture of Shares:			
	Equity Share Capital A/c Dr.		2,000	
	To Share Forfeited A/c (100 × ₹ 8)			800
	To Discount on Issue of Share A/c (100 × ₹ 2)			200
	To Calls-in-Arrears A/c (100 × 5)			1,000
	(100 Shares Were Forfeited for Non-payment of Call)			
	Step 2: On Re-issue of Forfeited Shares:			
	Bank A/c (100 × ₹ 14) Dr.		1,400	
	Discount on Issue of Shares A/c (100 × 2) Dr.		200	
	Shares Forfeited A/c (100 × 4) Dr.		400	
	To Equity Share Capital A/c			2,000
	(100 Forfeited Shares Re-issued at [(₹ 1,400 ÷ ₹ 100) 14 per Share)]			
	Step 3: On Transfer of Profit:			
	Shares Forfeited A/c Dr.		400	
	To Capital Reserve A/c			400
	(Profit on Re-issue Transferred to Capital Reserve)			
	(₹ 800 – ₹ 400)			

1.28.2 A Part of Forfeited Shares Are Re-Issued

Sometimes, all forfeited shares are not re-issued and only a part of forfeited shares will be re-issued.

Accounting Treatment:

In such case, i.e., when all the forfeited shares are not re-issued at a single instance, the whole balance of share forfeiture account shall not be transferred to capital reserve. The reason is that the capital profit arises only with respect to the shares re-issued and NOT on all the forfeited shares.

Hence, the amount to be transferred to capital reserve is not the same as we have made so far. Care should be taken to see that the amount forfeited on shares that have not been re-issued should not be transferred to the capital reserve. This amount should be kept under a separate head "Share Forfeiture Account", which has to be utilized for allowing discount whenever such shares will be re-issued.

In this case, the amount to be transferred to capital reserve will have to be ascertained by subtracting the amount of discount utilized on the re-issue of shares from the amount forfeited on shares re-issued.

Illustration 1.35

Model: All forfeited shares are not re-issued

The directors of a company forfeited 1,000 equity shares of ₹ 10 each on which the first call of ₹ 3 and final call of ₹ 3 were not paid.

Of these, 400 shares were re-issued for payment of ₹ 3,200. You are required to pass entries for (a) forfeiture of shares and (b) re-issue of shares, and prepare forfeited shares account and show how this will appear in the balance sheet.

Solution

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
Stage IV	**Step 1:** On Forfeiture of Shares:			
	Share Capital A/c 1,000 × ₹ 10 Dr.		10,000	
	To Share Forfeited A/c (₹ 1,000 × ₹ 4)			4,000
	To Calls-in-Arrears A/c (₹ 1,000 × ₹ (3 + 3))			6,000
	(1,000, Shares Forfeited for Non-payment of First Call and Final Calls)			
	The Same Entry may be Passed by Showing Each Call Separately Instead of Calls-in-Arrears as Follows:			
	Share Capital A/c Dr.		10,000	
	To Share Forfeited A/c			4,000
	To Share First Call A/c			3,000
	To Share Final Call A/c			3,000
	Step 2: On Re-issue of Shares:			
	Bank A/c (400 × ₹ 8) Dr.		3,200	
	Forfeited Shares A/c (400 × ₹ 2) Dr.		800	
	To Share Capital A/c			4,000
	(Of 1,000 Shares Forfeited, 400 Shares are Re-issued for ₹ 3,200, i.e., ₹ 8 per Share)			

	Step 3: On Transfer of Profit on Re-issue:			
	Forfeited Shares A/c Dr.		800	
	To Capital Reserve A/c			800
	(Profit on Re-issue Transferred to Capital Reserve)			

Calculation of Profit on Re-issue of Forfeited Shares:

(i) Amount Received on Forfeiture: 400 × ₹(10 – 6) = ₹1,600
(Only Re-issued Number Should Be Taken into Account)

(ii) Less: Discount Amount to Be Adjusted for 400 × ₹2 = ₹800
Re-issue of Forfeited Shares
Original Issue – Re-issue ₹2
(₹10) – (₹8)

(iii) Profit on Re-issue to Be Transferred to Capital Reserve = ₹800

Ledger Account
Forfeited Shares A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Share Capital A/c	4,000		By Share Capital A/c	10,000
	(400 × ₹10)			(1,000 × ₹10)	
	To Capital Reserve A/c	800			
	To Balance c/d	5,200			
		10,000		*2	10,000
				By Balance b/d	5,200

Balance Sheet
as on …

Liabilities		₹	Assets	₹
SHARE CAPITAL:				
Paid-up Capital	……			
Add: Reserve & Surplus:				
*2 Share Forfeited Account	5,200	5,200		

Illustration 1.36

Model: Over-subscription, pro-rata allotment forfeiture, partial re-issue

X Ltd. forfeited 50 shares of ₹20 each issued at a premium of 20% to Vivek who had applied for 60 shares for non-payment of allotment money ₹10 per share (including premium) and first and final call of ₹10 per share. Of these, 25 shares were re-issued to Rahul credited as fully paid for ₹18 per share.

Give journal entries to record forfeiture and re-issue of forfeited shares assuming that the company has been adopting the policy of adjusting excess application money towards other sums due on shares.

Solution

First, ascertain the amount due but not paid as allotment as follows:

Step 1:	Total Number of Shares Applied for	60 Shares
*[1]**Step 2:**	Total Money Paid on Application Number of Shares × Application Money (60 × ₹ 4)	₹ 240
Step 3:	Adjusted Application Money Adjusted for 50 Shares × ₹ 4	₹ 200
Step 4:	Excess Application Money (Step 2 – Step 3)	₹ 40
Step 5:	Total Amount Due on Allotment (50 × ₹ 10) (Including Premium)	₹ 500
*[2]**Step 6:**	Amount Due but Not Paid on Allotment (Step 5 – Step 4)	₹ 460

Journal in the Books of X Ltd.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
Stage IV	**Step 1:** On Forfeiture of Shares:			
	Share Capital A/c (50 × ₹ 20) Dr.		1,000	
	Securities Premium A/c (50 × ₹ 4) Dr.		200	
	*[1] To Forfeited Shares A/c			240
	*[2] To Share Allotment A/c			460
	To Share First & Final Call A/c (50 × ₹ 10)			500
	(50 Shares Forfeited for Non-payment of Allotment Money & Calls—Applied for 60 Shares)			
	Step 2: On Re-issue of Shares:			
	Bank A/c (25 × ₹ 18) Dr.		450	
	Forfeited Shares A/c [25 × (₹ 20 – ₹ 18)] Dr.		50	
	To Share Capital A/c			500
	(Of 50 Shares Forfeited, 25 were Re-issued @ ₹ 18 per Share)			
	Step 3: On Transfer of Profit:			
	*[3] Forfeited Shares A/c Dr.		70	
	To Capital Reserve A/c			70
	(Profit on Re-issue of 25 Forfeited Shares Transferred to Capital Reserve)			

*[3] Profit on Re-issue:

Amount Received on Forfeiture (for 25, 30 Applicants would have been received) (30 × ₹ 4)	=	120
Less: Discount to be Adjusted for Re-issue: 25 × (₹ 20 – ₹ 18) ₹ 2	=	50
∴ Profit on Re-issue	=	70

Illustration 1.37

Model: Forfeiture of shares—Originally issued at discount, only a part of forfeited shares re-issued

The directors of a company forfeited 100 shares of Mr. X. who paid on application and allotment ₹ 4 (shares of ₹ 10 each issued at a discount of 10%), ₹ 2 on first call but failed to pay ₹ 3 on final call. Out of these, 40 shares were re-issued at ₹ 7 per share. Pass journal entries in respect of forfeiture and re-issue of shares only.

Solution

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
Stage IV	**Step 1:** On Forfeiture of Shares:				
	Share Capital A/c (100 × ₹ 10)	Dr.		1,000	
	To Share Final Call A/c (100 × ₹ 3)				300
	To Discount on Issue of Shares A/c (100 × ₹ 1)				100
	To Share Forfeited A/c (100 × ₹ 6)				600
	(100 Shares were Forfeited for Non-payment of Final Call ₹ 3 per Share)				
	Step 2: On Re-issue of Forfeited Shares:				
	Bank A/c (40 × ₹ 7)	Dr.		280	
	Discount on Issue of Shares A/c (40 × ₹ 1)	Dr.		40	
	Shares Forfeited A/c (40 × ₹ 2)	Dr.		80	
	To Share Capital A/c				400
	(40 Shares Were Re-issued @ ₹ 7 per Share @ ₹ 1 Debited to Discount on Issue of Shares A/c)				
	Step 3: On Transfer of Profit on Re-issue:				
	Share Forfeited A/c	Dr.		160	
	To Capital Reserve A/c				160
	(Profit Transferred to Capital Reserve)				

Calculation of Profit:

40 Shares Forfeited Amount 40 × ₹ 6	₹ 240
Less: Discount (40 Shares × (₹ 9 – ₹ 7))	₹ 80
∴ Profit to be Transferred:	₹ 160

1.29 EMPLOYEE STOCK OPTION PLAN

Companies may offer their equity shares to their employees. Such shares are purchased at the will of employees. In order to encourage their employees, to retain the super skilled in the companies, such a scheme is introduced which is known as Employee Stock Option Plan (ESOP). This is a right awarded to an employee to purchase the equity shares of the company at a pre-determined price.

This term "employee"—as per the provisions of the Companies Act 1956—includes permanent employee of the company working in India or out of India; or an employee of a subsidiary or a holding company; or director, etc.

Under this scheme, the employee has the right to exercise the option to purchase shares within the vesting period. Vesting period denotes the time during which the scheme is in operation.

But, employees holding more than 10% of the outstanding equity shares of the company shall not be eligible to exercise their option to purchase shares under ESOP scheme.

Shares issued under this scheme should be locked-in for a minimum period of one year from the date of allotment:

Accounting Treatment:

The value of options under this scheme is an expense to the company. So, it has to be written off over the vesting period.

Accounting value of option = Number of option × (Market price – Exercsie price)

To illustrate, assume that a public limited company grants 500 options to its employees at the rate of ₹ 50 per option and on that date the market price of share is ₹ 150, then the value of option will be:

$$= 500 \times (₹\,150 - ₹\,50)$$
$$= 500 \times (₹\,100) = ₹\,50{,}000$$

This is also termed as "option discount".

There are two alternative circumstances:

(i) Where the employees exercise the option

(ii) Where the employees do not exercise the option

In the first alternative, the accounting value of option (option discount) is treated as:

(a) Employee compensation

(b) Has to be amortized on a straight-line basis over the vesting period

In the second alternative, the employee compensation equal to the amortized portion of the value of lapsed options has to be debited to employee stock option outstanding A/c and credited to deferred employee compensation expense A/c.

Journal Entries:

1. When Option is Granted:

Deferred Employee Compensation Expense A/c	Dr.	....	
To Employee Stock Opinion Outstanding A/c			...

2. When Employees Exercise the Option:

Cash/Bank A/c	Dr.	...	
Employee Stock Option Outstanding A/c	Dr.	...	
To Equity Share Capital A/c			...
To Securities Premium A/c			...

3. For Amortizing the Expense

Employee Compensation Expense A/c	Dr.		
To Deferred Employee Compensation Expense A/c			...

4. When the Option Lapses:

The Value of Options is Split into Two Parts:

(i) Amortized Value of Options Lapsed}: $\dfrac{\text{No. of Option Lasped} \times \text{Discount} \times \text{Time Interval}}{\text{Vesting Period}}$

Time Interval → Date of Offer and Date of Lapse

(ii) Unamortized Value of Options Lapsed:} $\frac{\text{No. of Option Lasped} \times \text{Discount} \times \text{Time Interval}}{\text{Vesting Period}}$

Time Interval → Date of Lapse and Vesting Period

Entry will be:

Employee Stock Options Outstanding A/c	Dr.	...	
To Employee Compensation Expense A/c			...
(Amortized Value)			
To Deferred Employee Compensation Expansive A/c			...
(Unamortized Value)			

These entries can be clearly explained through the following illustration:

Alpha Ltd. grants 1,000 options to the employees and directors at ₹150 per option against the market price of ₹350, the vesting period is 2 years. Pass the journal entries:

Step 1: Value of Option is Calculated as:

Value of Option = Number of Options × (Market Price – Exercise Price)

= 1,000 × (₹350 – ₹150)

= 1,000 × ₹200

= ₹2,00,000

Step 2: Vesting Period = 2 years (Given)

Hence, This Value of Option, i.e., ₹2,00,000, Is to Be Amortized in 2 years, Each Year ₹1,00,000.

Step 3: Entry 1:

			₹
Deferred Employee Compensation Expense A/c	Dr.	2,00,000	
To Employee Stock Option Outstanding A/c			2,00,000
(1,000 Options Granted at a Discount of ₹200)			

Step 4: Entry 2:

Employees Compensation Expense A/c	Dr.	1,00,000	
To Deferred Employee Compensation A/c			1,00,000
(Amortization over Period 2 years)			

Note: This entry will be repeated each year till it is written off. In this illustration, vesting period is only 2 years. Hence, it is written off with next year's entry.

Illustration 1.38

Model: Employee stock option

Renu & Co. Ltd. granted 1,000 options on 1 April 2007 at ₹80 (Nominal value of ₹20) when the market price was ₹320, the vesting period was two and a half years. The maximum exercise period was one year. On 1 May 2009, 300 invested options lapsed and 600 options were exercised on 30 June 2010, and remaining 100 options lapsed at the end of exercise period. Pass necessary journal entries in the books of Renu & Co. Ltd.

Solution

Note: This is the case when the option granted is exercised by some employees and not exercised by some.

Step 1: Ascertain of Accounting Value of Options:

- Formula: Accounting Value of Options}: Number of Options × (Market Price – Exercise Price)

- Substituting the Given Figures in the Formula,
  Accounting Value of Options = 1,000 × (₹320 – ₹80)
  = 1,000 × ₹240
  = ₹2,40,000

Step 2: Calculation of Amortization:

- Here, the term, "Amortization" should be understood.
- It is nothing but that the Accounting Value of Option has to be divided proportionately for each year, depending up on the Vesting Period.
- Here, Accounting Value of Option = ₹2,40,000
- This value has to be apportioned for 2½ years, which is the Vesting Period given in the question.

First Year

- Hence, Amortization Value for first year $= \frac{₹2,40,000}{2\frac{1}{2} \text{ years}}$

$$\text{Or} = \frac{2,40,000}{2} \times 5$$

$$= ₹96,000$$

Second Year

- Similarly, for second year $= \frac{₹2,40,000}{2\frac{1}{2} \text{ years}} = ₹96,000$

Third Year

- For the third year, i.e. for 6 months till 30 June 2010

$= ₹\frac{2,40,000}{0.5} =$ or $\frac{96,000}{2} = ₹48,000$

Step 3: Reversal of Compensation Accounting on Lapse of 300 Options Has to Be Done:

Formula: $\frac{\text{Total Value of Compensation}}{\text{Total No. of Options}} \times$ Number of Options Not Exercised

$$= \frac{₹2,40,000}{1,000} \times 300 = ₹72,000$$

Step 4: Deferred Compensation Expenses Have to be Found Out:

Formula: $\frac{\text{Not Yet Amortized Value of Compensation}}{\text{Total No. of Options}} \times$ Number of Options Not Exercised

$$= \frac{(₹2,40,000 - ₹96,000 - ₹96,000)}{1,000} \times 300$$

$$= \frac{₹48,000}{1,000} \times 300 = ₹14,400$$

Step 5: Employees Compensation Expense Has to be Calculated:

Formula: $\frac{\text{Amortized Value of Compensation}}{\text{Total No. of Options}} \times$ Number of Options Not Exercised

$$: \frac{₹96,000 + ₹96,000}{1,000} \times 300$$

$$: \frac{₹1,92,000}{1,000} \times 300 = ₹57,600$$

Step 6: Deferred Employee Compensation Expense:
(Amortization of Deferred Compensation)
= (₹ 48,000 – ₹ 14,400) = ₹ 33,600

Step 7: Calculation of Securities Premium:
Formula: Number of Options Exercised (Market Price – Face Value)
= 600 × (₹ 320 – ₹ 20) = 600 × 300
= ₹ 1,80,000

Step 8: Employee Compensation Expense on 1 October 2010 has to be calculated:
Formula: Number of Vested Options Lapsed (Market Price – Exercise Price)
= 100 × (₹ 320 – ₹ 80)
= 100 × ₹ 240 = ₹ 24,000

Step 9: Amortization Portion:
(Step 5) Number of Options Lapsed × (Market Price – Exercise Price) × $\frac{2}{2.5}$
= 300 (320 – 80) = 300 × ₹ 240 = ₹ 72,000 × $\frac{2}{2.5}$
= ₹ 57,600

Step 10: Unamortized Portion:
(Step 4) = 300 × ₹ 240 × $\frac{00.5}{2.5}$ = ₹ 14,400

Note: Steps 9 and 10 are already shown with a different approach in Step 4 and 5.

Step 10: Passing of Journal Entries:

Books of Renu & Co. Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 April 2007	Deferred Employee Compensation Expense A/c Dr. To Employee Stock Options Outstanding A/c {1,000 Options Granted at a Discount of ₹ (320 – 80): ₹ 240} [Ref: Step 1]		2,40,000	 2,40,000
31 March 2008	Employee Compensation Expense A/c Dr. To Deferred Employee Compensation Expense A/c (Amortized: Deferred Compensation) [Ref: Step 2: 1st Year]		96,000	 96,000
31 March 2009	Employee Compensation Expense A/c Dr. To Deferred Employee Compensation Expense A/c (Deferred Compensation Amortized) [Ref: Step 2: 2nd Year]		96,000	 96,000
31 May 2009	Employee Stock Options Outstanding A/c Dr. To Employee Compensation Expense A/c To Deferred Employee Compensation Expense A/c (Reversal of Compensation on Lapse of 300 Unvested Options) (Ref: Steps 3 to 5)		72,000	 57,600 14,400
31 March 2010	Employee Compensation Expense A/c Dr. To Deferred Employee Compensation Expense A/c (Deferred Compensation Amortized) (Ref: Step 6)		33,600	 33,600

30 June 2010	Bank A/c (600 × ₹ 80)	Dr.		48,000	
	Employee Stock Options Outstanding A/c	Dr.		1,44,000	
	(600 × ₹ 240)				
	To Equity Share Capital A/c				12,000
	(600 × ₹ 20)				
	To Securities Premium A/c				1,80,000
	(Ref: Step 7)				
	(600 Options Exercised at an Exercise Price of ₹ 80 Each and an Accounting Value of ₹ 240 Each)				
1 October 2010	Employee Stock Options Outstanding A/c}	Dr.		24,000	
	To Employee Compensation Expense A/c				24,000
	(Reversal of Compensation Accounting on Lapse of 100 Vested Options at the End of Exercise Period)				
	(Ref: Step 8).				

In balance sheet, Employee Stock Options Outstanding will be shown as part of shareholder's equity.

Deferred employee compensation will also be shown as part of shareholders' equity but as a negative item.

The expense on exercise of stock option is charged to profit and loss A/c according to GAPP.

1.29.1 Employee Stock Purchase

A public limited company may issue shares under Employee Stock Purchase Scheme, during any accounting period.

Journal entry to be passed for issue of shares under Employee Stock Purchase Scheme will be:

Cash/Bank A/c	Dr.	...	[Number of Shares × Issue Price]
Employee Compensation Expense A/c}	Dr.	...	[Accounting Value of Options]
To Share Capital A/c		...	[Number of Shares × Face Value]
To Securities Premium A/c		...	[Number of Shares (Market Price – Face Value)]

Illustration 1.39

Model: Employee stock purchase

'X' Ltd. issued 1,000 shares on 1 January 2010, under Employee Stock Purchase Scheme at ₹ 50 when the market price was ₹ 150. Pass the necessary journal entries assuming that the face value of a share is ₹ 10.

Solution

Basic Calculations:

1. Accounting Value of Shares:

Formula: Accounting Value of Shares} Number of Options (Market Price – Exercise Price)

= 1,000 (₹ 150 – ₹ 50)

= 1,000 × ₹ 100 = ₹ 1,00,000

2. Value of Security' Premium:
   Formula: Security Premium: Number of Options Exercise (Market Price – Exercise Price)
   = 1.000 (₹ 150 – ₹ 10)
   = 1.000 × ₹ 140 = ₹ 1,40,000
3. Journal:

Books of X Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 January 2010	Bank A/c (1,000 × ₹ 50)	Dr.		50,000	
	Employee Compensation Expense A/c (Ref: 1 above)	Dr.		1,00,000	
	To Equity Share Capital A/c (1,000 × ₹ 10)				10,000
	To Securities Premium A/c (Ref: 2 above)				1,40,000
	(1,000 Shares Issued at ₹ 50 when Market Price is ₹ 150)				

1.30 ISSUE OF BONUS SHARES

The shares which are allotted to existing equity shareholders without any consideration are known as "bonus shares". These bonus shares are issued in order to capitalize the profits of the company. Only if there is specific provision in the Articles of Association, a company can issue bonus shares.

1.30.1 SEBI Guidelines with Respect to Issue of Bonus Shares

The following are some guidelines that are issued by SEBI regarding the issue of bonus shares:

(i) The bonus issue can be made only out of free reserves, generated out of genuine profits or securities premium collected in cash.
(ii) Reserves created by revaluation of fixed assets cannot be used for issue of bonus shares.
(iii) The bonus issue cannot be made unless partly paid shares are made fully paid-up.
(iv) The declaration of bonus issue, in lieu of dividend, is not permitted.
(v) If the company announces the issue of bonus shares with the approval of the Board of Directors, it must implement the proposal within six months from the date of approval and, furthermore, it cannot reverse or defer such decision.
(vi) If there is no provision on capitalization of reserves for the issue of bonus shares in the Articles of Association, first such provision should be enacted in the Articles by passing the needed resolution.
(vii) Consequent to the issue of bonus shares, if the subscribed and paid-up capital exceed the authorized share capital, then the company has to pass a resolution to increase the authorized capital to the desired level.
(viii) No company with pending conversion of fully convertible debentures (FCDs)or partially convertible debentures (PCDs) can issue bonus shares.
(ix) The company must not have defaulted in payment of interest or principal in respect of fixed deposits, interest on existing debentures; principal on redemption.
(x) The company must not have defaulted in respect of payment of statutory dues of the employees such as contribution to PF, gratuity, bonus, etc.

Accounting Treatment:

(a) On Issue of Bonus Shares:

Source/Reserve used: A/c Dr. ... [With the Amount for which Bonus Shares are Issued]

(Capitalization of Profit—General Reserve or Securities of Premium A/c)

To Bonus to Equity Shareholder's A/c ...

(b) On Distribution of Bonus Shares:

Bonus to Equity Shareholders A/c Dr. ...

To Equity Share Capital A/c ...

In Balance Sheet

The following note should be given in the balance sheet after the issue of bonus shares:

… Of the above shares, … are allotted as fully paid up by way of bonus shares, using credit balances in ……

(Source should be mentioned, here—General Reserve or Securities Premium or P&L A/c).

This is in compliance with the Schedule VI Part I of the Companies Act.

Illustration 1.40

Model: Issue of bonus shares

An extract of the balance sheet of a public limited company is given in the following:

Liabilities	₹	**Assets**	₹
Issued & Subscribed Capital:			
30,000 Equity Shares	3,00,000		
of ₹ 10 Each, Fully Paid:			
Reserves & Surplus:	1,00,000		
Capital Reserve			
Securities Premium	70,000		
General Reserve	3,00,000		
Profit & Loss A/c	60,000		
	x x		x x

The company issues fully paid bonus equity shares of ₹ 10 each for every three equity shareholders held to its equity shareholders. For this purpose, balances in profit & loss account & general reserve are used to the necessary extent.

Pass journal entries regarding the issue of bonus shares.

Solution

Note:

For every three equity shareholders, 1 bonus share is issued

∴ For 30,000 equity shareholders the number of bonus shares issued = $\frac{30,000}{3}$ = 10,000

Total amount needed: ₹ 10 × 10,000 = ₹ 1,00,000

This is to be used from P&L A/c & general reserve as per the direction given in the problem.

Amount available in P&L A/c = ₹ 60,000

∴ Next, ₹ 40,000 is to be taken from general reserve.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Profit & Loss A/c	Dr.		60,000	
	General Reserve A/c	Dr.		40,000	
	To Bonus to Equity Shareholders A/c				1,00,000
	(Utilization of P&L A/c and General Reserve for Issue of Bonus Shares of ₹ 1,00,000 to the Holders of Equity Shares of ₹ 3,00,000)				
	Bonus to Equity Shareholders A/c	Dr.		1,00,000	
	To Equity Share Capital A/c				1,00,000
	(Distribution of Bonus Shares)				

1.31 RIGHTS ISSUE

According to Section 81 of the Companies Act, the existing shareholders of a company have a right to subscribe to the fresh issue of capital or to reject offer or to sell their rights. It is a legal obligation to offer the fresh issue to the existing shareholders in their existing proportion. The existing shareholders can authorize the company to offer such shares to the public by a special resolution.

The share price of the share will always be higher than the previous issue price. Value of such right may be determined by using the following formula:

Value of right = Market Price of a Share – Average Price of a Share

where the Average Price of a Share =

$$\frac{\text{Market Price of the Existing Shares + Issue Price of Proportionate Right Shares}}{\text{Existing Shares + Rights Shares}}$$

Accounting Treatment:

Journalizing the transactions for right issue of shares is similar to that of shares issued at par for application and allotment etc.

Illustration 1.41

Model: Value of right

A limited company offers new shares of ₹ 100 each at 20% premium to the existing shareholders in the ratio of every one share for every four shares held. The market price of share is ₹ 150. Calculate the value of right.

Solution

Method I:

First Calculate the Average Price of share:

$$\text{Formula} = \frac{\text{Market Price of Existing Shares + Issue Price of Right Shares}}{\text{Existing Shares + Rights Shares}}$$

$$= \frac{(₹\,150 \times 4) + (₹\,100 + 20\%)}{4 + 1}$$

$$= \frac{₹\,600 + ₹\,120}{5} = \frac{₹\,720}{5} = ₹\,144$$

Value of Right: Market Price of a Share – Average Price of a Share

= ₹ 150 (Given) – ₹ 144 (As Determined Above)

= ₹ 6

Method II:

Another Formula to Determine Value of Right:

$$\text{Value of Right} = \frac{\text{Number of New Shares}}{\text{Total Number of Shares}} \text{ (Cum Right Price – New lssue Price}$$

$$= \frac{1}{(4+1)} \times (₹\,150 - ₹\,120)$$

$$= \frac{1}{5} \times ₹\,30.$$

$$= 6$$

Students may opt either of the method to determine the value of right.

1.32 SWEAT EQUITY

- Shares which are issued by the company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights to use intellectual property are called "sweat equity shares".
- Sweat Equity shares—a new type of equity shares was introduced by the Companies (Amendment) Act 1999, through Section 79-A.
- Section 79 deals with the power of a company to issue shares at a discount (discussed earlier).
- Notwithstanding anything contained in Section 79, a company may issue sweat equity shares if the following conditions are fulfilled:
  - (i) The issue of sweat equity shares is authorized by a special resolution passed by the company in the general meeting.
  - (ii) The resolution specifies the number of shares, current market price, the consideration, if any, and the class or classes of directors or employees to whom such shares are issued.
  - (iii) Not less than one year has elapsed since the date of commencement of business.
  - (iv) The sweat equity shares of a company, whose equity shares are listed on a recognized stock exchange, are issued in accordance with the regulations issued by the SEBI in this behalf.

Accounting Treatment:

Journal entries for issue sweat equity shares are the same as those for issue of any other equity shares.

1.33* UNDERWRITING

A company issues shares for consideration other than cash. Underwriting commission is one such instance, i.e., shares are allotted to underwriters instead of cash for the services rendered by them.

Underwriting: It is a kind of arrangement between a person (agency or other form of organisation) and a company in order to secure a guarantee from that person or body that the shares and debentures offered to the public will be taken up by the public. In case the shares and debentures are not taken up by public, they will be taken up by the person or body in accordance with the agreement. Such guarantor (person or body) is called the "underwriter", and the process "Underwriting", for which the underwriter is entitled to receive commission for the services. The commission is known as underwriting commission. The company allots shares to discharge underwriting commission instead of cash.

Entries:

(a) Underwriting Commission A/c Dr. ...
To Underwriter A/c ...

(b) Underwriter A/c Dr. ...
To Share Capital A/c ...

[*A separate chapter (Chapter 2) for "underwriting on shares" follows this chapter.]

Illustration 1.42

Model: Issue of shares for consideration other than cash: Underwriter and promoter

Vas Bhag Ltd. was registered with an authorized share capital of ₹ 20, 00,000 divided into shares of ₹ 10 each. It acquired the business of M/s Gopi & Sons, taking over the following assets at the values stated against each one of them:

	₹
Freehold Premises	5,00,000
Machinery	3,50,000
Furniture	60,000
Stock	1,60,000
Sundry Debtors	30,000

The consideration was discharged by issue of 1,00,000 equity shares at a premium of 10%.

The company allotted 2,000 shares at par to promoters as remuneration for their services.

The company offered to public 25,000 equity shares at a premium of 10% and 20,000 15% preference shares at par, the entire amount being payable on application. The entire issue was underwritten by M/s Dev & Raj Sons for a commission of 2% of the issue price payable in the form of equity shares of Vas Bhag Ltd at par. The issue was fully subscribed to by the public.

You are required to pass journal entries, prepare necessary ledger accounts and construct the balance sheet of the company.

Solution

In the Books of Vas Bhag Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Step 1: On Various Assets Taken Over:				
	Freehold Premises A/c	Dr.		5,00,000	
	Machinery A/c	Dr.		3,50,000	
	Furniture A/c	Dr.		60,000	
	Stock A/c	Dr.		1,60,000	
	Sundry Debtors A/c	Dr.		30,000	
	To M/s Gopi & Sons A/c				11,00,000
	(Assets Taken Over from M/s Gopi & Sons)				

	Step 2: On Issue of Shares to M/s Gopi & Sons in Lieu of Cash for Assets Taken Over:			
	M/s Gopi & Sons A/c Dr.		11,00,000	
	To Equity Share Capital A/c			10,00,000
	To Securities Premium A/c			1,00,000
	(1,00,000 Equity Shares of ₹ 10 Each at a Premium of 10% Allotted to M/s Gopi & Sons to Discharge Consideration for the Assets)			
	Step 3: On Allotment of Shares to Promoters			
	Goodwill A/c Dr.		20,000	
	To Equity Share Capital A/c			20,000
	(2,000 Shares of ₹ 10 Each at Par, Allotted to Promoters for Their Services as Remuneration Instead of Cash)			
	Step 4: On Allotment of Shares & Pref. Shares			
	Equity Share Applications & Allotment A/c Dr.		2,75,000	
	15% Pref. Shares Application & Allotment A/c Dr.		2,00,000	
	To Equity Share Capital A/c			2,50,000
	To Securities Premium A/c			25,000
	To 15% Pref. Share Capital A/c			2,00,000
	(Allotment of 25,000 Equity Shares of ₹ 10 Each at a Premium of 10% & 20,000, 15% Pref. Shares of ₹ 10 Each at Par, i.e., Allotment Money Due)			
	Step 5: On Receipt of Applications & Allotment Money:			
	Bank A/c Dr.		4,75,000	
	To Equity Share Application & Allotment A/c}			2,75,000
	To 15% Pref. Shares Application & Allotment A/c}			2,00,000
	(Application & Allotment Money Received on Equity Shares & 15% Pref. Shares)			
	Step 6: On Underwriting Commission DUE:			
	Underwriting Commission A/c Dr.		9,500	
	To M/s Dev & Raj Sons A/c			9,500
	(Underwriting Commission due to Dev & Raj @ 2% on ₹ 4,75,000, the Issue Price of Equity Shares & 15% Pref. Shares)			
	Step 7: Underwriting Commission Discharged of:			
	M/s Dev & Raj Sons A/c Dr.		9,500	
	To Equity Share Capital A/c			9,500
	(950 Shares of ₹ 10 Each at Par to Dev & Raj Sons in Lieu of Cash Payment for Underwriting Commission)			

Ledger Account

Bank Account

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application and Allotment A/c	2,75,000		By Balance c/d	4,75,000
	To 15% Preference Share Application and Allotment A/c	2,00,000			
		4,75,000			4,75,000
	To Balance b/d	4,75,000			

Equity Share Capital A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	12,79,500		By Gopi & Sons A/c	10,00,000
				By Goodwill A/c	20,000
				By Equity Share Applications & Allotment A/c	2,50,000
				By M/s Dev & Raj Sons A/c	9,500
		12,79,500			12,79,500
				By Balance b/d	12,79,500

Securities Premium A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	1,25,000		By M/s Gopi & Sons A/c	1,00,000
				By Equity Shares Application and Allotment A/c	25,000
		1,25,000			1,25,000
				By Balance b/d	1,25,000

15% Preference Share Capital A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	2,00,000		By 15% Pref. Share Applications & Allotment A/c	2,00,000
		2,00,000			2,00,000
				By Balance b/d	2,00,000

M/s Gopi & Sons A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	10,00,000		By Freehold Premises	5,00,000
	To Securities Premium A/c	1,00,000		By Machinery	3,50,000
				By Furniture	60,000
				By Stock	1,60,000
				By Sundry Debtors	30,000
		11,00,000			11,00,000

Equity Share Applications & Allotment A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	2,50,000		By Bank A/c	2,75,000
	To Securities Premium A/c	25,000			
		2,75,000			2,75,000

15% Preference Share Applications & Allotment A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To 15% Preference Share Capital A/c	2,00,000		By Bank A/c	2,00,000
		2,00,000			2,00,000

Underwriting Commission A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To M/s Dev & Raj Sons A/c	9,500		By Balance c/d	9,500
		9,500			9,500
	To Balance b/d	9,500			

M/s Dev & Raj Sons A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	9,500		By Underwriting Commission A/c	9,500
		9,500			9,500

Balance Sheet of Vas Bhag Ltd.
as at …

Liabilities	₹	Assets	₹
SHARE CAPITAL:		FIXED ASSETS:	
Authorized:	—	Goodwill	20,000
2,00,000 Shares of ₹ 10 Each	20,00,000	Furniture	60,000
Issued & Subscribed:		Machinery	3,50,000
20,000, 15% Pref. Shares of ₹ 10 Fully Paid up	2,00,000	Freehold Premises	5,00,000
1,27,950 Equity Shares of ₹ 10 Each Fully Paid up	12,79,500	CURRENT ASSETS, LOANS AND ADVANCES:	
(Of the Above Shares, 1,02,950 Equity Shares are Allotted as Fully Paid up for Consideration Other than Cash)		(A) Current Assets	
		Stock	1,60,000
		Sundry Debtors	30,000
		Cash at Bank	4,75,000
RESERVE & SURPLUS:		(B) Loans & Advances	—
Securities Premium	1,25,000	MISCELLANEOUS EXPENDITURE:	
		Underwriting Commission	9,500
	16,04,000		16,04,500

1.34 BUY-BACK OF SHARES

According to Section 77A of the Companies Act, 1956, a company can buy its own shares either from the (a) existing equity shareholders on a proportionate basis or (b) open market or (c) odd lot shareholders; or (d) employees of the company pursuant to a scheme of stock option or sweat equity.

Some important provisions of Section 77A:

1. The buy-back should be authorized by the Articles.
2. Special resolution is to be passed in the general meeting of shareholders.
3. The buy-back of the shares cannot exceed 25% of paid-up capital and free reserves in a financial year.
4. The debt–equity ratio should not be more than 2:1 after such buy-back.
5. All the shares for buy-back should be fully paid up.
6. The buy-back should be completed within 12 months from the date of passing the special resolution.
7. The company must fill a solvency declaration with the Registrar and SEBI in the form of an affidavit.

A company that buys-back its own shares shall extinguish and physically destroy the shares within seven days of the last date of completion of buy-back, as per Section {77A (7)}.

According to Section 77A (8), where a company completes the buy-back of its shares, it shall not make further issue of shares within 24 months.

1.34.1 SEBI Guidelines on Buy-Back of Shares

Following are some of them:

1. Buy-back of shares cannot be from any persons through negotiated deals, whether on or of Stock Exchange or through spot transactions or through private arrangement.

2. Public announcement among other things should specify the following:
   (a) Specify the date of despatch of the offer letter, which is termed as "specified date". The date so specified shall not be less than earlier than 30 days but not later than 42 days.
   (b) The company shall file information to the SEBI within seven working days from the date of public announcement.
   (c) The offer of buy-back shall remain open to the members for a period of not less than 15 days but not exceeding 30 days. However, the opening date for offer shall not be earlier than 7 days or later than 30 days from the specified date.
   (d) The company shall complete the verification of offers within 15 days from the date of closure and shares lodged shall be deemed to have been accepted unless communication of rejection is made within 15 days from the date of closure.

1.35 ESCROW ACCOUNT

"Escrow" means a contract or bond deposited with a third person, by whom it is to be delivered to the guarantee on the fulfilment of some condition.

A company has to open an "escrow account" if it wants to initiate the process of buy-back of shares.

An escrow account consists of (1) cash deposited with a commercial bank or (2) bank guarantee in favour of a merchant banker or (3) deposit of acceptable securities with appropriate margin or (4) a combination of (1) (2) & (3) with merchant banker with an amount equal to 25% of the consideration payable if the consideration is not more than ₹ 100 crore plus 10% of the consideration exceeding ₹ 100 crore. On completion of the process of buy-back of shares, the amount and or securities deposited in escrow account will be released to the company. In case of non-fulfilment of obligations by the company, SEBI can forfeit the escrow account.

Comprehensive Illustrations—Advanced Level

Illustration 1.43

Fantastic Industries Ltd. issued a prospectus, inviting applications for 1,00,000 shares of ₹ 20 each at a premium of ₹ 10 per share, payable as follows:

	₹
On Application	5
On Allotment	15 (Including Premium)
On First Call	8
On Final Call	2

Applications were received for 1,50,000 shares and allotment was made pro-rata to the applicants of 1,20,000 shares, the remaining applications being refused. Money received in excess on the applications was adjusted towards the amount due on allotment.

P, to whom 2,000 shares were allotted, failed to pay allotment money and on his failure to pay the first call, his shares were forfeited. Q, the holder of 3,000 shares, failed to pay the two calls, and so his shares were also forfeited. All these sold to R, credited as fully paid for ₹ 16 per share.

Journalize the above transactions in the books of the company.

[Sri Venkateswara University]

Solution

Basic calculations shown step-wise:

Step 1:

- This is a Case of Over-subscription.
- For 1,20,000 Applicants, 1,00,000 Shares Were Allotted.
- The Remaining 30,000 Applications Were Rejected and Application Money is to be Refunded on this.

Step 2:

			₹
	Excess Application Money:		
	Application Received: 1,50,000 × ₹ 5	=	7,50,000
	Less: Rejected & Refunded: 30,000 × ₹ 5	=	1,50,000
			6,00,000
	Less: Application Money on 1,00,000 Shares:		5,00,000
∴	Excess Application Money	=	1,00,000
	This Amount Has to be Adjusted on Allotment Money.		

Step 3:

Amount Due on Allotment & Actual Money Received on Allotment Due:		
Due for 1,00,000 Shares @ ₹ 15 per Share	=	15,00,000
Less: Excess Application Money Already Adjusted with Allotment (Step 2)		1,00,000
		14,00,000
Less: P Failed to Pay on Allotment (2,000 Shares × 15, He Would Have Applied for $\left[\frac{1,20,000}{1,00,000} = \frac{6}{5}\right] \frac{6}{5} \times 2000 = 2400$ Shares 2,400 × Application Money = for Excess 400 Shares × ₹ 5 = ₹ 2,000) (₹ 30,000 – ₹ 2,000)		28,000
Actual Amount Received on Allotment Due	=	13, 72,000

Step 4:

Amount Paid by P:	
As Already Calculated in Step 3, the Shares.	
He Would Have Been Applied for Would Be	= 2,400 Shares
$\frac{6}{5} \times 2,000 = 2,400$	
[He Would Have Applied for 2,400 Shares to Get 2,000 Shares]	
Application Money Received from P on 2,400 Shares	= 2,400 × ₹ 5 = ₹ 12,000

Step 5:

[Amount Paid by Q:		
For 3,000 Shares, He Would Have Applied for:		
$\frac{1,20,000}{1,00,000} \times 3,000$	=	3,600 Shares

As He Paid His Application Money and Allotment Money, the Excess Money on (3,600 – 3,000) = 600 Shares Need Not Be Adjusted Again. To Explain the Difference Between P and Q, This Step is Inserted Here:

Here for Q, Only 3,000 Shares Need be Taken into Account]

Step 6:

Profit Transferred to Capital Reserve:

		₹
Forfeited Shares Amount P (Ref: Step 4)	=	12,000
Forfeited Shares Amount Q (3,000 × ₹ 10)	=	30,000
		42,000
Exc 1. Prem.		
Less: Discount on Re-issue of (2,000 + 3,000) 5,000 Shares (₹ 20 – ₹ 16) × ₹ 4	=	20,000
∴ Profit to be Transferred	=	22,000

Fantastic Industries Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I:			
	(a) Bank A/c Dr.		7,50,000	
	To Share Application A/c			7,50,000
	(Application Money Received on 1,50,000 Shares @ ₹ 5 per Share)			
	(b) Share Application A/c Dr.		5,00,000	
	To Share Capital A/c			5,00,000
	(Application Money on 1,00,000 Applications Transferred to Share Capital A/c)			
	(c) Share Application A/c Dr.		2,50,000	
	To Share Allotment A/c			1,00,000
	To Bank A/c			1,50,000
	(Transfer of Remaining 20,000 Applications Money to Share Allotment A/c and 30,000 Applications Money Refunded)			
	Stage II:			
	(a) Share Allotment A/c Dr.		15,00,000	
	To Share Capital A/c			5,00,000
	To Securities Premium A/c			10,00,000
	(Allotment Money Due)			
	(b) Bank A/c Dr.		13,72,000	
	To Share Allotment A/c			13,72,000
	(Receipt of Share Allotment Money After Adjustment) (Ref: Step 3)			

	Stage III:			
	(a) Share First Call A/c Dr.		8,00,000	
	To Share Capital A/c			8,00,000
	(First Call Money Due on 1,00,000 Shares @ ₹ 8 Each)			
	(b) Bank A/c Dr.		7,60,000	
	To Share First Call A/c			7,60,000
	(First Call Money Received on 1,00,000 – (2,000 + 3,000) = 95,000 Shares)			
	(c) Share Final Call A/c Dr.		1,96,000	
	To Share Capital A/c			1,96,000
	(Final Call Money Due on 98,000 Shares @ ₹ 2 per Share) (1,00,000 – P's Share 2,000)			
	(d) Bank A/c Dr.		1,90,000	
	To Share Final Call A/c			1,90,000
	(Final Call Money Received on 98,000 – Q's Share 3,000 = 95,000 Shares)			
	Stage IV: Forfeiture of Shares & Re-issue:			
	(a) Forfeiture of Shares of P:			
	Share Capital A/c Dr.		36,000	
	Securities Premium A/c (2,000 × ₹ 10) Dr.		20,000	
	To Share Allotment A/c (Ref: Step 3)			28,000
	To Share First Call A/c 2,000 × ₹ 8			16,000
	To Share Forfeited A/c 2,000 × ₹ 6			12,000
	(P's 2,000 Shares Forfeited for Non-payment of Allotment Money & First Call)			
	(b) Forfeiture of Shares of Q:			
	Share Capital A/c Dr.		60,000	
	To Share First Call A/c (3,000 × ₹ 8)			24,000
	To Share Final Call A/c (3,000 × ₹ 2)			6,000
	To Share Forfeited A/c (3,000 × ₹ 10)			30,000
	(Q's Shares – 3,000 Forfeited for Non-payment of Two Calls)			
	(c) Re-issue of Forfeited Shares:			
	Bank A/c (5,000 × ₹ 16) Dr.		80,000	
	Shares Forfeited A/c (5,000 × ₹ 4) Dr.		20,000	
	To Share Capital A/c			1,00,000
	(5,000 Shares (2,000 of P + 3000 of Q) were Re-issued at ₹ 16 per Share)			
	(d) Transfer to Capital Reserve:			
	Share Forfeited A/c Dr.		22,000	
	To Capital Reserve A/c			22,000
	(Balance of Shares Forfeited A/c Transferred to Capital Reserve)			
	(Ref: Step 6)			

Illustration 1.44

Raghav Ltd. invited applications for 1,00,000 shares of ₹ 20 each. The shares were issued at a premium of ₹ 10 per share, payable as follows:

On application and allotment ₹ 16 per share (including a premium of ₹ 6). Balance including premium in the first and final call.

Applications for 1,50,000 share were received. Applications for 10,000 shares were rejected and pro-rata allotment was made on the remaining applicants on the following basis:

(i) Applicants for 80,000 shares were allotted 60,000 shares

(ii) Applicants for 60,000 shares were allotted 40,000 shares

Mr. A, who belonged to the first category, was allotted 300 shares. He failed to pay the first call money.

Mr. B, who belonged to the second category, was allotted 200 shares and he also failed to pay the first call money. Their shares were forfeited. The forfeited shares were re-issued at ₹ 24 per share fully paid up.

Prepare cash book and pass necessary journal entries.

Solution

Basic Calculations:

Step 1: Number of Shares Applied for by A:

- A Belonged to First Category—i.e., 80,000 Applicants were Allotted 60,000 Shares.
  i.e., 80,000:60,000 (or) 8:6 (or) 4:3
- $\therefore$ For A = $\frac{4}{3} \times 300$ Shares = 400 Shares

Step 2: Number of Shares Applied for by B:

- B Belonged to Second Category—i.e., 60,000 Applicants Were Allotted 40,000 Shares.
  i.e., 60,000:40,000 (or) 6:4 (or) 3:2
- $\therefore$ For B = $\frac{3}{2} \times 200 = 300$ Shares.

Step 3: Surplus Application Money from A & B:

A: (Applied Shares – Allotted Shares)

$$= \begin{Bmatrix} 400 \text{ Shares} \\ \text{(Ref: Step 1)} \end{Bmatrix} - \begin{Bmatrix} 300 \text{ Shares} \\ \text{(Given)} \end{Bmatrix} = 100 \text{ Shares}$$

i.e., for 100 Shares, Application Money Received from A = 100 × ₹ 16 = ₹ 1,600

B: Excess Application Money Received from B:

B: (Applied Shares – Allotted Shares)

= (300 – 200) = 100 Shares

(Ref: Step 2) (Given)

$\therefore$ Surplus Application Money on 100 Shares by B = 100 × ₹ 16 = ₹ 1,600

Total Surplus Application and Allotment Money Paid by A & B which is to be Adjusted in Calls = ₹ 3,200

Step 4: Money Received from First and Final Call:

First and Final Call Money Due		
1,00,000 × ₹ 14 (₹ 30 – ₹ 16)	=	14, 00,000
Less: Calls-in-Advance:		
(1,40,00 – 1,00,000) = 40,000 × ₹ 16}	=	6, 40,000
		7, 60,000
Less: Call Money Not Received:	₹	
500 × ₹ 14	= 7,000	
Less: Excess Application Money	= 3,200	3,800
(Ref: Step 3)		
Actual Amount Received on Calls:		7, 56 200

Step 5:

Cash book

Dr. **Cr.**

Date	Particulars	₹	Particulars	₹
	To Equity Share Application and Allotment A/c (1,50,000 × ₹ 16)	24,00,000	By Equity Share Application and Allotment A/c (10,000 × ₹ 16)	1,60,000
	To Share First & Final Call A/c (Ref: Step 4)	7,56,200	By Balance c/d	30,08,200
	To Share Capital A/c (Re-issue) (500 × ₹ 20)	10,000		
	To Securities Premium A/c (500 × ₹ 4) (Re-issue) (Difference: ₹ 20 × 24)	2,000		
		31,68,200		31,68,000

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I (b): & **Stage II** (b): Combined Entry			
	Equity Share Application & Allotment A/c Dr.		22,40,000	
	To Equity Share Capital A/c 1,00,000 × ₹ 10			10,00,000
	To Securities Premium A/c 1,00,000 × ₹ 6			6,00,000
	To Calls-in-Advance A/c (Bal)			6,40,000
	(Application & Allotment Money Transferred to Share Capital and Excess Transferred to Call-in-Advance)			
	Stage III (a):			
	Equity Share First & Final Call A/c Dr.		14,00,000	
	To Share Capital A/c			10,00,000
	To Securities Premium A/c			4,00,000
	(Call Money Due on 1,00,000 Shares and Balance of Premium)			

	(b) Calls-in-Advance A/c	Dr.		6,40,000	
	To Share First & Final Call A/c				6,40,000
	(Calls-in-Advance Adjusted)				
	(Ref: Step 4)				
	Stage IV (b) Combined Entry:				
	Share Capital A/c	Dr.		10,000	
	Securities Premium A/c	Dr.		2,000	
	To Shares Forfeited A/c (500 × 10 + ₹ 3,200)				8,200
	To Shares First & Final call A/c (Ref: Step 4)				3,800
	(Shares Forfeited)				
	(d) Shares Forfeited A/c	Dr.		8,200	
	To Capital Reserve A/c				8,200
	(Profit on Re-issue Transferred to Capital Reserve)				

Illustration 1.45

Raj Ltd. invited applications for issuing 20,000 equity shares of ₹ 100 each. The amount was payable as follows:

On Application	₹ 20
On Allotment	₹ 50
On First & Final Call	₹ 30

Applications for 40,000 shares were received and the allotment was made as follows:

Category	Shares Applied for	Shares Allotted
A	5,000	4,000
B	10,000	3,000
C	25,000	13,000

All the shares were allotted on pro-rata basis and excess application money was adjusted towards sum due on allotment.

Mr. X, who belonged to 'category A' and to whom 60 shares were allotted, failed to pay the allotment money. His shares were forfeited immediately after allotment money was not received.

Mr. Y, who belonged to 'category C' and who had applied for 25 shares, failed to pay the final call money. His shares were forfeited after final call.

The forfeited shares were re-issued at ₹ 90 per share fully paid up.

Journalize the above transactions in the books of Raj Ltd.

Solution

Step 1: Total Number of Shares Applied for by Mr. X =

He Belonged to 'Category A' in Which 4,000 Shares were Allotted for 5,000 Shares Applied for i.e., 50,000:40,000 (or) 5:4

For Every 5 Applications Applied for, 4 Shares Are Allotted

$\therefore$ For 60 Shares = $60 \times \frac{5}{4} = 75$ Shares

Step 2: For X: Amount Due but Not Paid on Allotment:

			₹
	(i) Total Amount Sent by Mr. X, on Application (i.e., 75 × ₹20)}	=	1,500
Less:	(ii) Application Money 60 Shares × ₹20	=	1,200
	(iii) Excess Application Money	=	300
	(iv) Total Money Due on Allotment (60 Shares × ₹50)	=	3,000
	(v) Amount Due but Not Paid on Allotment (₹3,000 – ₹300)	=	2,700
	(iv) (iii)		

Step 3: Actual Allotment Amount Received:

			₹
	(i) Amount Due on Allotment: (20,000 × ₹50)}	=	10,00,000
Less:	(ii) (a) Already Received		
	Excess Application × Application Money		₹
	(40,000 – 20,000) × ₹20	=	4,00,000
	(b) Amount Due but Not Paid on Allotment by 'X'} {4,00,000 / 2,700}	=	2,700
			4,02,700
	Actual Allotment Money Received	=	5,97,300

Step 4: As Y's Shares Were Forfeited After Final Call, It Is Shown Directly in Journal.

Step 5:

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I:			
	(a) Bank A/c Dr.		8,00,000	
	To Share Application A/c			8,00,000
	(Application Money Received on 40,000 Shares @ ₹20 Share)			
	(b) Share Application A/c Dr.		8,00,000	
	To Share Capital A/c			4,00,000
	To Share Allotment A/c			4,00,000
	(Applications Money on 20,000 Shares Transferred to Share Capital; Balance Adjusted with Allotment)			
	Stage II:			
	(a) Share Allotment A/c Dr.		10,00,000	
	To Share Capital A/c			10,00,000
	(Share Allotment Money Due on 20,000 Shares @ ₹50 Each)			
	(b) Bank A/c Dr.		5,97,300	
	To Share Allotment A/c			5,97,300
	(Actual Allotment Money Received) Ref: Step 3			
	Stage III:			
	(a) Share First and Final Call A/c Dr.		5,98,200	
	To Share Capital A/c			5,98,200
	(Call Money Due on 19,940 Shares)			

	(b) Bank A/c Dr. To Share First and Final Call A/c (Call Money Receive on 19,915 Shares)		5,97,450	 5,97,450
	Stage IV: (a) Share Capital A/c Dr. To Share Allotment A/c To Forfeited Shares A/c (X's 60 Shares Forfeited for Non-payment of Allotment Money)		4,200	 2,700 1,500
	(b) Share Capital A/c Dr. To Shares Forfeited A/c To Shares First & Final Call A/c (Y's 25 Shares Forfeited for Non-payment of First & Final Call Money)		2,500	 1,750 750
	(c) Bank A/c Dr. Shares Forfeited A/c Dr. To Share Capital A/c (60 + 25 : 85 Shares Re-issued at ₹ 90 as Fully Paid up)		7,650 850	 8,500
	(d) Shares Forfeited A/c Dr. To Capital Reserve A/c (Profit on Re-issue Transferred to Capital Reserve) (₹ 1,500 + ₹ 1,750 – ₹ 850)		2,400	 2,400

Illustration 1.46

Model: Issue of bonus shares

Shiva Ltd. presents the following balance sheet:

Balance Sheet as at ……..

Liabilities	₹	Assets	₹
SHARE CAPITAL:		FIXED ASSETS:	
Authorized	30,00,000	Plant & Machinery	12,00,000
Issued & Subscribed:		Furniture & Fixtures	1,50,000
5,000, 14% Pref. Shares of ₹ 100 Each Fully Paid up	5,00,000	Patents & Trademarks	50,000
		CURRENT ASSETS, LOANS & ADVANCES:	
1,00,000 Equity Shares of ₹ 10 Each, Fully Paid up	10,00,000	(A) CURRENT ASSETS:	
		Stock	11,00,000
RESERVES & SURPLUS:		Debtors	1,50,000
Capital Reserve	1,50,000	Cash in Hand	5,000
Securities Premium	1,00,000	Cash at Bank	3,15,000
General Reserve	7,50,000	(B) LOANS & ADVANCES:	
Profit & Loss Account	1,50,000	Bills of Exchange	70,000
CURRENT LIABILITIES & PROVISIONS:			
(A) Current Liabilities:			
Sundry Creditors	1,80,000		
(B) Provisions:			
Provision for Taxation	2,10,000		
	30,40,000		30,40,000

The company purchased new machinery for ₹1, 50,000 for which it paid ₹50,000 by cheque and allotted 15% preference shares (1,000) of ₹100 each as fully paid up to the vendors.

The company then issued one fully paid BONUS equity share of ₹10 each for every five equity shares held to its equity shareholders. For this purpose, the balances in profit and loss account and general reserve are utilized to the necessary extent.

You are required to pass necessary journal entries to record the above transactions. Redraft the company's balance sheet.

Solution

In the Books of Shiva Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Machinery A/c Dr.		1,50,000	
	To Vendor A/c			1,50,000
	(New Machinery Purchased)			
	Vendor A/c Dr.		1,50,000	
	To Bank A/c			50,000
	To 15% Preference Share Capital A/c			1,00,000
	(₹50,000 Paid by Cheque and 1,000 15% Preference Shares are Allotted to the Vendor for the Machinery Purchased)			
	Profit and Loss A/c Dr.		1,50,000	
	General Reserve A/c Dr.		50,000	
	To Bonus to Equity Shareholders A/c			2,00,000
	(Profit & Loss A/c and General Reserve Utilized for Issue of Bonus Shares of ₹2,00,000 to Holders of Equity Shareholders, i.e., in the Ratio of 5:1)			
	Bonus to Equity Shareholders A/c Dr.		2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Bonus Shares Distributed)			

Note: Issue of Bonus shares:

For every FIVE equity holders ONE BONUS SHARE was allotted; issued & subscribed equity shares were ₹10,00,000.

$\therefore$ Bonus shares allotted: $\frac{10,00,000}{5}$ = ₹2, 00,000

20,000 bonus shares of ₹10 each as fully paid up.

For this purpose, P&L A/c amount ₹1, 50,000—Refer balance sheet & general reserve

(₹2, 00,000 – ₹50,000) ₹50,000 were utilized.

Shiva Ltd. Balance Sheet as at…

Reconstructed After Issue of Bonus Shares

Liabilities	₹	Assets	₹
SHARE CAPITAL:		FIXED ASSETS:	
Authorized Capital	30,00,000	Plant & Machinery	13,50,000

Issued & Subscribed:		(₹ 12, 00,000 + ₹ 1,50,000)	
5,000, 14% Pref. Shares of ₹ 100 Each Fully Paid up	5,00,000	New	
		Furniture & Fixtures	1,50,000
		Patents & Trademarks	50,000
1,000 15% Pref. Shares of ₹ 100 Each Fully Paid up (Allotted to Vendor)	1,00,000	CURRENT ASSETS, LOANS & ADVANCES:	
		(A) CURRENT ASSETS:	
1,20,000 Equity Shares of ₹ 10 Each Fully Paid-up (of the Above Shares, 20,000 Equity Shares of ₹ 10 Each, Allotted by Way of Bonus Shares)	12,00,000	Stock	11,00,000
		Debtors	1,50,000
		Cash in Hand	5,000
		Cash at Bank	2,65,000
RESERVES & SURPLUS:		₹ 3,15,000 – ₹ 50,000	
Capital Reserve	1,50,000	Vendor	
Securities Premium	1,00,000	(B) LOANS & ADVANES:	
General Reserve	7,00,000	Bills of Exchang	70,000
(₹ 7, 50,000 – ₹ 50,000)			
P&L A/c (1,50,000 – 1, 50,000)	—		
CURRENT LIABILITIES & PROVISIONS:			
(A) Current Liabilities:			
Sundry Creditors	1,80,000		
(B) Provisions:			
Provision for Taxation	2,10,000		
	31,40,00		31,40,000

Summary

A company is an artificial person. It is created by law. It has a perpetual entity. Liability of members is limited. It has a common seal. In companies, management is separated from ownership. It is a voluntary allocation of persons with a common purpose.

For kinds or types of companies—refer text.

A Private company is defined in Section 3(1) (iii).

Privileges of a private limited company: (i) Two persons will be enough to float it; (ii) No need to issue prospectus; (iii) Can commence business after receiving Certificate of Incorporation and need not wait to get Certificate of Commencement of Business; (iv) Quorum—two members will be sufficient; (v) Need not hold a statutory meeting; (vi) Minimum subscription clause will not apply; (vii) Directors need not take up qualification shares and (x) The public cannot inspect P&L A/c of private companies.

Memorandum of Association: An important document which lays down the framework within which a company has to work.

Articles of Association: A certificate issued by the Registrar after perusal of required documents submitted to him by the company.

Prospectus: A document issued by the company inviting the public for the subscription of shares or debentures.

Certificate of Commencement of Business: A certificate issued by the registrar after scrutinizing

the stipulated documents submitted by a company. A public limited company can commence business only after getting this certificate.

Share capital: Capital raised by issue of shares.

Types of share capital: Refer text for details.

Management of companies: Refer text.

Floating of companies is explained in eight stages in detail in the main part of the text.

Minimum subscription: The minimum amount to be raised by the issue of shares. As per the SEBI norms, a company should receive 90% of the issued amount from public subscription. The prospectus stipulates the minimum subscription amount.

Issue of shares: Shares may be issued (i) for cash or (ii) for consideration other than cash.

1. Issue of shares for cash: Different stages and accounting treatment are discussed in detail in the text.

   Over-subscription and under-subscription: Illustrated in detail in the main part of the text.

   Calls-in-arrears: When shareholders fail to pay the amount due on calls, the amount not received so is usually termed due on calls. This may be treated (i) by opening calls-in-arrears account and (ii) without opening calls-in-arrear account.

   Calls-in-advance is explained in detail in Illustrations 1.11 to 1.13.

   Different allotment of shares is explained in Illustration 1.14.

   Issue of shares

   (i) **Issue of shares at par:** When the issue price of a share is equal to the face value of share, such issue is an issue at par.

   (ii) **Issue of shares at premium:** If the issue price is higher than the face value, then such issue is at premium to be governed by Section 79 of the Companies Act.

   (iii) **Issue of shares at a discount:** When the issue price is less than the nominal value, such issue is an issue at a discount. This is subject to Section 79 of the Companies Act illustrated in detail in the text (For the issue of shares, refer Illustrations 1.15 to 1.18). For preparation of cash book, refer Illustrations 1.19 and 1.20.

   Preparation of ledger accounts and balance sheet: Refer Illustrations 1.21 to 1.24.

2. **Issue of shares for consideration other than cash:** Under this, purchase of assets against issue of shares occurs. Accounts treatment is illustrated in Illustration 1.25.

   Forfeiture of shares: When the shareholders fail to pay any due, their shares can be forfeited by the directors of the company after compliance with statutory provisions. Different cases (types) of forfeiture and re-issue are discussed in depth in Illustrations 1.26 to 1.37.

   Employee Stock Option Plan: Companies may offer their equity shares to their employees at a pre-determined price. Accounting treatment is explained in Illustration 1.38. Employee stock purchase is explained in illustration 1.38.

   Issue of bonus shares: Companies may issue shares to the existing shareholders without any consideration subject to the provisions of the Articles of Association. For SEBI Guidelines relating to issue of bonus shares and accounting treatment, refer text.

   Rights issue: The existing shareholders have a right to subscribe to the fresh issue of capital or to reject or to sell their rights as per Section 81 of the Companies Act. Determination of value of right is explained in Illustration 1.41.

   Sweat equity: A new type of equity shares was introduced by the Companies (Amendment) Act, 1999 through Section 79A. Accounting treatment is similar to that of issue of other equity shares.

   Buy-back of shares: As per Section 77A of the Companies Act, a company can buy its own shares. For provisions of the Act and SEBI Guidelines refer the text.

   Escrow account: An account to be opened by the company to initiate the process of buy-back of shares.

Key Terms

Company: An association of many persons who contribute money or money's worth to a common stock and employ it in some common trade or business and who share the profit or loss arising therefrom.

Private Company: A company which by its articles:

(i) Limits the number of members to 50 (ii) Restricts the right of its members to transfer shares and (iii) Prohibits any invitation to the public to subscribe for any shares or debentures of the company

Promoter: A person who undertakes all the activities in the formation of a company.

Memorandum of Association: A document which defines the objects and powers of a company.

Articles of Association: A document containing rules and regulations for the internal management of affairs of the company.

Certificate of Incorporation: A document by which company comes into existence (by obtaining this from the Registrar of companies).

Prospectus: Company's invitation to the public for the subscription for its shares of debentures.

Certificate of Commencement of Business: A document that necessitates a public company to (obtain from the Registrar) commence business.

Minimum Subscription: The amount that a company must raise before the allotment of shares.

Share: Fractional part of the capital.

Authorized Capital: The maximum amount which a company can issue during its life.

Issued Capital: A part of authorized capital that is offered to the public.

Subscribed Capital: That part of issued capital which is subscribed by the public.

Called-up Capital: That part of the subscribed capital which the shareholders are called upon by the company to pay.

Paid-up Capital: That part of the called-up capital which the shareholders actually paid.

Reserve Capital: That part of the subscribed capital not already called up.

Preference Share: Share that enjoys preferential rights:

(i) The right to receive dividend

(ii) The right to receive capital

Equity Share: Share that has no preference rights in respect of annual dividend and return of capital (in case of liquidation).

Stock: The shares of a company in a different form.

Application Money: A specified amount that has to be paid along with filled in application forms by the public to subscribe for the shares of a company.

Allotment: The process of confirming the quantum of shares to be awarded to the applicants.

Allotment Money: A specified amount required by the company to be paid after allotment is confirmed.

Calls of Shares: The balance amount (left after money received on application and allotment from the alloitees) that has to be collected by the company through one or more calls (notices).

Calls-in-Advance: Money from the shareholders in advance towards calls not yet made by the company.

Calls-in-Arrears: Dues which the shareholders failed to pay the amount on allotment and or calls on specified dates.

Over-subscription: Receipt of applications for more number of shares than the number offered for subscriptions to the public through prospectus.

Under-subscription: Receipt of applications received are less than the offered for subscription through prospectus.

Pro-rata Allotment: Proportionate allotment of shares to all the applications who have applied for subscription of shares.

Stock Invest: An instrument used by an investor to pay application money for shares applied for through banker with a letter of authority and guarantee.

Shares Issued at Par: Issue price and nominal value of shares are equal.

Issue of Shares at Premium: Issue price > Nominal Value.

Issue of Shares at Discount: Issue Price < Nominal Value.

Forfeiture of Shares: Seizure of shares and termination of membership for default in payment of allotment and or call money.

Bonus Shares: Shares issued by the company to the existing equity shareholders in settlement of the bonus declared.

Rights Issue of Shares: The right to receive first the fresh issue of shares by the existing shareholders with the option to accept or reject or renounce such offer.

Sweat Equity Shares: Shares issued by a company to its employees or directors at a discount for consideration other than cash for providing know-how or making available rights to use intellectual property.

Buy-Back of Shares: Repurchase by a company of its own shares.

Employee Stock Option Scheme: An offer awarded to an employee to purchase shares of the company at a pre-determined price with a right to exercise the option of purchase within the vesting period.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. A company is a natural person.
2. The members of a company have a limited liability.
3. In case of public limited companies, there are no restrictions on the transfer of shares.
4. All those private companies are also to be treated as public limited companies, if 25% or more of paid-up capital is held by public companies.
5. If 50% of the paid-up capital of any company is held by Central or State Government or both, such company is said to be a government company.
6. A public company can commence business as soon as the Certificate of Incorporation is obtained.
7. In a private company, if special Articles of Association are not prepared, Table A of Company's Act will apply.
8. A public limited company can allot shares only if the minimum subscription is subscribed for by the public.
9. Now, in India, chartered companies may be formed by adhering statutory provisions.
10. The Memorandum of Association has to be signed by at least seven members.
11. Prospectus is nothing but an invitation to the public to subscribe for shares or debentures of a company.
12. Minimum subscription is the amount that should not be less than 50% of the issue.
13. Employee's Stock Option Scheme permits the employees of a company to subscribe for any number of shares at a privileged price at any time.
14. Authorized capital should be stated in the Memorandum of Association.
15. In general, a company will not issue its entire nominal capital at a time.
16. Capital reserve is mainly utilized for distribution of dividend.
17. Redeemable preference shares cannot be issued by a company.
18. Equity shares without voting rights can be issued by a company.
19. Preference shareholders also have a right to vote under special circumstances.
20. Shares can be issued only for cash.
21. The premium received on shares may be distributed among shareholders like other profits.
22. The companies entering the capital market can retain out of subscription up to 10% of the number of shares offered.
23. When shares are issued at a premium, over the amount of premium has to be credited to share allotment account.
24. Normally, the rate of discount must not exceed 20% of face value when shares are to be issued at discount.
25. The balance of calls-in-advance account is to be added to the amount of subscribed capital.

26. The allotment of shares should be completed within one month of the issue of the prospectus.
27. A new company cannot issue shares at a discount.
28. A public company can issue deferred shares.
29. Until the forfeited shares are re-issued, the balance on the shares forfeited account is shown in the balance sheet under "share capital".
30. Discount on shares is to be shown on "assets".

Answers:

1. False	2. True	3. True
4. True	5. False	6. False
7. False	8. True	9. False
10. True	11. True	12. False
13. False	14. True	15. True
16. False	17. False	18. True
19. True	20. False	21. True
22. True	23. False	24. False
25. False	26. False	27. True
28. False	29. True	30. True

II. Fill in the blanks with apt word(s)

1. In India, joint stock companies should be registered under the _____Act, 1956.
2. A company is an _____ person.
3. In general, the liability of the members of a company is _____.
4. A government company should hold a minimum of _____ of the paid-up capital.
5. In a public company, shares can be _____ to other parties without restriction.
6. Life Insurance Corporation is formed by _____.
7. _____ contain the internal rules and regulations of the company.
8. _____ means an invitation to the public for the subscription of its shares or debentures.
9. Minimum subscription is the amount which is so stated in the prospectus and can in no case be less than _____ of the issue.
10. A public company can commence business only on obtaining the Certificate of _____.
11. Raising capital by issue of share is called ____.
12. The maximum amount of capital which the company shall be allowed to have is termed as _____.
13. The capital which is actually offered to the public for subscription is known as _____.
14. The difference between issued capital and authorized capital is called _____.
15. That capital represented by the shares that the public actually subscribes for is called _____.
16. If the shares issued for subscription are wholly subscribed for, then issued capital would be ___ as subscribed capital.
17. When the directors ask for only a part of the nominal amount of the shares, the amount asked for its called _____.
18. Paid-up capital = Called-up capital _____.
19. When a shareholder fails to pay the call amount within the due date, such amount is referred to as _____.
20. That part of the issued capital which has not been called is known as _____.
21. When a portion of the subscribed capital is not already called up, it becomes the _____.
22. The share capital of a company limited by shares shall be of equity share capital and _____. capital.
23. Shares which are not preference shares are ___.
24. A joint stock company can issue shares for cash and _____.
25. Application money cannot be less than _____. of the nominal value of the shares.
26. Amount payable on application is called _____.
27. Sum payable on allotment is called _____.
28. Shares may be issued in any of the three ways: (i) At par (ii) At premium and (iii) _____.
29. When an issue price of the share is equal to its face value, then such shares are said to have been issued at _____.
30. When the number of shares applied for is more than the number of shares offered for issue, shares are said to be _____.
31. When the number of shares applied for is less than the number of shares offered to public for subscription, the shares are said to be _____.
32. When shares are issued at an amount more than the face value, such an issue is said to be made at a _____.
33. When shares are issued at a price less than its face value, shares are said to be made at a _____.
34. When a company accepts money paid by its allotments for the calls not yet due, such amount is called _____.
35. A public company cannot issue _____ shares.

36. A non-company cannot issue shares at a _____.
37. Calls-in-advance do not form part of _____. capital.
38. A call money as shares should not exceed _____ of the face value of share.
39. In general, a preference share is always deemed to be _____, non-convertible and non-participating.
40. Companies are now permitted to issue equity shares with _____ voting rights.

Answers:

1. companies
2. artificial legal
3. limited
4. 51%
5. transferred
6. Special Act of Parliament
7. Articles of Association
8. Prospectus
9. 90%
10. Commencement of Business
11. share capital
12. authorized capital or
13. issued capital
14. unissued capital
15. subscribed capital
16. same
17. called-up
18. calls-in-arrears
19. calls-in-arrears
20. uncalled
21. reserve capital
22. preference share
23. equity shares
24. for consideration other than cash
25. 5%
26. application money
27. allotment money
28. At discount
29. par
30. over-subscribed
31. under
32. premium
33. discount
34. calls-in-advance
35. deferred
36. discount
37. paid-up
38. 25%
39. cumulative registered capital
40. disproportionate

III: Multiple choice questions—Choose the correct answer

1. A company is created by
   (a) adhering statuary provisions in the specified Act
   (b) Special Act of Parliament
   (c) special status of its members
   (d) none of these
2. The capital of a company consists of
   (a) equity shares
   (b) equity and preference shares
   (c) preference shares
   (d) none of these
3. A private company which is a subsidiary of public company is a
   (a) public company
   (b) private company
   (c) chartered company
   (d) none of these
4. Share application account is a
   (a) real A/c
   (b) nominal A/c
   (c) personal A/c
   (d) none of these
5. Share allotment account is a
   (a) real A/c
   (b) personal A/c
   (c) nominal A/c
   (d) none of these
6. The difference between subscribed capital and called-up capital is
   (a) paid-up capital
   (b) calls-in-advance
   (c) calls-in-arrears
   (d) uncalled capital
7. Holders of preference shares will have a right to vote if the dividend remains in arrears for a period not less than
   (a) two years
   (b) three years
   (c) six years
   (d) none of these

8. The minimum share application money will be
   (a) 90% of nominal value of shares
   (b) 5% of nominal value of shares
   (c) 12% of the nominal value of shares
   (d) 6% of the nominal value of shares
9. A company wishes to pay dividend on shares; which of the following may be utilized?
   (a) profit and loss A/c
   (b) premium on shares
   (c) general reserve
   (d) other surplus
10. Premium received on issue of shares account is shown on
   (a) liabilities side of the balance sheet
   (b) assets side of the balance sheet
   (c) profit and loss appropriation A/c
   (d) profit and loss A/c
11. Discount on issue of shares account is shown on
   (a) profit and loss A/c
   (b) liabilities side of the balance sheet
   (c) assets side of the balance sheet
   (d) profit and loss A/c
12. The allotment of shares should be completed (from the date of issue) within
   (a) one month (b) 60 days
   (c) 90 days (d) 120 days
13. The rate of discount, while issuing shares at discount, should not exceed
   (a) 5% (b) 10%
   (c) 6% (d) 9%
14. Interest on "calls in advance" and "calls in arrears" should be paid at
   (a) 6% (b) 5%
   (c) 9% (d) none of the above
15. Nominal value of share is ₹ 10%; ₹ 7.50 has been called up. On forfeiture, the amount to be debited to share capital account will be
   (a) ₹ 10 (b) ₹ 2.50
   (c) ₹ 7.50 (d) ₹ 5
16. If a ₹ 1,000 share (nominal value) has been issued at a premium of ₹ 20, on which the whole of the amount has been called up, has been forfeited for non-payment of ₹ 40, the share capital account will be debited by
   (a) ₹ 100 (b) ₹ 20
   (c) ₹ 40 (d) ₹ 120
17. If a share of ₹ 100 issued at a premium of ₹ 10, on which ₹ 90 (including premium) have been called and ₹ 70 (including premium) paid is forfeited, the capital accounted is to be debited by
   (a) ₹ 90 (b) ₹ 80
   (c) ₹ 70 (d) ₹ 110
18. Money received in advance before it is actually due will be
   (a) debited to calls paid in advance A/c
   (b) debited to calls-in-arrears A/c
   (c) credited to calls in arrears A/c
   (d) credited to calls paid in advance A/c
19. Forfeited shares account is finally closed by transferring of its balance to
   (a) general reserve A/c
   (b) profit & loss A/c
   (c) capital reserve A/c
   (d) balance sheet
20. The "buy-back" of shares may be done
   (a) at par
   (b) at discount
   (c) at premium
   (d) all of the above

Answers:

1. (a)	6. (d)	11. (c)	16. (a)
2. (b)	7. (a)	12. (d)	17. (b)
3. (d)	8. (b)	13. (b)	18. (d)
4. (c)	9. (b)	14. (d)	19. (c)
5. (b)	10. (a)	15. (c)	20. (d)

Short Answer Questions

1. Define: Company.
2. What is the nature of a private limited company?
3. Mention any four salient features of a public limited company?
4. What is meant by a "share"?
5. Enlist the various major kinds of shares?
6. What is meant by "equity share"?
7. Explain: Preference share.

8. What do you mean by "cumulative preference share"?
9. What is meant by "non-cumulative preference share"?
10. What is meant by "convertible preference share"?
11. What is meant by "redeemable preference share"?
12. What do you mean by "registered capital"?
13. What is an "issued capital"?
14. What is meant by "subscribed capital"?
15. What is meant by "unissued capital"?
16. What is meant by "paid-up capital"?
17. What is meant by "uncalled capital"?
18. What is meant by "reserve capital"?
19. Explain the term "chartered company?"
20. Give four examples of companies that are enacted by Special Act of Parliament.
21. Define: Government Company.
22. Define: Memorandum of Association.
23. What is meant by "Articles of Association".
24. What is a "prospectus"?
25. Explain the term "application of shares".
26. Explain the term "application money"?
27. What do you mean by "allotment"?
28. Explain "allotment money".
29. What do you mean by "minimum subscription"?
30. Explain "call".
31. What is a call money?
32. What is the maximum amount of a call as per Table A
33. Mention the minimum time interval between two consecutive calls as per Table A.
34. Explain "issue of share at par".
35. Explain "issue of share at premium".
36. Explain "issue of share at discount".
37. Explain "securities premium account".
38. Can a new company issue shares at a discount?
39. How "securities premium account" can be shown in the balance sheet?
40. How will you treat "discount on issue of shares" in the books of accounts of a company?
41. Explain "issue of shares for consideration other than cash".
42. What is "over-subscription of shares"?
43. What is "under-subscription of shares"?
44. Explain "pro-rata allotment"?
45. What is "calls-in-advance"?
46. How will you treat "calls-in-advance" in the balance sheet?
47. What is "calls-in-arrears"?
48. How will you show "calls-in-arrears" in the balance sheet?
49. What is the rate of percentage of interest allowed for "calls-in-advance" and "calls-in-arrears"?
50. Explain "forfeiture of shares".
51. When shares are forfeited, mention the amount the forfeited shares account to be credited.
52. How will "the balance in forfeited shares accounts" appear in the balance sheet?
53. At the time of forfeiture of shares, with what amount the "share capital account" is debited?
54. Can forfeited shares be issued discount?
55. Journalize the transaction, when a company re-issues forfeited shares.
56. Can shares be surrendered?
57. What do you mean by "stock invest scheme"?
58. What are the uses of securities premium?
59. What is meant by "sweat equity"?
60. Explain "Employees Stock Option Scheme".
61. What is meant by "escrow account".
62. Explain "buy-back of shares".
63. What is meant by "rights issue"?
64. How will you determine the value of a right?
65. Explain "underwriting".
66. What is meant by "underwriting commission"?
67. How will you treat "underwriting commission" in the books of accounts of the company?
68. Explain "capital reserve".
69. How does "reserve capital" differ from "capital reserve"?
70. What do you mean by "private placement of shares"?

Essay Type Questions

1. Define "company". Discuss the salient features of a company.
2. Enumerate the various kinds of companies with salient features of each kind of company by citing apt examples.
3. What is a "private company"? How does it differ from a public company?
4. What is Memorandum of Association? Explain its contents in detail.
5. What is "Articles of Association"? Explain its contents and its significance?
6. What is a "prospectus"? Explain the important clauses in a prospectus.
7. You are a promoter. How will you float a new company?
8. What is "share capital"? Describe the different kinds of share capital.
9. What are the major kinds of shares? Describe the internet characteristics of different types of preference shares.
10. Tabulate the major differences between preference shares and equity shares.
11. Explain the different stages in issue of shares. Also give journal entries for them.
12. What is "over-subscription of shares"? Explain the SEBI Guidelines to ensure proportional allotment in marketable lots on a fair basis.
13. What do you mean by calls-in-arrear? Explain the different methods of accounting treatment of calls-in-arrears.
14. Explain the provisions of Section 78 with respect to issue of shares at a premium.
15. Explain the provision of Section 79 of the Company's Act with respect to issue of shares at a discount.
16. Explain the process of forfeiture of shares (a) at par; (b) at a premium and (c) at a discount.
17. What do you mean by "buy-back of shares"? What are the main provisions envisaged in section 77 A of the Companies Act with respect to "buy-back of shares"? What are the SEBI Guidelines relating to this?
18. Explain "Employee Stock Option Plan". What is the accounting treatment for Employee Stock Option Scheme? Journalize the transactions relating to "ESOP".
19. Explain the accounting treatment for issue of "bonus shares".
20. How will you treat underwriting commission in the books of accounts of the company. Use imaginary figures.

Exercises

Part A—For Undergraduate Level

1. Sri. Ram & Co. Ltd. invited applications for 20,000 shares of the value of ₹10 each. The amount is payable as ₹4 on application and ₹3 on allotment and the balance when required. The whole of the issue was applied for and cash duly received.

   Journalize the above transactions.

   [Model: Over-subscription of shares—Excess applications rejected]
2. Robert & Co. Ltd. invited applications for 50,000 shares of ₹10 each payable as:

On Application	₹2
On Allotment	₹3
Balance When Required	

   60,000 shares were applied for. The directors accepted applications for 50,000 shares and rejected the remaining applications. Allotment money was received on 49,800 shares.

   Give journal entries. Prepare the ledger accounts. Show how these items would appear in the balance sheet.

   [**Ans:** Balance sheet total: ₹2,49,400]

   [Model: Issue of shares at par—Over-subscribed, partial allotment]
3. Rahim & Co. Ltd. invited applications for 25,000 shares of ₹100 each payable as ₹25 on application; ₹35 on allotment and the balance when required.

   Applications were received for 30,000 shares. The directors accepted applications for 22,000 shares in fully, allotted 3,000 shares to applications for 5,000 shares and rejected applications for 3,000 shares. Excess application money was refunded.

Mr. X, a shareholder holding 250 shares, failed to pay the money due on allotment.

Give journal entries and prepare necessary ledger accounts.

[Model: Shares issued at par—Over-subscribed, full allotment to some applications, partial allotment to others, no allotment to the balance applications]

4. Good Luck & Co. offered 30,000 shares of ₹ 10 each to the public which were payable as:

On Application	₹ 2
On Allotment	₹ 5

The Balance When Required

Applications for 55,000 shares were received on which the directors allotted as follows:

Applications for 25,000 shares—Full

Applications for 25,000 shares—20%

Applications for 5,000 shares—NIL

Record the journal entries and prepare the ledger accounts.

[Model: Comprehensive]

5. Prem Ltd. invited applications for 1,00,000 equity shares of ₹ 10 each on the following terms:

On Application	₹ 2
On Allotment	₹ 3
On First & Final Call	₹ 5

Applications were received for 1,20,000 shares. It was decided

(i) To reject applicants for 20,000 shares

(ii) To allot 50% to Mr. Patel who has applied for 40,000 shares

(iii) To allot in full to Mr. Dua who has applied for 10,000 shares

(iv) To allot the balance of the available shares pro-rata among the other applications

(v) To utilize excess applications money in part payment of allotment and final call

Give journal entries till the stage of allotment assuming that the entire sum due an allotment is received in full.

[Model: Issue of shares at par—Under-subscribed]

6. Gopal Ltd. offered 1,00,000 shares of ₹ 10 each to be payable as:

On Application	₹ 2
On Allotment	₹ 3
On First Call	₹ 2
On Final Call	₹ 3

The public applied for 90,000 shares which were allotted all money were duly received.

Make journal entries. Prepare the ledger accounts. Show the balance sheet.

[**Ans:** Total of balance sheet: ₹ 9,00,000]

[Model: Entries in cash book and journal]

7. Same figures as in Question 6. Prepare cash book and make entries in cash book and journal.

[**Ans:** Cash book total: ₹ 9, 00,000 (Balance b/d)]

[Model: Issue of two classes of shares]

8. Leela and Krishna Ltd. issued 1,00,000 equity shares of ₹ 10 each and 10,000 preference shares of ₹ 100 each payable as follows:

	Equity Shares	Preference Shares
	₹	₹
On Application	4	30
On Allotment	2	40
On First and Final Call	4	30

The public applied for 1,20,000 equity shares and 9,000 preference shares. Applications for preference shares were accepted in full. Out of applications, equity shares applications for 10,000 shares were rejected; applications for 85,000 shares were accepted in full and 15,000 shares were allotted to the remaining applicants.

All money was duly received.

Make entries in cash book and journal.

[**Ans:** Cash book total: ₹ 19,40,000; Balance b/d: ₹ 19,00,000]

[Model: Issue of shares at premium]

9. A company issued 30,000 shares of ₹ 10 each payable at a premium of ₹ 3 per share. Instalments were fixed as follows:

On Application	₹ 4
On Allotment (Including ₹ 3 for Premium)	₹ 5
On Call	₹ 4

All amounts were duly received.

You are required to prepare cash account in the books of the company and pass necessary journal entries.

[**Ans:** Cash book balance: ₹ 3,90,000]

[Model: Issue of shares at a premium—Over-subscription, calls-in-arrears]

10. A company offered to the public 2,00,000 equity shares of ₹10 each at a premium of Re 1 per share. The payment was to be made as follows:

On Application	₹2
On Allotment	₹4
	(Including Premium)
On First Call	₹2.50
On Final Call	₹2.50

Applications totalled for 3,50,000 shares. Applications for 1,00,000 shares were rejected; those totalling 1,50,000 shares were allotted 1,00,000 shares and the remaining applications were accepted in full. The directors made both the calls.

One shareholder, holding 5,000 shares (Full allottee), failed to pay the calls. Expenses amounted to ₹10,000.

Pass journal entries and relevant extracts from the balance sheet relating to the above transactions.

[**Ans:** Calls-in-arrears: ₹25,000]

11. Radha Rukmani Ltd issued to public 50,000 equity shares of ₹10 each at a premium of ₹1 per share payable as follows:

On Application	₹2
On Allotment	₹4
	(Including Premium)
On Calls	₹5

Applications were received for 40,000 shares and all were accepted. All moneys due were fully received except first and final call on 3,000 shares.

Pass journal entries and prepared the balance sheet.

[**Ans:** Total of balance sheet: ₹4,25,000]

12. Leela & Krishna Ltd. invited applications for 10,000 shares of ₹100 each at a premium of ₹20 per share. The shares are payable ₹30 on application, ₹50 (including premium) on allotment, and ₹40 on first and final call.

There was over-subscription and applications were received for 19,000 shares. Allotment was made as follows:

	Share Applied	Shares Alloted
To the Applicants of	8,000	8,000
To the Applicants of	1,000	Nil
To the Applicants of	10,000	2,000
	19,000	10,000

Excess money paid on applications was adjusted against sums due on allotment and first and final call. All moneys due were received.

How will you deal with the excess application money? Show your workings and pass journal entries in the books of the company.

[**Ans:** (i) Amount refunded to applicants: ₹90,000

(ii) Transfer from share application A/c to allotment A/c: ₹1,00,000

(iii) Transfer from share application to first & final call A/c: ₹80,000]

[Model: Shares issued at a discount]

13. A company issued 10,000 equity shares of ₹10 each at a discount of Re 1 per share payable as follows:

On Application	₹3
On Allotment	₹3
	(Excluding Discount)
On First & Final Call	₹3

All the amounts were duly received. Pass the necessary journal entries in the books of the company.

[Model: Issue at a discount, calls-in-arrears]

14. A company issued 5,000 shares of ₹100 each at a discount of 5%. The issue was fully subscribed by paying ₹20 per share on application. The balance was payable as to ₹20 on allotment (with adjustment of discount); ₹25 on first call and ₹30 on final call.

All the calls were made and recovered except a final call on 500 shares held by Mr. X.

Pass journal entries to record the above transactions and show the balance sheet.

[**Ans:** The total of balance sheet: ₹4,85,000; Cash alone in b/s: ₹4,60,000]

[Model: Calls-in-arrears and calls-in-advance]

15. A company with a registered capital of ₹10,00,000 in shares of ₹100 each issued 4,000 of such shares, payable ₹10 per share on application, ₹20 per share on allotment, ₹30 per share on first call.

All the money payable on allotment was duly received. On the first call being made, one shareholder Mr. X paid the entire balance on his holding of 60 shares and another shareholder Mr. Y holding 200 shares failed to pay the first call on his shares.

Pass the necessary journal entries. Show how this will appear in the balance sheet.

[**Ans:** Total of balance sheet: ₹2,36,400;
Paid-up capital: ₹2,40,000;
Calls in-arrears: ₹6,000;
Calls-in-advance: ₹2,400]

[Model: Issue at premium—Over-subscription, calls-in-arrears & calls-in-advance; Interest on calls-in-arrear and calls-in-advance]

16. On 1 January 2010, XYZ Ltd. makes an issue of 1,00,000 equity shares of ₹10 each payable as follows:

On Application	₹2
On Allotment	₹3
	(Including Premium)
On First & Final Call	₹6
(3 months After Allotment)	

Applications were received for 1,30,000 shares and directors made allotment in full to the applicant demanding five or more shares and returned money to the applicants for 30,000 shares. One shareholder, who was allotted 200 shares paid first and final call with allotment money and another shareholder did not pay allotment money on his 300 shares but which he paid with first and final call. The directors have decided to change and allow interest, as the case may be, on calls-in-advance respectively according to the Provisions of Table 'A'.

You are required to journalize the above transactions.

[**Ans:** (i) Calls-in-arrear A/c: ₹900
(ii) Calls-in-advance A/c: ₹1,200
(iii) Interest on calls-in-arrear A/c: ₹11.30
(iv) Interest on calls-in-advance A/c: ₹18.00]

[Model: Calls-in-advance and calls-in-arrears (Issue at a discount)]

17. XYZ Ltd. issued 50,000 equity shares of ₹10 each at a discount of 10% payable as follows:

On Application	₹2
On Allotment	₹2
On First Call	₹2
On Final Call	₹2

Applications were received for 60,000 shares and the directors allotted 50,000 shares and refunded the application money for 10,000 shares.

The allotment money was duly received on all shares. One shareholder holding 5,000 shares did not pay the first and final calls. Another shareholder holding 1,000 shares paid the final call money along with the first call itself.

Pass necessary journal entries in the books of XYZ Ltd.

[**Ans:** Calls-in-arrears: ₹25,000; Calls-in-advance: ₹3,000]

[Model: Issue of shares for consideration other than cash]

18. Vas Ltd. purchased the machinery worth ₹9,00,000 from Subbu & Co. in fully paid shares of ₹100 each.

Make entries in the books of Vas Ltd. in each of the following alternatives:

(a) If the said is at par

(b) at a premium of 20%

(c) at a discount of 10%

[Model: Forfeiture of shares—Issued at par]

19. A public limited company offered 10,000 shares of ₹100 each to the public on the following terms:

₹20 payable on application; ₹50 on allotment and the balance as and when required.

Applications were received for 14,000 shares and allotments were made as follows:

8,000 Applications Were Given 8,000 Shares

5,000 Applications Were Given 2,000 Shares

1,000 Applications Were Given Nil.

Applications money is to be applied towards allotment and the balance beyond that is to be refunded.

A shareholder who applied for 100 shares and was given 100 shares failed to pay the allotment money. His shares were forfeited.

Pass journal entries to record the above transactions.

[Model: Forfeiture of shares—Issued at premium]

20. ABC Ltd. issued 1,00,000 shares of ₹10 each at ₹120 payable as follows:

On Application	₹2.50
On Allotment	₹4.50
	(Including Premium)
On First Call	₹2
On Final Call	₹3

90,000 shares were applied for and allotted. All money was received with the exception of first and final calls on 2,000 shares held by Mr. Y.

These shares were forfeited. You are required to journalize the above transactions. Prepare the necessary ledger accounts and the balance sheet.

[**Ans:** Total of balance sheet: ₹ 10, 70,000]

[Model: Forfeiture of shares—Miscellaneous]

21. Parul Ltd. with a share capital of ₹ 10, 00,000 divided into 10,000 shares of ₹ 100 each offers the shares to the public as follows:

On Application	₹ 20
On Allotment	₹ 20
On First Call	₹ 30
On Second and Final Call	₹ 30

Shareholder "P" who holds 150 shares has paid only the application money.

Shareholder "Q" who holds 100 shares paid application money on 100 shares and allotment money on only 50 shares. He did not pay any other call money.

Shareholder "R" who holds 90 shares has paid only the application and allotment money.

Shareholder "S" who holds 20 shares has paid application, allotment and first call money.

Shareholder "T" who holds 15 shares has paid application, allotment and first call money in full and second call money on only 10 shares.

The company forfeits the shares of the above shareholders who have not paid the due.

Journalize the above transactions in the books of Parul Ltd.

[Model: Forfeiture of shares—Issued at a discount]

22. A company invited applications for 10,000 shares of ₹ 100 each at a discount of 10% payable as follows:

On Application	₹ 20
On Allotment	₹ 30
On First Call	₹ 20
On final Call	₹ 20

Whole of the issue was subscribed and paid for with the exception of one shareholder who holds 200 shares failed to pay both the calls and another shareholder holding 300 shares failed to pay the final call. Those shares were forfeited.

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

[Model: Re-issue of forfeited share; Forfeiture—Originally issued at par, re-issued at discount]

23. X Ltd. issued 1,00,000 equity shares of ₹ 10 each payable as follows:

On Application	₹ 2
On Allotment	₹ 5
On Call	₹ 3

The public applied for 80,000 shares which were allotted. All the money due on shares weas received except for the call on 1,000 shares. These shares were forfeited and re-issued at ₹ 8 per share.

Journalize the above transactions in the books of "X" Ltd.

[Model: Forfeiture of shares—Originally issued at premium, re-issued at discount]

24. Renu Ltd. issued 1,00,000 equity shares of ₹ 10 each at 20% premium as follows:

On Application	₹ 2.50
On Allotment	₹ 4.50 (Including Premium)
On First Call	₹ 2.00
On Final Call	₹ 3.00

90,000 shares were applied for and allotted. All money was received with the exception of First and Final calls on 2,000 shares held by Mr. A. These shares were forfeited consequently. These forfeited shares were re-issued at ₹ 9 per share.

You are required to pass necessary journal entries.

Prepare ledger accounts and the balance sheet.

[**Ans:** Capital reserve A/c: ₹ 8,000; Total of balance sheet; ₹ 10,88,000]

[Model: Re-issue of forfeited shares—Originally issued at discount]

25. A company issues 1,00,000 equity shares of ₹ 10 each at a discount of 10%, payable as follows:

On Application	₹ 2
On Allotment	₹ 3
On First Call	₹ 2
On Final Call	₹ 2

All money was received duly except on 500 shares held by Mr. Gopi, who did not pay both calls. These shares where forfeited and re-issued at ₹ 7 per share.

You are required to journalize the above transactions in the books of the company.

[Model: When all forfeited shares are not re-issued]

26. A company makes an issue of 10,000 shares of ₹ 100 each, amount is payable as follows:

On Application	₹ 20
On Allotment	₹ 25
On First Call	₹ 25
On Final Call	₹ 30

A shareholder holding 400 shares did not pay both the calls and all his shares were forfeited. Out of these, 250 shares are re-issued at ₹ 90 per share.

Pass journal entries in the books of the company.

[Model: Forfeiture of shares originally issued at premium—A part reissued]

27. A company issues 10,000 shares of ₹ 100 each at a premium of 25% and the amount is payable as follows:

On Application	₹ 30
On Allotment	₹ 45
	(Including Premium)
On First Call	₹ 20
On Final Call	₹ 30

All shares were fully subscribed and duly paid with the exception of 200 shares held by Mr. X, who did not pay allotment (including premium). These shares were forfeited. Of these, 150 shares were re-issued at ₹ 110 per share.

You are required to journalize the above transactions.

[Model: Re-issue of forfeited shares originally issued at discount—Portion of forfeited shares re-issued]

28. A company invited applications for 50,000 shares of ₹ 100 each at a discount of ₹ 4 per share payable as:

On Application	₹ 20
On Allotment	₹ 30
On First & Final Call	₹ 46

The applications were received for 45,000 shares and all of these were accepted. All money due was received except the first and final call on 2,000 shares. These shares were forfeited, 1,000 of these shares were re-issued as fully paid for the payment of ₹ 80 per share.

Pass entries in the cash book and the journal of the company.

Construct the balance sheet of the company.

[**Ans:** Cash book total: ₹ 43,08,000; Total of balance sheet: ₹ 44,84,000]

Model: Pro-rata allotment—Over-subscription, Forfeited and re-issued)

29. A company issued 50,000 shares of ₹ 10 each at a premium of ₹ 2 per share, payment to be made as follows:

On Application	₹ 2
On Allotment	₹ 5
	(Including Premium)
On First Call	₹ 2
On Final Call	₹ 3

Applications were received for 1,00,000 shares. Applications for 25,000 shares were rejected and allotment was made proportionately to the remaining applicants. All the money was received except the final call on 500 shares, which were forfeited. 400 of the forfeited shares were re-issued as fully paid @ ₹ 15 per share.

You are required to journalise the above transaction.

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

On Application	₹ 2
On Allotment	₹ 5
	(Including Premium)
On First Call	₹ 3
On final Call	₹ 2

Applications were received for 15,000 shares and pro-rata allotment was made on applications for 12,000 shares. Money over paid on applications was employed towards the sum due on allotment.

Mr. A, who took 200 shares, failed to pay the allotment money and his shares were forfeited on his failure to pay the first call also.

Mr. B, the holder of 300 shares, failed to pay the two calls and his shares were forfeited after the second call. Of the shares forfeited, 400 shares were sold to "C" credited as fully paid for ₹ 9 per share, the whole of Mr. A's shares being included.

Show the journal entries by separately showing your workings on capital reserve.

[**Ans:** Amount to be transferred to capital reserve: ₹ 1,080]

Exercises

Part B—For Advanced Level

31. On 1 January 2010, the directors of X Ltd. issued 1,20,000 equity shares of ₹10 each at ₹12 per share, the amount payable as to ₹5 on application (including premium) ₹4 on allotment and the balance on 15 April 2010.

On 10 January 2010, applications were received for 1,60,000 shares. Of the cash received in excess, ₹80,000 were returned and ₹1, 20,000 were applied towards the amount due on allotment. The balance of allotment money was received on 30 January 2010. All the shareholders paid the call due on 15 April 2010, with the exception of one shareholder, holding 1,000 shares. These shares were forfeited on 31 May 2010.

You are required to pass journal entries and also prepare the balance sheet of the company on 31 May 2010.

[**Ans:** Total of the balance sheet: ₹14,37,000]

[Model: Question No. 31 to Question No. 45—Comprehensive and miscellaneous]

32. XY Co. Ltd. offered to the public 2,00,000 equity shares of ₹10 each at a premium of Re 1 per share. The payment was to be as follows:

On Application	₹2
On Allotment	₹4
	(Including Premium)
On First Call	₹2.50
On Final Call	₹2.50

Applications were received for 3,50,000 shares. Applications for 1,00,000 shares were rejected. Applicants for 1,50,000 shares were allotted 1,00,000 shares and remaining applications were accepted in full. The directors made both the calls. One shareholder holding 5,000 shares failed to pay the two calls and his shares were consequently forfeited. 2,000 of these shares were re-issued as fully paid at ₹8 per share. Expenses of the issue came to ₹10,00,000.

You are required to prepare cash book, the journal and the balance sheet.

[**Ans:** Balance sheet: ₹21,91,000]

33. Senthil Ltd. offers 10,000 shares of ₹100 each to the public for subscription. The money is payable as follows:

On Application	₹20
On Allotment	₹30
On Call	₹50

The company received applications for 12,000 shares. Applications for 8,400 shares pay the application money in cash. The remaining applicants pay the money through stock invests. The shares are allotted on pro-rata basis. All allottees pay the allotment and final call moneys on due dates.

You are required to pass journal entries in the books of Senthil Ltd. assuming that surplus application money received was refunded.

[**Ans:** Hint: 1. Number of shares allotted to applicant who applied through stock invest = 3,000 shares

2. Even though unused "stock invest" are physically returned to the applicants, refund is not to be recorded. The reason is that stock invests are encashed by the company only to the extent of shares allotted to them]

34. Following are the extracts from the draft balance sheet of Doss Ltd. as on 31 March 2010:

Authorized Capital	₹
8,00,000 Equity Shares of ₹100 Each	80,00,000
Issued and Subscribed Capital:	
20,000 Equity Shares of ₹100 Each Fully Paid	20,00,000
Reserve Fund	4,00,000
Profit and Loss Account	3,20,000

A resolution was passed declaring the issue of bonus 20% on equity shares to be provided as to ₹2, 40,000. Out of profit & loss account ₹1,60,000 out of reserve fund. The bonus is to be satisfied by issuing fully paid equity shares.

You are required to set out journal entries to give effect to the resolution and show how they would affect the balance sheet.

[**Ans:** (i) Issued & subscribed capital:

₹24,00,000

(ii) Reserve fund: ₹2, 40,000

(iii) Profit and loss A/c: ₹80,000]

35. NIWAS Ltd. has an authorized capital of ₹10,00,000 divided into 1,00,000 equity shares of ₹10 each. Its subscribed capital is ₹6,40,000 being 80,000 shares of ₹10 each, ₹8 paid up per share. Out of the general reserve, it has been decided to:

(i) Declare a dividend of ₹ 2 per share

(ii) Utilize such dividend for making partly paid-up shares as fully paid up

(iii) Issue 20,000 bonus shares fully paid up in the ratio of 1 bonus share to 4 existing shares

Pass the journal entries in the books of the company.

36. Sundar Ltd. presents the following balance sheet to you:

Liabilities	₹	**Assets**	₹
SHARE CAPITAL:		FIXED ASSETS:	
Authorized	10,00,000	Plant & Machinery	4,30,000
Issue & Subscribed:		Furniture & Fittings	50,000
1,500, 12% Preference Shares of ₹ 100 Each Fully Paid	1,50,000	Patents & Trademarks	10,000
3,000 Equity Shares of ₹ 100 Each, Fully Paid up	3,00,000	CURRENT ASSETS, LOANS & ADVANCES:	
RESERVES & SURPLUS:		(A) CURRENT ASSETS:	
Capital Reserve	65,000	Stock	3,92,500
Securities Premium	45,000	Debtors	53,500
General Reserve	2,90,000	Cash in Hand	2,250
Profit & Loss A/c	52,500	Cash at Bank	97,750
CURRENT LIABILITIES & PROVISIONS:		(B) LOANS & ADVANCES:	
(A) Current Liabilities:		Bills of Exchange	20,000
Sundry Creditors	62,500		
(B) Provisions:			
Provision for Taxation	91,000		
	10,56,000		10,56,000

The company purchases new machinery for ₹ 62,500 for which it pays ₹ 12,500 in cash and allots 500 15% preference shares of ₹ 100 each as fully paid up to vendors. The company then issues one fully paid bonus equity share of ₹ 100 each for every three equity shares held to its equity shareholders. For this purpose, the balances in profit & loss A/c and general geserve are used to the necessary extent.

You are required to pass journal entries for the above-mentioned transactions and redraft the company's balance sheet.

[**Ans:** Total of balance sheet: ₹ 11,06,000]

37. "A" Ltd. has a share capital of 5,00,000 equity shares of ₹ 10 each. Market value is ₹ 25 per share. The company decides to make a rights issue to the existing shareholders in proportion of one rights share of ₹ 10 at a premium of ₹ 3 per share for every 5 shares held.

Calculate the value of right.

[**Ans:** Value of right: ₹ 2]

38. Popular Ltd. granted 1,000 options on 1 January 2007 at ₹ 50 (Nominal value of ₹ 10 each) when the market price was ₹ 200; the vesting period was two and a half years. The maximum exercise period was one year. On 1 February 2009, 300 unvested options lapsed and 600 options were exercised on31 March 2010 and the remaining 100 options lapsed at the end of exercise period.

Pass necessary journal entries in the books of Popular Ltd.

39. Dorga Co. Ltd. issued 50,000 equity shares of ₹ 100 each at a premium of 25%; ₹ 50 per share being payable along with application and the balance including premium being payable on allotment. Applications totalled 49,000 shares. All the applications are fully accepted. Allotment money on 250 shares is not received. These shares are forfeited. Of these, 200 shares are reissued as fully paid up @ ₹ 95 per share.

Pass journal entries for the above transactions crediting securities premium account:

(i) Only when the amount of the premium has been received.

(ii) As soon as the amount of the premium becomes due.

40. Verma Ltd. with an authorized capital of ₹ 60,00,000 offered to public 60,000 equity shares of ₹ 100 each as a premium of 10%. The payment was to be made as follows:

On Application	₹ 30
On Allotment	₹ 50
	(Including Premium)
On First & Final Call	₹ 30

Applications totalled 80,000 shares; shares were

allotted on pro-rata basis. Kashyap who had applied for 80 shares and to whom 40 shares had been allotted failed to pay the balance of allotment money due from him. His shares were forfeited and then re-issued to Anju at ₹80 (including premium of ₹10) per share paid up @ ₹60 per share. Vijay, another shareholder, failed to pay the call money on 20 shares held by him. His shares were forfeited and later were re-issued as fully paid up to Ajay @ ₹120 per share.

Expenses of the issue came to ₹24,000.

Prepare the journal, the cash book, the ledger and the balance sheet.

[**Ans:** (i) Capital reserve: ₹3,000

(ii) Total of the balance sheet: ₹44,03,400]

41. X Ltd. invited applications for 10,000 shares of ₹100 each at a discount of 6% payable as follows:

On Application	₹25
On Allotment	₹34
On First & Final Call	₹35

The applications received were 9,900 and all of those were accepted. All moneys due were received except the first and final call on 10 shares which were forfeited. Five shares were re-issued @ ₹90 as fully paid.

Prepare the cash book, the journal and the balance sheet of the company.

[**Ans:** Cash book total: ₹9,30,700; Capital reserve: ₹275; Balance sheet total: ₹9,90,070]

42. Arul Ltd. issued 1,00,000 equity shares of ₹10 each at a discount of 10% payable as to ₹2.50 per share along with application; ₹2.50 per share on allotment and the balance on the first and final call to be made six months after allotment. The issue was fully subscribed for.

Call on 60 shares was not received. Consequently, they were forfeited. Half of these shares were reissued as fully paid up @ ₹8 per share and later the remaining shares were re-issued as fully paid up @ ₹11 per share.

Pass journal entries in the books of Arul Ltd.

[**Ans:** Capital reserve: ₹150]

43. The issued share capital of Nataraj Ltd. consists of 5,00,000 equity shares of ₹10 each fully paid up. The company offers to its shareholders shares on the rights basis in the ratio of 1:1; the shares of ₹10 each being offered at a premium of ₹10 per share. Half of the price was payable with the application and the balance was payable on allotment, distribution being as follows:

	With Application	On Allotment
	₹	₹
Share Capital	5	5
Securities Premium	5	5
	10	10

All the shareholders accepted the offer. One shareholder holding 1,500 shares paid the full offer price with his application. Another shareholder holding 1,000 shares failed to pay the allotment money and his shares were forfeited. Later, the shares were re-issued as fully paid up for ₹20,000 cash.

Journalize the above transactions.

[**Ans:** Transfer to capital reserve: ₹5,000]

44. ABC Ltd. registered with Table 'A' as its articles was formed with an authorized capital of 40,000 equity shares of ₹100 each. On 1 October 2008, 20,000 shares were issued, fully paid, to the vendors and 16,000 were subscribed by the public. On the latter, ₹25 a share was payable on application, ₹25 on allotment, ₹25 on first call due on 1 December 2008, and ₹25 on the second call due on 1 March 2009.

On the shares subscribed by the public, they had been paid on 30 September 2009 the following:

On 12,000 sharesthe full amount called

On 3,600 Shares	₹75 per Share
On 100 Shares	₹50 per Share
On 300 Shares	₹25 per Share

On 30 September 2009, the directors forfeited the shares on which less than ₹75 has been paid. The calls-in-arrear on the 3,600 shares were collected on 31 October 2009, together with the necessary interest. The forfeited shares were reissued on the same date to Mr. X, at ₹80 per share.

Submit journal entries for the transaction and set out the capital items as they should appear in the company's balance sheet as at 31 March 2009 and 31 March 2010.

[**Ans:** Total of balance sheet as at 31 March 2009: ₹ 34,82,500 31 March 2010: ₹ 36,07,500]

45. A prospectus issued by a company invited applications for 40,000 equity shares of ₹ 100 each, payable ₹ 20 on application and ₹ 20 on allotment and the balance two equal instalments at intervals of three months each after allotment.

The vendor was to receive 4,000 fully paid equity shares as part payment of the purchase consideration of ₹ 32,00,000 made up as follows:

Land & building: ₹ 12,00,000; plant: ₹ 7,00,000; stock in trade: ₹ 9,00,000 and the balance as goodwill.

The offer was over-subscribed by 4,000 shares and the amount due on allotment was received in full.

₹ 10,50,000 and ₹ 10,40,000 were received on first and second call, respectively. Show the accounts concerned after opening the books, recording the above receipts on account of capital, and paying the balance of the purchase consideration to the vendor.

(Journal entries are not required)

[**Ans:** Cash book balance: ₹ 8,90,000]

Underwriting of Shares and Debentures

2

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Define "underwriting".
2. Explain "underwriting commission".
3. Know the provisions of Section 76 of the Companies Act, with respect to payment of underwriting commission.
4. Understand the terms: Underwriters, Sub-underwriters, Brokers and Managers to issues.
5. Know the different types of underwriting.
6. Explain Abatement Clause.
7. Understand marked, unmarked and firm-underwriting applications.
8. Determine the liability of the underwriters in respect of an underwriting contract.
9. Solve problems based on different types of underwriting
10. Explain the key terms in this chapter.

When a company issues shares, it should receive the amount of minimum subscription as mentioned in the prospectus. According to the provisions of Section 69 (1) of the Companies Act, the minimum subscription should not be less than 90% of the issue value. It should be received within 120 days from the date of opening of the issue. Otherwise, all the amounts received by the Company should be refunded to the respective applicants. The said issue will have to be abandoned. In order to avoid such an awkward position, companies seek the help of Underwriters. In this chapter, all the factors relating to underwriting of shares and debentures are discussed in detail.

2.1 UNDERWRITING—DEFINITION

Underwriting is an act of extending guarantee to a company to ensure that the shares or debentures offered to the public are subscribed for within the stipulated period.

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".

Salient features of underwriting are as follows:

- Underwriting is undertaking a responsibility (or) extending a guarantee.

- It is a contract between a company and persons or institutions, called underwriters.
- In case, if the shares or debentures are not subscribed for by the public, the underwriters should take up the shares and pay for them.
- For such services, they are eligible to charge commission called "underwriting commission", as per the provisions of the Act.
- The contract is enforceable by law.
- In case, if the shares are subscribed for fully by the public, underwriters need not take any share but are entitled to the commission on the whole of shares underwritten.
- The Articles of the Company should permit for such payment on commission.

2.2 UNDERWRITING COMMISSION AND PAYMENT

As already stated, underwriting commission is to be paid for the services (i.e., facilitating the task of achieving the minimum subscription quantum from the public when a company launches new issue of shares or debentures) rendered by the underwriters (persons or institutions). The commission is paid to the underwriters for the risks they undertake. Nowadays, the importance of underwriters has attained a level of vital importance. Because of this, some of the financial institutions of the central government take the role of underwriters, e.g., LIC, UTI, IDBI, SBI and commercial banks. Underwriting commission has to be paid to the underwriters as per the terms of the contract subject to the provisions envisaged in the Companies Act.

According to Section 76 of the Companies Act, payment of commission to underwriters will be subject to the following:

- The Articles of Association of the Company should authorize any commission on issue of shares. In other words, a company cannot pay any underwriting commissions unless it is permitted by its Articles.
- Commission should not be paid to any person on shares or debentures that are not offered to the public for subscription as per Section 76 (4A).
- The amount or rate of percent of the commission should be disclosed in the prospectus or the statement in lieu of Prospectus.
- The provisions of the Companies Act limit the commission in case of issue of shares to 5% of the issue price of shares or the rate authorized by the Articles, whichever is less.
- In case of issue of debentures, the commission should not exceed 2.5% or the rate authorized by its Articles, whichever is less.
- The following table shows the payment of underwriting commission which is in accordance with the Guidelines issued by the Stock Exchange Division of the Department of Economic Affairs, Ministry of Finance—Ref. No. F14/1/SE/85:

Particulars	On Amount Devolving on the Underwriters (Percent)	On Amounts by the Public (Percent)
(A) Equity Shares	2.5	2.5
(B) Preference Shares/convertible and Non-convertible Debentures		
(a) For Amounts up to ₹ 5 lakh	2.5	1.5
(b) For Amounts in Excess of ₹ 5 lakh	2	1

- The rates specified in the above table is the maximum limit. But, companies are at their liberty to negotiate with the underwriters, subject to the limit.

- Underwriting commission should not be payable on shares subscribed for by the promoters group, employees, directors, their friends and business associates.

2.3 SUB-UNDERWRITERS

An underwriter may seek the help of several underwriters to facilitate his task. But all such have to work under the principal underwriter—who had actually entered into contract with the company. These underwriters are called "sub-underwriters." Sub-underwriters have to work under an underwriter. Sub-underwriters are generally appointed by an underwriter. They are responsible only to the underwriter. In any case, sub-underwriters have no priority of contract with the company. Their remuneration is in accordance with the terms of their contract with the underwriter. Sub-underwriters are entitled to receive remuneration from the underwriters, which, is called "overall commission". The limit shown in the table includes the overall commission. Hence, the underwriters are not entitled for any extra claim for this purpose.

2.4 BROKERS

Brokers role differ from those of underwriters. A broker's job is to procure subscription for shares or debentures. A broker will not make any commitment, or take responsibility or even any risk. However, a broker is entitled to receive remuneration called "brokerage" to procure subscription by him. Brokerage may be paid in addition to underwriting commission, if any.

Section 76 (3) of the Companies Act provides for payment of brokerage. The Stock Exchange Division of the Department of Economic Affairs, Ministry of Finance vide their reference No. F14/1/SE/85 dated 7 May 1985, has laid down the following provisions with respect to brokerage:

- Brokerage applicable to all types of public issues of Corporate securities is fixed at 1.5% whether the issue is underwritten or not.
- The listed companies are allowed to pay brokerage on private placement of capital at the maximum rate of 0.5%.
- Brokerage should not be allowed in respect of promoters quota, including the amounts taken up by the directors, their friends and employees; and in respect of the rights issues taken up or renounced by the existing shareholders.
- Brokerage will not be paid when the applications are made by the institutions/banks against their underwriting commitments or on the amounts devolving on them as underwriters consequent to under-subscription of the issues.

2.5 MANAGERS TO THE ISSUE

Companies are at their liberty to appoint one or more agencies as their managers to the issue. They are entrusted with the entire matter relating to an issue of share or debenture from the planning stage till the completion of all required formalities with respect to the issue. They are paid for the services rendered. The aggregate amount payable as fees to the managers to the issue will be as follows:

(i) For issues up to ₹ 5 crore: 0.5%

(ii) For issues above ₹ 5 crore: 0.2%.

2.6 APPLICATIONS—MARKED, UNMARKED AND FIRM-UNDERWRITING APPLICATIONS

A company has to issue to the public applications in the prescribed format to subscribe for shares/debentures. Such application forms may be issued by the company or by the underwriters or by both.

2.6.1 Marked Applications

Application forms issued by an underwriter or a broker are stamped with their name and address. Such applications are called "marked applications".

These marked applications facilitate the task of the company to identify and quantify the quantum of shares that have been applied through a particular underwriter or broker. The marked applications are deemed to be received through the underwriter or broker, even if they are sent to the company by the applicants. In case, if the whole of issue has been underwritten by a sole underwriter, the applications need not get marked. All applications, whether submitted directly to the company or sent through underwriters, will be entitled to commission on the whole issue.

2.6.2 Unmarked Applications

Applications that do not bear the stamp of underwriter or broker are called "unmarked applications". It means that these applications were issued to the public directly by the company. They are otherwise called "direct applications".

2.6.3 Firm-underwriting Applications

At times, the underwriters of an issue may agree to take up a specified number of shares in addition to the shares underwritten. Under such circumstances, the underwriters should fill up and submit the applications to the company, just like any other applicant, paying the needed application money. These applications which are filled and sent to the company by the underwriters are known as "firm-underwriting applications".

2.7 TYPES OF UNDERWRITING

Underwriting contracts may be divided into two categories:

1. Pure underwriting
2. Firm underwriting

2.7.1 Pure Underwriting

Under this type of agreement, the underwriter's liability is wholly contingent, whereby he agrees to subscribe for shares or debentures that are not subscribed for by the public.

This may be divided into two types as follows:

(a) Complete underwriting
(b) Partial underwriting

2.7.1.1 Complete Underwriting

In case the whole of the issue of shares or debentures is underwritten (without imposing "firm" underwriting), it is called "complete underwriting".

The issue may be wholly underwritten by a single underwriter. In such a case, the underwriter agrees to take the entire risk.

The issue may be underwritten by more than one underwriter. In that case, each underwriter agrees to take risk only to a certain extent, and not the entire risk.

2.7.1.2 Partial Underwriting

In case only a part of the issue of shares or debentures of a company is underwritten, it is called "partial underwriting".

In partial underwriting, the issue may be underwritten by a single underwriter or more than one underwriter. In both the situations, the underwriter agrees to take risk only to a certain limited extent.

2.7.2 Firm Underwriting

Under this type of agreement, the underwriter's liability is partly contingent and partly definite. The agreement specifies a definite commitment to take up a specified number of shares, irrespective of the number of shares subscribed for by the public. In this case, the underwriter's liability is determined in addition to the shares "firmly" underwritten. In other words, the underwriter has to take:

(i) The number of shares he has agreed for "firm";

(ii) The number of shares he is obliged to take up on the basis of agreement.

In case, if the agreement includes "Abatement Clause", then that "firm" liability is to be adjusted against normal underlying liability.

To illustrate, Mr. A. underwrites 60% of an issue of 1,00,000 shares. Besides, he applies for 10,000 shares "firm". His marked applications are for 45,000 shares. Determine his liability.

Explanation:

Step 1: No. of Shares of the Issue = 1,00,000

Step 2: Mr. A Underwrites 60% $= \frac{60}{100} \times 1{,}00{,}000$

= 60,000 shares

Step 3: No. of Marked Applications = 45,000
(Applications sent through him)

Step 4: Mr. A's Liability = 60,000 – 45,000
(in case of Normal Underwriting) = 15,000
(Step 2 – Step 3)

Step 5: Total No. of Shares to be Taken by A = 15,000 + 10,000
(Including Shares "Firm") = 25,000 shares

Step 6: If underwriting agreement includes "Abatement clause", Mr. A has to take up only 15,000 shares since "abatement" is given for "firm" underwriting applications from his total liability (i.e., 25,000 shares)

2.8 ACCOUNTING TREATMENT

2.8.1 Journal Entries

2.8.1.1 In the Books of the Company

Step 1: For Shares Subscribed for (by the public):

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

(Shares Allotted to the Public)

Step 2: For Underwriters Liability:

Underwriter's A/c	Dr. …	
To Share Capital A/c		….

(Shares to be Taken by the Underwriters)

Step 3: For Underwriting Commission:

Underwriting Commission A/c	Dr. …	
To Underwriter's A/c		….

(Underwriting Commissions Payable)

Step 4: For Net Amount Receivable from Underwriters:

Bank A/c	Dr. …	
To Underwriter's A/c		….

(Amount Received in Settlement from the Underwriters)

2.8.1.2 In the Books of the Underwriter

Step 1: For Shares to be Taken by Underwriter:

Share in Company A/c	Dr. …	
To Company A/c		….

(Shares Received from Company as per the Terms of Agreement)

Step 2: For Commission Receivable:

Company A/c	Dr. …	
To Underwriting Commission A/c		….

(Commission Receivable)

Step 3: For Payment of Cash:

Company A/c	Dr. …	
To Bank A/c		….

(Payments Made to the Company)

Step 4: For Decline in the Market Value of Securities Acquired from the Company:

Profit and Loss Account	Dr. …	
To Share in Company A/c		….

(Decline in Market Value Recorded)

Illustration 2.1

Model: Journalizing transactions entire issue underwritten by one underwriter

ABC Ltd. issued 1,00,000 equity shares of ₹ 10 each at par. The issue was undertaken by Sure Shares & Co. for maximum commission permitted by law. The public applied for and received 70,000 shares.

Pass journal entries in the books of ABC Ltd. and also show how these items will appear in the balance sheet of ABC Ltd.

Solution

Basic Calculations:

*1. Underwriting commission:

According to the Companies Act (Section 76), the maximum commission allowed is 5% on the issue value.

However, according to SEBI Guidelines, the maximum commission permitted is 2.5%. The latest guidelines are to be taken into account.

Hence, underwriting commission will be:

Issue

(Value) = 1,00,000 × 10 = ₹ 10,00,000
2.5% on ₹ 10,00,000 = ₹ 25,000.

*2. No. of shares to be undertaken by Sure Shares & Co.:
No. of shares issued by the company: 1,00,000
No. of shares subscribed by the public: 70,000
Balance left out to be
undertaken by Sure Shares & Co. = 30,000 Shares
Value: 30,000 × ₹ 10 = ₹ 3,00,000

*3. Net commission payable to underwriter: (or)
Receipt of balance from underwriters after adjusting commission (As the case may be):
In this case, commission is less whereas his obligation to the company is more, that is, commission: only ₹ 25,000 whereas his liability to the company is: obligation – commission, i.e., ₹ 3,00,000 – ₹ 25,000 = ₹ 2,75,000

Books of ABC Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Step 1 For Shares Subscribed by Public:				
	Bank A/c	Dr.		7,00,000	
	To Equity Share Capital A/c				7,00,000
	(70,000 shares subscribed by public)				
*2	Step 2 For Underwriter's Liability:				
	Sure Shares & Co. A/c	Dr.		3,00,000	
	To Equity Share Capital A/c				3,00,000
	(As Per Contract, Shares to be Undertaken by the Underwriter)				
*1	Step 3 For Underwriting Commission:				
	Underwriting Commission A/c	Dr.		25,000	
	To Sure Shares & Co. A/c				25,000
	(Commission @ 2.5% on Issue Value)				
*3	Step 4 For Receipt of Balance from Underwriter				
	Bank A/c	Dr.		2,75,000	
	To Sure Shares & Co. A/c				2,75,000
	(Balance Received from Underwriter after Adjusting Commission)				

Balance Sheet of ABC Ltd.

Liabilities	₹	Assets	₹
SHARE CAPITAL:		Cash as Bank	9,75,000
1,00,000 Equity Shares of ₹ 10 each	10,00,000	(Step 1 + Step 4 in Journal)	
		MISCELLANEOUS EXPENDITURE:	
		Underwriting Commission	25,000
		(Step 3 in Journal)	
	10,00,000		10,00,000

Illustration 2.2

Model: Issue of both shares and debentures underwritten by one underwriter

Veer Ltd. issued 5,000 equity shares of ₹100 each and 5,000 10% debentures of ₹100 each. The debentures were issued at a discount of 8%. The whole of the issue was underwritten by M/s Durai & Co. for a commission of 2.5% on the issue price of shares and 2.5% on the issue price of debentures. The public applied for 4,500 equity shares and 4,200 debentures. These were immediately paid for. The underwriters fulfilled their obligations.

You are required to prepare journal ledger accounts and show the balance sheet of Veer Ltd.

Solution

Note: Issue of debentures has been discussed in detail in the chapter "Issue and Redemption of Debentures". Students may refer it for clear understanding.

(i) For debentures subscribed by the public:

Number of debentures subscribed	= 4,200
Value	= 4,200 × 100 = ₹4,20,000
Discount @ 8%	= 8% on ₹4,20,000
	= ₹33,600
∴ Payment received	= ₹4,20,000 – ₹33,600
	= ₹3,86,400

(ii) Number of debentures not applied for by public:

(5,000 – 4,200)	= 800 debentures
Value = 800 × ₹100	= ₹80,000
Discount @8%	= 6,400
∴ Underwriter's A/c	= ₹(80,000 – 6,400) = ₹73,600

(iii) Commission on debentures:

Issue value of debentures	= (Face value – Discount)
	= (₹5,00,000 – 8% on 5,00,000)
	= ₹5,00,000 – ₹40,000
	= ₹4,60,000
Commission @ $2\frac{1}{2}$ % on debentures	= ₹4,60,000 × $\frac{5}{2 \times 100}$ = 11,500

(iv) For shares, calculation is similar to that of Illustration 2.1.

Veer Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	1. For receipt of Public Subscription for Equity Shares:			
	Bank A/c Dr.		4,50,000	
	To Equity Share Capital A/c			4,50,000
	(Amount Received in Full for 4,500 Equity Shares from the Public)			

	2. For Receipt of Subscription of Debentures:			
	Bank A/c Dr.		3,86,400	
	Discount on Issue of Debentures A/c Dr.		33,600	
	To 10% Debentures A/c			4,20,000
	(Amount Received for 4,200 Debentures from the Public)			
	3. For Underwriter's Obligation to Take up Shares not Applied for by Public:			
	M/s Durai & Co. A/c Dr.		50,000	
	To Equity Share Capital A/c			50,000
	(500 shares not Applied for by the Public Taken Over by Underwriter)			
	4. For Debentures not Applied for by the Public, Underwriter's Obligation to Take up As Per the Agreement:			
	M/s Durai & Co. A/c Dr.		73,600	
	Discount on Issue of Debentures A/c Dr.		6,400	
	To 10% Debentures A/c			80,000
	(800 Debentures not Applied for by the Public Taken Over by Underwriters)			
	5. For Underwriting Commission:			
	Underwriting Commission on Shares A/c Dr.		12,500	
	Underwriting Commission on Debentures A/c Dr.		11,500	
	To M/s Durai & Co. A/c			24,000
	[Underwriting Commission on Shares as 2.5% on ₹ 5,00,000 and as 2.5% on Debentures ₹ (5,00,000 – 40,000)]			
	6. On Receipt from Underwriters after the Adjustment of Commission:			
	Bank A/c Dr.		99,600	
	To M/s Durai & Co. A/c			99,600
	(Amount Received from Underwriters)			

Ledger Accounts

Equity Share Capital A/c

Particulars	₹	Particulars	₹
To Balance c/d	5,00,000	By Bank A/c	4,50,000
		By M/s Durai & Co. A/c	50,000
	5,00,000		5,00,000
		By Balance b/d	5,00,000

10% Debentures A/c

Particulars	₹	Particulars	₹
To Balance c/d	5,00,000	By Bank A/c	3,86,400
		By Discount on Issue of Debentures A/c	33,600
		By M/s Durai & Co. A/c	73,600
		By Discount on Issue of Debentures A/c	6,400
	5,00,000		5,00,000
		By balance b/d	5,00,000

M/s Durai & Co. A/c

Particulars	₹	Particulars	₹
To Equity Share Capital A/c	50,000	By Underwriting Commission on Shares	12,500
To 10% Debentures A/c	73,600	By Underwriting Commission on Debentures	11,500
		*3 By Bank (Balancing Fig)	99,600
	1,23,600		1,23,600

Bank A/c

Particulars	₹	Particulars	₹
To Equity Share Capital A/c	4,50,000	By Balance c/d	9,36,000
To 10% Debentures A/c	3,86,400		
To M/s Durai & Co. A/c	99,600		
	9,36,000		9,36,000
To Balance c/d	9,36,000		

Underwriting Commission on Shares A/c

Particulars	₹	Particulars	₹
To M/s Durai & Co. A/c	12,500	By Balance c/d	12,500
	12,500		12,500
To Balance b/d	12,500		

Underwriting Commission on Debentures A/c

Particulars	₹	Particulars	₹
To M/s Durai & Co.	11,500	By Balance c/d	11,500
	11,500		11,500
To Balance c/d	11,500		

Discount on Issue of Debentures A/c

Particulars	₹	Particulars	₹
To 10% Debentures A/c	33,600	By Balance c/d	40,000
To 10% Debentures A/c	6,400		
	40,000		40,000
To Balance c/d	40,000		

Balance Sheet of Veer Ltd.

as on ….

Liabilities	₹	Assets	₹
SHARE CAPITAL:		Bank	9,36,000
5,000 Equity Share of ₹ 100 each	5,00,000	Underwriting Commission on Shares	12,500
SECURED LOANS:		Underwriting Commission on Debentures	11,500
10% Debentures 5,000 each @ ₹ 100	5,00,000	Discount on Issue of Debentures	40,000
	10,00,000		10,00,000

2.8.1.2.1 Complete Underwriting

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

In case, if an issue is subscribed fully by the public, the underwriter is relieved from the clutches of any liability.

Otherwise, if an issue is not subscribed entirely, the underwriter has to shoulder the liability for the members of shares or debentures which are not applied for by the public. That means, the underwriter has to pay for such shares or debentures which are not subscribed by public. Under this type of underwriting, computation of underwriting commission is very simple and easy.

(b) When an entire issue is fully underwritten by more than one underwriter:

In case, if an issue is fully subscribed by the public, the underwriters are free from any liability. They are entitled to receive commission on their agreed ratio.

Otherwise, if the issue is not subscribed fully, then liability of each of the underwriter is determined by using the following format (specimen):

Statement showing the liability of the underwriters:

Particulars	No. of Shares			
	X	Y	Z	Total
Step 1: Gross Liability (Agreed Ratio) of Each Underwriter	×	×	×	××
Step 2: Less: Marked Applications	×	×	×	××
Step 3: Balance (Step 1 – Step 2)	××	××	××	×××
Step 4: Less: Unmarked Applications in the Ratio of Gross Liability	×	×	×	××
Step 5: Liability of Underwriters	××	××	××	×××
Step 6: Less: Any Excess (Surplus) of one Underwriter to Other Underwriters	×	×	×	—
Step 7: Net Liability of Underwriters	×××	×××	×××	×××

Illustration 2.3

Model: Whole issue underwritten by two or more partners

Jaya Ltd. issued 1,00,000 equity shares. The whole of issue was underwritten as:

A: 50%; B: 25%; C: 25%

Applications for 80,000 shares were received in all, out of which applications for 20,000 shares had the stamp of A, those for 10,000 shares that of B and those of 20,000 shares that of C. The remaining applications for 30,000 shares did not bear any stamp.

You are required to determine the liability of the underwriters.

Solution

(i) Basic calculation:

Total number of shares issued: 1,00,000

Gross liability ratio = A:B:C = 50%:25%:25%

= 50:25:25

= 2:1:1.

On this ratio, the number of shares has to be apportioned:

A: $1,00,000 \times \frac{2}{4}$: 50,000 shares

B: $1,00,000 \times \frac{1}{4}$: 25,000 shares

C: $1,00,000 \times \frac{1}{4}$: 25,000 shares

(ii)

Statement Showing Liability of Underwriters

Particulars	No. of Shares			
	A	B	C	Total
Step 1: Gross Liability (Ref: Basic Calculation)	50,000	25,000	25,000	1,00,000
Step 2: Less: Marked Applications (Given)	20,000	10,000	20,000	50,000
	30,000	15,000	5,000	50,000
Step 3: Less: Unmarked Applications in the Ratio of Gross Liability	15,000	7,500	7,500	30,000
	15,000	7,500	(–2,500)	20,000
Step 4: C Has Surplus 2,500 Shares to be Transferred to A and B in Their Gross Liability Ratio, i.e. 2:1 (Rounded Off)	1,667	833	+2500	—
	13,333	6,667	—	20,000

Illustration 2.4

Model: Whole issue is underwritten by two or more underwriters in an agreed ratio.

VRV Ltd. made a public issue of 1,00,000 equity shares of ₹ 10 each. The entire issue was underwritten by five underwriters as follows:

P: 20%; Q: 25%; R: 30%; S: 15%; T: 10%

Applications bearing the rubber stamp of an underwriter are to be applied in relief of his liability.

As a result of the issue, the following applications were received:

Bearing the rubber stamp of	P	for	15,000	shares
Bearing the rubber stamp of	Q	for	10,000	shares
Bearing the rubber stamp of	R	for	12,000	shares
Bearing the rubber stamp of	S	for	5,000	shares
Bearing the rubber stamp of	T	for	8,000	shares
Not bearing any stamp			30,000	shares
			80,000	shares

You are required to find the liability of each underwriter individually.

Solution

Statement Showing Underwriters' Liability

Particulars	No. of Shares					
	P	Q	R	S	T	Total Shares
Step 1: Gross Liability (Apportion 1,00,000 Shares in the Ratio Given, i.e., P—20:Q—25:R—30:S—15:T—10)	20,000	25,000	30,000	15,000	10,000	1,00,000
Step 2: Less: Marked Applications (Given in the question)	15,000	10,000	12,000	5,000	8,000	50,000
Step 3: (Step 1 – Step 2)	5,000	15,000	18,000	10,000	2,000	50,000
Step 4: Unmarked Applications Apportion 30,000 Shares (Given) in Gross Liability Ratio, i.e., 20:25:30:15:10	6,000	7,500	9,000	4,500	3,000	30,000
Step 5: (Step 3 – Step 4)	(–1,000)	7,500	9,000	5,500	(–1,000)	20,000
Step 6: Two partners P&T Bear Excess Liability, i.e., Their Surplus have to be (2000) Transferred to Q, R and S in Their Ratio 25:30:10	(+1,000)	769	923	308	(+1000)	–
Step 7: Net Liability (Step 5 – Step 6) (i.e., P and T's Liability Fulfilled Only by Q, R and S have to Bear Their Liability in Agreed Ratio)	–	*[1]6,731	*[2]8,077	*[3]5,192	–	20,000

Step 8: Final allotment of shares is as follows:

			No. of Shares
	To the Public (Given)	:	80,000
*1	To Underwriter Q	:	6,731
*2	To Underwriter R	:	8,077
*3	To Underwriter S	:	5,192
	Total Number of Shares	:	1,00,000

At times, while apportioning the surplus among others, the result may show that the underwriters who have attired their agreed ratio will have to again shoulder additional liability. In such cases, the surplus has to be again reapportioned to avoid excess liability. This concept can best be explained through the following illustration:

Illustration 2.5

Devi Ltd. was formed with a capital of ₹20,00,000 in ₹10 shares, the whole amount being issued to the public. The underwriting of these shares was as follows:

L: 70,000; M: 60,000; N: 40,000; O: 20,000; P: 6,000; Q: 4,000

All the marked application forms were to go in relief of the underwriters whose stamp they bear. The application forms marked by the underwriters were:

L: 20,000; M: 45,000; N: 40,000; O: 15,000; P: 10,000; Q: NIL

Applications for 40,000 shares were received on forms not marked. Draw up a statement showing the number of shares each underwriter had to take up.

[Madras University Modified]

Solution

Statement Showing Underwriters' Liability

	No. of Shares						
Particulars	**L**	**M**	**N**	**O**	**P**	**Q**	**Total Shares**
Step 1: Gross Liability (Apportion 20,00,000 Shares in the Ratio, i.e; 70:60:40:20:6:4 (or) 35:30:20:10:3:2) (Given in the problem)	70,000	60,000	40,000	20,000	6,000	4,000	2,00,000
Step 2: Less: Marked Applications (Given in question)	20,000	45,000	40,000	15,000	10,000	Nil	1,30,000
Step 3: (Step 1 – Step 2)	50,000	15,000	—	5,000	(–4,000)	4,000	70,000
Step 4: Less: Unmarked Applications Apportion 40,000 Shares (Given) in 35:30:20:10:3:2 Ratio	14,000	12,000	8,000	4,000	(–1,200)	800	40,000
Step 5: (Step 3 – Step 4)	36,000	3,000	(–8,000)	1,000	(–5,200)	3,200	30,000
Step 6: Excess (Surplus) Liability Transferred (i.e., N's and P's) to Other Underwriters in Their Ratio— L:M:O:Q:in 35:30:10:2 (8,000 + 5,200 in 35:30:10:2)	(–6,000)	(–5,142)	(+8,000)	(–1,714)	+5,200	–344	—
Step 7: (Step 5 – Step 6)	30,000	(–2,142)	—	(–714)	—	2,856	30,000
Step 8: Now Arises the Said Problem. Underwriters M and N's Surplus have again to be Apportioned to Others in (35:2, i.e., ₹2,856 in 35:2 Ratio)	–2,702	+2,142	—	(+714)	—	(–154)	—
Step 9: (Step 7 – Step 8) Net Liability	26,298				2,702	30,000	

2.8.1.2.2 Partial Underwriting

(a) When a part of an issue is underwritten by one underwriter:

Under this type, a single underwriter will underwrite a part of the issue—say 65%. The underwriter's liability is confirmed to 65% of the issue. For the remaining part (100 – 65) 35%, the company itself has to shoulder the responsibility.

In such cases, the underwriter is given credit for all the marked applications whereas the unmarked forms are to be credited to the company.

The liability of the underwriter is determined by using the following form:

Statement showing the liability of the underwriter:

Particulars	No. of Shares
Step 1: Total Issue of Shares or Debentures	×
Step 2: Less: The Portion Left out by Underwriter	×
Step 3: Gross Liability of the Underwriter	××
Step 4: Less: Marked Applications	×
Step 5: Balance	××
Step 6: Less: (Surplus) Excess Unmarked Application	×
Step 7: Net Liability of the Underwriter	××

Important note

In case the marked applications exceed the gross liability of the underwriter, he cannot be insisted upon to take shares or debentures. The same will hold good even if there is a shortage of applications towards their part of the issue for which the company is responsible. In other words, the underwriter's liability is NIL in such a situation.

Illustration 2.6

'X' Ltd. issued 50,000 equity shares of ₹50 each and 75% of the issue was underwritten by Mr. 'A'. Applications for 40,000 were received in all, out of which applications for 25,000 were marked. Determine the liability of Mr. 'A'.

Solution

Statement Showing Liability of 'A'

Particulars	No. of Shares	
	Mr. A	**Company**
Step 1: Gross Liability (75% of 50,000 Shares to Mr. A)	37,500	12,500
Step 2: Less: Unmarked Applications Credited to the Company (Received – Marked) (40,000 shares – 25,000 shares)	—	15,000
Step 3: Number of Surplus Applications Accruing to the Company – 2,500 Shares— to be Credited to the Underwriter Mr. A.	37,500	(–2,500)
Step 4: Less: Marked Applications (Given)	–2,500	+2,500
	35,000	Nil
	25,000	—
Step 5: Net Liability of the Underwriter Mr. A (Step 3 – Step 4)	10,000	—

Note: The column for "Company" is shown to assess surplus applications accruing to the Company.

II (b) When a part of the issue is underwritten by two or more underwriters:

If two or more underwriters underwrite a part of issue of shares/debentures, then the liability of each of the underwriter is to be determined by using the following form:

Statement Showing Liability of Each Underwriter

Particulars	No. of Shares				
	A	B	C	D	Company
Step 1: Gross Liability of Underwriters	×	×	×	×	×
Step 2: Less: Marked Applications	×	×	×	×	×
Step 3: Balance	××	××	××	××	××
Step 4: Less: Excess (Surplus) Marked Applications in Gross Liability Ratio	×	×	×	×	×
Step 5: Balance	××	××	××	××	××
Step 6: Less: Excess from Other Underwriters Allocated to Others in Their Gross Liability Ratio	×	×	×	×	×
Step 7: Net Liability of the Underwriters	×××	×××	×××	×××	×××

Illustration 2.7

Model: When a part of issue is underwritten by more than one underwriter.

ABC Ltd. issued 1,00,000 shares of ₹ 50 each. These shares were underwritten as under:

M: 50,000 shares; N: 30,000 shares

The public applied for 80,000 shares which included marked applications as follows:

M: 12,000 shares; N: 3,000 shares

You are required to determine the liability of the underwriters

[Bharathidasan University Modified]

Solution

(i) This is a case of partial underwriting by two underwriters.

Total shares : 1,00,000

Less: Underwritten by M and N

50,000 + 30,000 : 80,000

∴ Company's liability = 20,000 shares

(ii) The surplus applications accruing to the company has to be determined by opening additional column "Company". This has to be apportioned to M and N in 5:3 ratio.

Statement Showing Liability of the Underwriters

Particulars	No. of Shares		
	M	N	ABC Ltd
Step 1: Gross Liability (Shares Underwritten as Given)	50,000	30,000	20,000
Step 2: Less: Unmarked Applications (50,000 + 30,000 –12,000 – 3,000) Credited to the Company	—	—	65,000

Step 3: Less: Surplus Applications 45,000 Accrued to the Company. They are to be Credited to the Underwriters M and N in 5:3 Ratio	50,000 (–28,125)	30,000 (–16,875)	(–45,000) +45,000
	21,875	13,125	Nil
Step 4: Less: Marked Applications	12,000	3,000	
Step 5: Net Liability of Underwriters	9,875	10,125	—

Illustration 2.8

Poornima Ltd. issued 6,000 debentures of ₹ 100 each. The issue was underwritten as follows:

Praveen: 30%; Diraj: 30%; Ansul: 20%

The Company received applications only for 5,000 debentures.

You are required to determine the liability of the underwriters.

Solution

(i) This is partial underwriting.

(ii) The Company has to be considered as an underwriter.

Its liability = 100% − Total of underwriters' share

= 100% − (30% + 30% + 20%)

= 100% − 80% = 20%

∴ Number of debentures = 20% of 6,000 debentures

= 1,200 debentures

Statement Showing Liability of the Underwriters

Particulars	No. of Shares			
	Praveen	**Diraj**	**Ansul**	**Poornima Ltd.**
Step 1: Gross Liability 6,000 Debentures in the Ratio of 30%; 30%; 20% and 20%	1,800	1,800	1,200	1,200
Step 2: Less: Unmarked Applications Credited to the Company—5,000 Debentures × 20/100	—	—	—	1,000
Step 3: Less: Marked Applications	1,800	1,800	1,200	200
No Information on Marked Applications. Therefore, Total Applications Received 5,000 are to be Apportioned in the Ratio 3:3:2:2	1,500	1,500	1,000	—
Step 4: Net Liability of Underwriters	300	300	200	—

2.8.1.2.3 Firm Underwriting

The underwriter has to subscribe for the shares or debentures underwritten "firm". In case of over subscription, underwriter will get priority over the general public for the shares or debentures underwritten "firm".

When the underwriting agreement is silent on this, i.e, if nothing is mentioned specific, then "firm underwriting" applications are to be dealt with as follows:

Approach I: All applications are to be treated as "marked applications". The respective underwriters will be given the entire advantage for shares or debentures "underwritten firm".

Approach II: The advantage (benefit) of applications for shares or debentures "underwritten firm" is to be apportioned to all underwriters in their gross liability ratio. That is, they will be treated as "unmarked applications".

Illustration 2.9

Model: Firm underwritings

One underwriter Poonam Ltd. issued 60,000 shares of ₹ 100 each. The whole issue was underwritten by Khan. In addition, there is a firm underwriting of 5,000 shares by Khan Applications for 48,000 shares received by the company in all. Determine the liability of Khan.

Approach I: When the entire benefits of applications for shares "underwritten firm" is given to the respective underwriters (Treated as "marked applications"), their liability is to be determined by using the following form.

Statement Showing Liability of the Underwriters

Particulars	No. of Shares			
	A	**B**	**C**	**Total**
Step 1: Gross Liability of the Underwriters	×	×	×	×
Step 2: Less: Firm Underwriting	×	×	×	×
Step 3: Balance	××	××	××	××
Step 4: Less: Marked Applications	×	×	×	×
Step 5: Balance	××	××	××	××
Step 6: Less: Unmarked Applications in the Ratio of Gross Liability	×	×	×	×
Step 7: Balance	××	××	××	××
Step 8: Less: Transfer of Excess (Surplus) of any Underwriter to other Underwriters in the Ratio of Gross Liability	×	×	×	×
Step 9: Net Liability of Underwriters	××	××	××	××
Step 10: Add: Firm Underwriting	×	×	×	×
Step 11: Total Liability of Underwriters	×××	×××	×××	×××

Solution

Statement Showing Liability of Khan

Particulars	No. of Shares
Step 1: Gross Liability	60,000
Step 2: Less: (Marked Applications + Unmarked Applications + Firm Applications) Total Applications Received (Given)	48,000
Step 3: Net Liability (Normal Underwriting Agreement)	12,000

Step 4: Add: "Firm" Underwriting (Given)	5,000
Step 5: Liability of the Underwriter (Khan) (Total)	17,000

Firm underwriting—Two or more underwriters—Full issue

Approach II: When the entire benefit of applications for shares "underwritten firm" are not given to respective underwriters (treated as "unmarked applications"), their liability is to be determined by using the following form:

Statement Showing the Liability of the Underwriters

Particulars	No. of Shares			
	A	B	C	Total
Step 1: Gross Liability of the Underwriters	×	×	×	×
Step 2: Less: Marked applications	×	×	×	×
Step 3: Balance	××	××	××	××
Step 4: Less: (Unmarked + Firm Writing Applications) in Gross Liability Ratio	×	×	×	×
Step 5: Balance	××	××	××	××
Step 6: Less: Transfer of Excess from Any Underwriter to Other Underwriters in Their Gross Liability Ratio	×	×	×	×
Step 7: Net Liability of Underwriters	××	××	××	××
Step 8: Add: Firm Underwriting	×	×	×	×
Step 9: Total Liability of the Underwriters	××	××	××	××

Illustration 2.10

Model: Firm underwriting—Benefit given to underwriter treated as marked applications

M/S Varma Ltd. issued 1,00,000 equity shares of ₹ 10 each at par. The entire issue was underwritten as follows:

X: 50,000 shares (Firm underwriting 6,000 shares); Y; 30,000 shares (Firm underwriting 10,000 shares); Z: 20,000 shares (Firm underwriting 4,000 shares)

The total applications including firm underwriting were 80,000 shares. The marked applications were as follows:

X: 25,000 shares; Y: 10,000 shares; Z: 5,000 shares

Determine the liability of each underwriter and the amount of commission payable to them assuming the rate of commission to be 4% on issue price.

Solution

(a) Calculation of commission payable to underwriters:

Note: Maximum rate allowed by law is 5%.

(i) Underwriter X:

Commission = No. of shares underwritten × Value of shares × 4% (Given)

Commission = 50,000 × ₹ 10 × $\frac{4}{10}$ = ₹ 20,000

(ii) Underwriter Y:

Commission = 30,000 × ₹ 10 × $\frac{4}{100}$ = ₹ 12,000

(iii) Underwriter Z:

Commission = 20,000 × ₹ 10 × $\frac{4}{100}$ = ₹ 8,000

Total underwriting commission (i + ii + iii) = ₹ 40,000

(b)

Statement Showing Liability of Underwriters

Particulars	No. of Shares			
	X	Y	Z	Total
Step 1: Gross Liability (Given)	50,000	30,000	20,000	1,00,000
Step 2: Less: Marked Applications (Given)	25,000	10,000	5,000	40,000
Step (2A)	25,000	20,000	15,000	50,000
Step 3: Less: Unmarked Applications in Gross Liability Ratio (Total Applications – Marked Applications) (80,000 – 40,000) = 40,000 in the Ratio of 5:3:2	20,000	12,000	8,000	40,000
Step 4: Net Liability (Step 2A– Step 3)	5,000	8,000	7,000	20,000
Step 5: Add: Firm Undertaking	6,000	10,000	4,000	20,000
Step 6: Total Liability	11,000	18,000	11,000	40,000

Illustration 2.11

Model: Firm underwriting

Approach I: Market applications (Benefit given to underwriters)

Excellent Ltd. made an issue of 1,20,000 equity shares of ₹ 10 each which were underwritten as follows:

Ram: 60,000 shares; Rahim: 36,000 shares; Robert: 24,000 shares

In addition, there was "firm" underwriting as follows: Ram: 5,000 shares; Rahim: 2,500 shares; Robert: 6,000 shares.

The total subscriptions including "firm" underwriting were for 90,500 shares.

The following marked applications were included in the subscriptions:

Ram: 15,000 shares; Rahim: 20,000 shares; Robert: 12,000 shares.

Show the liabilities of each underwriter by treating "firm" underwriting applications as 'marked applications'.

Solution

Note:

- This is "firm" underwriting by two or more partners.

- As there is specific direction, treat like "marked applications", the first approach, i.e., the advantage (benefit) of firm underwriting, has to be given to individual underwriters.
- First, number of "unmarked applications" will be determined as follows:

Particulars	No. of Shares
Step 1: Total Applications Including "Firm":	90,500
Step 2: Less: Firm Underwriting Applications: (Ram—5,000 + Rahim—2,500 + Robert—6,000)	13,500
	77,000
Step 3: Less: Marked Applications (Ram—15,000 + Rahim—20,000 + Robert—12,000)	47,000
Step 4: Unmarked Applications from the Public =	30,000

- In determining the net liability of individual underwrites, "firm underwriting" has to be deducted and in determining the total liability of underwriters, the same "firm underwriting" shares have to be added to net liability to the shareholders.
- Approach I is adopted to determine the liability of underwriters as follows:

Statement Showing Liability of Underwriters

Particulars	No. of Shares			
	Ram	Rahim	Robert	Total
Step 1: Gross Liability (Given)	60,000	36,000	24,000	1,20,000
Step 2: Less: Marked Applications (Given)	15,000	20,000	12,000	47,000
Step 3: Less: Firm Underwriting	45,000	16,000	12,000	73,000
	5,000	2,000	6,000	13,000
Step 4: Less: Unmarked Applications Apportioned in the Ratio of 60:36:24 or 10:6:4	40,000	14,000	6,000	60,000
	6,500	3,900	2,600	13,000
Step 5: Net Liability of Underwriter	33,500	10,100	3,400	47,000
Step 6: Add: Firm Underwriting	5,000	2,000	6,000	13,000
Step 7: Total Liability of Underwriters	38,500	12,100	9,400	60,000

Illustration 2.12

Model: Determination of net amount due from underwriters—when the benefit of firm underwriting is given to the individual underwriters.

Kavya Ltd. issued 3,00,000 equity shares of ₹10 each as ₹7 per share was payable along with application and balance an allotment. The issue was underwritten equally by P, Q and R for a commission of 3%. Applications for 2,80,000 shares were received as per details below:

Underwriter	Firm Applications	Marked Applications	Total
P	10,000	80,000	90,000
Q	10,000	92,000	1,02,000
R	6,000	68,000	74,000
Unmarked Applications	—	—	14,000
			2,80,000

It was agreed to credit the unmarked applications equally to P and R. Kavya Ltd. accordingly made the allotment and received the amounts due from the public. The underwriters settled their accounts.

You are required to

(i) Prepare a statement showing the liability of the underwriters

(ii) Determine the net amount due from the underwriter.

(Direction–Adopt Approach I, i.e, the benefit of firm underwriting is given to individual underwriters.)

Solution

(i)

Kavya Ltd.

Statement Showing Liability of Underwriters

Particulars	No. of Shares			
	P	Q	R	Total
Step 1: Gross Liability (in Equal Proportion)	1,00,000	1,00,000	1,00,000	3,00,000
Step 2: Less: Marked Applications (Given)	80,000	92,000	68,000	2,40,000
	20,000	8,000	32,000	60,000
Step 3: Unmarked Applications Divided Equally to P and R As Per Direction 14,000 =	7,000	—	7,000	14,000
	13,000	8,000	25,000	46,000
Step 4: Firm Underwriting (Given)	10,000	10,000	6,000	26,000
	3,000	(–2,000)	19,000	20,000
Step 5: Less: Q's Surplus 2,000 Transferred to P and Q in Gross Liability Ratio (1:1)	(–1,000)	+2,000	(–1,000)	—
Step 6: Net Liability of Underwriters	2,000	—	18,000	20,000
Step 7: Add: Firm Underwriting	10,000	10,000	6,000	26,000
Step 8: Total Liability of Underwriter	12,000	10,000	24,000	46,000

Allotment of shares will be as follows:

			No. of Shares
1	To the Public (3,00,000 – 46,000)	=	2,54,000
2	To P—Underwriter (Normal + Firm) 2,000 + 10,000	=	12,000
3	To Q—(0 + 10,000) (Ref: Steps 6 and 7)	=	10,000
4	To R—(18,000 + 6,000) (Ref: Steps 6 and 7)	=	24,000
	Total	=	3,00,000

(ii) Determination of net amount due from underwriters:

Particulars	P	Q	R	Total
Step 1: Shares to be Subscribed (Ref: (i) in Shares) Step 8	12,000	10,000	24,000	46,000
Step 2: Amount Due @ ₹ 7 Per Share (Given) (Step 1 × ₹ 7) ₹	84,000	70,000	1,88,000	3,42,000
Step 3: Less: Commission @ 3% on Nominal Value of Shares Underwritten (1,00,000 × ₹ 10 × $\frac{3}{100}$ for each)	30,000	30,000	30,000	90,000
Step 4: Net Amount Due from Underwriters (Step 2 – Step 3)	54,000	40,000	1,58,000	2,52,000

Illustration 2.13

Model: Determination of net amount due from underwriters, when the benefit of firm underwriting is not given to individual underwriters.

Figures—Same as in Illustration 2.14

Solution

(i)

Statement Showing Liability of Underwriters

Particulars	No. of Shares			
	P	Q	R	Total
Step 1: Gross Liability	1,00,000	1,00,000	1,00,000	3,00,000
Step 2: Less: Marked Applications (Given)	80,000	92,000	68,000	2,40,000
	20,000	8,000	32,000	60,000
Step 3: Firm and Unmarked Applications (Subscription – Marked = 2,80,000 – 2,40,000 = 40,000)	20,000	—	20,000	40,000
Step 4: Net Liability of Underwriters	—	8,000	12,000	20,000
Step 5: Add: Firm Underwriting	10,000	10,000	6,000	26,000
Step 6: Total Liability of Underwriter	10,000	18,000	18,000	46,000

Allotment of shares:

To the public (3,00,000 – 46,000)	=	2,54,000 shares
To P—(Normal liability + Firm) (Ref: Step 4 + Step 5: 0 + 10,000)	=	10,000 shares
To Q—(8,000 + 10,000) (Step 4 + Step 5)	=	18,000 shares
To R—(12,000 + 6,000) (Step 4 + Step 5)	=	18,000 shares
Total	=	3,00,000 shares

(ii) Determination of amount due from underwriters

Particulars	P	Q	R	Total
Step 1: Shares to be Subscribed No. of [Ref: Step 6 of (i)] (Shares)	10,000	18,000	18,000	46,000
Step 2: Amount Due @ ₹ 7 Per Share (Step 1 × ₹ 7) (₹)	70,000	1,26,000	1,26,000	3,22,000
Step 3: Less: Commission @ 3% on Nominal Value of Shares Underwritten (1,00,000 × ₹ 10 × $\frac{3}{100}$) (₹)	30,000	30,000	30,000	90,000
Step 4: Net Amount Due from Underwriters} (₹)	40,000	96,000	96,000	2,32,000

Illustration 2.14

Model: Firm and partial underwriting one underwriter

Sardar Parel Co. Ltd. issued 50,000 12% preference shares of ₹ 100 each. 70% of the issue was underwritten by Yoga. In addition, there is a firm underwriting of 7,500 shares by Yoga. Applications for 45,000 shares were received by the company in all. The marked applications totalled 20,000 shares. Determine the liability of Yoga.

Solution

Calculation of unmarked applications:

Total applications received (Subscribed)	=	45,000 shares
Less: Marked applications (Given)	=	20,000 shares
	=	25,000 shares
Less: "Firm" underwriting	=	7,500 shares
Total unmarked applications	=	17,500 shares

Statement Showing Liability of Yoga

Particulars	Shares Underwritten by Yoga	Remaining to Company
Step 1: Gross Liability 70% of 50,000 Shares	35,000	15,000
Step 2: Less: Unmarked Applications (Credit Given to Company – Ref: Note)	—	17,500
	35,000	–2,500

Step 3: Less: [Credit Given to Underwriter as it is Treated Like Marked Form] Surplus 2,500 Shares Accruing to the Company.	–2,500	+2,500
	32,500	—
Step 4: Less: Firm Underwriting (Given)	7,500	—
	25,000	—
Step 5: Less: Marked Applications (Given)	20,000	—
Step 6: Net Liability of Yoga	5,000	—
Step 7: Add: Firm Underwriting (Given)	7,500	—
Step 8: Total Liability of Yoga—the Underwriter	12,500	—

Illustration 2.15

Model: Partial and firm underwriting

More than one or two underwriters B, C and D underwrote 75% of an issue of 40,000 6% preference shares of ₹ 100 each in the ratio of 5:3:2. The "firm" and "marked" applications of the underwriters are as follows:

	Firm	Marked
B	5,000	7,000
C	4,000	6,000
D	1,000	2,000

Applications for 30,000 shares were received in all. You are required to prepare a statement of liability of each underwriter treating firm underwriting applications like unmarked forms.

Solution

Basic calculations:

(i) Ascertainment of gross liability of underwriters:

Total number of shares issued = 40,000

Number of shares underwritten = 75% of 40,000 shares

= 30,000 shares

Ratio of underwriting = 5:3:2

Hence, gross liability of B = $\frac{5}{10} \times 30{,}000 = 15{,}000$ shares

Gross liability of C = $\frac{3}{10} \times 30{,}000 = 9{,}000$ shares

Gross liability of D = $\frac{2}{10} \times 30{,}000 = 6{,}000$ shares

(ii) Calculation of unmarked applications:

Total applications received = 30,000

Less: Marked applications

(B—7,000 + C—6,000 + D—2,000) = 15,000

∴ Unmarked applications = 15,000

Statement Showing Liability of Underwriters

Particulars	No. of Shares				
	B	C	D	Company	Total
Step 1: Gross Liability (Ref: Basic Calculations (i))	15,000	9,000	6,000	10,000 (25%)	40,000
Step 2: Less: Marked Application (Given)	7,000	6,000	2,000	—	15,000
Step 3: Credit Given to Company with Respect to Unmarked Applications as it is Treated like Unmarked Form (30,000 – 15,000 = 15,000)	8,000	3,000	4,000	10,000	25,000
	—	—	—	15,000	15,000
	8,000	3,000	4,000	(–5,000)	10,000
Step 4: Credit Given to Underwriters with Respect to Surplus Accruing to the Company in 5:3:2 Ratio	2,500	1,500	1,000	+5,000	—
Step 5: Net Liability of Underwriters	5,500	1,500	3,000	—	10,000
Step 6: Add: Firm Underwriting	5,000	4,000	1,000	—	10,000
Step 7: Total Liability of the Underwriters	10,500	5,500	4,000	—	20,000

[Advanced Level for Professional Course Students]

Illustration 2.16

Model: Comprehensive

The following underwriting takes place:

X: 18,000 shares; Y: 7,500 shares; Z: 4,500 shares.

In addition, there is firm underwriting:

X; 2,400 shares; Y: 900 shares; Z: 3,000 shares

The share issue is 30,000—Total subscription including firm underwriting was 21,300 shares and the forms included the following marked forms:

X: 3,000 shares; Y: 6,000 shares; Z: 1,500 shares

You are required to show the allocation of liability of the underwriters.

[C.A. (Final). Modified]

Solution

Approach I: When shares underwritten "firm" are treated as marked applications, i.e., the entire benefits of applications for shares underwritten firm is given to respective Underwriters.

Stage I: Calculation of unmarked applications:

Tabulate the figures as follows:

Underwriter	Marked Forms (No. of Shares)	No. of Shares Under Firm Underwriting	Total No. of Shares
X	3,000	2,400	5,400

Y	6,000	900	6,900
Z	1,500	3,000	4,500
Total	10,500	6,300	16,800*

Total subscription = 21,300 shares

*Less: (Marked forms + Firm underwriting shares for all the three $x + y + z$ underwriters) = 16,800 shares

$\therefore$ Unmarked applications = 4,500 shares

Stage II: Liability of underwriter is determined as follows by preparing a statement showing liability of the underwriters:

Statement Showing Liability of the Underwriters

Particulars	**No. of Shares**			
	X	**Y**	**Z**	**Total**
Step 1: Gross Liability (Given)	18,000	7,500	4,500	30,000
Step 2: Less: Unmarked Applications (4,500) Apportioned in the Ratio 180:75:45 or 60:25:15	2,700	1,125	675	4,500
	15,300	6,375	3,825	25,500
Step 3: Less: Marked Forms + Firm Underwriting	5,400	6,900	4,500	16,800
Step 4: Net Liability	9,900	(–525)	(–675)	8,700
Step 5: Surplus of Y & Z's to be Transferred to X	(–525 –675)	(+525)	(+675)	—
Step 6: Normal Liability As Per Agreement	8,700	—	—	8,700
Step 7: Add: Firm Underwriting	2,400	900	3,000	6,300
Step 8: Total Liability of Underwriters	11,100	900	3,000	15,000

Approach II: When shares underwritten firm are treated as "unmarked applications".

Statement Showing Liability of the Underwriters

Particulars	**X**	**Y**	**Z**	**Total**
Step 1: Gross Liability	18,000	7,500	4,500	30,000
Step 2: Less: Unmarked Applications (21,300 – 10,500 = 10,800)	6,480	2,700	1,620	10,800
	11,520	4,800	2,880	19 200
Step 3: Less: Marked Forms	3,000	6,000	1,500	10,500
	8,520	(–1,200)	1,380	8,700
Step 4: Less: Y's Surplus to X and Z in 60:15	960	(+1,200)	240	—
Step 5: Net Liability =	7,560	—	1,140	8,700
Step 6: Add: Firm Underwriting	2,400	900	3,000	6,300
Step 7: Total Liability of the Underwriters	9,960	900	4,140	15,000

Illustration 2.17

Sunlight Ltd. invited applications from public for 50,000 equity shares of ₹ 50 each at a premium of ₹ 10 per share. The entire issue was underwritten by underwriters W, X, Y and Z to the extent of 30%, 30%, 20% and 20%, respectively with the provision of firm underwriting of 1,500, 1,000, 500 and 500 shares, respectively.

The underwriters were entitled to the maximum commission permitted by law.

The Company received applications for 35,000 shares from public out of which applications for 9,500, 5,000, 10,500 and 4,000 shares were marked in favour of W, X, Y and Z, respectively.

Calculate the liability of each one of the underwriters. Also ascertain the underwriting commission payable to different underwriters.

[C.S. (Inter). Modified]

Solution

Approach I: When the shares underwritten firm are treated as "marked applications".

Statement Showing Liability of the Underwriters

Particulars	No. of Shares				
	W	X	Y	Z	Total
Step 1: Gross Liability	15,000	15,000	10,000	10,000	50,000
Step 2: Less: Unmarked Applications (35,000 – 29,000) 6,000 in 3:3:2:2 Ratio	1,800	1,800	1,200	1,200	6,000
	13,200	13,200	8,800	8,800	44,000
Step 3: Less: Marked + Firm	11,000	6,000	11,000	4,500	32,500
	2,200	7,200	(–2,200)	4,300	11,500
Step 4: Y's Excess Transferred to W, X and Z in 3:3:2	825	825	+2,200	550	—
Step 5: Net Liability	1,375	6,375	—	3,750	11,500
Step 6: Add: Firm Underwriting	1,500	1,000	500	500	3,500
Step 7: Total Liability of the Underwriters	2,875	7,375	500	4,250	15,000

Approach II: When shares underwritten firm are treated as "unmarked applications".

Note:

Calculation of unmarked application:

Applications received for subscription	=	35,000	shares
Add: Shares underwritten firm	=	3,500	shares
Total applications	=	38,500	shares
Less: Marked applications	=	29,000	shares
∴ Unmarked applications	=	9,500	shares

Statement Showing Liability of Underwriters

Particulars	No. of Shares				
	W	X	Y	Z	Total
Step 1: Gross Liability (50,000 in 3:3:2:2 Ratio)	15,000	15,000	10,000	10,000	50,000
Step 2: Less: Unmarked Application (Ref: Note ₹ 9,500 in 3:3:2:2)	2,850	2,850	1,900	1,900	9,500
	12,150	12,150	8,100	8,100	40,500
Step 3: Less**:** Marked Applications	9,500	5,000	10,500	4,000	29,000
	2,650	7,150	(–2,400)	4,100	11,500
Step 4: Less: Y's Excess Credited to W, X And Z in 3:3:2	900	900	+2,400	600	—
Step 5: Net Liability	1,750	6,250	—	3,500	11,500
Step 6: Add: Firm Underwriting	1,500	1,000	500	500	3,500
Step 7: Total Liability of the Underwriters	3,250	7,250	500	4,000	15,000

Calculation of Underwriting Commission:

Commission permitted by law is $2\frac{1}{2}$ % of the issue price of share

		₹	₹
Underwriting Commission on Shares A/c	Dr.	20,000	
To M/s Vamanan & Co. A/c			20,000
(Commission due to Underwriters on Shares—As per SEBI guidelines 2.5% on ₹ 8,00,000)			
Underwriting Commission on Debentures A/c	Dr.	18,000	
To M/s Vamanan & Co. A/c			18,000
(Commission due to Underwriters on Debentures @ 2.5% on ₹ 80,000 × 10 – 10% 8,00,000 – 80,000 = ₹ 7,20,000)			
Bank A/c	Dr.	1,02,000	
To M/s Vamanan & Co. A/c			1,02,000
(Commission on Shares and Debentures Received by the Underwriters – ₹ 20,000 + ₹ 18,000 after Deducting from his Liability 50,000 + 90,000, i.e., ₹ 1,40,000 – ₹ 38,000 = ₹ 1,02,000)			

(b) Preparation of ledger accounts

(i) **Equity Share Capital A/c**

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	8,00,000		By Bank A/c	7,50,000
				By Vamanan & Co.	50,000
		8,00,000			8,00,000
				By Balance b/d	8,00,000

(ii) **10% Debentures A/c**

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	8,00,000		By Bank A/c	6,30,000
				By Discount on Issue of Debentures A/c	70,000
				By Vamanan & Co.	90,000
				By Discount on Issue of Debentures A/c	10,000
		8,00,000			8,00,000
				By Balance b/d	8,00,000

Illustration 2.18

PVR Ltd. issued 80,000 equity shares of ₹10 each and 80,000 10% debentures of ₹10 each, the debentures were issued at a discount of 10%. The whole of issue was underwritten by M/s. Vamanan & Co. for a commission as per the legal limit in force now, on the issue price of shares and debentures. The public applied for 75,000 shares and 70,000 debentures. They were immediately paid for. The underwriters fulfilled their obligations.

You are required to

(a) Pass journal entries

(b) Prepare ledger accounts

(c) Construct the balance sheet of PVR Ltd.

Solution

(a)

PVR Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Bank A/c Dr.		7,50,000	
	To Equity Share Capital A/c			7,50,000
	(Allotment and Receipt of Money on 75,000 Shares @ ₹ 10 each			

	Bank A/c	Dr.		6,30,000	
	Discount on Issue of Debentures A/c	Dr.		70,000	
	To 10% Debentures A/c				7,00,000
	(Allotment and Receipt of Money on 70,000 Debentures as 10% Discount)				
	M/s Vamanan & Co A/c	Dr.		50,000	
	To Equity Share Capital A/c				50,000
	Allotment of Remaining Shares 80,000 – 75,000: 5,000 Shares not Applied for by the Public to the Underwriters)				
	M/s Vamanan & Co. A/c	Dr.		90,000	
	Discount on Issue of Debentures A/c	Dr.		10,000	
	To 10% Debentures A/c				1,00,000
	(Allotment of Balance Debentures (80,000 – 70,000) 10,000 Debentures not Applied for by the Public to the Underwriters				

(b)

M/s Vamanan & Co. A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	50,000		By Underwriting Commission on Shares A/c	20,000
	To 10% Debentures A/c	90,000		By Underwriting Commission on Debentures A/c	18,000
				By Bank A/c (Balancing Figure)	1,02,000
		1,40,000			1,40,000

Bank A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	7,50,000		By Balance c/d	14,82,000
	To 10% Debentures A/c	6,30,000			
	To M/s Vamanan & Co. A/c	1,02,000			
		14,82,000			14,82,000
	To Balance b/d	14,82,000			

Underwriting Commission on Shares A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To M/s Vamanan & Co. A/c	20,000		By Balance c/d	20,000
		20,000			20,000
	To Balance b/d	20,000			

Underwriting Commission on Debentures A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To M/s Vamanan & Co. Ltd.	18,000		By Balance c/d	18,000
		18,000			18,000
	To Balance b/d	18,000			

Discount on Issue of Debentures A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To 10% Debentures A/c	70,000		By Balance c/d	80,000
	To 10% Debentures A/c	10,000			
		80,000			80,000
	To Balance b/d	80,000			

(c) Construction of balance sheet:

Balance Sheet of PVR Ltd
As on ….

Liabilities	₹	Assets	₹
Share Capital:		Bank	14,82,000
80,000 Equity Shares of ₹. 10 Each	8,00,000	Miscellaneous Expenditure	
Secured Loan:		Underwriting Commission on Shares	20,000
80,000 10% Debentures of ₹ 10 Each	8,00,000	Underwriting Commission on Debentures	18,000
		Discount on Issue of Debentures	80,000
	16,00,000		16,00,000

Summary

Underwriting of shares and debentures: Underwriting is a contract entered into by a company with persons or institutions who undertake to take up shares or debentures which may not be subscribed for by the public. The consideration for underwriting is "underwriting commission".

Payment of the commission is regulated by legal provisions, which is 2.5% of the issue price of shares, now.

Types of underwriting:

1. Pure underwriting: Under this type, the underwriter's liability is purely contingent. The underwriter agrees to subscribe for the shares or debentures of the company which are not applied for by the public.

   Pure underwriting may further be classified into: (i) complete underwriting and (b) partial underwriting. In case of complete underwriting, the whole of the issue of shares or debentures of a company is underwritten without any firm underwriting. In case of a partial underwriting, only a portion of the issue of shares or debentures is underwritten whereas for the remaining portion, the company is to be treated as "underwriter".
2. Firm underwriting: Under this type, the underwriter's liability is partly contingent and partly definite. The underwriter has to take (i) the number of shares he has applied firm and (ii) the number of shares he is obliged to take up as per terms of the underwriting agreement.

Marked applications: These are applications received from public bearing the stamp or making of a particular underwriter. If the applications do not bear any stamp or marking, they are called unmarked or direct applications.

Firm under writing applications: The underwriters will agree to take up a specified number of shares "firm" apart from the shares underwritten. This is an additional liability for the underwriters.

Determination of liability of the underwriters, commission on underwriting, preparation of journal, ledger accounts and the balance sheet are all discussed in various illustrations (Ref: illustrations 2.1 to 2.20)

Key Terms

Underwriting: A contract entered into by a company with persons or institutions to facilitate the task of subscription of shares or debentures by the public.

Underwriter: Persons or institutions who enter into contract of underwriting with the company.

Underwriting Commission: Remuneration for services rendered by underwriters in discharging the obligation of underwriting.

Pure Underwriting: A type of contract in which the underwriter agrees to subscribe for shares or debentures of the company which are not applied for by the public.

Firm Underwriting: A type of underwriting contract in which the underwriters of an issue agree to take up a specified number of shares "firm" in addition to the shares underwritten.

Marked Applications: Applications forms for shares or debentures issued to public for subscription bearing the name of the underwriters.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. Underwriting is only an adjustment, which cannot be enforceable by law.
2. The underwriters can take up a portion or whole issue made for public subscription.
3. The underwriting commission is payable on the shares to be taken up by the underwriters
4. Payment of the commission is to be authorized by the Articles of Association of the Company.
5. Underwriting commission is payable on shares taken by the promoters, directors.

6. Underwriters may be asked to agree for less commission than prescribed by the statutory provisions.
7. Sub-underwriters are appointed by the company only.
8. In case of partial underwriting, the company is also treated as underwriter for the remaining part of the issue.
9. The application form issued by the company directly to the public bear marking or stamp.
10. In case of firm underwriting, the underwriters agree to take up a specified number of shares "firm" in addition to the shares undertaken as per contract.
11. Unmarked applications can be distributed among the underwriters in the ratio of gross liability.
12. When shares or debentures are allotted to the underwriters, the underwriter's account is credited.

Answers:

1. False	5. False	9. False
2. True	6. True	10. True
3. False	7. False	11. True
4. True	8. True	12. False

II: Fill in the blanks with apt word(s)

1. Underwriting is a contract between the company and the _____ who may be persons or institutions.
2. The prime motive underlying underwriting is to protect the company against the danger of not receiving _____
3. The consideration for the service rendered by the underwriters is _____.
4. The payment of commission is as per Section _____ of the Companies Act.
5. The commission is payable on shares or debentures offered to the _____ only.
6. According to the guidelines issued by the SEBI, the maximum commission on shares is _____.
7. Underwriters may reduce their risk by entering an agreement with another person is called as _____.
8. Companies may appoint one or more agencies as _____ to the issue, who take charge from planning till the completion of all formalities to an issue.
9. Underwriting agreements may broadly be divided into two types: (i) _____ and (ii) _____.
10. Under pure underwriting, the underwriter's liability is purely _____.
11. Under firm underwriting, the underwriter's liability is partly _____ and partly _____.
12. The marked applications facilitate the task of determining the _____ of each underwriter.
13. Marked applications are also known as _____.
14. When commission is payable to the underwriters, _____ A/c is to be credited.
15. When the net amount due from the underwriters on the shares taken by them is received, _____ A/c is to be debited.

Answers:

1. underwriters
2. minimum subscription
3. underwriting commission
4. 76
5. public
6. 2.5%
7. sub-underwriter
8. manager
9. pure; firm
10. contingent
11. definite; contingent
12. liability
13. direct applications
14. underwriter's A/c
15. bank A/c

III: Multiple choice questions—Choose the correct answer

1. Under complete underwriting type of contract, the liability of the single underwriter shall be
   (a) number of shares underwritten – number of shares applied for by the public
   (b) number of shares underwritten
   (c) number of shares applied for by the public
   (d) none of these
2. The underwriter is entitled to receive remuneration on
   (a) the nominal value of shares actually purchased
   (b) the issue price of shares underwritten
   (c) the number of shares applied for by the public
   (d) none of these
3. When an underwriter agrees to take up a definite number of shares in addition to underwritten shares, it is called

(a) complete underwriting
(b) partial underwriting
(c) firm underwriting
(d) none of these

4. As per Section 76 of the Company's Act, commission payable to an underwriter should not exceed
   (a) 0.5% (b) 2%
   (c) 6% (d) 5%
5. As per the guidelines issued by SEBI, the commission payable to an underwriter is
   (a) 2.5%
   (b) 5%
   (c) 6%
   (d) 10%
6. The aggregate amount payable as fees to managers for issues up to ₹5 crore is
   (a) 0.2% (b) 2%
   (c) 0.5% (d) 2.5%
7. A company issued 10,000 equity shares, which were underwritten exclusively by Mr. Felix. The company received applications for 15,000 shares. Mr. Felix is entitled to receive commission on
   (a) 15,000 shares
   (b) 5,000 shares
   (c) 10,000 shares
   (d) none of these
8. Rose Ltd. issued 10,000 shares of ₹10 at a discount of ₹1 per share. The underwriting commission will be paid on
   (a) ₹1,00,000
   (b) ₹1,10,000
   (c) ₹90,000
   (d) none of these

Answers:

1. (a) 2. (b) 3. (c) 4. (d)
5. (a) 6. (b) 7. (c) 8. (c)

Short Answer Questions

1. Define "underwriting".
2. What is the prime underlying purpose of "underwriting" of shares and debentures of a company?
3. Explain the provisions of Section 69 (1) of the Companies Act.
4. What do you mean by "underwriting commission"?
5. Who are "underwriters"?
6. Write a short note on the activities of a "broker"?
7. Write a short note on the role of "managers to the issue".
8. Name the main types of underwriting?
9. Explain: Firm underwriting.
10. What do you understand by the term "marked applications"?
11. What is meant by "direct applications"?
12. Explain the "Abatement Clause" with respect to shares taken "firm".
13. Explain: Gross liability ratio.
14. Name the approaches for dealing with "firm underwriting applications"?
15. What is the main difference between marked and unmarked applications in accounting treatment?

Essay Type Questions

1. Explain the various legal provisions for payment of underwriting commission.
2. Explain the various types of underwriting agreement.
3. How will you determine the liability of underwriters when
   (a) an entire issue is fully underwritten by a single underwriter and
   (b) entire issue is underwritten by two or more underwriters.
4. How will you determine the liability of the underwritten
   (a) when a part of the issue is underwritten by only one underwriter and
   (b) when a part of issue is underwritten by two or more underwriters.
5. Explain the two approaches of dealing with "firm underwriting" applications.

Exercises

Part A—For Undergraduate Level

[Model: Complete underwriting—Entire issue underwritten by one underwriter]

1. X Ltd. issued 50,000 equity shares of ₹100 each at par. The whole issue was underwritten by Good Securities & Co. for a commission of 2%. The company received applications only for 25,000 shares. All the applications were accepted. Give journal entries, assuming that all amounts due have been received.

   [**Ans:** Net liability of the underwriter: ₹ 25,00,000; Commission: ₹1,00,000]

   [Model: Complete underwriting—Entire issue underwritten by one underwriter]

2. A company issued 80,000 equity shares of ₹100 each at par and 4,000 debentures of ₹1,000 each at ₹950. The whole of the issue has been underwritten by Venu & Co. The whole of the shares are applied for but applications for 3,200 debentures only were received. All the applications were accepted. Commission payable to the underwriter is the maximum amount permissible legally.

   Give journal entries to record the above transactions and prepare the balance sheet at this stage, assuming that all amounts due have been received.

   [**Ans:** Underwriting commission (at 2.5%) on shares: ₹2,00,000; Underwriting commission on debentures (at 2%): ₹45,600; Underwriter's liability: ₹7,60,000; Balance sheet total: ₹1,20,00,000]

   [Model: Whole issue is underwritten by two or more underwriters]

3. X Ltd. issued 3,00,000 equity shares. The whole of the issue was underwritten by P: 40%; Q: 30% and R: 30%. Applications for 2,40,000 shares were received in all, out of which applications for 60,000 shares had the stamp of P, those for 30,000 shares that of Q and 60,000 shares that of R. The remaining applications for 90,000 shares did not bear any stamp.

   You are required to show the net liability of the underwriters.

   [**Ans:** Net liability of P: 24, 000 shares; Q: 33,000 shares; R: 3,000 shares]

4. XYZ Ltd., which was incorporated on 1 September 2010, issued applications for 2,50,000 equity shares of ₹100 each. The entire issue was fully underwritten by P, Q, R and S as P; 1,00,000 shares; Q: 75,000 shares; R: 50,000 shares and S: 25,000 shares.

   Applications were received for 2,25,000 shares of which marked applications were as follows:

   P: 1,10,000 shares; Q; 45,000 shares; R: 55,000 shares and S: 5,000 shares.

   You are required to calculate the net liability of individual underwriters, by giving credit to unmarked applications in the ratio of gross liability.

   [**Ans:** Q: 11,250 shares; S: 13,750 shares]

5. R.M.S. Ltd. was formed with a capital of ₹10,00,000 in ₹10 shares, being issued to the public. The underwriting of these shares was as follows:

   A: 35,000 shares; B: 30,000 shares; C: 20,000 shares; D: 10,000 shares; E: 3,000 shares F; 2,000 shares.

   All marked applications were to go in relief of the underwriters, whose names they bear. The applications marked by the underwriters were as:

   A: 10,000 shares; B: 22,500 shares; C: 20,000 shares; D: 7,500 shares; E: 5,000 shares and F: Nil.

   Applications for 20,000 shares were received on unmarked forms.

   Draw up a statement showing the number of shares each underwriter had to take up.

   [**Ans:** A: 13,650 shares and F: 1,350 shares]

   [Model: Partial underwriting—by one underwriter]

6. Y Ltd. issued 1,00,000 equity shares of ₹10 each at a premium of 10% and 4,000 debentures of ₹100 each at ₹95. 80% of the issue is underwritten by Patel & Co. at the maximum rate of commission allowed by law. Applications were received for 80,000 equity shares and 3,000 debentures which were accepted and payments for these were received in full.

   You are required to journalise the above transactions and show the entries in the balance

sheet assuming that the amount due from the underwriter has been received.

[**Ans:** Commission an shares: ₹22,000; Commission on debentures: ₹5,320; Cash received from underwriter: ₹2,24,680; Balance sheet total: ₹14,36,000]

[Model: Partial underwriting—by more than one underwriter]

7. Rising Sun Ltd. issued 1,00,000 equity shares of ₹50 each. The issue was underwritten by underwriters as follows: X: 30%; Y: 30%; Z: 20%

   However, the company received applications for 80,000 shares only.

   You are required to determine the liability of the respective underwriters and write the journal entries in the books of the company.

   [**Ans:** X takes 6,000 shares; Y takes 6,000 shares; Z takes 4,000 shares]

8. A company issued 1,00,000 shares of ₹50 each for public subscription. The issue was underwritten as follows:

   A: 25%; B: 30%; C: 25%

   The company received a total number of 70,000 applications of which marked applications were as follows:

   A: 20,000 shares; B: 15,000 shares and C: 20,000 shares. Determine the liability of each of the underwriters

   [**Ans:** A: 5,000 shares; B: 15,000 shares; C: 5,000 shares]

   [Model: Firm underwriting]

9. The following underwriting took place:

   X: 1,00,000 shares; Y: 60,000 shares; Z: 40,000 shares

   In addition, there was firm underwriting as:

   X: 20,000 shares; Y: 10,000 shares; Z: 30,000 shares

   The share issue was for 2,00,000 shares. Total subscriptions including firm underwriting was 1,70,000 shares and the forms included the following marked forms:

   X: 40,000 shares; Y: 20,000 shares; Z: 20,000 shares show the allocation of liability of the underwriters.

   [**Ans:** Total liability (including firm): X Y Z

   (i) Firm treated as marked (Approach I): 35,000 25,000 30,000

   (ii) Firm treated as unmarked (Approach II): 35,000 23,000 32,000]

10. Surya Co. Ltd. has an authorized capital of ₹25,00,000 divided into 25,000 equity shares of ₹100 each. The company issued for subscription of 12,500 shares at a premium of ₹20 each. The entire issue was underwritten as:

    A: 7,500 shares (Firm underwriting 1,250 shares);

    B: 3,750 shares (Firm underwriting 500 shares);

    C: 1,250 shares (Firm underwriting 250 shares).

    Out of the total issue, 11,250 shares including firm underwriting were subscribed. The following were the marked forms:

    A: 4,000 shares; B: 2,500 shares and C: 1,000 shares.

    Calculate the liability of each underwriter.

    [**Ans:** Final liability (including firm): A B C

    (i) Firm treated as marked: 2,333 667 250

    (ii) Firm treated as unmarked : 2,415 585 250

    (Rounded off)]

11. Chandra Ltd. issued 2,00,000 equity shares of ₹20 each at par. The entire issue was underwritten as follows:

    P: 1,20,000 shares (Firm underwriting 16,000 shares);

    Q: 50,000 shares (Firm underwriting 20,000 shares);

    R: 30,000 shares (Firm underwriting 6,000 shares).

    The total applications including firm underwriting were for 1,42,000 shares. The marked applications were as follows:

    P: 36,000 shares; Q: 45,000 shares and R: 16,000 shares.

    The underwriting contract provides that credit for unmarked applications be given to

the underwriters in proportion to the shares underwritten.

Determine the liability of each underwriter.

[**Ans:** Final liability to underwriters:

	P	Q	R
(i) Firm treated as marked:	69,600	20,000	10,400
(ii) Firm treated as unmarked :	68,000	20,000	12,000]

12. The following underwriting takes place:

X: 30,000 shares; Y: 12,500 shares; Z: 7,500 shares

In addition, there is firm underwriting as follows:

X: 4,000 shares; Y: 1,500 shares; Z: 5,000 shares

The issue is for 50,000 shares. Total subscriptions including firm underwriting is for 35,500 shares and the applications include the following marked forms:

X: 5,000 shares; Y: 10,000 shares; Z: 2,500 shares

Show the allocation of liability of the underwriters if the firm underwritten shares are treated as unmarked applications:

[**Ans:** X: 16,600; Y: 1,500; Z: 6,900 shares]

[Model: Partial and firm underwriting]

13. Ansul & Co Ltd. issued 4,00,000 shares which were underwritten as follows:

A: 40%; B: 30%; C: 20%

The underwriters made firm underwriting as follows:

A: 30,000 shares; B: 20,000 shares; C: 50,000 shares

The total subscriptions excluding firm underwriting, but including marked applications were for 2,00,000 shares.

The marked applications were as follows:

A: 80,000; B: 50,000 shares; C: 20,000 shares.

You are required to prepare a statement showing the liability of the underwriters.

[**Ans:** Liability of the underwriters

	A	B	C
(i) Firm applications treated as marked:	75,556	66,668	57,776
(ii) Firm application treated as unmarked:	61,112	53,332	85,556

14. V, R and S underwrote 80% of an issue of 4,00,000 preference shares of ₹10 each in the ratio of 2:2:1. The "Firm" & "Marked" applications of the underwriters are as follows:

	Marked	Firm
V	80,000	48,000
R	60,000	40,000
S	20,000	32,000

Applications for 3,20,000 shares were received in all. Prepare a statement showing the liability of each of the underwriters.

[**Ans:** V: 64,000; R: 76,000; S: 60,000 shares]

Exercises

Part B—For Advanced Level

15. PVR Ltd. issued 32,000 equity shares of ₹100 each and 32,000 and 10% debentures of ₹100 each, issued at a discount of 6%. The whole of issue was underwritten by Safe & Secure Ltd. for a commission of 2.5% on issue price of shares and 2.5% on the issue price of debentures. The public applied for 28,800 shares and 25,600 debentures. These were immediately paid for. The underwriters fulfilled their obligations.

You are required to

(i) Prepare journal entries

(ii) Prepare ledger accounts

(iii) Draw the balance sheet.

[**Ans:** Underwriting commission on shares: ₹80,000; Underwriting commission on debentures: ₹75,200; Balance sheet total:₹64,00,000]

16. Five Stars Ltd. comes out with a public issue of share capital on 1 April 2011 of 1,00,000 equity shares of ₹100 each at a premium of 5%. ₹25 is payable on application (on or before 30 April 2011) and ₹30 on allotment (30 June 2011) including premium. The issue is underwritten

by two underwriters–Vijay and Ajay—the commission being 5% of the issue price. Each of the underwriters underwrites 2,000 shares firm.

Subscriptions totalled 96,000 shares, the distribution of forms being:

Vijay: 52,000 shares; Ajay: 36,000 and unmarked forms 8,000.

One of the allotees (using forms marked with the name of Vijay) for 200 shares failed to pay the amount due on allotment, all other moneys due being received in all including any due from the shares devolving upon the underwriters. The commission due is paid as per agreement. The shares of different allottees are finally forfeited on 30 September 2001 and re-allotted for payment in cash of ₹ 40 per share.

You are required to pass summary journal entries to record the above events and transactions including cash.

17. Rajan & Co. Ltd. issued 50,000 shares of ₹ 100 each at a premium of 20% (₹ 20 per share). The entire issue was underwritten as follows:

X: 25,000 shares (Firm underwriting 5,000 shares);

Y: 15,000 shares (Firm underwriting 2,500 shares);

Z: 10,000 shares (Firm underwriting 2,500 shares).

Shares applied for were 45,000 shares, the following being the marked forms:

X: 17,500 shares including firm underwriting;

Y: 7,000 shares including firm underwriting;

Z: 8,000 shares including firm underwriting.

What is the liability of each underwriter and how much commission will each get, assuming it is the maximum allowed by law?

[**Ans:** Total liability X: 5,935 shares;
Y: 6,565 shares;
Z: 2,500 shares]

18. M/s Reddy Ltd. has authorized capital of ₹ 50,00,000 divided into 1,00,000 equity shares of ₹ 50 each. The company issued for subscription 25,000 shares at a premium of ₹ 5 each. The entire issue was underwritten as follows:

Amar: 15,000 shares (Firm underwriting 2,500 shares)

Akbar: 7,500 shares (Firm underwriting 1,000 shares)

Antony: 2,500 shares (Firm underwriting 500 shares)

Out of total issue, 22,500 shares including firm underwriting were subscribed.

The following were the marked forms:

Amar: 8,000 shares

Akbar: 5,000 shares

Antony: 2,000 shares

Determine the liability of each underwriter.

[C.S. Modified]

[**Ans:**

Amar	Akbar	Antony
4,833	1,167	500
	(OR)	
4,677	1,133	500 shares]

19. Global (Indian) Ltd. Issued 4,00,000 equity shares which were underwritten as follows:

Underwriter	Shares underwritten
X Ltd.	2,40,000
Y Ltd.	1,00,000
Z Ltd.	60,000

The above-mentioned underwriters made application for firm underwriting as follows:

X Ltd.	32,000 shares
Y Ltd.	40,000 shares
Z Ltd.	12,000 shares

The total applications excluding firm underwriting but including marked applications were for 2,00,000 shares. The marked applications were as under:

X Ltd.	40,000 shares
Y Ltd.	50,000 shares
Z Ltd.	20,000 shares

The underwriting contracts provide that underwriters be given credit for firm applications and that credit for unmarked applications be given in proportion to the shares underwritten.

You are required to show the allocation of liability. [C.A. (Inter). Modified]

[**Ans:** Total liability X Ltd.: 1,36,000 shares;
Y Ltd.: 40,000 shares;
Z Ltd.: 24,000 shares]

20. Himalaya Mount Ltd. issued 3,60,000 shares which were underwritten as:

A: 2,16,000 shares;

B: 90,000 shares;

C; 54,000 shares

The underwriters made applications for firm underwriting as follows:

A: 28,800 shares;

B: 10,800 shares;

C: 36,000 shares the total subscription excluding firm underwriting (including marked applications) were 1,80,000 shares.

The marked applications were:

A: 36,000 shares;

B: 72,000 shares;

C: 18,000 shares.

You are required to prepare a statement showing the net liability of underwriters.

[C.S. (Inter). Modified]

[**Ans:** Total liability: A: 1,19,520 shares;
B: 10,800 shares;
C: 49,680 shares]

Redemption of Preference Shares

3

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Understand the term "redemption of preference shares".
2. Know the Provisions of the Company's Act relating to issue and redemption of redeemable preference shares.
3. Distinguish between revenue profits and capital profits.
4. Determine the amount of new issues of shares (Minimum fresh issue of shares).
5. Understand and apply the logical sequence involved in redemption of preference shares.
6. Pass the required journal entries for redemption of preference shares.
7. Pass the needed journal entries for conversion of preference shares into equity shares.
8. Understand, create and utilize "capital redemption reserve account".
9. Solve problems relating to redemption of preference shares under various and varied circumstances.
10. Define certain key terms associated with redemption of preference shares.

In general, a company cannot return its share capital to the shareholders. However, the Companies Act stipulates certain provisions on this matter. Section 100 of the Companies Act necessitates special resolution for reduction of share capital. According to Section 100,a company limited by shares or a company limited by guarantee and having a share capital, may, if so authorized by its articles, by special resolution, reduce its share capital subject to confirmation by the Court (now Tribunal). A special resolution under this section is in this Act referred to as "a resolution for reducing share capital."

3.1 ISSUE AND REDEMPTION OF PREFERENCE SHARES

Subject to the provisions of Section 80 of the Companies Act, a company limited by shares may, if so authorized by its articles, issue preference shares which are, or at the option of the company are to be liable, to be redeemed. Some of the important provisions of this section are as follows:

(i) 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 for the purposes of the redemption.

(ii) No such shares shall be redeemed unless they are fully paid. To redeem partly paid preference shares, a Call has to be made to make them fully paid.

(iii) 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 (security) premium account, before the shares are redeemed.

(iv) 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 seen available for dividend, be transferred to a reserve fund, to be called the "capital redemption reserve fund (account)", a sum equal to the nominal amount of the shares redeemed.

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

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

(vii) 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 be deemed to be increased by the issue of shares in pursuance of this sub-section. (Section 611).

(viii) Provided that, where new shares are issued before the redemption of the old shares, the new shares shall not, so far as it relates to stamp duty, be deemed to have been issued in pursuance of this sub-section unless the old shares are redeemed within one month after the issue of the new shares.

(ix) The capital redemption reserve (CRR) account may be applied by the company in paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares. CRR cannot be utilized for any other purpose.

(x) Notwithstanding anything contained in this Act, no company limited by shares shall, after the commencement of the Companies (Amendment) Act, 1996, issue any preference share which is irredeemable or is redeemable after the expiry of a period of 20 years from the date of its issue.

(xi) According to Section 80A, every preference share issued before the commencement of the Companied (Amendment) Act 1988, which is irredeemable, shall be redeemed by the Company within a period not exceeding 5 years from such commencement, (i.e., on or before 1993).

(xii) If it is not redeemable before the expiry of 10 years from the date of issue thereon in accordance with the terms of its issue and which had not been redeemed before such commencement, shall be redeemed by the company on the date on which such share is due for redemption or within a period of not exceeding 10 years from such commencement, whichever is earlier. That means all the existing redeemable preference shares shall be redeemed on their due dates or within 10 years (i.e., on or before 1998).

(xiii) Provided that, where a company is not in a position to redeem any such share within the aforesaid period and to pay the dividend, if any, due thereon (such shares being here after referred to as unredeemed preference shares), it may with the consent of the Tribunal, issue further redeemable preference shares equal to the amounts due.

3.2 DETERMINATION OF THE AMOUNT OF NEW ISSUE

After familiarizing with the legal provisions with respect to issue and redemption of preference shares, we have to understand the term "minimum fresh issue of shares". In general, companies decide to utilize all the permissible reserves, for the redemption and for the balance amount, if any required, to make new issue of shares. The main objective is to minimize the quantum of new issue of shares:

That minimum new issue shall be made

(a) At par (or)
(b) At a premium (or)
(c) At a discount

The amount of such new issue is ascertained by using the following formula:

$$\left\{\begin{matrix}\text{Minimum issue}\\ \text{to be made}\end{matrix}\right\} = \left\{\begin{matrix}\text{Face value of redeemable preference shares + Premimum payable on redemption}\\ \text{– Securities premium in balance sheet – Revenue reserves in balance sheet}\end{matrix}\right\} \times \frac{100}{\text{Premium percentage on new issue (or) } 100 - \text{Discount percentage on new issue}}$$

Illustration 3.1

Model: Minimum fresh issue of shares

From the following particulars, determine minimum fresh issue of shares when the fresh issue is (i) at par; (ii) at a premium of 10% and (iii) at discount of 10%.

Redeemable preference shares to be redeemed are ₹ 3,00,000; premium payable on redemption is 5%; securities premium in balance sheet is ₹ 20,000. Revenue reserve in balance sheet is ₹ 1,30,000.

Solution

(i) When fresh issue is made at par:

(a) Write the formula:

$$\left\{\begin{matrix}\text{Minimum fresh}\\ \text{issue}\end{matrix}\right\} = \left\{\begin{matrix}\text{Face value of redeemable preference shares + Premimum payable on redemption}\\ \text{– Securities premium in balance sheet – Revenue reserves in balance sheet}\end{matrix}\right\}$$

(b) Substitute the values (given in problem) in the formula:

$$\text{Minimum fresh issue} = \left\{3,00,000 + \left(\frac{5}{100} \times 3,00,000\right) - 20,000 - 1,30,000\right\}$$

$$= ₹\,3,00,000 + ₹\,15,000 - ₹\,20,000 - ₹\,1,30,000$$
$$= ₹\,3,15,000 - ₹\,1,50,000$$
$$= ₹\,1,65,000$$

(ii) When fresh issue is made at a premium of 10%:

(a) Write the formula:

$$\left\{\begin{matrix}\text{Minimum fresh}\\ \text{issue}\end{matrix}\right\} = \left\{\begin{matrix}\text{Face value + Premimum on redemption}\\ \text{– Securities premium – Revenue reserves}\end{matrix}\right\} \times \frac{100}{100 + \text{Premium}}$$

(b) Substitute the values:

$$= \left\{₹\,3,00,000 + \left(\frac{5}{100} \times 3,00,000\right) - ₹\,20,000 - ₹\,1,30,000\right\} \times \frac{100}{100 + 10}$$
$$= ₹\,1,65,000 \times \frac{100}{110}$$
$$= ₹\,1,50,000$$

Face value of fresh issue = ₹ 1,50,000

Premium on the fresh issue = $₹\,1,50,000 \times \frac{10}{100}$

= 15,000

(iii) When fresh issue is at 10% discount:

(a) Write the formula:

$$\left\{\begin{matrix}\text{Minimum fresh}\\ \text{issue}\end{matrix}\right\} = \left\{\begin{matrix}\text{Face value of share + Premimum on redemption}\\ \text{– Securities premium – Revenue reserves}\end{matrix}\right\} \times \frac{100}{100 - \text{Discount percentage}}$$

(b) Substitute the values in the formula:

$$\text{Minimum fresh issue} = \left\{3,00,000 + \left(\frac{5}{100} \times 3,00,000\right) - 20,000 - 1,30,000\right\} \times \frac{100}{100 - 10\%}$$

$$= ₹\,1,65,000 \times \frac{100}{90}$$

$$= ₹\,1,83,333$$

Face value of fresh issue = ₹ 1,83,333

$$\text{Discount on fresh issue} = ₹\,1,83,333 \times \frac{10}{100}$$

$$= ₹\,18,333$$

Hence, net proceeds = ₹ 1,83,333 – ₹ 18,333

= ₹ 1,65,000

Note: Adjustment for fresh issue of shares:

The fresh issue will be adjusted for higher ten, if the face value is ₹ 10 and adjusted for higher hundred, if the face value is ₹ 100.

To illustrate, in the above illustration—when fresh issue is issued at discount—the number of shares will be 18,340 if the issue price is ₹ 10,the number of shares to be issued will be 18,400 if the face value is ₹ 100. It is to be noted here that adjustment should not be made to the nearest ten or hundred rupees. It must be adjusted for higher ten or higher hundred as illustrated above. The reason is that it will result in complications as the entire permissible reserve is already utilized to ascertain fresh issue.

Journal entries to be passed for issue and redemption of preference shares:

I: Entries for receiving cash:

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
(i)	Final Call On Partly Paid Preference Shares:				
	Redeemable Preference Share Final Call A/c	Dr.		—	
	To Redeemable Preference Share Final Call A/c				—
	(Final Call Money Due or to be Received)				
(ii)	On Receipt of Final Call Amount:				
	Bank A/c	Dr.		—	
	To Redeemable Preference Share Final Call A/c				—
	(Final Call Amount Received)				
(iii)	(a) On Sale of Assets at a Loss:				
	Bank A/c (Actual Cash Received)	Dr.		—	
	Profit & Loss A/c (Loss on Sale)	Dr.		—	
	To Asset A/c (Book Value)				—
	or				
	To Investment A/c				—
	(Sale of Investment/Assets as a Loss)				

(iii)	(b) On Sale of Assets at a Profit:			
	Bank A/c (Actual Cash Received) Dr.		—	
	To Profit & Loss A/c (Profit)			—
	To Asset A/c (Book Value)			—
	or			
	(Sale of Asset at a Profit Investment A/c)			—
(iv)	New Issue of Debentures or Bonds:			
	Bank A/c Dr.		—	
	To … % Debentures A/c			—
	To … % Bonds A/c			—
	(Issue of Bonds/Debentures)			
(v)	New Issue of Shares at a Premium:			
	Bank A/c Dr.		—	
	To Share Capital A/c			—
	To Securities Premium A/c			—
	(New Issue of Share at a Premium for Redemption of Preference Shares)			

II: Entries for Transfers**:**

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
(i)	For Transfer to Capital Redemption Reserve:			
	General Reserve A/c Dr.		—	
	Profit & Loss A/c Dr.		—	
	To Capital Redemption Reserve A/c			—
	(Transfer of Revenue Reserves to Capital Redemption Reserve A/c for Redemption)			
(ii)	For Redeemable Preference Share Capital and Premium Payable on Redemption:			
	Redeemable Preference Share Capital A/c Dr.		—	
	Premium on Redemption A/c Dr.		—	
	To Redeemable Preference Shareholders A/c			—
	(Transfer of Share Capital and Premium Payable to Shareholders)			
(iii)	For Adjustment of Premium Payable on Redemption:			
	Securities Premium A/c Dr.		—	
	Profit and Loss A/c Dr.		—	
	To Premium on Redemption A/c			—
	(Premium Payable Adjusted from Securities Premium or Profit and Loss A/c)			

III:	Entry for Cash Payment:				
	Redeemable Preference Shareholders A/c	Dr.		—	
	To Bank A/c				—
	(Final Payment Made to Shareholders)				
IV:	Entries for Bonus Issue:				
(i)	For Ddeclaration of Bonus:				
	Capital Redemption Reserve A/c	Dr.		—	
	General Reserve A/c	Dr.		—	
	Profit & Loss A/c	Dr.		—	
	To Bonus to Shareholders A/c				—
	(Bonus Payable to Shareholders)				
(ii)	For Issue of Bonus Shares:				
	Bonus to Shareholders A/c	Dr.		—	
	To Equity Share Capital A/c				—
	(Issue of Bonus Shares to the Equity Shareholders)				

3.3 STAGES IN SOLVING PROBLEMS

The following are the important stages in solving problems with respect to redemption of preference shares:

3.3.1 Stage 1—Ascertainment of Amount of Capital Redemption Reserve (CRR)

Preference shares may be redeemed in one of the following ways:

(i) Out of revenue reserves
(ii) Out of the proceeds of a fresh issue of shares
(iii) Combination of (i) and (ii)

The amount to be transferred to CRR may be ascertained by using the following formula:

$$\text{Amount to be transferred to CRR} = \text{Face value of preference shares to be redeemed} - \text{Amount received from new issue of shares (excluding premium)}$$

In case if new issue is not given in the problem, minimum fresh issue must be ascertained before ascertaining the transfer to CRR.

Note: If revenue reserves are used, an equal amount has to be transferred to CRR.

3.3.2 Stage 2—Premium on Redemption of Preference Shares

Premium on the redemption of preference shares, if any, has to be provided in the following order:

1. Source (i): Securities premium existing in the balance sheet
2. Source (ii): Premium on new issue of shares
3. Source (iii): Revenue reserves

3.3.3 Stage 3—Tackling "Cash Problem"

Cash position may not be strong even in reputed companies. Cash problem, i.e., shortage of cash, may arise in certain companies. Shortage of cash is to be determined in the following way:

Step 1:	Face value of preference shares to be redeemed:	…
Step 2:	Add: Premium payable on redemption:	…
Step 3:	Total cash required for redemption	xxx
Step 4:	Less: Final call received on partly paid redeemable preference shares	…
		xxx
Step 5:	Less: Cash received from new issue of shares or debentures	…
		xxx
Step 6:	Less: Cash or bank balance given in the balance sheet	…
Step 7:	Shortage of cash to redeem preference shares	xxx

Shortage of cash is determined one of the following orders, which are based on assumption:

(i) Investments in balance sheet are sold at par
(ii) Trade debtors are realized at par
(iii) Bank overdraft is utilized to the possible limit

3.3.4 Stage 4—Transfers and Payment

Step 1: Revenue reserves that are used for redemption of preference shares have to be transferred to CRR account.

Step 2: Premium on redemption has to be provided out of appropriate source of accumulated profits.

Step 3: These two, i.e., redeemable preference share capital and premium payable on redemption, have to be transferred to each preference shareholders' account individually.

Step 4: In general, cash payment has to be made to the shareholders.

3.3.5 Stage 5: Bonus Issue of Shares

If bonus issue is mentioned in the question, then bonus issue has to be made. Bonus issue is primarily made out of CRR. In case CRR is insufficient, capital profits has to be utilized for issue of bonus shares. Even then, if it is not sufficient, revenue profits can also be utilized for issue of bonus shares. In general, bonus shares are issued to the existing equity shareholders in an appropriate ratio, to be decided by the Board of Directors.

At this stage, one has to understand the terms "revenue profits" and "capital profits" and their inherent characteristics constituents:

Revenue profits (or) profits that are transferable to CRR are as follows:

(i) It generally represents or forms part of general reserve
(ii) It is dividend equalization reserve
(iii) It is also a reserve fund

(iv) It represents revenue portion of profit on sale of investment and fixed assets
(v) Profits available for dividend
(vi) Profits that can be transferable to CRR are revenue profits
(vii) Workmen's compensation fund
(viii) Insurance fund
(ix) Debenture redemption fund
(x) Profit and loss account
(xi) Workmen's accident fund
(xii) Debenture redemption account

Capital profits (or) profits which cannot be transferable to CRR are as follows:

(i) It represents only capital reserves and not general reserves
(ii) Profits prior to incorporation
(iii) It represents capital portion of profit on sale of fixed assets and investments
(iv) Securities premium account
(v) Depreciation reserve
(vi) Forfeited shares account
(vii) Existing CRR
(viii) Development rebate reserve

Illustration 3.2

Model: Redemption of preference shares out of revenue reserves

Pap & Dev Ltd. issued 1,00,000 equity shares of ₹ 10 each and 7,500 redeemable preference Shares of ₹ 100 each, all shares being fully called and paid up on 31 March 2011. Profit and loss account showed undistributed profits of ₹ 5,00,000 and general reserve stood at ₹ 4,00,000. On 1 April 2011, the directors decided to redeem the existing preference shares at ₹ 110 utilizing as much profits as would be required for the purpose.

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

Solution

Note:

1. General reserve account has to be exhausted for creating CRR account and any balance required has to be utilized from P&L A/c.
   In this question, amount equal to nominal value is 7,500 × ₹ 100—₹ 7,50,000.
   General reserve account stood at ₹ 4,00,000
   Balance to be made from P&L at ₹ 3,50,000.
2. As securities premium account is not given in the question, premium payable on redemption of preference shares has to be adjusted against P&L A/c.
   In this question, premium is ₹ (110 – 100) × 7,500 = ₹ 75,000.
   Now, the necessary journal entries have to be passed in the order as shown below:

Pap & Dev Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 April 2011	(i) For Transfer to CRR:			
	General Reserve A/c Dr.		4,00,000	
	Profit & Loss A/c Dr.		3,50,000	
	To Capital Redemption Reserve A/c			7,50,000
	(Transfer Made out of General Reserve and Profit & Loss A/c for Redemption—See Note 1 Above)			
1 April 2011	(ii) For Redeemable Preference Share Capital and Premium Payable On Redemption:			
	Redeemable Preference Share Capital A/c Dr.		7,50,000	
	Premium On Redemption A/c Dr.		75,000	
	To Redeemable Preference Share Holders A/c			
	(Transfer of Share Capital and Premium Payable to Preference Shareholders)			8,25,000
1 April 2011	(iii) For Adjustment of Premium Payable On Redemption:			
	Profit & Loss A/c Dr.		75,000	
	To Premium On Redemption of Pref. Shares A/c			75,000
	(Premium Payable Adjusted from P&L A/c) (See Note 2)			
1 April 2011	(iv) On Cash Payment:			
	Redeemable Preference Shareholders A/c Dr.		8,25,000	
	To Bank A/c			8,25,000

Illustration 3.3

Model: Redemption of preference shares—At Par and out of profits

The following is the extract of balance sheet of Shiva Co. Ltd. as on 31 December 2010:

Share Capital	₹
1,00,00 Equity shares of ₹ 10 each	10,00,000
20,000 redeemable preference shares of ₹ 100 each}	20,00,000
Capital reserve	8,00,000
General reserve	7,50,000
Profit & Loss A/c	20,00,000

The Company exercises its option to redeem preference shares on 1 January 2011. The Company has sufficient cash.

You are required to pass journal entries relating to redemption.

Solution

Basic calculation:

$$\left\{\begin{matrix}\text{Amount to be transferred equal to}\\ \text{nominal value of shares to be redeemed}\end{matrix}\right\} = \text{Number of shares} \times \text{Face value}$$

$$= 20{,}000 \times ₹\,100$$

$$= ₹\,20{,}00{,}000$$

Amount available in general reserve = ₹ 7,50,000

Balance to be met from P&L A/c = (₹ 20,00,000 – ₹ 7,50,000) = ₹ 12,50,000

Shiva Co. Ltd.
Journal Entries

Date	Particulars	L.F	Dr. ₹	Cr. ₹
1 January 2011	(i) For Transfer of an Amount:			
	General Reserve A/c Dr.		7,50,000	
	Profit & Loss A/c Dr.		12,50,000	
	To Capital Redemption Reserve A/c			20,00,000
	(Transfer of an Amount to CRR Ref: Basic Calculation)			
	(ii) For Amount Payable On Redemption:			
	Redeemable Preference Share Capital A/c Dr.		20,00,000	
	To Redeemable Pref. Shareholders A/c			20,00,000
	(Amount Payable On Redemption of Preference Shares)			
	(iii) For Payment Made to Shareholders:			
	Redeemable Preference Shareholders A/c Dr.		20,00,000	
	To Bank A/c			
	(Payment Made to Preference Shareholders on Redemption)			20,00,000

Illustration 3.4

Model: Redemption of preference shares—At premium and out of profits

The balance sheet of Krishna Ltd. as on 31 March 2011 was as follows:

Liabilities	₹	Assets	₹
1,00,000 Equity Shares of ₹ 10 Each, Fully Paid	10,00,000	Sundry Assets	15,00,000
		Bank Balance	9,50,000
5,000 Redeemable Preference Shares of ₹ 100 Each, Fully Paid	5,00,000		
Profit & Loss A/c	8,00,000		
Creditors	1,50,000		
	24,50,000		24,50,000

On the above date, the preference shares were redeemed at a premium of 10%.

You are required to:

(a) Pass journal entries

(b) Construct the amended balance sheet

Solution

Note: As general reserve is not given in the problem, entire amount for redemption is to be utilized in P&L A/c only.

Krishna Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2011	(i) For Creation of CRR:			
	Profit & Loss A/c Dr.		5,50,000	
	To Capital Redemption Reserve A/c			5,00,000
	To Premium On Redemption of Pref. Shares			50,000
	(Provision of Premium and Creation of CRR)			
	(ii) For Transfer of Amount Due on Redemption to Shareholders A/c:			
	Redeemable Preference Share Capital A/c Dr.		5,00,000	
	Premium On Redemption Pref. Shares A/c Dr.		50,000	
	To Redeemable Pref. Shareholders A/c			5,50,000
	(Amount Due On Redemption Transferred to Pref. Shareholders A/c)			
	(iii) For Payment Made On Redemption:			
	Redeemable Preference Shareholders A/c Dr.		5,50,000	
	To Bank A/c			5,50,000
	(Payment Made On Redemption)			

Illustration 3.5

Model: Redemption at par and out of fresh issue

M/s Rukmani Tex Ltd. has part of its share capital as 8,000 redeemable preference shares of ₹ 50 each. When the shares became due for redemption, the company decided that the whole amount will be redeemed out of a fresh issue of equal amount of equity shares of ₹ 10 each.

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

Solution

As the entire amount required for redemption of preference shares will have to be met by fresh issue of equity shares, first the amount needed is determined as follows:

Value of preference shares to be redeemed = 8, 000 × ₹ 50

= ₹ 4, 00,000

$$\therefore \text{ Number of fresh issue of equity shares} = \frac{₹4,00,000}{₹10}$$

= 40,000

M/s Rukmani Tex Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) For fresh issue of Equity Shares:			
	Bank A/c Dr.		4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Fresh Issue of 40,000 Equity Shares @ ₹ 10 Each, for Redemption of Preference Shares)			
	(ii) For Amount Due to Pref. Shareholders:			
	Redeemable Preference Share Capital A/c Dr.		4,00,000	
	To Redeemable Preference Shareholders A/c			4,00,000
	(Amount Due to Pref. Shareholders On Redemption of 8,000 Pref. Shares of ₹ 50 Each)			
	(iii) For Payment to Pref. Shareholders:			
	Redeemable Preference Shareholders A/c Dr.		4,00,000	
	To Bank A/c			4,00,000
	(Payment to Pref. Shareholders).			

Illustration 3.6

Model: Redemption at par partly out of profits and partly out of fresh issue

M/s Leela Agro Ltd. has part of its share capital in 5,000 12% redeemable preference shares of ₹ 100 each. The general reserve of the company shows a credit balance of ₹ 6,00,000. The directors decided to utilize 70% of the reserve in redeeming the preference shares and the balance is to be met from the proceeds of the fresh issue of sufficient number of equity shares of ₹ 10 each.

Give journal entries to record these transactions.

Solution

Basic calculations:

1. CRR to be created = 70% of the reserve
   (Partly out of profits) = 70% of ₹ 6,00,000 = ₹ 4,20,000
2. Number of fresh issue of shares:
   Balance = (₹ 5,00,000 – ₹ 4,20,000) = ₹ 80,000

$$= \frac{₹\ 80,000}{₹\ 10} = ₹\ 8,\ 000$$

M/s Leela Agro Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) For Creation of CRR:			
	General Reserve A/c Dr.		4,20,000	
	To Capital Redemption Reserve A/c			4,20,000
	(CRR Created Out of General Reserve 70% (Ref: Basic Calculation 1) for Redemption of Preference Shares: Partly Out of Profits)			

	(ii) For Fresh Issue of Equity Shares: Bank A/c Dr. To Equity Share Capital A/c (8,000 Equity Shares Issued @ ₹ 10 Each for Redemption: Partly Out of Fresh Issue)		80,000	 80,000
	(iii) For the Amount Due to Pref. Shareholders: Redeemable Preference Share Capital A/c Dr. To Redeemable Preference Shareholders A/c (Amount Due to Pref. Shareholders On Redemption of 5,000 Pref. Shares @ ₹ 100 Each)		5,00,000	 5,00,000
	(iv) For Payment to Preference Shareholders: Redeemable Preference Shareholders A/c Dr. To Bank A/c (Payment of Amount to Pref. Shareholders)		5,00,000	 5,00,000

Illustration 3.7

Model: Redemption of preference shares at par—Fresh issue at premium

On 31 March 2011, the balance sheet of Radha Ltd. stood as follows:

Liabilities	₹	Assets	₹
Equity Share Capital	15,00,000	Sundry assets	19,00,000
Redeemable Pref. Share Capital	6,00,000	Bank	8,50,000
Profit & Loss Account	4,00,000		
Sundry Creditors	2,50,000		
	27,50,000		27,50,000

On the above date, the preference shares have to be redeemed. 30,000 Equity shares of ₹ 10 each are issued at ₹ 11. The company also issued 10% debentures totaling ₹ 4,00,000. The shares and debentures are fully subscribed and paid for. The preference shares are duly redeemed.

You are required to give journal entries and the balance sheet after redemption.

Solution

Basic calculation:

Total amount required for redemption = ₹ 6,00,000

Amount realized on issue of fresh shares = ₹ 3,00,000

∴ Balance required = ₹ 3,00,000

₹ 3,00,000 has to be transferred to CRR out of profits, i.e., from P&L A/c in this question.

Radha Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr.(₹)
31 March 2011	Bank A/c Dr. To Equity Share Capital A/c (30,000 × ₹ 10) To Securities Premium A/c (30,000 × ₹ 1) To 10% Debentures A/c (Issue of 30,000 Equity Shares of ₹ 10 Each at a Premium of ₹ 1 and 10% Debentures ₹ 4,00,000)		7,30,000	 3,00,000 30,000 4,00,000

	Profit & Loss Account	Dr.		3,00,000	
	To Capital Redemption Reserve A/c				3,00,000
	(Balance Required Transferred to CRR Ref: Basic Calculation)				
	Redeemable Preference Share Capital A/c	Dr.		6,00,000	
	To Redeemable Preference Shareholders A/c				6,00,000
	(Transfer of Amount to Preference Shareholders on redemption)				
	Redeemable Preference Shareholders A/c	Dr.		6,00,000	
	To Bank A/c				6,00,000
	(Payment to Preference Shareholders				

Balance Sheet of Radha Ltd.
as on 31 March 2011 (After Redemption)

Liabilities	₹	Assets		₹
Share Capital:		Sundry assets		19,00,000
Equity Share Capital (₹ 15,00,000 + ₹ 3,00,000)	18,00,000			
Reserve & Surplus:		Bank	₹ 8,50,000	
Securities Premium A/c	30,000		+ ₹ 7,30,000	
			₹ 15,80,000	
		Less:	6,00,000	9,80,000
Capital Redemption Reserve A/c	3,00,000			
Profit & Loss A/c (₹ 4,00,000 – ₹ 3,00,000)	1,00,000			
Secured Loan:				
10% Debentures	4,00,000			
Current Liabilities:				
Sundry Creditors	2,50,000			
	28,80,000			28,80,000

Illustration 3.8

Model: Redemption at a premium—Partly out of profits and partly out of fresh issue of shares at par

Srinivas Ltd. have part of their share capital in 4,000 10% redeemable preference shares of ₹ 100 each. The Company decided to redeem the preference shares at premium of 10%. The general reserve of the company stood at ₹ 5,00,000. The directors decided to utilize 50% of the reserve in redeeming the preference shares and the balance is to be met from the proceeds of fresh issue of sufficient number of equity shares of ₹ 10 each. The premium on redemption is to be met from the year's profit and loss appropriation account.

Give journal entries to record the above transactions.

Solution

Srinivas Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	General Reserve A/c Dr.		2,50,000	
	To Capital Redemption Reserve A/c			2,50,000
	(50% of Reserve, i.e., 50% of 5,00,000 ₹ 2,50,000 is Created and Transferred to CRR)			
	Bank A/c Dr.		1,50,000	
	To Equity Share Capital A/c			1,50,000
	(For the Remaining ₹ 1,50,000—15,000 Equity Shares of ₹ 10 Each Issued)			
	Redeemable Preference Share Capital A/c Dr.		4,00,000	
	Premium On Redemption of Preference Shares A/c Dr.		40,000	
	To Redeemable Preference Shareholders A/c			4,40,000
	(Amount Payable to the Redeemable Preference Shareholders)			
	Profit and Loss Appropriation A/c Dr.		40,000	
	To Premium On Redemption of Pref. Shares A/c			40,000
	(Premium On Redemption Provided Out of P&L Appropriation A/c)			
	Redeemable Preference Shareholders A/c Dr.		4,40,000	
	To Bank A/c			4,40,000
	(Payment to Redeemable Pref. Shareholders On Redemption)			

Illustration 3.9

Model: Redemption at premium and fresh issue at premium

M/s Subbu Ltd. has 6,000 8% redeemable preference shares of ₹ 100 each fully paid. The Company decides to redeem the pref. shares on 31 March 2011 at a premium of 10%.

The Company makes the following issues:

(a) 40,000 Equity shares of ₹ 10 each at a premium of 10%

(b) 2,000 9% Debentures of ₹ 100 each

The issue was fully subscribed and allotments were made. The redemption was duly carried out. The Company has sufficient profits.

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

Solution

M/s Subbu Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2011	Bank A/c Dr.		4,40,000	
	To Equity Share Capital A/c			4,00,000
	To Securities Premium A/c			40,000
	(Issue of 40,000 Equity Shares of ₹ 10 Each at a Premium of 10% for Redemption of Preference Shares)			
	Bank A/c Dr.		2,00,000	
	To 9% Debentures A/c			2,00,000
	(Issue of 2,000 Debentures of ₹ 100 Each)			
	Profit and Loss Appropriation A/c Dr.		2,00,000	
	To Capital Redemption Reserve A/c			2,00,000
	(Transfer of Requisite Amount for Redemption to CRR A/c from P&L Appropriation A/c)			
	8% Redeemable Preference Share Capital A/c Dr.		6,00,000	
	Premium On Redemption of Pref. Shares A/c Dr.		60,000	
	To Redeemable Pref. Shareholders A/c			6,60,000
	(Amount Due to Pref. Shareholders)			
	Securities Premium A/c Dr.		40,000	
	P&L Appropriation A/c Dr.		20,000	
	To Premium On Redemption of Pref. Shares A/c			60,000
	(Transfer of Needed Amount for Redemption from Securities Premium and P&L Appropriation A/c)			
	Redeemable Preference Shareholders A/c Dr.		6,60,000	
	To Bank A/c			6,60,000
	(Payment of Amount to Preference Shareholders on Redemption)			

Illustration 3.10

Model: Redemption of preference shares at premium—Partly out of fresh issue of shares and partly out of profits.

Raj Gopal Ltd. has an authorized capital of ₹ 10,00,000 comprising 3,000 8% redeemable preference shares of ₹ 100 each and 70,000 equity shares of ₹ 10 each.

The preference shares are redeemable on 31 March 2011 at a premium of 10%.

The summarized balance sheet was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Sundry assets	5,00,000
Authorized:		Investments	30,000
70,000 Equity Shares of ₹ 10 Each	7,00,000	Bank	1,20,000
3,000 8% Preference Shares of ₹ 100 Each	3,00,000		
Paid-up Capital:			
30,000 Equity Shares of ₹ 10 Each	3,00,000		
2,000 8% Preferences Shares of ₹ 100 Each	2,00,000		
Capital Reserve	20,000		
General Reserve	30,000		
Profit & Loss A/c	40,000		
Sundry Creditors	60,000		
	6,50,000		6,50,000

The Board has passed necessary resolutions duly and the following transactions took place:

(i) To provide cash for redemption of preference shares, the investments were sold for ₹ 50,000 and 15,000 equity shares of ₹ 10 each were issued to the existing shareholders at ₹ 12 per share payable in full. All moneys were duly redeemed.

(ii) The redeemable preference shares were duly redeemed.

You are required to give necessary journal entries and the amended balance sheet.

Solution

Basic calculations:

(i) The requisite amount for redemption:

Number of preference shares × Nominal value = 2,000 × ₹ 100 = ₹ 2,00,000

(ii) The requisite amount for premium on redemption:

10% of ₹ 2,00,000 = ₹ 20,000

(iii) Amount to be transferred from general reserve and P&L A/c:

= Requisite amount for redemption – Equity shares issued for redemption

= ₹ 2,00,000 – (15,000 shares × ₹ 10)

= ₹ 2,00,000 – ₹ 1,50,000 = ₹ 50,000.

Raj Gopal Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2011	Bank A/c Dr.		50,000	
	To Investments A/c			30,000
	To Profit & Loss A/c			20,000
	(Investments Sold at Profit)			

31 March 2011	Bank A/c Dr.		1,80,000	
	To Equity Share Capital A/c			1,50,000
	To Securities Premium A/c			30,000
	(Issue of 15,000 Equity Shares of ₹ 10 Each at a Premium of ₹ 2 Per Share for Redemption of Pref. Shares)			
31 March 2011	General Reserve A/c Dr.		30,000	
	Profit & Loss A/c Dr.		20,000	
	To Capital Redemption Reserve A/c			50,000
	[Transfer Out of General Reserve and P&L A/c to CRR]			
31 March 2011	8% Redeemable Preference Share Capital A/c Dr.		2,00,000	
	Premium on Redemption of Pref. Shares A/c Dr.		20,000	
	To Redeemable Preference Shareholders A/c			2,20,000
	(Transfer of Amount Due to Pref. Shareholders)			
	Securities Premium A/c Dr.		20,000	
	To Premium On Redemption of Pref. Share			20,000
	(Premium on Redemption of Shares Set off Against Securities Premium)			
	Redeemable Preference Shareholders A/c Dr.		2,20,000	
	To Bank A/c			2,20,000
	(Payment Made to Redeemable Pref. Shareholders)			

Balance Sheet of Raj Gopal Ltd.
as on 31 March 2011

Liabilities	₹	**Assets**	₹
Share capital:		Sundry Assets	5,00,000
Authorized:		Bank	
70,000 Equity Shares of ₹ 10 Each	7,00,000	(₹ 1,20,000 + ₹ 50,000 + ₹ 1,80,000 – ₹ 2,20,000)	1,30,000
3,000 8% Preference Shares of ₹ 100 Each	3,00,000		
Paid-up Capital:			
30,000 + 15,000 Equity Shares of ₹ 10 Each	4,50,000		
Reserves & Surplus:			
Capital Reserve	20,000		
Profit & Loss A/c			
(40,000 +20,000 – 20,000)	40,000		
Capital Redemption Reserve	50,000		
Current Liabilities:			
Sundry Creditors			
Securities Premium A/c	60,000		
(₹ 30,000 – ₹ 20,000)	10,000		
[Set off]			
	6,30,000		6,30,000

Illustration 3.11

Model: Issue of bonus shares

Sunderraj Ltd. issued 10,000 8% redeemable preference shares of ₹100 each at par on 1 July 2003, redeemable at the option of the company on or after 30 June 2009 partly or fully.

Redemptions were made out of profits as follows:

(i) 2,000 Shares on 30 June 2009 at par

(ii) 2,500 Shares on 31 December 2009 at 10% premium

(iii) Remaining shares on 30 June 2010 at a premium of 5% making a fresh issue of 4,000 equity shares of ₹100 each at a premium of 10%

On 30 June 2010,the company also decided to capitalize 50% of its capital redemption reserve by issuing bonus shares of ₹10 each fully paid at a premium of ₹2 per share.

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

Solution

Basic calculations:

(i) Amount required for redemption transferred out of profits to capital redemption reserve A/c:

Total amount required for redemption =	₹10,00,000
Less:	
(a) On 30 June 2009: ₹2,00,000	
(b) On 31 December 2009: ₹2,50,000	
(c) On 30 June 2010: ₹4,00,000	₹8,50,000
	₹1,50,000

(ii) Ascertainment of bonus:

	₹
Transfer to capital redemption reserve on 30 June 2009:	2,00,000
Transfer to capital redemption reserve on 31 December 2009:	2,50,000
Transfer to capital redemption reserve on 30 June 2010:	1,50,000
	6,00,000

∴ Bonus at 50% of capital redemption reserve = ₹6, 00,000 × $\frac{50}{100}$ = ₹3, 00,000

Sunderraj Ltd.

Journal Entries

Date	Particulars	LF	Dr. ₹	Cr. ₹
30 June 2009	Profit & Loss A/c Dr.		2,00,000	
	To Capital Redemption Reserve A/c			2,00,000
	(Transfer of Profits to CRR for Redemption)			
	(2,000 Shares at Par)			
30 June 2009	8% Redeemable Preference Share Capital A/c Dr.		2,00,000	
	To Redeemable Preference Shareholders A/c			2.00.000
	(Amount Due to Preference Shareholders for Redeeming Pref. Shares)			

30 June 2009	Redeemable Preference Shareholders A/c Dr.		2,00,000	
	To Bank A/c			2,00,000
	(Amount Paid to Pref. Shareholders)			
31 December 2009	Profit & Loss A/c Dr.		2,75,000	
	To Capital Redemption Reserve A/c			2,50,000
	To Premium On Redemption of Preference Shares A/c			25,000
	(Amount Transferred to CRR)			
31 December 2009	8% Redeemable Preference Share Capital A/c Dr.		2,50,000	
	Premium On Redemption of Pref. Shares A/c		25,000	
	To Redeemable Preference Shareholders A/c			2,75,000
	(Amount Due to Preference Shareholders On Redemption)			
31 December 2009	Redeemable Preference Shareholders A/c Dr.		2,75,000	
	To Bank A/c			2,75,000
	(Amount Paid to Pref. Shareholders)			
30 June 2009	Bank A/c Dr.		4,40,000	
	To Equity Share Capital A/c			4,00,000
	To Securities Premium A/c			40,000
	(Issue of 4,000 Equity Shares of ₹ 100 Each at a Premium of ₹ 10)			
30 June 2009	Profit & Loss A/c Dr.		1,50,000	
	To Capital Redemption Reserve A/c			1,50,000
	(Amount Transferred Out of Profits to CRR Ref: Basic Calculation: (i)			
30 June 2009	8% Redeemable Preference Share Capital A/c Dr.		5,50,000	
	Premium on Redemption Of Pref. Shares A/c Dr.		27,500	
	To Redeemable Preference Shareholders A/c			5,77,500
	(Amount Due to Pref. Shareholders for Redeeming Pref. Shares)			
30 June 2009	Securities Premium A/c Dr.		27,500	
	To Premium On Redemption of Pref. Shares A/c			27,500
	(Premium On Redemption of Shares Set off Against Securities Premium A/c)			
30 June 2009	Redeemable Preference Shareholders A/c Dr.		5,77,500	
	To Bank A/c			5,77,500
	(Redemption of (10,000 – 2,000 – 2,500) 5,500 Pref. Shares @ a Premium of 5%)			
30 June 2009	Capital Redemption Reserve A/c Dr.		3,00,000	
	To Bonus to Shareholders A/c			3,00,000
	(50% of CRR Used for Issue of Bonus Shares)			

30 June 2009	Bonus to Shareholders A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Issue of 25,000 Bonus Shares of ₹10 Each at a Premium of ₹2 Per Share)		3,00,000	 2,50,000 50,000

Illustration 3.12

Model: Utilization of profit and loss A/c balance for redemption—Restricted use

Rajabather Ltd. has an issued share capital of 1,300 9% redeemable preference shares of ₹100 each and 45,000 equity shares of ₹10 each.

The preference shares are redeemable at a premium of 10% on 1 April 2011.

The Company's balance sheet as on 31 March 2011 was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	6,50,000
1,300 9% Redeemable Preference Shares of ₹100 Each Fully Paid	1,30,000	Investments	37,000
45,000 Equity Shares of ₹10 Each Fully Paid	4,50,000	Bank	63,000
Profit & Loss A/c	80,000		
Sundry Creditors	90,000		
	7,50,000		7,50,000

To carry out the redemption of preference shares, the Company decided:

(i) To sell all investments at ₹30,000

(ii) To finance part of the company from company funds, subject to leaving a balance of ₹23,000 in the P&L A/c

(iii) To issue sufficient equity shares of ₹10 each at a premium of 20% per share to raise the balance of funds required

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

You are required to pass the necessary journal entries to record the above transactions and prepare the balance sheet of the company soon after the redemption is completed.

Solution

Determination of equity shares to be issued:		₹
Profit & Loss A/c (As shown in balance sheet)		80,000
Less: Loss on sale of investments ₹37,000 – ₹30,000 =	₹7,000	
Amount to be retained in the company	= ₹23,000	30,000
Amount to be transferred to CRR =		50,000
Nominal amount of equity shares to be issued:		
(1,300 × ₹100 – ₹50,000) =		80,000

$\therefore$ Number of shares to be issued = $\frac{₹80,000}{₹10}$ = 8, 000

Rajabather Ltd.
Journal Entries

Date	Particulars	L.F	Dr. ₹	Cr. ₹
1 April 2011	Bank A/c Dr.		30,000	
	Profit & Loss A/c Dr.		7,000	
	To Investments A/c			37,000
	(Sale of Investments and Loss On Sale is Transferred to P&L A/c)			
1 April 2011	Bank A/c Dr.		96,000	
	To Equity Share Capital A/c			80,000
	To Securities Premium A/c			16,000
	(Issue of 8,000 Equity of ₹ 10 Each at a Premium of ₹ 2 Per Share) (Ref: Calculation Above)			
1 April 2011	Profit & Loss A/c Dr.		50,000	
	To Capital Redemption Reserve A/c			50,000
	(Amount Available for Transfer to CRR)			
1 April 2011	9% Redeemable Preference Share Capital A/c Dr.		1,30,000	
	Premium On Redemption A/c Dr.		13,000	
	To Redeemable Pref. Shareholders A/c			1,43,000
	(Amount for Redemption Transferred to Preferences Shareholders)			
1 April 2011	Securities Premium A/c Dr.		13,000	
	To Premium On Redemption A/c			13,000
	(Premium On Redemption Charged to Securities Premium A/c)			
1 April 2011	Redeemable Preference Shareholders A/c Dr.		1,43,000	
	To Bank A/c			1,43,000
	(Payment to Preference Shareholders On Redemption)			

Bank A/c

Particulars	₹	Particulars	₹
To Balance B/d	63,000	By Redeemable Preference Shareholder A/c	1,43,000
To Investment	30,000		
To Equity Share Capital A/c	80,000	By Balance c/d	46,000
To Securities Premium A/c	16,000		
	1,89,000		1,89,000
To Balance B/d	46,000		

Balance Sheet of Rajabather Ltd.
as on 1 April 2011

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Issued, Subscribed and Paid up:	5,30,000	Current Assets:	6,50,000
53,000 (45,000 + 8,000) Equity Shares of ₹ 10 Each Fully Paid			
Reserve & Surplus:		Bank (Ref: Bank A/c)	46,000
Capital Redemption Reserve	50,000		
Securities Premium A/c			
(₹ 16,000 – ₹ 13,000)	3,000		
Profit & Loss A/c	23,000		
Current Liabilities:			
Sundry Creditors	90,000		
	6,96,000		6,96,000

Illustration 3.13

Model: Untraceable shareholders

The following is the summarized balance sheet of Jaya Ltd. as on 31 March 2011:

Liabilities	₹	Assets	₹
Share Capital: Authorized:		Fixed Assets	4,00,000
1,000 6% Redeemable Preference Shares of ₹ 100 Each Fully Paid	1,00,000	Current Assets	2,50,000
50,000 Equity Shares of ₹ 10 Each Fully Paid up	5,00,000		
Issued & Subscribed:			
900 6% Redeemable Preference Shares of ₹ 100 Each Fully Paid	90,000		
40,000 Equity Shares of ₹ 10 Each Fully Paid up	4,00,000		
Securities Premium A/c	10,000		
Profit & Loss A/c	1,00,000		
Creditors	50,000		
	6,50,000		6,50,000

The preference shares were redeemed on 7 April 2011 at a premium of 10%. A bonus issue of one equity share for every five shares held was made on the same date. No trace could be found of the holders of 25 preference shares.

You are required to give the necessary journal entries and construct the resultant balance sheet in a summarized form.

Solution

Note: In this question, some shareholders having 25 preference shares are shown as not traceable.

The amount due to such untraceable shareholders should not be included in the journal entries.

That amount should be shown in the balance sheet under the head "Current Liabilities" till they claim their dues.

Jaya Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
7 April 2011	6% Redeemable Preference Shares Capital A/c	Dr.		90,000	
	Premium On Redemption of Pref. Shares A/c	Dr.		9,000	
	To Redeemable Preference Shareholders A/c				99,000
	(Amount Payable to Pref. Shareholders)				
7 April 2011	Profit & Loss A/c	Dr.		90,000	
	To Capital Redemption Reserve A/c				90,000
	(Amount Transferred to CRR)				
7 April 2011	Securities Premium A/c	Dr.		9,000	
	To Premium on Redemption of Preference Shares A/c				9,000
	(Premium on Redemption of Pref. Shares Charged to Securities Premium A/c				
7 April 2011	Redeemable Preference Shareholders A/c	Dr.		96,250	
	To Bank A/c				96,250
	(Payment Made to (900 – 25) 875 Pref. Shares @ ₹110 Per Share)				
7 April 2011	Capital Redemption Reserve A/c	Dr.		80,000	
	To Bonus to Shareholders A/c				80,000
	(CRR Appropriated to Issue $\frac{40,000}{5}$ 8,000 Bonus Shares to the Existing Shareholders in the Ratio of 5:1)				
7 April 2011	Bonus to Shareholders A/c	Dr.		80,000	
	To Equity Share Capital A/c				80,000
	(Issue of 8,000 Bonus Shares of ₹10 Each, Fully Paid up)				

Balance Sheet of Jaya Ltd.

as on 31 March 2011 (After Redemption)

Liabilities	₹	Assets	₹
Share Capital: Authorized:		Fixed Assets	4,00,000
1,000 6% Redeemable Preference Shares of ₹100 Each Fully Paid	1,00,000	Current Assets: ₹2,50,000	
		Less: Cash Paid On Redemption: ₹96,250	1,53,750

50,000 Equity Shares of ₹ 10 Each Fully Paid up	5,00,000		
Issued & Subscribed:			
(40,000+8,000) 48,000 Equity Shares of ₹ 10 Each Fully Paid	4,80,000		
Reserves & Surplus:			
Securities Premium (₹ 10,000 – ₹ 9,000)	1,000		
Profit & Loss A/c			
(₹ 1,00,000 – ₹ 90,000)	10,000		
Capital Redemption Reserve			
(₹ 90,000 – ₹ 80,000)	10,000		
Current Liabilities:			
Creditors	50,000		
Preference Shareholders (25 Shares × 110)	2,750		
	5,53,750		5,53,750

Illustration 3.14

Model: Minimum fresh issue of shares

Redeemable preference shares to be redeemed: ₹ 5,00,000

Premium on redemption: 8%

Divisible profits available: ₹1,00,000

Fresh issue of equity shares of ₹10 each is to be made at 20% premium

From the above data, you are required to calculate:

(a) Minimum fresh issue of shares

(b) The amount of issue

Solution

(a) Determination of minimum fresh issue:

Write the formula:

Minimum fresh issue = Redeemable pref. shares to be redeemed – Divisible profits – General Reserve – Securities premium

Substitute the available data in the formula,

= ₹ 5,00,000 – ₹ 1,00,000 – N.A – N.A.

= ₹ 4,00,000

or

= ₹ 4,00,000 ÷ ₹ 10 = 40,000 shares

(b) To determine the amount of issue, we have to work out the following steps:

Step 1: Premium on minimum issue (₹ 4,00,000 × 20%) (Ref: (a)) = ₹ 80,000

Step 2: Add: Existing premium = NIL

Step 3: Total premium (Step 1 + Step 2) = ₹ 80,000

Step 4: Requisite amount for premium redemption
of preference shares ₹ 5,00,000 × 8% = ₹ 40,000

Step 5: As total premium (Step 3) is higher than the requisite amount for premium on redemption of preference shares (Step 4), no need to apply the special equation to determine the amount of fresh issue. (If the total premium is not sufficient to pay off premium on redemption, special equation has to be applied to ascertain the amount of fresh issue.)

Step 6: Hence, the minimum amount of fresh issues of shares is ₹ 4,00,000 (Ref: (a)).

Illustration 3.15

Model: Minimum fresh issue of shares (Application of equation)

Redeemable preference shares = ₹ 10,00,000
Premium on redemption = 10%
Divisible profits available = ₹ 1,50,000
Balance in general reserve = ₹ 1,00,000
Securities premium = ₹ 50,000

Fresh issue is to be made at 5% premium. From the above data, you are required to determine:

(a) Minimum fresh issue of shares
(b) The amount of issue

Solution

(a) Determination of minimum fresh issue:

Write the formula:

Minimum fresh issue = Redeemable pref. shares to be redeemed – Divisible profits – General reserve – Securities premium

Substitute the figures in the formula,

= ₹ 10,00,000 – ₹ 1,50,000 – ₹ 1,00,000 – ₹ 50,000
= ₹ 7,00,000

(b) To determine the amount of issue, the following sequence of steps has to be followed:

Step 1: Premium on minimum issue (₹ 7,00,000 × 5%) = ₹ 35,000
Step 2: Existing securities premium (Given)} = ₹ 50,000
Step 3: Total premium (Step 1 + Step 2) = ₹ 85,000
Step 4: Requisite amount for premium on redemption of pref. shares (₹ 10,00,000 × 10%) = ₹ 1,00,000
Step 5: As the total premium (Step 3) is lower than the requisite premium on redemption of preference shares (Step 4), we have to apply the equation to find out the amount of fresh issue.

Stage II: Application of equation to find the amount of fresh issue:

Step 1: Assume the new issue to be made as x.

Step 2: Write the formula:

Face value of redeemable pref. shares + Premium payable/on redemption
= Securities premium in balance sheet + General Reserve + Divisible Profits + $x \times x \times$ Percentage of premium on new issue

Step 3: Substitute the figures in the equation,

$\{₹\ 10,00,000 + ₹\ 1,000,000\} = \{₹\ 50,000 + ₹\ 1,000,000 + ₹\ 1,50,000 + x + x \times (x)5\%\}$

Step 4: $₹\ 11,00,000 = ₹\ 3,00,000 + x + x\left(\frac{5}{100}\right)$ or $0.05x$

Step 5: ₹ 11,00,000 – ₹ 3,00,000 = x + 0.5x

Step 6: ₹ 7,00,000 = 1.5x

Step 7: $x = \frac{7,\ 00,000}{1.05}$ = ₹ 6, 66, 666. 67

Step 8: ∴ Minimum amount of fresh issue = 6, 66, 670

Illustration 3.16

Model: Minimum fresh issue—Fresh issue to be made at a discount

Redeemable preference shares: ₹ 12,00,000
Premium on redemption: 5%
Profit & Loss A/c balance: ₹ 4,00,000
General reserve balance: ₹ 2,80,000
Securities premium A/c: ₹ 40,000
Fresh issue is to be made at a discount of 10%

From the above data, you are required to ascertain the amount of fresh issue of shares applying the equation.

Solution

Step 1: Assume the new issue as x

Step 2: Face value of premium redeemble + on pref. shares redemption
= Securities premium + General reseve + P & L A/c + x – 0.1x
(₹ 12, 00,000 + ₹ 60,000) = (₹ 40,000 + ₹ 2, 80,000 + ₹ 4, 00,000 + x – 0.1x)

Step 3: ₹ 12, 60,000 = ₹ 7, 20,000 + 0.9x

Step 4: ₹ 12, 60,000 – ₹ 7, 20,000 = 0.9x

Step 5: ₹ 5, 40,000 = 0.9x

$$\frac{₹.\ 5,\ 40,000}{0.9} = x$$

Step 6: x = ₹ 6, 00,000

Step 7: Fersh issue to be made = ₹ 6, 00,000

For Advanced Level

Illustration 3.17

Model: Minimum fresh issue of shares at premium

The balance sheet of Manu as on 31 March 2011 is as follows:

Liabilities	₹	Assets	₹
4,000 Equity Shares of ₹ 100 Each Fully Paid up	4,00,000	Fixed Assets	4,50,000
		Investments	30,000
2,000 – 8% Redeemable Preference Shares of ₹ 100 Each Fully Paid	2,00,000	Current Assets	2,20,000
		Miscellaneous Expenditure (not yet Written off)	80,000
Securities Premium	9,700		
Profit & Loss A/c	1,20,000		
Current Liabilities	50,300		
	7,80,000		7,80,000

On the above date, it was decided to redeem the preference shares at a premium of 10%. The directors has decided that only the minimum number of fresh equity shares of ₹100 each at a premium of 5% be issued to provide for redemption of such preference shares as could not otherwise be redeemed. You are required to give the necessary journal entries and prepare the balance sheet soon after redemption.

[B.Com (Hons). Modified]

Solution

Stage I: Ascertainment of minimum fresh issue of shares (Apply the equation)

Assume minimum fresh issue as 'x'.

Equation: Face value of redeemed pref. shares + Premium payable on redemption

= Securities premium + P & L A/c + x + 0.05x

Substitute the figures,

(₹ 2,00,000 + ₹ 20,000) = (₹ 9, 700 + ₹ 1, 20,000 + x + 0.05x)

₹ 2,20,000 = ₹ 1,29,700 + 1.05x

₹ 2,20,000 – ₹ 1,29,700 = 10.5x

1.05x = ₹ 90,300

x = ₹ 90,300/1.05 = ₹ 86, 000

$$\therefore \text{ Number of shares} = \frac{₹\ 86,\ 000}{₹100} = 860 \text{ shares}$$

Stage II: **Journal Entries**

Date	Particulars		L.F	Dr. ₹	Cr. ₹
31 March 2011	Bank A/c	Dr.		90,300	
	To Equity Share Capital A/c (860 × ₹ 100)				86,000
	To Securities Premium A/c (860 × ₹ 5)				4,300
	(Issue of 860 Equity Shares of ₹ 100 Each at a Premium of 5%)				
31 March 2011	Profit & Loss A/c	Dr.		1,14,000	
	To Capital Redemption Reserve A/c				1,14,000
	(Amount (₹ 2,00,000 – ₹ 86,000) ₹ 1,14,000 Transferred to CRR)				
31 March 2011	Securities Premium A/c	Dr.		14,000	
	Profit & Loss A/c	Dr.		6,000	
	To Premium On Redemption of Pref. Shares A/c				20,000
	(Premium Payable On Redemption of Pref. Shares Created)				
31 March 2011	8% Redeemable preference shares capital A/c	Dr.		2,00,000	
	Premium On Redemption of Pref. Shares A/c	Dr.		20,000	
	To Redeemable Preference Shareholders A/c				2,20,000
	(Amount Payable On Redemption of Pref. Shares, i.e., 2,000 Pref. Shares of ₹ 100 Each at a Premium of 10% to Shareholders)				
31 March 2011	Redeemable Preference Shareholders A/c	Dr.		2,20,000	
	To Bank A/c				2,20,000
	(Payment On Redemption to Shareholders)				

Stage III:

Balance Sheet
as on 31 March 2011 (After Redemption)

Liabilities	₹	Assets	₹
(4,000 + 860) 4,860 Equity Shares of ₹ 100 Each Fully Paid up	4,86,000	Fixed Assets	4,50,000
Capital Redemption Reserve	1,14,000	Investments	30,000
Current Liabilities	50,300	Current Assets:	90,300
		(₹ 2,20,000 + 90,300 – ₹ 2,20,000)	
		Miscellaneous Expenditure (Not Yet Written off)	80,000
	6,50,300		6,50,300

Illustration 3.18

Model: Minimum fresh issue of shares at a discount

The balance sheet of M/s Laxmi Ltd. as on 31 March 2010 was as follows:

Liabilities	₹	Assets	₹
2,000 8% Redeemable Preference Shares of ₹ 100 Each Fully Paid	2,00,000	Sundry Assets	9,00,000
		Cash at Bank	2,00,000
4,000 6% Redeemable Preference Shares of ₹ 50 Each, ₹ 25 Per Share Paid up	1,00,000		
40,000 Equity Shares of ₹ 10 Each	4,00,000		
Reserves & Surplus:			
Capital Reserve	1,20,000		
Securities Premium	20,000		
Dividend Equalization Reserve	1,10,000		
Current Liabilities	1,50,000		
	11,00,000		11,00,000

The company decided to redeem the preference shares at a premium of 5%. To enable the redemption to be carried out, the company decided to issue after carrying out, the necessary formalities required under law, sufficient number of new equity shares at a discount of 10%.

You are required to give the necessary journal entries and prepare the balance sheet soon after the redemption

Solution

Important notes:

1. 4,000 6% Preference shares cannot be redeemed. The reason being that they are only partly paid and not fully paid.
2. Premium payable on redemption = ₹ 2,00,000 × 5/100 = ₹ 10,000. This amount alone can be paid out of securities premium. Hence ₹ 10,000 alone can be shown as premium payable on redemption in formula

3. CRR is to be created from dividend equalization reserve.

Step 1: Ascertainment of minimum new issue of shares:

Assume new issue to be made as x.

Write the equation:

{Face value of redeemed pref. shares + Premium on redemption}

= {Securities premium (Part) + Revenue reserves + $x - 0.1x$}

Substitute the figures in the equation, we get

$$(2,00,000 + ₹10,000) = \left\{\begin{pmatrix}₹10,000\\ \text{Ref: Note2}\end{pmatrix} + (₹1,10,000) + x - 0.1x\right\}$$

$₹2,10,000 = (₹1,20,000 - 0.9x)$

$$x = \frac{₹90,000}{9} = ₹1,00,000$$

New issue to be made = ₹ 1, 00,000

$$\text{Number of new equity shares} = \frac{1,00,000}{₹10} = 10,000$$

Step 2: Calculation of CRR:

Nominal value of new equity shares	=	₹1,00,000
Less: Discount at 10% on ₹1,00,000	=	₹10,000
∴ Net proceeds	=	₹90,000

CRR = Face value of redeemable pref. shares – Net proceeds

= ₹2,00,000 – ₹90,000

= ₹1,10,000

This amount is to be created from dividend equalization reserve.

Step 3:

Journal entries:

M/s Laxmi Ltd

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2010	Bank A/c Dr.		90,000	
	Discount on Issue of Shares A/c Dr.		10,000	
	To Equity Share Capital A/c			1,00,000
	(Issue of 10,000 Equity Shares of ₹10 Each at a Discount of 10% for Redemption)			
31 March 2010	Dividend Equalization Reserve A/c Dr.		1,10,000	
	To Capital Redemption Reserve A/c			1,10,000
	(Amount Transferred to CRR from Dividend Equalization Reserve On Redemption Ref Step 2)			
31 March 2010	Redeemable Preferences Share Capital A/c Dr.		2,00,000	
	Premium On Redemption A/c Dr.		10,000	
	To Redeemable Preference Shares A/c			2,10,000
	(Amount Payable On Redemption)			

31 March 2010	Securities Premium A/c Dr. To Premium On Redemption A/c (Premium Payable On Redemption Charged to Securities Premium A/c)		10,000	 10,000
31 March 2010	Redeemable Preference Shareholders A/c Dr. To Bank A/c (Amount Paid On Redemption to Preference Shareholders)		2,10,000	 2,10,000
31 March 2010	Securities Premium A/c Dr. To Discount On Issue of Shares A/c (Discount On Issue of Shares Written off Against Securities Premium A/c)		10,000	 10,000

Step 4: **Balance Sheet of M/s Laxmi Ltd.**
as on 31 March 2010

Liabilities	₹	Assets	₹
Share Capital:		Sundry Assets	9,00,000
Authorized Issued & Paid Up:		Cash at Bank	
4,000 6% Redeemable Preference Shares of ₹ 50 each, ₹ 25 Paid	1,00,000	(₹ 2,00,000 + CRR ₹ 90,000 – Redemption ₹ 2,10,000)	80,000
(40,000 + 10,000) 50,000 Equity Shares of ₹ 10 Each Fully Paid	5,00,000		
Reserves & Surplus:			
Capital Redemption Reserve	1,10,000		
Capital Reserve	1,20,000		
Current Liabilities	1,50,000		
	9,80,000		9,80,000

Illustration 3.19

Model: Forfeiture and re-issue of redeemable preference shares

Following is the balance sheet of M/s Thomas Co. Ltd. as on 31 March 2011 in a summarized form:

Liabilities	₹	Assets	₹
Share capital:		Bank	1,20,000
Paid-Up Share Capital 4,000 Equity Shares of ₹ 100 Each Fully Paid	4,00,000	Other Assets	8,25,000
2,000 8% Redeemable Preference Shares of ₹ 100 Each: 2,00,000			
Less: Calls in Arrears of 100 Shares} 5,000	1,95,000		
Reserves & Surplus:			
General Reserve	2,50,000		
Development Rebate Reserve	40,000		
Other Liabilities	60,000		
	9,45,000		9,45,000

The redeemable preference shares were redeemed on the following basis:

(i) Further 1,500 equity shares were issued at a premium of 10%.

(ii) Expenses of fresh issue of shares ₹ 4000.

(iii) Out of 100 preference shares, holders of 80 shares paid the call money before the date of redemption. The balance of 20 shares were forfeited and they were re-issued as fully paid shares on receipt of ₹ 1,500 before redemption.

(iv) Preference shares were redeemed at a premium of 10% and share premium was utilized in full for this purpose.

You are required to pass journal entries and prepare summarized balance sheet after redemption.

Solution

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2011	Bank A/c Dr.		1,65,000	
	To Equity Share Capital A/c			1,50,000
	To Securities Premium A/c			15,000
	(Issue of 500 Equity Shares of ₹ 100 Each at a Premium of 10% for Redemption of Preference Shares)			
31 March 2011	Share Issue Expenses A/c Dr.		4,000	
	To Bank A/c			4,000
	(Payment of Expenses of Issue of Shares)			
31 March 2011	Bank A/c Dr.		4,000	
	To Calls in Arrears A/c			4,000
	(Amount Due On Final Call for 80 Shares @ ₹ 50 Per Share Received)			
31 March 2011	Redeemable Preference Share Capital A/c Dr.		2,000	
	To Calls in Arrears A/c			1,000
	To Forfeited Shares A/c			1,000
	(Forfeiture of 20 Preference Shares of ₹ 100 Each for Non-payment of Final Call of ₹ 50)			
31 March 2011	Bank A/c Dr.		1,500	
	Forfeited Shares A/c Dr.		500	
	To Redeemable Preference Shares Capital A/c			2,000
	(20 Forfeited Shares Were Re-issued for ₹ 1,500)			
31 March 2011	Forfeited Shares A/c Dr.		500	
	To Capital Reserve A/c			500
	(Profit On Forfeited Shares Transferred to Capital Reserve A/c) (₹ 1,000 – ₹ 500)			
31 March 2011	8% Redeemable Preference Share Capital A/c Dr.		2,00,000	
	Premium On Redemption A/c Dr.		20,000	
	To Redeemable Preference Shareholders A/c			2,20,000

31 March 2011	General reserve A/c Dr. To Capital Redemption Reserve A/c (Amount Transferred Out of Profits to CRR) (₹ 2,00,000 – ₹ 1, 50,000) ↓ ↓ Face Value Fresh Issue		50,000	50,000
31 March 2011	Securities Premium A/c Dr. General Reserve A/c Dr. To Premium On Redemption A/c (Premium Payable On Redemption Charged to Securities Premium A/c and General Reserve A/c)		15,000 5,000	20,000
31 March 2011	Redeemable Preference Shareholders A/c Dr. To Bank A/c (Payment to Shareholders On Redemption)		2,20,000	2,20,000

Before preparing the balance sheet, bank balance has to be determined by preparing bank A/c as follows:

Particulars	₹	**Particulars**	₹
To Balance b/d (Given)	1,20,000	By Shares Issue Expenses A/c	4,000
To Equity Share Capital A/c	1,50,000	By Redeemable Preference Shareholders A/c	2,20,000
To Securities Premium A/c	15,000		
To Calls-in-Arrears A/c	4,000	By Balance c/d (Balancing Figure)	66,500
To Redeemable Preference Share Capital A/c	1,500		
	2,90,500		2,90,500
To Balance b/d	66,500		

Balance Sheet of M/s Thomas Co. Ltd.
as on 31 March 2011

Liabilities	₹	**Assets**	₹
Share Capital:		Bank (Ref: Bank A/c)	66,500
(4,000 + 1,000) 5,500 Equity Shares of ₹ 100 Each	5,50,000	Other Assets	8,25,000
		Share Issue Expenses	4,000
Reserves & Surplus:			
General Reserve (₹ 2,50,000 – ₹ 50,000 – ₹ 5,000)	1,95,000		
Capital Redemption Reserve	50,000		
Capital Reserve	500		
Development Rebate Reserve	40,000		
Other Liabilities	60,000		
	8,95,500		8,95,500

Illustration 3.20

Model: Redemption by conversion

A: Redeeming preference shares by converting them into equity shares at a premium:

Journal entry:

(i) Redeemable preference share capital A/c Dr. …

To Equity Share Capital A/c …

To Securities Premium A/c …

(Redemption of preference shares by converting into equity shares of ₹ … at … % premium)

(ii) Profit & Loss appropriation A/c Dr. …

To Capital Redemption Reserve A/c …

(Transfer of amount from P&L A/c to CRR)

Example: ABC Ltd. redeemed ₹ 10,00,000 preference shares by converting them into equity shares of ₹ 100 each at 25% premium.

Pass journal entries for the redemption.

Solution

ABC Ltd

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) Redeemable Preference Share Capital A/c Dr.		10,00,000	
	To Equity Share Capital A/c			8,00,000
	To Securities Premium A/c			2,00,000
	(Redemption of Preference Shares of ₹ 10,00,000 in to Equity Shares of ₹ 100 Each at a Premium of 25%)			
	(ii) Profit & Loss Appropriation A/c Dr.		2,00,000	
	To Capital Redemption Reserve A/c			2,00,000
	(Transfer from P&L Appropriation A/c to CRR)			

B: Redemption of preference shares by converting them into equity share at a discount:

Journal entry:

Redeemable Preference Share Capital A/c Dr. …

Discount on Issue of Shares A/c Dr. …

To Equity Share Capital A/c …

(Redemption of preference shares by converting into equity share issued at discount)

Example: XYZ Ltd. redeemed ₹ 9,00,000 preference shares by converting them into equity shares issued at 10% discount. Pass journal entries.

Solution

XYZ Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Redeemable Preference Share Capital A/c Dr.		9,00,000	
	Discount On Issue of Shares A/c Dr.		1,00,000	
	To Equity Share Capital A/c			1,00,000
	(Redemption of ₹ 9,00,000 Preference Shares by Converting them into Equity Shares Issued at 10% Discount)			

C: Redemption at a premium by converting them into equity shares at a discount:

Example:

PQR Ltd. redeemed 2,000 preference shares of ₹ 100 each at a premium of ₹ 12.50 per share by converting into equity shares of ₹ 10 each at a discount of 10%.

Pass necessary entries for redemption.

Solution

PQR Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) Redeemable Preference Share Capital A/c Dr.		2,00,000	
	Premium On Redemption A/c Dr.		25,000	
	To Redeemable Pref. Shareholders A/c			2,25,000
	(Redemption of 2,000 Pref. Share of ₹ 100 Each at a Premium of ₹ 12.50 Per Share)		2,25,000	
	(ii) Redeemable Pref. Shareholders A/c Dr.		25,000	
	Discount On Issue of Shares A/c Dr.			2,50,000
	To Equity Share Capital A/c			
	(Issue of Equity Shares @ 10% Discounts)		25,000	
	(iii) Profit & Loss A/c Dr.			25,000
	To Premium On Redemption A/c			
	(Transfer from P&L A/c of ₹ 25,000 to Premium on Redemption A/c)			

Illustration 3.21

Model: Bonus issue—Out of general reserve redemption of pref. share at premium

VRS Ltd. had 1,00,000 equity shares of ₹ 10 each fully paid and 50,000 9% redeemable preference shares of ₹ 10 each fully paid, redeemable at a premium of 10%.

The company had a credit balance of ₹ 4,00,000 on profit and loss account and ₹ 5,00,000 on general reserve.

The Company resolved:

(a) To issue 30,000 equity shares of ₹ 10 each at ₹ 12 per share in order to provide part of the funds for the redemption of preference shares.
(b) To redeem preference shares
(c) To make a bonus issue of one share for every two held by the existing equity shareholders from the general reserve. The resolutions were carried into effect.

You are required to pass journal entries and prepare ledger accounts and also show the share capital and reserve of the company as they would appear in its balance sheet after the completion of the redemption.

Solution

Stage I: Recording journal entries:

VRS Ltd.
Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Bank A/c	Dr.		3,60,000	
	To Equity Share Capital A/c				3,00,000
	To Securities Premium A/c				60,000
	(Issue of 30,000 Equity Shares of ₹ 10 Each at ₹ 12 Per Share)				
	9% Redeemable Preference Share Capital A/c	Dr.		5,00,000	
	Premium On Redemption A/c	Dr.		50,000	
	To Redeemable Pref. Shareholders A/c				5,50,000
	(Amount Due to Pref. Shareholders)				
	Securities Premium A/c	Dr.		50,000	
	To Premium On Redemption A/c				50,000
	(Transfer to Premium On Redemption)				
	Profit & Loss A/c	Dr.		2,00,000	
	To Capital Redemption Reserve A/c				2,00,000
	(Transfer of Profit to CRR)				
	Redeemable Preference Shareholder A/c	Dr.		2,00,000	
	To Bank A/c				2,00,000
	(Payment On Redemption to Shareholders)				
	General Reserve A/c	Dr.		5,50,000	
	To Bonus to Shareholders A/c				5,50,000
	(Bonus Declared Out of General Reserve)				
	Bonus to Shareholders A/c	Dr.		5,00,000	
	To Equity Share Capital A/c				5,00,000
	(Issue of Bonus Share: One Equity Share for Every Two Held)				

Stage II: Preparation of various ledger accounts:

1. Equity Share Capital A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	18,00,000		By Balance b/d	10,00,000
				By Bank A/c	3,00,000
				By Bonus to Shareholders A/c	5,00,000
		18,00,000			18,00,000
				By Balance b/d	18,00,000

2. Securities Premium A/c

Date	Particulars	₹	Date	Particulars	₹
	To Premium On Redemption A/c	50,000		By Bonus A/c	60,000
	To Balance c/d	10,000			
		60,000			60,000
				By Balance b/d	10,000

3. 9% Redeemable Preference Share Capital A/c

Date	Particulars	₹	Date	Particulars	₹
	To Preference Shareholder A/c	5,00,000		By Balance b/d	5,00,000
		5,00,000			5,00,000

4. Bank A/c

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital A/c	3,00,000		By Redeemable Pref. Shareholders A/c	5,50,000
	To Securities Premium A/c	60,000			
	To Balance c/d	1,90,000			
		5,50,000			5,50,000
				By Balance b/d	1,90,000

5. 9% Redeemable Preference Shareholder's Account

Date	Particulars	₹	Date	Particulars	₹
	To Bank A/c	5,50,000		By 9% Redeemable Pref. Share Capital A/c	5,00,000
				By Premium On Redemption	50,000
		5,50,000			5,50,000

6. Capital Redemption Reserve A/c

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	2,00,000		By Profit & Loss A/c	2,00,000
		2,00,000			2,00,000
				By Balance b/d	2,00,000

7. General Reserve A/c

Date	Particulars	₹	Date	Particulars	₹
	To Bonus to Shareholders A/c	5,00,000		By Balance c/d	5,00,000
		5,00,000			5,00,000

Stage III: Preparation of balance sheet (Extract)

(Extract) Balance Sheet of VRS Ltd.

as on…

Liabilities	₹	Assets	₹
Share Capital:			
Authorized, Subscribed, & Issued:			
(1,00,000 + 30,000 + Bonus 50,000)1,80,000 Equity Shares of ₹10 Each Fully Paid	18,00,000		
Reserves & Surplus:			
Securities Premium			
Capital Redemption Reserve	10,000		
Profit & Loss A/c	2,00,000		
Liabilities:	2,00,000		
Bank	1,90,000		

Illustration 3.22

Model: Redemption of preference shares at a premium and issue of bonus shares out of CRR

The following is the summarized balance sheet of Swamy Ltd. as on 31 December 2010:

Liabilities	₹	Assets	₹
Share Capital:		Sundry Assets	14,50,000
Authorized:		Bank	3,50,000
2,000 8% Redeemable Preference Shares of ₹100 Each	2,00,000		
10,000 Equity Shares of ₹ 100 Each			
Paid-Up Capital:	10,00,000		
1,500 8% Redeemable Pref. Shares of ₹ 100 Each	1,50,000		

6,000 Equity Shares of ₹100 Each Fully Paid Profit & Loss A/c Reserve Fund Sundry Creditors	6,00,000 5.00,000 5,00,000 50,000		
	18,00,000		18,00,000

On 5 January 2011, the preference shares were redeemed at a premium of ₹20 per share. The company could not trace the shareholders of 500 preference shares. On 7 January 2011, a bonus issue paid equity share for five shares held was made.

You are required to pass the necessary journal entries in the books of Swamy Ltd. and also prepare balance sheet, soon after redemption.

Solution

Swamy Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
5 January 2011	8% Redeemable Preference Share Capital A/c Dr. Premium On Redemption of Preference Share A/c Dr. To Redeemable Preference Shareholders A/c (Amount Due to Pref. Shareholders Transferred. 1,500 × ₹100:1,50,000; 1,500 × ₹20 = ₹30,000		1,50,000 30,000	 1,80,000
5 January 2011	Profit & Loss A/c Dr. To Capital Redemption Reserve A/c (Transfer of Profit to CRR)		1,50,000	1,50,000
5 January 2011	Profit & Loss A/c Dr. To Premium On Redemption of Pref. Shares A/c (Premium On Redemption P rovided Out of P&L A/c)		30,000	30,000
5 January 2011	Redeemable Preference Shareholders A/c Dr. To Bank A/c (payment to Pref. Shareholders Holding 1,500 – 500 Shares Not Traceable (i.e., 1,000 Pref. Shares × ₹100 + ₹20 premium)		1,20,000	1,20,000
7 January 2011	Capital Redemption Reserve A/c Dr. To Bonus to Shareholders A/c (Bonus Shares to Shareholder Declared 6,000 Shares One for Every Five Shareholders, i.e., 1,200 Shares @ ₹100 Per Share)		1,20,000	1,20,000
7 January 2011	Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Issue of 1,200 Share of ₹100 Each as Bonus Shares)		1,20,000	1,20,000

Swamy Ltd.
Balance Sheet (After Redemption)

Liabilities	₹	Assets	₹
Share Capital:		Sundry Assets	14,50,000
Authorized: 2,000 8% Redeemable Pref. Shares of ₹ 100 Each	2,00,000	Bank A/c: (₹ 3,50,000 –₹ 1,20,000)	2,30,000
10,000 Equity Shares of ₹ 100 Issued & Subscribed:	10,00,000-		
(6000 + 1,200) 7,200 Equity Shares Including Bonus Share of ₹ 100 Each	7,20,000		
Reserves & Surplus:			
Capital Redemption Reserve (₹ 1,50,000 – ₹ 1,20,000)	30,000		
Reserve Fund	5,00,000		
Profit & Loss A/c (₹ 5,00,000 – ₹ 1,80,000)	3,20,000		
Current Liabilities:			
Sundry Creditors	50,000		
Preference Shareholders (500 × ₹ 120 = ₹ 60,000)	60,000		
	16,80,000		16,80,000

Illustration 3.23

Model: Redemption of preference shares rights issue

The balance sheet of Veera & Co. Ltd. as on 31 March 2011 disclosed the following data:

Authorized Share Capital:	₹
3,000 9% Redeemable Preference Share of ₹ 100 Each	3,00,000
10,000 Equity Shares of ₹ 100 Each	10,00,000
Paid-Up Capital:	
1,500 9% Redeemable Preference Shares of ₹ 100 Each	1,50,000
7,500 Equity Shares of ₹ 100 Each, ₹ 80 Paid Up	6,00,000
Capital Reserve	70,000
General Reserve	1,80,000
Securities Premium	10,000
Profit & Loss A/c	75,000

On 6 April 2011, the preference shares were to be redeemed at a premium of 10% for the purpose of redemption, the company decided to:

(i) Issue 2,500 10% Debentures of ₹ 100 each

(ii) Convert the partly paid-up equity shares into fully paid up without requiring the shareholders to pay for the same

(iii) Issue fully paid rights shares of ₹ 100 each at a premium of 20 % per share in the proportion of one share for every five shares held

You are required to give necessary journal entries to record the above transactions.

Solution

Veera & Co. Ltd.
Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
6 April 2011	9% Redeemable Pref. Share Capital A/c	Dr.		1,50,000	
	Premium On Redemption of Pref. Shares	Dr.		15,000	
	To Redeemable Pref. Shareholders A/c				1,65,000
	(Amount Due On Redemption)				
6 April 2011	General Reserve A/c	Dr.		1,50,000	
	To Capital Redemption Reserve A/c				1,50,000
	(Transfer of Amount to CRR for Redemption)				
6 April 2011	Securities Premium A/c	Dr.		10,000	
	Profit & Loss A/c	Dr.		5,000	
	To Premium On Redemption of Pref. Shares A/c				15,000
6 April 2011	Bank A/c	Dr.		2,50,000	
	To 10% Debentures A/c				2,50,000
	(Issue of 2,500 Debentures of ₹ 100 Each)				
6 April 2011	Redeemable Pref. Shareholders A/c	Dr.		1,65,000	
	To Bank A/c				1,65,000
	(On Redemption of Pref. Shares)				
6 April 2011	Equity Share Final Call A/c	Dr.		1,50,000	
	To Equity Share Capital A/c	Dr.			1,50,000
	(Amount Due On Final Call) 7,500 Shares × ₹ 20				
6 April 2011	Capital Redemption Reserve A/c	Dr.		1,50,00	
	To Bonus to Equity Shareholders A/c				1,50,000
	(Issue of Bonus Shares 7500 ÷ 5: 1,500 Shares × ₹ 100)				
6 April 2011	Bonus to Equity Shareholders A/c	Dr.		1,50,000	
	To Equity Share Final Call A/c				1,50,000
	(Bonus Adjusted to Equity Shareholders Against Final Call)				
6 April 2011	Bank A/c	Dr.		1,80,000	
	To Equity Share Capital A/c				1,50,000
	To Securities Premium A/c				30,000
	(Issue of Rights Shares in Proportion of 1:5 at a Premium of ₹ 20 Per Share) (1,500 Shares @ ₹ 100 Each + ₹ 20 Prem.)				

Summary

Issue and redemption of preference shares can be made by a company in accordance with the provision of Section 80 and Section 80A of the Companies Act.

A company may issue if the Article of the Company authorizes or a special resolution has to be passed to amend the articles to make the issue.

Only fully paid preference shares can be redeemed.

Redemption can be possible only out of revenue profits and not from capital profits.

Premium on redemptions is a capital loss, which can be met from "securities premium account".

Available profits for redemption have to be transferred to capital redemption reserve and CRR may be used to issue fully paid bonus shares.

Redemption of preference shares will not affect the authorized capital.

Minimum fresh issue of share: At the time of redemption, all the permissible reserves have to be utilized first and then only new issue of shares for the balance amount can be made. The formula for determining such minimum issue is:

Minimum issue to be made = Face value of redeemable preference shares + Premium payable on redemption – Securities premium in balance sheet – Reserve in balance sheet

$$\times \frac{100}{100 + \text{Premium percentage on new issue}}$$

(If new issue is at premium)

Important stages involved in solving problems relating to redemption of preference shares:

1. Ascertainment of CRR
2. Making provision for premium on redemption of preference shares
3. Determination of cash position for redemption
4. Ensuring transfer and cash payment
5. Dealing with bonus issue, if any.
6. Problems with respect to redemption refer Illustrations 3.1 to 3.23

Key Terms

Capital Redemption Reserve: A reserve to which a sum equal to the nominal amount of the shares redeemed is transferred out of profits. After the redemption, this account will take the place of redeemable preference share capital.

Minimum Fresh Issue of Shares: A scheme of new issue of shares in which companies may utilize all the permissible reserves first and only then, this may make issue of new shares for the needed balance.

Untraceable Shareholders: Shareholders who are not traceable to make payment at the time of redemption. Amount due to such shareholders will be shown in the balance sheet on the liabilities side under the heading "Current Liabilities" till their settlement.

Redemption by Conversion: A method of converting preference shares into equity shares to meet the requisite amount for redemption.

Premium on Redemption: The excess amount paid to preference shareholders at the time of redemption. Such premium has to be provided out of the securities premium account or out of other profits.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. A company cannot return its share capital to the shareholders according to Section 100 of the Companies Act.
2. Redeemable preference shares can be redeemed if such shares are partly paid.
3. Redeemable preference shares can be redeemed out of capital reserve.

4. Premium on redemption of preference shares can be provided out of securities premium A/c.
5. Creation of, or transfer of, amount to capital redemption reserve need not be necessary for redemption.
6. CRR can be utilized to issue fully paid bonus shares to equity shareholders.
7. Redemption of preference shares will reduce the authorized capital.
8. A company cannot issue preference shares which can be redeemed beyond a period of 20 years.
9. Profits available for dividend relate to revenue profits of a company.
10. The term "proceeds" represents the amount received including the amount of share premium on the new issue of shares.
11. Premium on redemption is a capital loss.
12. Bonus shares involve cash flow immediately.
13. Depreciation reserve is a capital profit.
14. Dividend equalization reserve is a capital profit.
15. Companies exhaust all the permissible reserves before launching new issue of shares for redemption.
16. The proceeds of fresh issue of debentures can be utilized for redemption of redeemable preference shares.
17. The amount due to "untraceable shareholders" should be first recorded in the books of journal.
18. Premium on issue of debentures can be utilized to pay premium on redemption of preference shares.
19. Workmen's compensation fund can be transferred to CRR at the time of redemption.
20. CRR, already existing in the books, can be to utilized as profits available for dividend.

Answers:

1. True	2. False	3. False
4. True	5. False	6. True
7. False	8. True	9. True
10. False	11. True	12. False
13. True	14. False	15. True
16. False	17. False	18. True
19. True	20. False	

II: Fill in the blanks with apt word(s)

1. A company limited by shares, can issue redeemable preference shares, only if it is authorized by its_____.
2. Redeemable preference shares cannot be redeemed unless they are_____.
3. Redeemable preference shares can be redeemed either out of the _____ of the company or out of proceeds of _____.
4. Premium on redemption of preference has to be provided either out of the _____of the company or out of the _____.
5. An amount equal to the face value of the preference shares to be redeemed must be transferred to _____.
6. Capital redemption reserve can be utilized to issue fully paid _____ to equity shareholders.
7. Redemption of preference shares will not _____ _____ the authorized.
8. U/s 80-5 (A) of the Companies Act, a company cannot issue irredeemable preference shares or shares which can be redeemed beyond a period of _____ years.
9. All the _____ profits are not included for the purpose of redemption.
10. After redemption, CRR will take the place of _____ share capital .
11. Bonus shares will not involve any _____ immediately.
12. Dividend equalization reserve is _____ profit.
13. Profit prior to incorporation is _____ profit.
14. Workmen's compensation fund is _____ profit.
15. Securities premium A/c is _____profit.
16. At times, "current assets" include (presumption) _____.
17. In case of calls-in-arrears, redeemable preference shares cannot be _____.
18. ABC Ltd. has issued 5,000 equity shares of ₹ 100 each at a premium of ₹ 20 each. For redemption, the amount that would be taken as "proceeds of fresh issue" is _____.
19. XYZ Ltd. has issued 5,000 8% preference shares of ₹ 100 at a discount of 20% the amount for "proceeds of fresh issue" would be _____.
20. At times, reserve fund is also allowed to be transferred to _____.

Answers:

1. Articles of Association
2. fully paid up

3. profits; fresh issue of shares
4. profits; securities premium A/c
5. capital redemption reserve
6. bonus shares
7. reduce or affect or alter
8. 20
9. capital
10. redeemable preference
11. cash flow
12. revenue
13. capital
14. revenue
15. capital
16. cash/bank balance
17. redeemed
18. ₹ 5,00,000
19. ₹ 4,00,000
20. CRR

III: Multiple choice questions—Choose the correct answer

1. Sections 80 and 80 A of the Companies Act provide for the issue and redemption of
   (a) redeemable reference shares
   (b) equity shares
   (c) debentures
   (d) bonds
2. A company limited by shares can issue preference shares which can be redeemed only if authorized by
   (a) the board of directors
   (b) the articles of the company
   (c) court order
   (d) ordinary resolution
3. In case preference shares are redeemed out of profits otherwise available for dividend, a sum equal to the face value of shares should be transferred to
   (a) capital reserve
   (b) capital redemption reserve
   (c) general reserve
   (d) none of these
4. A company cannot issue irredeemable preference shares which can be redeemed beyond a period of
   (a) 20 years (b) 10 years
   (c) 5 years (d) none of these
5. Amount due to "untraceable shareholders" may be
   (a) transferred to P&L A/c
   (b) kept as general reserve
   (c) transferred to CRR
   (d) shown as "Current Liabilities" in the balance sheet
6. At times, transfer to capital redemption reserves can be made from
   (a) general reserve (b) capital reserve
   (c) P&L A/c (d) none of these
7. Premium on redemption of preference shares shall be met out of
   (a) CRR (b) P&L A/c
   (c) capital reserve
   (d) securities premium A/c

Answers:

1. (a) 2. (b) 3. (c) 4. (a)
5. (d) 6. (a) 7. (d)

Short Answer Questions

1. Explain the term: Redeemable preference shares.
2. Enlist the important provisions of Section 80 of the Companies Act.
3. Explain the provisions envisaged in Section 80-5 (A) of the Companies Amendment Act 1996.
4. What do you understand by "proceeds of fresh issue of shares"?
5. What are the various ways to provide for "premium on redemption"?
6. Enlist the profits available for transfer to CRR.
7. Enumerate the various profits which cannot be transferred to CRR.
8. Explain the meaning of "minimum fresh issue of shares".
9. How would you ascertain "any shortage of cash" for redemption purpose?
10. Write a short note on "untraceable shareholders".

11. How would you deal with "calls-in-arrears" as the time of redemption?
12. Pass journal entries for redemption of preference shares at a premium.
13. Give the necessary journal entries for conversion of preference shares into equity shares.
14. Give journal entries with respect to bonus shares (both declaration and issue in proportion).
15. In 2010,ABC Ltd. redeemed ₹ 90,000 preference shares by converting them into equity shares issued at 10% discount. Pass journal entry

Essay Type Questions

1. Explain the provisions of Sections (i) 80 (ii) 80 A (iii) 80 A (1) and (iv) 80-5(A) of the Companies Act.
2. Enlist the various items of revenue profits that can be transferred to capital redemption reserve.
3. Name the various items of capital profits which cannot be transferred to CRR.
4. Explain the procedure with respect to redemption of preference shares.
5. How will you determine the minimum fresh issue of shares to be made (i) at par; (ii) at premium and (iii) at discount?
6. How will you ascertain capital redemption reserve?
7. Explain the procedure involved in redemption of partly paid-up preference shares.
8. What do you mean by redemption by conversion? Discuss the various ways adopted with an illustration.
9. Is there any difference between "rights issue for redemption" and "bonus issue for redemption"? Substantiate you answer.

Exercises

Part A—For Undergraduate Level

1. The balance sheet of Ext Ltd. as on 31 March 2011 was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Sundry Assets	10,95,000
6,000 Equity Shares of ₹ 100 Each Fully Paid	6,00,000	Bank Balance	4,20,000
3,000 Redeemable Preference Shares of ₹ 100 Each	3,00,000		
General Reserve	2,40,000		
Profit & Loss A/c	1,50,000		
Sundry Creditors	2,25,000		
	15,15,000		15,15,000

On that date, the preference shares were redeemed at par. You are required to pass journal entries and also prepare balance sheet soon after the redemption.

[Madurai Kamaraj University Adapted and Modified]

[**Ans:** Transfer to capital redemption reserve: (i) Out of P&L A/c: ₹ 60,000; (ii) Out of general reserve: ₹ 2,40,000

Total of balance sheet (after redemption): ₹ 12,15,000]

[Model: Redemption at premium out of profits]

2. The balance sheet of "YE" Ltd. on 31 March 2011 was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Sundry Assets	39,20,000
8,000 6% Redeemable pref. Shares of ₹ 100 Each Fully Paid	8,00,000	Cash At Banks	16,80,00
3,20,000 Equity Shares of ₹ 10 Each Fully Paid	32,00,000		
Profit & Loss A/c	10,40,000		
Sundry Creditors	5,60,000		
	56,00,000		56,00,00

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

[Madras University Modified]

[**Ans:** Transfer to CRR: ₹8,00,000; Amended balance sheet total: ₹47,20,000]

[Model: Redemption at par out of fresh issue]

3. PQR Ltd. as part of its share capital has 8,000 redeemable preference shares of ₹100 each. When the shares became due for redemption, the company decided that the whole amount will be redeemed out of a fresh issue of equal amount of equity shares of ₹50 each.

   Show the journal entries in the books of the company.

   [**Ans:** Hint: Number of equity shares to be issued: 16,000 shares]

   [Model: Redemption at a premium, partly out of profits and partly out of fresh issue]

4. Cool Home Ltd. have part of their share capital in 5,000 9% redeemable preference shares of ₹100 each. The company decided to redeem the preference shares at a premium of 10%. The general reserve of the company shows a credit balance of ₹6,00,000. The directors decided to utilize 60% of the reserve in redeeming the preference shares and the balance is to be met from the proceeds of fresh issue of sufficient number of shares of ₹10 each. The premium is to be met from the year's Profit & Loss A/c.

   Give journal entries to record the above transactions.

   [**Ans:** General reserve to CRR: ₹3,60,000;

   Number of equity shares to be issued: 14,000 of ₹10 each]

   [Model: Redemption at a premium and fresh issue at a premium]

5. A company has 5,000 8% redeemable preference shares of ₹100 each fully paid. The company decided to redeem the shares on 31 March 2011 at a premium of 10%. The company made the following issues:

   (a) 30,000 Equity shares of ₹10 each at a premium of Re 1 each

   (b) 2,000 10% Debentures of ₹100 each

   The issue was fully subscribed and allotments were made. The redemption was duly carried out. The company had sufficient profits.

   You are required to give necessary journal entries.

   [**Ans:** Hint: Requisite amount from P&L appropriation A/c to CRR: ₹2,00,000; Payment due on redemption: ₹5,50,000]

   [Model: Redemption at par and fresh issue at premium]

6. The following is the summarized balance sheet of X Ltd. as on 31 March 2011:

Liabilities	₹	**Assets**	₹
Equity Share Capital	15,00,000	Sundry Assets	21,00,000
Redeemable Pref. Share Capital	6,00,000	Bank	7,50,000
Profit & Loss A/c	4,50,000		
Sundry Creditors	3,00,000		
	28,50,000		28,50,000

   On that date, the preference shares had to be redeemed. For this purpose 30,000 equity shares of ₹10 each were issued as ₹11. The company also issued 9% debentures totaling ₹4,50,000. The shares and debentures were immediately subscribed and paid for. The preference shares were duly redeemed.

   You are required to pass journal entries in the books of X Ltd. and prepare the balance sheet after redemption.

   [**Ans:** Total amount required to redeem pref. shares: ₹6,00,000; Amount of new issue of shares: ₹3,00,000; the balance ₹3,00,000 transferred to CRR out of P&L A/c; Balance sheet total: ₹ 30,30,300]

   [Model: Redemption at premium partly out of fresh issue and partly out of profits]

7. ABC Ltd. has an authorized capital of ₹ 40,00,000 comprising 10,000 8% redeemable preference shares of ₹100 each and 3,00,000 equity shares of ₹10 each.

   The preference shares are redeemable on 15 April 2011 at a premium of 10%.

   The summarized balance sheet of the company as on 31 March 2011 was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Sundry assets	17,50,000
Authorized:	30,00,000	Investment	2,00,000
3,00,000 Equity Shares of ₹ 10 Each		Bank	3,60,000
10,000 8% Redeemable pref. Shares of ₹ 100 Each	10,00,000		
Paid-Up Capital:			
1,25,000 Equity Shares of ₹ 10 Each	12,50,000		
5,000 8% Redeemable Pref. Shares of ₹ 100 Each	5,00,000		
Capital Reserve	50,000		
General Reserve	1,50,000		
Profit & Loss A/c	1,60,000		
Sundry Creditors	2,00,00		
	23,10,000		23,10,000

The necessary resolutions were duly passed and the following transactions were carried through:

(a) To provide cash for repayment of redeemable pref. shares, the investments were sold for ₹ 2,50,000 and 25,000 equity shares of ₹ 10 each were issued to existing shareholders at 20% premium. All moneys were duly received.

(b) The preference shares were duly redeemed.

You are required to pass necessary journal entries in the books of ABC Ltd. and prepare the amended balance sheet.

[**Ans:** ₹ 1,50,000 from general reserve and ₹ 1,00,000 from P&L A/c transferred to CRR;

Total of amended balance sheet: ₹ 21,10,000]

[Model: Redemption at premium partly out of fresh issue of preference shares and partly out of profits]

8. Vijay Ltd. had issued 8,00,000 equity shares of ₹ 10 each fully paid and 48,000 redeemable preference shares of ₹ 100 each fully paid. On 31 March 2011, the profit and loss account showed an undistributed profit of ₹ 8,00,000 and the general reserve account stood at ₹ 22,40,000.

   On 1 April 2011, the directors decided to issue 24,000 6% preference shares of ₹ 100 each and to redeem the existing preference shares at ₹ 110 each utilizing as less profits as possible for the purpose.

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

   [**Ans**: ₹ 22,40,000 out of general reserve and ₹ 1,60,000 out of revenue profits to be transferred to CRR]

   [Model: Issue of bonus shares]

9. The Rock Fort Ltd. issued 4,000 8% redeemable preference shares of ₹ 100 each at par on 1 January 2004, redeemable at the option of the company on or after 31 December 2010,partly or fully.

   Redemptions were made out of profits as follows:

   (a) 600 shares on 31 December 2010 at par

   (b) 800 shares on 31 March 2011 at 10% premium

   (c) Remaining shares on 30 June 2011 at a premium of 5% by making a fresh issue of 2,000 equity shares of ₹ 100 each at a premium of 10%

   On 30 June 2011, the company also decided to capitalize 50% of its CRR by issuing bonus shares of ₹ 100 each fully paid at a premium of ₹ 25 per share.

   You are required to pass the necessary journal entries in the books of The Rock Fort Ltd.

   [**Ans**: Amount equal to nominal value of pref. shares to be transferred to CRR on 31 December 2010: ₹ 60,000 (out of P&L A/c); on 31 March 2011: ₹ 80,000; on 30 June 2011: ₹ 60,000; Number of bonus shares to be issued: 800]

   [Model: Issue of bonus shares]

10. Krishan Ltd. has an authorized capital of ₹ 5,00,000 comprising 1,00,000 9% redeemable cumulative preference shares of ₹ 1 each and 4,00,000 ordinary shares of ₹ 1 each. The preference shares are redeemable on 1 April 2011 at ₹ 1.05 per share. The summarized balance sheet of the company as on 31 December 2010 was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Sundry assets	3,93,400
Issued and Fully Paid Up		Investments	28,000
Preference Shares	1,00,000	Bank Balance	56,000
Ordinary shares	2,00,000		
Capital Reserve	19,000		
General Reserve	40,000		
Profit & Loss A/c	85,000		
Sundry Creditors	33,400		
	4,77,400		4,77400

The necessary resolutions were duly passed and the following transactions carried through on the dates stated:

(a) All the investments were sold for ₹ 36,000

(b) 40,000 ordinary shares of ₹ 1 each were issued to the existing shareholders at ₹ 1.25 per share payable in full forthwith and duly paid

On 1 April 2011, in order to provide cash towards the redemption of preference shares, the above two took place. On 30 June 2011, the preference shares were duly redeemed and on 31 August 2011, a bonus issue of ordinary shares was made at the rate of one new share for every ten shares held.

You are required to pass necessary journal entries and prepare balance sheet.

[**Ans**: CRR: ₹ 60,000; Bonus shares: 24,000; Balance sheet total: ₹ 4,30,400]

[Model: Restriction on utilization of P&L A/c for redemption]

11. The following is the summarized balance sheet of a company as on 31 March 2011:

Liabilities	₹	Assets	₹
Share Capital:		Fixed assets	34,00,000
4,00,000 Equity Shares of ₹ 10 Each Fully Paid	40,00,000	Investments	3,50,000
		Cash at Bank	3,50,000
60,000 8% Redeemable Preference Shares of ₹ 20 Each, Fully Paid	12,00,000	Other Current Assets	29,00,000
Profit & Loss A/c	7,00,000		
Sundry Creditors	11,00,000		
	70,00,000		70,00,000

On 1 April 2011, the company decided to redeem preference shares at a premium of 5%.

In order to facilitate the redemption of preference shares, it was decided:

(a) To sell the investments for ₹ 3,00,000

(b) To finance part of the redemption from the company's funds subject to leaving balance of P&L A/c of ₹ 2,00,000

(c) To issue sufficient equity shares of ₹ 10 each at a premium of ₹ 2 per share to raise the balance of funds required

The preference shares were redeemed on due date and equity shares were fully subscribed.

You are required to pass necessary journal entries and prepare the balance sheet after redemption.

[**Ans**: CRR: ₹ 4,50,000; Balance sheet total: ₹ 65,90,000]

[Model: Untraceable shareholders]

12. The following is the summarized balance sheet of a company as on 31 December 2010:

Liabilities	₹	Assets	₹
Share Capital:		Fixed assets	2,60,000
Authorized:		Current assets	1,61,000
3,500 Equity Shares of ₹ 100 Each	3,50,000		
1,000 9% Redeemable Preference Shares of ₹ 100 Each	1,00,000		
Issued & Subscribed: 1,950 Equity Shares of ₹ 100 Each Fully Paid	1,95,000		
800 9% Redeemable Pref. Shares of ₹ 100 Each	80,000		
Reserves & Surplus:			
Profit & Loss A/c	1,00,000		
Sundry Creditors	46,000		
	4,21,000		4,21,000

The preference shares were redeemed on 1 January 2011 at a premium of ₹ 20 per share, the whereabouts of the holders of 60 such shares not being known. At the same time, a bonus issue of equity shares was made at par, one share being issued for every three shares held out of the capital redemption reserve A/c.

You are required to pass the journal entries to record the above transactions and prepare the balance sheet after redemption:

[**Ans**: CRR: ₹ 80,000; Bonus shares: ₹ 65,000; Balance sheet total: ₹ 3,32,200]

[Model: Minimum fresh issue of shares:

13. A company wants to redeem its 10,000 6% preference shares of ₹ 10 each, fully paid at 10% premium. The ledger accounts show the following balances:

Securities premium ₹ 2,000

P&L A/c (Cr.) ₹ 5,000

The directors redeemed the shares by making minimum fresh issue of equity shares of ₹ 10 each at a premium of 5%. Give journal entries.

[**Ans**: CRR: ₹ 6,660; Proceeds of fresh issue: ₹ 98,007]

[Model: Minimum fresh issue of shares]

14. Balance sheet of M/s Joshi Ltd. as on 31 March 2011 is as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed assets	66,00,000
Issued, subscribed and Fully Paid Up		Current Assets	24,00,000
30,000 Ordinary Shares of ₹ 100 Each	30,00,000		
15,000 Preference Shares of ₹ 100 Each	15,00,000		
Capital Reserve	3,00,000		
Securities premium A/c	3,00,000		
General Reserve	6,00,000		
Profit & Loss A/c	3,00,000		
Current Liabilities	30,00,000		
	90,00,000		90,00,000

The preference shares are to be redeemed at 10% premium. Fresh issue of equity shares is to be made to the extent required under the Company's Act for the purpose of this redemption. The shortfall in funds for the purpose of redemption after utilizing the proceeds of the fresh issue are to be met by taking a bank loan.

Show journal entries.

[**Ans**: New issue of equity shares: ₹ 6,00,000

Bank loan : ₹ 10,50,000]

[Model: Minimum fresh issue of shares at a discount]

15. The balance sheet of AX Ltd. as on 31 March 2011 was as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Sundry assets	43,00,000
10,000 9% Redeemable Pref. Shares of ₹ 100 Each Fully Paid	10,00,000	Cash at bank	7,00,000
20,000 6% Redeemable Pref. Shares of ₹ 50 Each, ₹ 25 Per Share Paid Up	5,00,000		
20,000 Equity Shares of ₹ 100 Each	20,00,000		
Reserves & Surplus:			
Capital Reserve			
Securities Premium	4,00,000		
Dividend Equalization Reserve	1,00,000		
Current Liabilities			
	5,50,000		
	4,50,000		
	50,00,000		50,00,000

On the above date, the Company decided to redeem the preference shares at a premium of 5%. To enable the redemption to be carried out the company decided to issue, after carrying

out the necessary formalities required under law, sufficient number of new equity shares at a discount of 10%.

You are required to pass the necessary journal entries and prepare the balance sheet after redemption

[**Ans**: CRR: ₹5,50,000; New issue to be made: ₹5,00,000]

[Model: Minimum fresh issue of shares at premium

16. The following is the summarized balance sheet of AZ Ltd.

Liabilities	₹	**Assets**	₹
Paid-Up Capital:		Sundry assets	12,80,000
3,000 9% Pref. Shares of ₹100 Each Fully Paid	3,00,000	Cash at bank	1,42,500
1,500 7% Pref. Shares of ₹100 Each, ₹75 Paid Up	1,12,500		
7,500 Equity Shares of 100 Each	7,50,000		
Capital Reserve	50,000		
Securities Premium	30,000		
Current Liabilities	1,80,000		
	14,22,500		14,22,500

It was decided to redeem both the classes of preference shares at a premium of 5%. The company issued equity shares of ₹100 each at a premium of 10% as were necessary to provide cash for redemption. The issue was fully subscribed and all the moneys were received.

You are required to give journal entries and prepare the balance sheet.

[**Ans**: CRR: Nil; Balance sheet total: ₹14,82,500]

[Model: Forfeiture and re-issue of redeemable preference shares]

17. Following is the summarized balance sheet of BX Ltd. as on 31 December 2010:

Liabilities	₹	**Assets**	₹
Paid-Up Share Capital:		Sundry assets	40,50,000
25,000 Equity Shares of ₹100 Each	25,00,000	Bank	4,50,000
5,000 6% Redeemable Pref. Shares of ₹100 Each: 5,00,000			
Less : Calls-in-Arrears on 250 Shares 5,000	4,95,000		
Reserves & Surplus:			
General Reserve	5,00,000		
Development rebate Reserve	2,50,000		
Other Liabilities	7,55,000		
	45,00,000		45,00,000

The redeemable preference shares were redeemed on the following basis:

(i) urther 2,250 equity shares were issued at a premium of 10%.

(ii) Expenses of fresh issue of shares ₹25,000.

(iii) Out of 250 preference shares, holders of 200 shares paid the call money before the date ofredemption. The balance of 50 shares were forfeited and they were re-issued as fully paid shares on receipt of ₹2,500 before redemption.

(iv) Preference shares were redeemed at a premium of 10% and share premium was utilized in full for the purpose.

You are required to pass journal entries and prepare summarized balance sheet after redemption:

[**Ans**: (i) Bank A/c to balance b/d: ₹1,29,000

(ii) Balance sheet total: ₹42,04,000]

[Model: Redemption at a premium and bonus issue out of general reserve]

18. Goodluck Co. Ltd. had 60,000 equity shares of ₹10 each fully paid and 30,000 6% redeemable preference shares of ₹10 each fully paid, redeemable at a premium of 10%. It had a credit

balance of ₹ 2,40,000 on P&L A/c and ₹ 3,00,000 on general reserve.

The company resolved:

(a) To issue 18,000 equity shares of ₹ 10 each at ₹ 12 per share in order to provide part of the funds for the redemption on preference shares

(b) To redeem the preference shares

(c) To make a bonus issue of one share for every two held by the existing shareholders from the general reserve. The resolutions were carried into effect

You are required to pass journal entries and prepare balance sheet after the completion of redemption.

[**Ans:**Transfer to CRR from profits: ₹ 1,20,000; General reserve to bonus holders: ₹ 3,00,000; Balance sheet extract: Share ₹ 10,80,000; Securities premium: ₹ 6,000; CRR: ₹ 1,20,000; P&L A/c: ₹ 1,20,000; Bank OD: ₹ 1,14,000)

[Model: Redemption at a premium and issue of bonus shares out of CRR]

19. The following is the summarized balance sheet of Sri Sai Ltd. as on 31 December 2010:

Liabilities	₹	**Assets**	₹
Share Capital:		Sundry Assets	49,60,000
Authorized			
1,20,000 9% Redeemable Preference Shares of ₹ 10 each	12,00,000	Bank	16,80,000
4,00,000 Equity Shares of ₹ 10 Each	40,00,000		
Paid-Up Capital:			
88,000 9% Redeemable Preference Shares of ₹ 10 Each	8,80,000		
2,40,000 Equity Shares of ₹ 10 Each Fully Paid	24,00,000		
Profit & Loss A/c	16,00,000		
Reserve Fund	16,00,000		
Sundry Creditors	1,60,000		
	66,40,000		66,40,000

On 7 January 2011, the preference shares were redeemed at a premium of ₹ 4 per share. The Company could not trace the holders of 9,600 preference shares. On 10 January 2011, a bonus issue of one fully paid equity share for four shares held was made.

Show the journal entries to record the above transactions and also prepare balance sheet, after redemption.

[**Ans**: Transfer of profits to CRR: ₹ 8,80,000; Balance sheet total: ₹ 55,42,400]

[Model: Rights issue for redemption]

20. The following information is extracted from the balance sheet of Full Moon Ltd as on 30 December 2010

Particulars	₹
Authorized Share Capital:	
20,000 9% Redeemable Preference Shares of ₹ 100 Each	20,00,000
4,00,000 Equity Shares of ₹ 10 Each	40,00,000
Paid-Up Capital:	
10,000 9% Redeemable Preference Shares of ₹ 100 Each	10,00,000
3,20,000 Equity Shares of ₹ 10 Each, ₹ 7.50 Paid Up	24,00,000
Capital Reserve	4,00,000
General Reserve	14,00,000
Securities Premium	48,000
Profit & Loss A/c	5,00,000

On 6 January 2011, the preference shares were redeemed at a premium of 5% for the purpose of redemption, the company decided to:

(i) Issue 16,000 6% debentures of ₹ 100 each

(ii) Convert the partly paid up equity shares into fully paid up without requiring the shareholders to pay for the same

(iii) Issue of fully paid rights shares of ₹ 10 each at a premium of ₹ 2 per share in proportion of one share for every four shares held

Give necessary journal entries to record the above transactions.

[**Ans:** CRR: ₹ 10,00,000;

Issue of rights share: Equity share capital A/c: ₹ 8,00,000;

Securities premium A/c: ₹ 1,60,000]

Exercises

Part B—For Advanced Level

21. The following is an extract from the balance sheet of a company as on 31 March 2011:

Particulars	₹	₹
Share Capital:		20,00,000
40,000 9% Preference Shares of ₹ 50 Fully Paid		
2,00,000 Equity Shares of ₹ 10 Each ₹ 7.50 Per Share Called Up	15,00,000	
Less: Calls Unpaid	15,000	14,85,000
Securities Premium Account		1,00,000
General Reserve		12,00,000
Calls in Advance (Final Call On Equity Shares)		5,000

On 1 April 2011, the Board of Directors decide the following:

(i) The fully paid preference shares are to be redeemed at a premium of 5% in May 2011, and for the purpose, 1,00,000 equity shares of ₹ 10 each are to be issued at par to be paid for in full on application in April 2011

(ii) The final call of ₹ 2.50 per share is to be made in July 2011

(iii) The 2,000 equity shares owned by X, an existing shareholder, who failed to pay the allotment money of ₹ 2.50 per call, were forfeited in the month of June 2011

The above decisions were duly complied with according to the time schedule laid down.

The amount due on the issue of fresh equity shares and on final call were duly received except from Y, who has failed to pay the final call money also. Those shares of Y were forfeited in the month of August 2011.

Of the total shares forfeited, 3,000 were issued to Z in September 2011, credited as fully paid at ₹ 9 per share, the whole of X's shares being included.

You are required to pass journal entries in the books of the company to record these transactions and show the relevant items on the liabilities side of the balance sheet (necessary extracts) according to the form prescribed by the Companies Act, 1956. Assume that the resources required for payment are available.

[**Ans:** CRR: ₹ 10,00,000;

Extracts on liabilities side of B/S:

Equity shares fully paid ₹ 29,90,000; Forfeited shares A/c: ₹ 5,000; CRR: ₹ 10,00,000; Capital reserve: ₹ 7,000; General reserve: ₹ 2,00,000]

22. The following balances are appearing in the books of Excellent Ltd:

Particulars	₹
Redeemable Preference Share Capital	20,00,000
Calls-in-Arrear (Redeemable Pref. Shares)	40,000
General Reserve	12,00,000
Securities Premium	1,60,000
Development Rebate Reserve	8,00,000

It is ascertained that:

Preference shares are of ₹ 100 each fully called, due for immediate redemption at a premium of 10%.

Calls-in-arrear are on account of final call on 2,000 shares held by four members whose whereabouts are not known.

Balance of general reserve and securities premium is to be fully utilized for the purposes of redemption and the short fall is to be made good by issue of equity shares of ₹ 10 each at par.

The redemption of preference shares was duly carried out. You are required to give the journal entries and the relevant extracts from the liabilities side of the balance sheet as they would appear after the redemption is carried out.

[C.A. (Inter). Modified]

[**Ans:** Amount to CRR: ₹ 11,60,000;

Preference shares redemption suspense A/c: ₹ 2,20,000]

23. The following balances were extracted from the books of Fortune Ltd. as on 31 March 2011:

Particulars	₹
10,000 9% Redeemable Preference Shares of ₹	10,00,000
100 Each, Fully Called Up}:	30,000
Less: Calls-in-Arrear @ ₹ 20 Per Share On 1,500	9,70,000
Shares}:	
Capital Reserve	50,000
General Reserve	2,50,000

The preference shares were redeemed on 1 April 2011 at a premium of ₹ 5 per share. The company issued 65,000 equity shares of ₹ 10 each at par, for the purpose of redeeming the preference shares, which were fully subscribed and duly allotted.

You are required to show the journal entries showing the transactions relating to the redemption of shares and the relevant extracts on the liabilities side of the balance sheet after such redemption.

[C.A. (Inter). Modified]

[**Ans:** CRR: ₹ 2,00,000]

24. ABC Ltd. has the following balance sheet as on 31 March 2011:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	11,00,000
Issued,		Current Assets	4,00,000
Subscribed &			
Fully Paid Up			
5,000 Equity	5,00,000		
Shares of ₹ 100			
Each			
2,500 Pref. Shares	2,50,000		
of ₹ 100 Each			
Capital Reserve	50,000		
Securities	50,000		
Premium A/c			
General Reserve	1,00,000		
Profit & Loss A/c	50,000		
Current Liabilities	5,00,000		
	15,00,000		15,00,000

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

Show the journal entries.

[C.A. (Inter). Modified]

[**Ans:** CRR: ₹ 1,50,000]

25. Sun Rise Ltd. issued share capital of 30,000 12% redeemable preference shares of ₹ 20 each and 2,00,000 equity shares of ₹ 10 each. The preference shares are redeemable at a premium of 5% on 1 January 2011.

As at 31 December 2011, the company's balance sheet stood at as follows:

Liabilities	₹	Assets	₹
Issued Share		Plant &	
Capital:	6,00,000	Machinery	12,50,000
30,000 12%		Furniture &	
Redeemable		Fixtures	4,50,000
Pref. Shares of		Investments	1,75,000
₹ 20 Each Fully		Stock	7,50,000
Paid		Debtors	7,00,000
2,00,000 Equity	20,00,000	Bank	1,75,000
Shares of ₹ 10			
Each Fully Paid			
Profit & Loss A/c	3,50,000		
Sundry Creditors	5,50,000		
	35,00,000		35,00,000

In order to facilitate the redemption of preference shares, it was decided

(a) To sell the investments for ₹ 1,50,000

(b) To finance part of the redemption from the company funds subject to leaving of balance in P&L A/c ₹ 1,00,000.

(c) To issue sufficient equity shares of ₹ 10 each at a premium of ₹ 2 per share to raise the balance of funds required

All the above-mentioned decisions were fully carried out and the preference shares were duly redeemed.

You are required to prepare:

(i) Journal entries to record the above transactions

(ii) A memorandum balance sheet as on completion of redemption

[I.C.W.A. (Inter). Modified]

[**Ans:** Fresh issue: 37,500 shares; Balance sheet total: ₹32,95,000]

26. The following is the balance sheet of Moonlight Ltd as on 31 December 2010:

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed assets	8,00,000
20,000 12% Redeemable Pref. Shares of ₹10 Each Fully Paid	2,00,000	Investments	2,00,000
40,000 9% Redeemable Pref. Shares of ₹10 each, ₹5 Per Share Paid Up	2,00,000	Current assets:	
40,000 Equity Shares of ₹10 Each Fully Paid	4,00,000	Stock: 80,000	
Reserve & Surplus:		Debtors: 1,20,000	
Securities Premium	1,60,000	Bank: 4,00,000	6,00,000
General Reserve	1,20,000		
Capital Reserve	1,40,000		
Profit & Loss A/c	1,80,000		
Current Liabilities	2,00,000		
	16,00,000		16,00,000

On 1 January 2011, the Company redeemed the preferences shares at a premium of 10%. In order to pay off the preference shareholders, it sold investments realizing ₹1,90,000. All payments were made except to shareholders of 120 who could not be traced.

On 1 April 2011, the company issued fully paid bonus shares in the ratio one for every share held on that date. Give the necessary journal entries and prepare the balance sheet after redemption.

[I.C.W.A. (Inter). Modified]

[**Ans**: CRR: ₹2,00,000; Bonus shares: ₹4,00,000; Balance sheet total: ₹13,71,320]

27. Following is the balance sheet of Crescent Ltd. as on 30 June 2011:

Liabilities	₹	**Assets**	₹
Preference Share capital		Fixed Assets	36,00,000
		Investments	3,00,000
15,000 Shares of ₹100 Each, Fully Called Up	15,00,000	Bank	5,40,000
Less: Final Call of ₹20 Per Share Unpaid	12,000		
	14,88,000		
Equity Share capital:			
1,80,000 Shares of ₹10 Each, Fully Paid Up	18,00,000		
Profit & Loss A/c	9,00,000		
Securities Premium A/c	90,000		
Sundry Creditors	1,62,000		
	44,40,000		44,40,000

On that date, the Board of Directors decided to redeem the preference shares at a premium of 10% and to sell investments at its market price of ₹2,40,000. All payments were made except to shareholders holding 300 shares who could not be traceable.

They also decided to issue sufficient number of equity shares of ₹10 each at a premium of Re 1 per share, required after utilizing the P&L A/c leaving a balance of ₹3,00,000. Premium on redemption is required to be set off against security premium account.

You are required to show the journal entries and the balance sheet of the company after redemption.

[C.S. (Inter). Modified]

[**Ans:** CRR: ₹5,40,000; Issue of new equity shares: ₹9,00,000; Balance sheet total: ₹38,19,000]

28. The following is the balance sheet of Seven Stars Ltd. as at 31 December 2011:

Liabilities	₹	Assets	₹
Preference Share Capital:		Fixed Assets	18,00,000
7,500 Shares of ₹ 100 Each Fully Called Up	7,50,000	Investments	1,50,000
Less: Final Call of ₹ 20 Per Share Unpaid	6,000	Bank	2,70,000
	7,44,000		
Equity Share Capital:			
90,000 Shares of ₹ 10 Each Fully Paid Up	9,00,000		
Securities premium	45,000		
Profit & Loss A/c	4,50,000		
Sundry Csreditors	81,000		
	22,20,000		22,20,000

On 30 May 2011, the Board of Directors decided to redeem the preference shares at a premium of 10% and to sell the investments at its market price of ₹ 1,20,000. They also decided to issue sufficient number of equity shares of ₹ 10 each at a premium of ₹ 1 per share, required after utilizing the P&L A/c leaving a balance of ₹ 1,50,000. Premium on redemption is required to set off against securities premium account.

Repayments on redemption were made in full except one shareholder holding 150 shares due to his leaving India for good.

Assume that calls-in-arrears were received in full. You are required to show the journal entries and the balance sheet of the company after redemption.

[C.S. (Inter). Modified]

[**Ans:** Number of new shares 48,000;

Balance sheet total: 19,15,500]

29. The following is the balance sheet of Jyothi Ltd. as at 31 March 2010:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Authorized		Gross Block	8,00,000
20,000 9%	2,00,000	Less:	
Redeemable		Depreciation	2,00,000
Pref. Shares of			6,00,000
₹ 10 Each			
1,80,000 Equity	18,00,000		
Shares of ₹ 10			
Each			
	20,00,000		2,00,000
Issued,		Investments	
Subscribed &		Current Assets,	
Paid up:		Loans &	
20,000 9%		Advances:	
Redeemable		Inventory	2,50,000
Pref. Shares of		Debtors	2,50,000
₹ 10 Each		Cash & Bank	3,00,000
1,00,000 Equity		Balances	
Shares of ₹ 10			8,00,000
Each			
(A)	12,00,000		
Reserve &	2,40,000	Miscellaneous	40,000
Surplus:		Expenditure (to	
General Reserve	1,40,000	the Extent Not	
Securities	37,000	Written off)	
Premium			
Profit & Loss A/c			
(B)	4,17,000		
Current Liabilities	23,000		
& Provisions: (C)			
Total (A+ B + C)	16,40,000	Total	16,40,000

For the year ended 31 March 2011, the Company made a net profit of ₹ 30,000 after providing ₹ 40,000 depreciation and writing off the miscellaneous expenditure amounting to ₹ 40,000.

The following additional information is available with regard to Company`s operation:

(i) The preference dividend for the year ended 31 March 2011 was paid before 31 March 2011.

(ii) Except cash and bank balances, other current assets and current liabilities as on 31 March 2011was the same as on 31 March 2010.

(iii) The Company redeemed the preference shares at a premium of 10%.

(iv) The Company issued bonus shares in the ratio of one share for every five equity shares held as on 31 March 2011.

(v) To meet the requirements of redemption, the Company sold a portion of the investments, so as to leave a minimum balance of ₹ 60,000 after such redemption.

(vi) Investments were sold at 90% of cost on 31 March 2011.

You are required to:

(a) Prepare necessary journal entries to record redemption and issue of bonus shares

(b) Prepare the cash and bank account

(c) Prepare the balance sheet as at 31 March 2011 incorporating the above transactions.

[C.A. (Inter). Modified]

[**Ans:** CRR: ₹2,00,000: Balance sheet total: ₹14,20,000]

30. The relevant section of the balance sheet of OKAY Ltd. as on 31 March 2011 is as follows:

Liabilities	₹
Share Capital:	24,00,000
Authorized:	
Issued & Subscribed:	
1,20,000 Equity Shares of ₹10 Each, Fully Paid Up}	12,00,000
4,500 8% Redeemable Preference Shares of ₹100 Each, Fully Paid Up}	4,50,000
Reserve & Surplus:	
Profit Prior to Incorporation	60,000
Capital Reserve	22,500
Securities Premium	15,000
General Reserve	1,20,000
Profit & Loss A/c	90,000

The pref. shares were due to be redeemed at a premium of 5 %. As the divisible profits were inadequate, the company after completing the legal formalities issued the minimum amount of equity shares of ₹10 each at a discount of 10%. All the preference shares were then redeemed.

You are required to pass journal entries for all the above transactions.

[**Ans:** Face value of new issue: ₹1,83,340; CRR: ₹1,34,994]

31. Following is the balance sheet of Vartika Ltd. as on 31 March 2004:

Liabilities	₹	**Assets**	₹
8% Preference Share Capital (20,000 × 50):	10,00,000	Fixed Assets	12,25,000
		Investments	2,00,000
		Bank	9,55,000
Less: Calls Unpaid: (2000 × 10):	20,000		
	9,80,000		
Equity Share Capital:			
1,00,000 Shares of ₹10 Each :			
₹7.50 Called Up:	7,50,000		
Less: Calls Unpaid:	2,500		
	7,47,500		
Securities Premium	50,000		
Reserves	6,00,000		
Calls in Advance	2,500		
	23,80,000		23,80,000

(i) Fully paid preference shares are redeemed at a premium of 5%.

(ii) 50,000 Equity shares of ₹10 each are issued at par, whole amount due and received on applications.

(iii) 1,000 Equity shares on which call @ ₹2.50 per share is unpaid are forfeited.

(iv) Final call of ₹2.50 per share is made and collected.

(v) Forfeited shares are re-issued @ ₹9 per share credited as fully paid.

You are required to prepare:

(a) Journal entries

(b) Revised balance sheet of company.

[B.Com (Hons). Delhi 2005]

[**Ans:** Balance sheet total: ₹21,89,000]

32. The balance sheet of M/s G Ltd as on 31 December 2005 was as follows:

Liabilities	₹	**Assets**	₹
Equity Shares of ₹ 100	15,00,000	Fixed	24,00,000
		Investments	3,00,000
7% Preference Shares of ₹ 100 Each	9,00,000	Bank	6,00,000
		Other Current Assets	15,00,000
Share Premium	1,50,000		
Capital Reserve	3,00,000		
Revenue Reserve	6,00,000		
6% Debentures	9,00,000		
Creditors	4,50,000		
	48,00,000		48,00,000

The preference shares and debentures were due for redemption on 1 January 2006. M/s G Ltd took the following steps in this regard:

(i) It issued 6,000 equity shares of ₹ 100 each at a premium of 10 % which were fully subscribed and paid for

(ii) It sold investments for ₹ 2,70,000

(iii) It arranged a bank over draft to the extent necessary

Give journal entries to record the above and prepare the balance sheet of the company.

[B.Com (Hons). Delhi 2006 Modified]

[**Ans:** Total of balance sheet: ₹ 39,30,000]

33. The capital structure of Suncity Ltd. consists of 50,000 equity shares of ₹ 10 each and 2,000 8% redeemable preference shares of ₹ 100 each fully paid up. Undistributed reserves and surplus stood as follows:

Cash and Bank amounted to ₹ 1,96,000. Preference shares are to be redeemed at a premium of 10% and for the purpose of redemption, the directors are empowered to make a fresh issue of equity shares at par after utilizing the undistributed reserves and surplus, subject to the condition that a sum of ₹ 40,000 shall be retained in general reserve.

Pass journal entries to give effect to the above arrangements assuming that the company could not trace the holders of 100 preference shares.

[B.Com (Hons). Delhi 2009]

34. A limited company wants to redeem its 10,000,9% preference shares of ₹ 10 each fully paid up at 10% premium. The ledger accounts show the following balances:

Securities premium A/c	₹ 12,000
Profit & Loss A/c	₹ 10,000

The company redeemed the preference shares by making minimum fresh issue of equity shares of ₹ 10 each at 5% premium. Calculate the amount of fresh issue of equity shares.

[B.Com (Hons). Delhi 2009]

[**Ans:** 9,000 shares × ₹ 10 = ₹ 90,000]

Issue and Redemption of Debentures

4

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Understand the meaning and basic characteristics of a debenture.
2. Classify debentures.
3. Distinguish Shares from debentures.
4. Know the meaning and functions of debenture trustee.
5. Explain what a charge really means.
6. Understand the various ways of issue of debentures—for cash, other than cash, as a collateral security.
7. Appraise the various categories of issues of debentures and redemption.
8. Know the accounting treatment for each such category.
9. Understand the methods of redemption—Provisions of Section 117C.
10. Explain the term: Debenture redemption reserve and know how to create DRR.
11. Understand redemption out of capital and its accounting treatment.
12. Know Redemption out of profit, types of sinking funds and their accounting treatment.
13. Explain the term: Convertible debentures—Fully convertible and partly convertible debenture (FCD and PCD) and accounting treatment on conversion.
14. Understand redemption by "purchase in the open market" and its accounting treatment.
15. Explain cum-interest and ex-interest—Questions and their accounting treatment.
16. Explain certain key terms related to this chapter.

The joint stock companies raise capital in different ways. One way of raising capital is through issue of "debentures". This represents the loan capital of companies. They are debt instruments. They have to be discharged at the date of maturity after paying specific interest at regular intervals. All the provisions relating to issue of debentures and their redemption are discussed in detail in this chapter with a number of illustrations.

4.1 MEANING AND DEFINITION OF DEBENTURE

According to Section 2(12) of the Companies Act, 1956, "Debenture" includes, "a debenture stock, bonds and any other securities of the company whether constituting a charge on the assets of a company or not."

According to Topham: "Debenture is a document given by a company as evidence of debt to the holder usually arising out of a loan and most commonly secured by a charge."

The true meaning of a debenture can best be understood if we know the basic features of a debenture which are given as follows:

- Debenture is a document given by the company in the form of a certificate.
- It is an instrument of debt owed by a company
- Mostly, it is secured by a charge
- Generally, this instrument (Debenture) specifies
  - Value (Normal or par)
  - Rate of interest
  - Periodicity of payment
  - Tenure
  - Terms of Redemption
- Usually, they are issued under the common seal of the company

4.2 MEANING OF SOME TERMS

Bond: Bond, like debenture, is also an instrument of debt. Contents and texture are similar to that of debenture. However, the main difference between bond and debenture is with respect to issue condition: A bond can be issued without pre-determined rate of interest.

Example: Deep discount bond, Zero coupon bond.

Debenture stock: Generally, individual debenture certificates are issued. For instance, a single debenture may be issued to one person. Sometimes, a company will create one loan fund. This is intended for a specified group. Each person in the group will be given a debenture stock certificate which specifies the part of the loan to which such person is entitled. Debenture stock is a document representing the loan capital of the company. The loan is consolidated into a single composite unit. This unit may be divided into a number of units of fixed amount, which may be of any denomination. Certificates are issued indicating each debenture stockholder's contribution.

The differences between "debenture" and "debenture stock" are depicted in the following table.:

Basis of Distraction	Debenture	Debenture Stock
1. Nature	Debenture is the description of an instrument.	This is the description of a debt.
2. Creation of charge	Each debenture may create a separate charge.	Charge is created by a "trust deed".
3. Transferability	Debenture is transferable in its entirety. Transfer in parts may not be possible.	Debenture stock may be transferable in parts, if articles permit.
4. Payment	A debenture may be either fully paid or partly paid.	The debenture stock must be fully paid.
5. Amount	Debenture is always for a fixed sum.	Here, the sum is not a fixed but may be of any amount.

Charge:

A charge is an encumbrance to meet the obligation. That means, the company agrees to mortgage specific

part of the assets towards the loan. Lenders have the right to secure their payment from the assets mortgaged. A charge may be first one or second charge. A charge may be either fixed charge or floating charge.

Some charges included in the category of charge are:

- A charge for the purpose of securing any issue of debenture.
- Uncalled share capital of the company.
- Any immovable property
- Any book debts of the company
- Any movable property (not pledged)
- Floating charge or any undertaking of the property
- Charge on calls unpaid
- Goodwill and other patents, copyrights obtained under Copyright Act

The Companies Act stipulates specifically that all charges should be registered with the Registrar of Companies.

Fixed charge: This is also known as "specific charge". This is created on definite, specific assets of permanent nature.

Example: Land, machinery, etc.

Floating charge: A charge is said to be "floating" when no specific asset but all assets are charged as security.

Note: In the event of winding up, this category holders have preference over unsecured creditors to settle the claim.

4.3 TYPES OF DEBENTURES

Debentures may be classified from the following standpoints:

1. Security
2. Redemption
3. Records
4. Priority
5. Convertibility

4.3.1 From Security Viewpoint

This may further be classified into two categories: (i) secured debentures and (ii) unsecured debentures.

Secured debentures: When debentures are secured by either a fixed charge or floating charge on the property of the company, they are called mortgage or secured debentures. A "mortgage deed", also known as Trust deed, has to be entered into between the parties.

Unsecured debentures: When debentures are issued without any charge or security, they are called unsecured or naked debentures. They have no security. They do not enjoy any special rights.

4.3.2 From Records Viewpoint

These can also be classified into two categories (i) registered debentures and (ii) bearer debentures.

1. Registered debentures:
   - Name, address and the required particulars of holders of this kind of debentures are entered in a register known as debenture ledger.

- The register is maintained by the Registrar.
- These are transferable but transfer requires execution of transfer deed.

2. Bearer debenture:

- These need not get registered and the company does not maintain any records.
- These can be transferred easily by mere delivery like a negotiable instrument.
- The interest and the principal amount on these debentures shall be payable upon presentation and delivery of the coupons and debentures.

4.3.3 From Redemption Viewpoint

These also can be classified into two categories: (i) redeemable debenture and (ii) irredeemable debenture.

Redeemable debenture: These debentures are to repaid by the company at the end of the specified period. It is repaid during the existence of the company.

Irredeemable debenture: These are not repayable during the lifetime of the company. They are perpetual. When the company is wound up, these will be repaid.

4.3.4 From Priority Viewpoint

These also may be classified into two categories: (i) first debentures and (ii) second debentures.

First debentures: These debentures will be repaid before and prior to other debentures. They have priority over others.

Second debentures: These debentures will be repaid only after the first debentures are redeemed.

4.3.5 From Convertibility Viewpoint

These also may be classified into two categories: (i) convertible debentures and (ii) non-convertible debentures

Convertible debentures:

- These many be convertible into equity or preference shares of the company.
- This may be done in accordance with the agreement between the debenture holders and the company.
- Partly convertible debentures: These debentures consist of two parts: convertible and non-convertible. The convertible part may be converted into shares at the expiry of specified period whereas the non-convertible part is redeemed in cash or the expiry of specified period. (PCD)
- Fully convertible debenture: When the entire amount of debenture is converted into shares on the expiry of specified period, they are known fully convertible debentures (FCD).

The following table gives the differences between fully convertible debentures (FCD) and party convertible debentures (PCD):

Basis of Difference	Fully Convertible Debenture (FCD)	Party Convertible Debenture (PCD)
1. Classification: As equity and debt	Classified as equity for debt equity computation.	Convertible portion is classified as "equity" and non-convertible part as "debt".
2. Debt equity ratio	Highly favorable debt–equity ratio.	Not high but favorable debt–equity ratio.
3. Capital base	High equity capital on conversion of debentures.	Lower equity capital on conversion of debentures.

4. Equity servicing	Higher burden of equity servicing.	Lower burden of equity servicing.
5. Suitability	Suitable for companies without established track record.	Not so much suitable as FCD.
6. Creation of redemption reserve	No need arises.	Required to be created for 50% of the face value of non-convertible part of debentures.
7. Buy-back facility	Not needed	Arrangements may be made for buy-back of non-convertible part.
8. Investor's response	Popular among the investors	Not popular among the investors.

AS per SEBI Guidelines, no company shall issue FCDs having a conversion period of more than 36 months unless conversion is made optional with "put" and "call" option.

"Call" Option: An option to buy is known as "call" option

"Put" Option: An option to sell is known as "put" option.

"Put" & "Call" Option: An option to either buy or sell is known as "put call option".

4.4 DIFFERENCES BETWEEN SHARES AND DEBENTURES

The following table shows the differences between shares and debentures:

Basis of Difference	Debentures	Shares
1. Status	A debenture holder is a lender, i.e., a loan credit or of the company .	A shareholder is a joint owner of the company.
2. Income	Interest on debenture is pre-determined and fixed.	Dividend on shares is neither pre-determined nor fixed.
3. Income payable to the holders	Debenture holders are entitled to receive interest and it is immaterial whether the company makes profit or loss.	Shareholders are entitled to receive dividend only when the company earns profit.
4. Nature with respect to profit	Interest on debenture is a charge against profit.	Dividend on shares is an appropriation of profit.
5. Refund	A debenture holder gets back amount at date of maturity.	A shareholder may not be able to get back his money on shares.
6. Safety	Debentures are secured.	Share are unsecured
7. Voting right	A debenture holder has no voting right.	A shareholder has voting right.
8. Discount on issue	Debentures can be issued at a discount. There are no legal restrictions.	Shares can be issued as a discount subject to provisions of Section 79.
9. Purchase its own debenture/ share	The company can purchase its own debentures without any legal restrictions.	A company cannot purchase its own shares.
10. Priority on winding up	A debenture holder gets priority in respect of repayment when the company is wound up	Shareholders get back their money only after settlement of all other claims.

At this stage, student should be able to understand about charge—its basic nature, first charge, second charge, PARI PASSU CLAUSE, unsecured creditors, etc.

We have already explained about secured and unsecured debentures. Here, we have to learn more about unsecured debenture. Here, we have to learn more about fixed and floating charge. A "charge" is nothing but mortgage. A fixed charge is generally created on immovable assets such as land, building, machinery and so on. In case a charge is fixed, the company may enjoy the possession of the assets but cannot sell or lease without consent of the charge holders. A floating charge is mostly on movables—properties that are frequently changing. In this case, it is not mortgage of property. Example, stock in trade. The floating charge will become or attain the status of a fixed charge under the following circumstances:

(i) When the company fails to pay interest or principal or both
(ii) When the receiver is appointed
(iii) When the company ceases to function
(iv) When the company is being wound up

First charge and second charge: First charge implies the priority of repayment. The assets against which first charge is created are first used in paying the secured lenders holding the first charge. The balance amount is used for satisfying the claims of creditors holding second charge. In case the dues of second charge holders are not fully paid off, the unpaid amount of such lenders is to be treated as unsecured. To that extent they are paid along with unsecured creditors. This concept can be explained with the help of the following illustration:

Illustration 4.1

Following are the relevant figures extracted from the balance sheet of XZ Ltd. as on 31 March 2011:

(₹ in Lakhs)

Liabilities	₹	Assets		₹
12% A Debentures (Secured by Charge over Land and Building)	3,000	Fixed Assets:		
		Gross Block:	10,000	
12% B Debentures (Secured by Charge over Land and Building)	2,500	Less: Depreciation Accumulated	2,000	8,000
12% C Debentures (Floating Charge)	4,000	Current Assets		4,000
Unsecured Creditors	2,500			
	12,000			12,000

Notes to Balance Sheet:

Land is valued at ₹ 2,000 lakh (Cost: ₹ 1,250 lakh)

Building is valued at ₹ 2,500 lakh (Book value: ₹ 2,000 lakh) including in gross black. Other fixed assets were estimated to be realized at ₹ 2,750 lakh and current assets are valued at ₹ 3,750 lakh.

You are required to estimate the deficiency of secured creditors who would rank as unsecured creditors. Also ascertain the amount of unsecured creditors.

Solution

Value of Specific Assets **(₹ in Lakhs)**

Part I:

Step 1: Calculation of Total Realizable Value of Land & Building:

Realizable Value of Land (Given)	2,000

Add:	Realizable Value of Building (Given)	2,500
	Total realizable Value of Land & Building	4,500
Step 2:		
Less:	First Charge Debenture Value, i.e.	3,000
	Amount Due to 12% A Debentures Surplus Amount	1,500
Step 3:	From the Surplus Amount Left out,	
	Second Charge Debentures to Be Deducted, i.e.,	
Less:	Amount Due to 12% B Debentures	2,500
	Deficiency	1,000
Step 4:	This Deficiency (Difference) Has to Be Ranked as Unsecured Creditor	1,000

Part II: Determination of Total Unsecured Creditors:

		(₹ in Lakhs)
Step 1:	Unsecured Creditors as Shown in Balance Sheet	2,500
Step 2:	Add: Deficiency Arose (Ref: Part I Step 4)	1,000
Step 3:	Total Unsecured Creditors	3,500

4.4.1 Debentures with Pari Passu Clause

"Pari Passu" means equal in respect of charge and repayment. Debentures issued with "Pari Passu" clause means they are to be ranked together for the purpose of security created. Even though they are issued on different dates, they are to be paid rateably. The amount realized on sale of assets secured is to be divided among the debenture holders in proportion to the amount. Thus, it differs from first charge and second charge.

In case debentures are issued without "Pari Passu" clause, debentures would be paid according to the date of issue. If some of them are issued on the same date, then they will be paid according to their serial number.

4.5 DEBENTURE TRUST DEED

In case, when a series of debentures are issued by a company, it will be difficult to create charges on the assets of the company to each individual debenture holder. This necessitates for a company to execute trust deed through which the assets of the company are charged by way of mortgage to the trustees.

Debenture trust deed is a document created by the company to protect the interest of debenture holders. It is a form of a contract between the company and the trustees for the debenture holders. Debenture trust deed is to be prepared before the debentures are offered for public subscription

Who can be trustees?

In case of issue of debenture with maturity of more than 18 months, the issuer shall appoint a debenture trustee for 18 months from the following eligible list:

1. A scheduled bank carrying on commercial activity.
2. A public financial institution within the meaning of Section 4 A(1) of The Companies Act, 1956.
3. An insurance company
4. A body corporate

Who cannot be A TRUSTEE:

The following cannot be appointed as a debenture trustee:

1. A person who beneficially holds shares in the company.
2. A person who is beneficially entitled to receive money which are to be paid to/by the company to the debenture trustee.
3. Persons entered into any guarantee in respect of principal debts, secured by debenture or interest thereon.

The primary function and duty of every debenture trustee is to:

(i) Call for periodic report from the body corporate
(ii) Take possession of the trust properly in accordance with the provisions of the trust deed
(iii) Enforce security in the interest of shareholders
(iv) Verify that the charge created should be completed within 30 days of issue of allotment letter and dispatch of debenture certificated

The following are the advantages of creating a trust deed:

(i) The interests of debenture holders are safeguarded
(ii) Volume of work of creating charge is reduced to a great extent for the corporate body
(iii) Trustees act effectively by enforcing security properly
(iv) They act as watch dogs
(v) As they are empowered, problems are resolved amicably without delay

4.5.1 SEBI Guidelines

Any company has to comply with the provisions issued by SEBI. Some of the revisions are:

(i) Credit rating from authorized credit rating agency will have to be obtained and the same should be disclosed in the document
(ii) All such credit ratings obtained during the three years preceding such issue have to be disclosed in the offer document
(iii) A trust deed shall be executed by the company in favour of the trustees within six months of the closure of the issue
(iv) Trustees shall be vested with requisite powers for protecting the debenture holders
(v) Trustees shall ensure the implementation of the conditions regarding creation of security for debentures and debenture redemption reserve

4.6 COUPON RATE

Usually debentures are issued with a specific rate of interest, and this specified rate interest, and this specified rate, is termed as "coupon rate". The specified rate may be fixed or floating.

The floating interest rate is usually tagged with the bank rate and yield on treasury bond plus a reward for risk. The bank rate and yield on treasury securities keep on fluctuating over a period of time. So such change is compensated in the risk premium.

Rate of interest in such a case is quoted as "PLR + 50 basis or 100 basis points".

To illustrate:

Suppose if PLR is 9%, the rate of interest will be:

PLR + 50 basis point (0.5) or 100 basis point (1)

9% + 0.5 or 9% + 1%

i.e., 9.5% or 10%

- " + basis points" is determined in relation to risk involved.

4.6.1 Zero Coupon Bond

A zero coupon bond does not carry any specific rate of interest. To compensate the investors, such bonds are issued at a substantial discount. The difference between the face value and issue price is the total amount of interest related to the duration of the bond

Periodic change of interest is calculated by the following formula:

$$Bo = \frac{MV}{(1 + i)^n}$$

Where, Bo = Value of zero coupon bond
MV = Maturity value of zero coupon bond
n = Life of zero coupon bond
i = Required rate of return

To determine the value of $(1 + i)^n$, Present value Interest Factor (PVIF) Table is used.

PVIF for "i" rate of interest and "n" years is written as PVIF, i, n.

(It is given in the table—the present value of ₹ 1. To ascertain the factor, the number of years column and rate of interest column may be referred).

From the formula given above, different factors can be computed:

$$Bo = MV \times PVIF\ i, n.$$

or

$$MV = \frac{Bo}{PVIF\ i,n}$$

or

$$PVIF\ i, n = \frac{Bo}{MV}$$

Illustration 4.2

ABZ Ltd. issued a zero coupon bond having 20 years maturity with face value of ₹ 1,000. At what price the company should issue the bond, if the required rate of return is 12%?

Solution

Write the formula

$$Bo = MV \times PVIF\ i, n$$

$$i = 12\%\ \&\ n = 20 \text{ years}$$

Refer the table, the present value is given as 0.1037.

Substitute the values in the formula:

$$Bo = ₹ 1,000 \times 0.1037$$

$$= ₹ 103.70$$

It implies that the investor will be able to get a zero coupon bond for ₹ 103.70 (today), the face value being ₹ 1,000.

4.7 ACCOUNTING FOR ISSUE OF DEBENTURES

The procedure and accounting entries for the issue of debenture are very much similar to that adopted for the issue of shares. After perusing the prospectus, the intending lenders apply for debentures in the prescribed form along with application money. Debentures, like shares, may be issued at par or at a premium or at a discount. If debentures are issued payable by application, allotment and call installments,

the same procedure is to be followed as for shares; the required amount may be payable in lump sum or in instalments. Like shares, debentures can also be issued for cash, for consideration other than cash and as a collateral security.

4.7.1 Issue of Debentures for Cash

Accounting entries are same as in the case of shares, the difference being the world "debenture" instead of "share", i.e., "debenture" has to be inserted in the place of "share".

4.7.1.1 Issue of Debentures at Par

Debenture is said to be issued at par, when an investor (prospective debenture holder) pays an amount equal to the face value of the debenture.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	STAGE I:			
	1. On Receipt of Applications:			
	Bank A/c Dr.		…	
	To …% Debenture Application A/c			…
	(Application Money @ ₹ … Received on …. Debenture Received)			
	2. On Transfer to Debenture A/c:			
	[***Note:*** Debenture A/c itself is a debenture capital A/c			
	…% Debenture Application A/c Dr.		...	
	To Debenture A/c			…
	(Application Money Received, Transferred to Debentures A/c)			
	2(a): For Refund of Excess Debenture Application Money:			
	…% Debenture Application A/c Dr.		…	
	To Bank A/c			…
	(Excess Application Money Refunded)			
	STAGE II:			
	1. On Allotment Money Due:			
	…% Debenture Allotment A/c Dr.		…	
	To Debenture A/c			…
	(Allotment Money Due on Debentures)			
	1(a): Excess Debenture Application Money Adjusted on Debenture Allotment A/c:			
	…% Debenture Application A/c Dr.		…	
	To Debenture Application A/c			…
	(Excess Debenture Application Money Adjusted on Debentures Allotment A/c)			
	2. On Receipt of Allotment Money:			
	Bank A/c Dr.		…	
	To % Debenture Allotment A/c			…
	(Allotment Money Received)			

	Stage III:			
	1. On Making Calls:			
	…% Debenture Call A/c Dr.		…	
	To …% Debenture A/c			…
	(Call Money Due)			
	2. On Receipt of Call Money:			
	Bank A/c Dr.		…	
	To …% Debenture Call A/c			…
	(Call Money Received)			

Note:

1. Now, student may compare these entries with those made for issue of shares and notice the similarity.
2. As in shares, if more than one call is made, the accounts are aptly titled as debenture first call A/c, second call A/c and so on. Accounting entries will be the same as shown is Stage III (1 & 2) for subsequent calls made and money received on them.

Illustration 4.3

Model: Issue of debentures at par

ABZ Ltd. issued 5,000, 10% debentures of ₹ 100 each, payable ₹ 25 on application, ₹ 40 on allotment and ₹ 35, two months after allotment. All the debentures were duly applied for and paid.

Pass journal entries in the books of the company and also show how these will appear in the balance sheet.

Solution

Note: ₹ 35 received after allotment is to be received as "call" amount.

In the Books of ABZ Ltd.

Journal

Date		L.F.	Dr. ₹	Cr. ₹
	Stage I:			
	1. On Receipt of Application Money:			
	Bank A/c Dr.		1,25,000	
	To 10% Debenture Application A/c			1,25,000
	(Application Money @ ₹ 25 for 5,000 Debenture Received (5,000 × 25)]			
	2. On Transfer of Application Money to Debenture Capital A/c:			
	10% Debenture Application A/c Dr.		1,25,000	
	To 10 % Debenture A/c			1,25,000
	(Application Money Transferred to Debentures A/c)			
	Stage II:			
	1. On Allotment Money Due:			
	10% Debenture Allotment A/c Dr.		2,00,000	
	To 10 % Debentures A/c			2,00,000
	(Allotment Money @ ₹ 40 on 5,000 Debentures Due) (5,000 × ₹ 40)			

	2. On Receipt of Allotment Money: Bank A/c Dr. To 10% Debenture Allotment A/c (Allotment Money Received on 5,000 Debentures @ ₹ 40 per Debenture)		2,00,000	 2,00,000
	Stage III: 1. On Call Money Due: 10% Debenture Call A/c Dr. To 10% Debentures A/c (Call Money @ ₹ 35 on 5,000 Debentures Due) 5,000 × ₹ 35)		 1,75,000	 1,75,000
	2. On Receipt Call Money: Bank A/c Dr. To 10% Debenture Call A/c (Call Money Received)		 1,75,000	 1,75,000

Balance Sheet of ABZ Ltd.

as at …

Liabilities	₹	Assets	₹
10% Debentures	5,00,000	Cash/Bank	5,00,000

4.7.1.2 Over-subscription of Debenture

- A Company cannot allot more debentures than it has offered for subscription.
- When applications received are more than offered for subscription of debentures, it is termed as "over-subscription" in the case of debentures.
- When applications received are more than offered for subscription of debentures, it is termed as "over-subscription" in the case of debentures.

Treatment of "over-subscription":

The following are the three alternative approaches for dealing over-subscription:

1. **Outright rejection:** The Board of Directors can reject the excess outright. Hence, the application money received has to be returned in full.
2. **Partial or Pro-rata allotment:** In case debentures are allotted pro-rata, excess application money has to be adjusted along with allotment money.
3. **Full allotment:** The directors may make full allotment to some applicants, partial allotment to some applicants, and no allotment to the rest.

For partial allotment, excess money received on application is adjusted with allotment money. For no allotment, application money is refunded entirely.

Illustration 4.4

Model: Debenture issued at a premium

BXY Ltd. issued 4,000 14% debenture of ₹ 100 each payable as:

On Application	₹ 20
On Allotment	₹ 50
On First & Final Call	₹ 30 (After 3 months Allotment)

The public applied for 6,000 debentures. Applications for 3,500 debentures were accepted in full. Applicants for 1,000 debentures were allotted 500 debentures and the remaining was rejected. Pass required journal entries.

Solution

Note: This is a case of over-subscription.

Number of Debentures Issued	=	4,000
Number of Debentures Subscribed	=	6,000
∴ Excess	=	2,000

Way of Allotment:

Fully Accepted Debentures	:	3,500
Partially Accepted Debentures	:	1,000 Debenture Applicants for 500 Debentures
Totally Rejected Debentures	:	1,500

(6,000 – 3,500 – 1,000)

- For partially accepted, excess application money has to be adjusted to allotment money.
- For totally rejected, application money should be refunded.

Accordingly, the following accounting entries are to be passed:

Books of BXY Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I:			
	1. Bank A/c Dr.		1,20,000	
	To 14% Debenture Application A/c			1,20,000
	(Application Money Received on 6,000 Debentures @ ₹ 20 per Debenture)			
	2. 14% Debenture Application A/c Dr.		80,000	
	To 14% Debentures A/c			80,000
	(Application Money Transferred on 4,000 Debentures to Debentures Capital A/c)			
	2 (a) 14% Debenture Application A/c Dr.		30,000	
	To Bank A/c			30,000
	(Application Money Rejected on 1,500 Applications Refunded)			
	Stage II:			
	1. 14% Debenture Allotment A/c Dr.		2,00,000	
	To 14% Debentures A/c			2,00,000
	(Allotment Money Due on 4,000 Debentures @ ₹ 50 per Debenture)			
	1. (a) 14% Debenture Application A/c Dr.		10,000	
	To 14% Debenture Allotment A/c			10,000
	(Partial Allotment, i.e., Allotment of 500 Debentures, Adjusted to Allotment A/c)			

	2. Bank A/c Dr. To 14% Debentures A/c (Allotment Money Received [1 – 1(a)]		1,90,000	1,90,000
	Stage III: 1. 14% Debentures Call A/c Dr. To 14% Debentures A/c (Call Amount ₹ 30 Due on 4,000 Debentures)		1,20,000	1,20,000
	2. Bank A/c Dr. To 14% Debenture Call A/c (Call Amount on 4,000 Debentures @ ₹ 30 per Debenture Received)		1,20,000	1,20,000

Illustration 4.5

Model: Over-subscription—Issue of debentures at a premium

Govil & Co. Ltd. issued 10,000, 10% debentures of ₹ 50 each at a premium of 20% payable as:

On Application : ₹ 15
On Allotment : ₹ 30 (Including Premium)
On First & Final Call : ₹ 15

Applications were received for 20,000 debentures. All allotment was made proportionately, over-subscription being applied to the amount due on allotment. All money was duly received.

Pass necessary journal entries.

Also pass the entry if the whole amount of debenture is collected in one instalment only.

Solution

Note:

- In this question, the entire surplus application is adjusted towards allotment. Only the remaining balance is received on allotment.
- As in the case of shares, the premium is shown separately as "Securities Premium A/c" along with the due on debenture allotment.

Over-subscription and premium will be treated as above. The required entries will have to be passed in the books of Govil & Co. Ltd. as follows:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: 1. Bank A/c Dr. To 10% Debenture Application A/c (Application Money Received on 20,000 Debenture @ ₹ 15 Each)		3,00,000	3,00,000
	2. 10% Debentures Application A/c Dr. To 10% Debenture A/c (Transfer of Application Money on Allotment of 10,000 Debenture @ ₹ 15 Each)		1,50,000	1,50,000

	Stage II:			
	1. 10% Debenture Allotments A/c Dr.		3,00,000	
	To 10% Debenture A/c			2,00,000
	To Securities Premium A/c			1,00,000
	(Allotment Money Due on 10,000 Debenture @ ₹30 Each Including a Premium of ₹10)			
	1 (a): 10% Debentures Application A/c Dr.		1,50,000	
	To Debenture Allotment A/c			1,50,000
	(Surplus Money Received Adjusted to Debenture Allotment Amount Due)			
	2. Bank A/c Dr.		1,50,000	
	To 10% Debenture Allotment A/c			1,50,000
	(Balance of Allotment Money Received on 10,000 Debentures)			
	Stage III:			
	1. 10% Debenture First & Final Call A/c Dr.		1,50,000	
	To 10% Debenture A/c			1,50,000
	(First & Final Call Money Due on 10,000 Debenture @ ₹15 Each)			
	2. Bank A/c Dr.		1,50,000	
	To 10% Debentures First and Final Call A/c			1,50,000
	(First and Final Call Money Received on 10,000 Debentures @ ₹15 Each)			

If the whole amount is collected in one instalment, then entry:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Bank A/c Dr.		6,00,000	
	To 10% Debentures A/c			5,00,000
	To Premium on Issue of 10% Debentures A/c			1,00,000
	(10,000 Debentures of ₹50 Each Issued at a Premium of ₹10 Each)			

4.7.1.3 Issue of Debentures at a Discount

Illustration 4.6

Model: Debentures issued at discount

Azhar & Co. Ltd. issued 5,000, 10% debentures of ₹100 each at on discount of 5% payable ₹40 on application and the balance on allotment. Pass the necessary journal entries.

Solution

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I:			
	1. Bank A/c Dr.		2,00,000	
	To 10% Debenture Application A/c			2,00,000
	(Application Money Received on 5,000 Debentures @ ₹40 per Debentures)			

	2. 10% Debentures Application A/c Dr. To 10% Debentures A/c (Application Money Transferred to Debentures A/c)		2,00,000	2,00,000
	STAGE II: 1. 10% Debentures Allotment A/c Dr. Discount on Issue of Debentures A/c Dr. To 10% Debenture A/c (Allotment Money Due to 10% Debentures)		2,75,000 25,000	3,00,000
	2. Bank A/c Dr. To 10% Debentures A/c (Allotment Money Received on Debentures) ***Note:*** When the entire amount is received in single installment, entry is:		2,75,000	2,75,000
	Bank A/c Dr. Discount on Issue of Debentures A/c Dr. To 10% Debentures A/c (5,000 10% Debentures A/c Issued at a Discount of 5%, ₹ 100 Each)		4,75,000 25,000	5,00,000

4.7.2 Issue of Debentures for Consideration Other than Cash

At times, a company purchases assets from a vendor and issue debentures is payment of purchase consideration.

Journal Entry:

(i) Assets A/c Dr. ....
To Vendor A/c ....
(Purchase of Assets)

(ii) Vendor A/c Dr. ....
To Debentures A/c ....
(Issue of Debentures)

Purchase consideration: Amount paid by the purchasing company for the purchase of assets is called "purchase consideration."

This is computed as:

Purchase Consideration = Value of Assets – Liabilities

These debentures may also be issued at par or at premium or at a discount.

Illustration 4.7

Model: Issue of debentures for consideration other than cash

Joy & Co. Ltd. purchased assets of the book value of ₹ 5,40,000 from another firm. It was agreed that the purchase price be paid by issuing 14% debentures of ₹ 100 each.

Pass necessary journal entries if the debentures are issued (a) at par; (b) at a discount of 10% and (c) at a premium of 25%

Solution

NOTE:

1. Since purchase consideration is given in the problem, no need to compute it.
2. Number of debentures issued to be determined as follows:
   (a) Number of debentures issued a par

$$= \frac{\text{Purchase Consideration}}{\text{Value of Debenture (Free Value at Par)}} = ₹\frac{5,40,000}{₹100} = 5,400 \text{ debentures}$$

   (b) Number of debenture to be issued at a discount of 10% $= \frac{\text{Price Consideration}}{\text{Discounted Value of Debenture}}$

$$= \frac{₹\ 5,40,000}{₹\ 100 - 10\%} = \frac{₹\ 5,40,000}{₹\ 90}$$

$$= 6,000 \text{ debentures}$$

   (c) Number of Debentures to be issued at a premium $= \frac{\text{Purchase Consideration}}{\text{Debenture Value with Premium}}$

$$= \frac{₹5,40,000}{₹100 + 25\%} = \frac{₹5,40,000}{₹125}$$

$$= 4,320 \text{ debentures}$$

In the books of Joe & Co. Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Assets A/c Dr.		5,40,000	
	To Vendors A/c			5,40,000
	(Assets Purchased from Another Firm)			
	Case (a): Debentures Issued at Par:			
	Vendors A/c Dr.		5,40,000	
	To 14% Debentures A/c			5,40,000
	(5,400 Debentures (See : Note 2(a)) of ₹ 100 Issued at Par)			
	Case (b): Debentures Issued at Discount:			
	Vendors A/c Dr.		5,40,000	
	Discount on Issue of Debentures A/c Dr.		60,000	
	To 14% Debentures A/c			6,00,000
	(6,000 Debentures (See: Note 2(b)) of ₹ 100 Each Issued at a Discount of 10%)			
	Case (c): Debentures Issued at Premium:			
	Vendor's A/c Dr.		5,40,000	
	To 14% Debentures A/c			4,32,000
	To Premium on Issue of Debentures A/c			1,08,000
	(4,320 Debentures (See: Note 2(c)) of ₹ 100 Each Issued at a Premium of 25%)			

Sometimes, a company purchases the business of another company:

Entry for this will be:

Sundry Assets A/c	Dr.	…	
Goodwill A/c	Dr.	…	
To Sundry Liabilities A/c			…
To Vendor's A/c			…
To Capital Reserve A/c			…

However, in the entry of the two items—(i) goodwill A/c and (ii) capital reserve A/c—only one item will appear.

In the case, the value of net assets, i.e. Asset – Liabilities will not be equal to purchase consideration. There will be either goodwill A/c or capital reserve A/c.

Goodwill A/c: Payment in excess of the value of net assets is to be treated as goodwill A/c.

Capital Reserve A/c: If value of net assets is greater than purchase price, it results in gain to the company. It is to be treated as capital profit and transferred to capital reserve A/c.

Illustration 4.8

Model: Issue of debentures for consideration other than cash—Purchases the business of another company.

Vijay Ltd. took over the assets and liabilities of ₹ 50,00,000 and ₹ 5,00,000 of Ajay Ltd. Vijay Ltd. paid the purchase consideration of ₹ 48,00,000 by issuing debentures of ₹ 100 each at a premium of 20%. Pass journal entries in the books of Vijay Ltd.

Solution

Step 1: This is a case of issue of debentures for consideration other than cash at premium and purchase of business of another company. This is not an individual vendor.

Step 2: Determination of Amount of Debentures:

For Making Payment of ₹ 120 (₹ 100 + 20% Premium), the Number of Debentures Issued by the Company } = 1 Debenture

For Making Payment of ₹ 48,00,000, the Number of Debentures to Be Issued by the Company } $= \frac{1}{120} \times$ ₹ 48,00,000

= 40,000 Debentures

*[2] Value = 40,000 Debentures × ₹ 100 = ₹ 40,00,000

Step 3: To Determine Goodwill or Capital Reserve:

In This Question, the Purchase Consideration Exceeds the Value of Net Assets,

i.e., Purchase Consideration > Net Assets

Hence, Goodwill arises.

* Net Value of Assets = ₹ 50,00,000 – ₹ 5,00,000

= ₹ 45,00,000

*[1] Goodwill = Purchase Consideration – Value of Net Assets

= ₹ 48,00,000 – ₹ *45,00,000

= ₹ 3,00,000

Step 4:

Books of Vijay Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Sundry Assets A/c Dr.		50,00,000	
	*[1]Goodwill A/c		3,00,000	
	To Liabilities A/c			5,00,000
	To Ajay Ltd. A/c			48,00,000
	(Purchase of Assets & Liabilities of Ajay Ltd.)			
	Ajay Ltd. A/c Dr.		48,00,000	
	*[2]To % Debentures A/c			40,00,000
	To Premium on Issue of Debentures A/c			8,00,000
	(Issue of 40,000 Debentures of ₹ 100 Each at a Premium of 20%)			

Illustration 4.9

Model: Issue of debentures for other than cash—Assets and liabilities taken over

PQR Ltd. purchased assets of ₹4,50,000 and took over liabilities of ₹40,000 at an agreed value of ₹4,05,000 of ST Ltd. PQR Ltd. issued debentures of ₹100 each at a 10% discount in full satisfaction of the purchase price. Pass necessary journal entries in the books of PQR Ltd.

Solution

Note

1. Determination of Capital Reserve/Goodwill:
   (i) Value of Net Assets = Assets – Liabilities
   = ₹4,50,000 – ₹40,000
   = ₹4,10,000
   (ii) Purchase Consideration = ₹4,05,000
   (iii) Value of Net assets is More than Purchase Price, and hence the Difference is Treated as Capital Reserve
   (iv) ∴ Capital Reserve = ₹4,10,000 – 4,05,000
   = ₹5,000
2. Calculation of Number of Debentures to Be Issued:
   For Making the Payment of ₹90 (₹100 – 10 % discount), the Number of Debentures) Issued by the Company = 1 Debenture
   For Making the Payment of ₹4,05,000, the number of Debentures to Be Issued by the Company = $\frac{1}{90}$ × ₹4,05,000
   = 4,500 Debentures
   ∴ Value = 4,500 × ₹100 = ₹4,50,000

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Sundry Assets A/c Dr.		4,50,000	
	To Sundry Liabilities A/c			40,000
	*[1]To Capital Reserve A/c			5,000
	To ST Ltd. A/c			4,05,000
	(Purchase of Assets & Liabilities of PQR Ltd. and the Difference Credited to Capital Reserve)			
	ST Ltd. A/c Dr.		4,05,000	
	Discount on Issue of Debentures A/c Dr.		45,000	
	To Debentures A/c			4,50,000
	(Issue of Debentures (4,500) of ₹ 100 Each at a Discount of 10 % Each)			

4.7.3 Issue of Debentures as Collateral Security

It means issue of debentures as a subsidiary or secondary security. In other terms, collateral security means additional security.

- When the loan is repaid, i.e. discharged, such debentures issued as collateral security are returned to the company.
- The lender is not entitled to any interest on such debentures.
- The lender is entitled to interest only on the amount of loan, but never on debentures.
- But in case of any breach of terms and conditions, then the creditor is entitled to have a claim on all rights as a debenture holder.

Accounting Treatment:

- No immediate liability arises by pledging the debenture as a collateral security.
- Hence, no entry is required at the time of issue.
- However, this fact has to be shown in the balance sheet under the head "Secured Loans" on the liabilities side of the balance sheet.
- At times, the issue as a collateral security is entered as:

  Debenture Suspense A/c Dr. …

  To Debentures A/c …
- At the time of repayment of loan, this entry has to be reversed.

Illustration 4.10

Model: Issue of debentures as collateral security

Subh Ltd. secured a loan of ₹ 20,00,000 from a Nationalized bank, issuing 30,000, 15% debentures of ₹ 100 each as collateral security.

Record necessary accounting entries for such issue.

Solution

Approach I: An extract of balance sheet has to be drawn as follows:

Extract of Subh Ltd.'s Balance Sheet

as on…

Liabilities	₹	Assets	₹
Secured Loans:			
Loan from Bank …	20,00,000		
(Secured by Issue of 30,000 Debentures of ₹ 100 Each as Collateral Security)			

Approach II:

Journal—Books of Subh Ltd.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Debenture Suspense A/c Dr.		30,00,000	
	To 15% Debentures A/c			30,00,000
	(Issue of 30,000 15% Debentures of ₹ 100 Each as Collateral Security for Bank Loan)			

An Extract of Balance Sheet

Liabilities	₹	Assets	₹
Secured Loans:		Miscellaneous Expenditure:	
30,000 15% Debentures of ₹ 100 Each Issued as Collateral Security	30,00,000	Debentures Suspense A/c	30,00,000
Loan from Bank	20,00,000		

4.8 TERMS OF ISSUE OF DEBENTURES

A limited company issues debentures on certain terms and redeems them under varying categories as follows:

Conditions of Issue	Conditions of Redemption
Issued at Par…	Redeemable at Par
Issued at Par…	Redeemable at Premium
Issued at Discount…	Redeemable at Par
Issued at Premium…	Redeemable at Par
Issued at Premium ….	Redeemable at Premium
Issued at Discount…	Redeemable at Premium

Note: Debentures are issued at par or premium or discount but redemption is only at par or premium and not at discount mostly.

Accounting Treatment:

Journal entries for different terms of issue and redemption are as follows:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
I	Issued at Par and Redeemable at Par:			
	Bank A/c Dr.		…	
	To Debentures A/c			…

II	Issued at Par and Redeemable at Premium:				
	Bank A/c	Dr.		…	
	Loss on Issue of Debenture A/c	Dr.		…	
	To Debentures A/c				…
	To Premium on Redemption of Debentures A/c				…
III	Issued at Discount and Redeemable at Par:				
	Bank A/c	Dr.		…	
	Discount on Issue of Debentures A/c	Dr.		…	
	To Debentures A/c				…
IV	Issued at Premium and Redeemable at Par:				
	Bank A/c	Dr.		…	
	To Debentures A/c				…
	To Securities Premium A/c				…
V	Issued at Discount and Redeemable at Premium				
	Bank A/c	Dr.		…	
	Discount on Issue of Debentures A/c	Dr.		…	
	Loss on Issue of Debentures A/c	Dr.		…	
	To Debentures A/c				…
	To Premium on Redemption of Debentures A/c				…

Journal Entries for Each Category

Category I: Debenture Issued at Par and Redeemable at Par:

Entry:

(i)	Bank A/c	Dr.	…	
	To Debenture Application A/c			…
(ii)	Debenture Application A/c	Dr.	…	
	To …% Debenture A/c			…

Illustration 4.11

Model: Debenture issued at par and redeemable at par

Govil Ltd. issued 20,000, 12% debentures of ₹ 50 each payable on application and redeemable at par any time after 4 years from the date of issue. Pass entries for the issue of debentures in the books of Govil Ltd.

Solution

Books of Govil Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) Bank A/c Dr.		10,00,000	
	To Debenture Application A/c			10,00,000
	(Application Money on 20,000 Debentures @ ₹ 50 Each Received) 20,000 × ₹ 50			
	(ii) Debenture Application A/c Dr.		10,00,000	
	To 12% Debentures A/c			10,00,000
	(Application Money Transferred to 12% Debentures A/c)			

Category II: Debentures Issued at a Discount and Redeemable at Par:

Entry:

(i)	Bank A/ c	Dr.	…	
	To Debentures Application A/c			…
(ii)	Debenture Application A/c	Dr.	…	
	Discount on Issue of Debentures A/c	Dr.	…	
	To …% Debentures A/c			…

Illustration 4.12

Model: Issue of debenture at discount redeemable at par

Goel Ltd. issued 25,000, 12% debentures of ₹ 100 each at discount of 10% redeemable at par at any time after 5 years. Record entries in the books of Goel Ltd. for the issue of debentures.

Solution

Books of Goel Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) Bank A/c Dr.		22,50,000	
	To Debenture Application A/c			22,50,000
	(Application Money Received on 25,000 Debentures) (25,000 × ₹ 100 – 10%: ₹ 90)			
	(ii) Debenture Application A/c Dr.		22,50,000	
	Discount on Issue of Debentures A/c Dr.		2,50,000	
	To 12% Debentures A/c			25,00,000
	(Transfer of Application Money & Recording Discount)			

Category III: Debentures Issued at Premium, Redeemable at Par:

Entry:

(i)	Bank A/c	Dr.	…	
	To Debenture Application A/c			…
(ii)	Debenture Application A/c	Dr.	…	
	To …% Debentures A/c			…
	To Securities Premium A/c			…

Illustration 4.13

Model: Issue of debentures at premium and redeemable at par

AB Ltd. issued 10,000 13% debenture of ₹ 100 at a premium of 10% redeemable at par. Pass journal entries for the issue of debentures.

(OR)

The same question may be asked as:

AB Ltd. issued ₹ 10,00,000 13% debentures at a premium of 10% redeemable at par. Pass necessary journal entries for issue of debentures.

Solution

Books of AB Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Bank A/c Dr.		11,00,000	
	To Debentures Application A/c			11,00,000
	(Application Money Received on 10,000 Debentures Including a Premium of 10%)			
	Debenture Application A/c Dr.		11,00,000	
	To 13% Debentures A/c			10,00,000
	To Securities Premium A/c			1,00,000
	(Debenture Application Money Transferred to Debenture A/c and the Premium to Securities Premium A/c)			

Category IV: Debentures are Issued at Par and Redeemable at Premium:

Entry:

(i) Bank A/c Dr. …
To Debentures Application A/c …

(ii) Debenture Application A/c Dr. …
To …% Debentures A/c …

(iii) Loss on Issue of Debentures A/c Dr. …
To Premium on Redemption of Debentures A/c …

(OR)

Entries (ii) and (iii) may be combined into a single entry as:

(ii) + (iii) Debenture Application A/c Dr. …
Loss on Issue of Debentures A/c Dr. …
To …% Debentures A/c …
To Premium on Redemption of Debentures A/c …

Illustration 4.14

Model: Issue of debentures at par and redeemable at premium

X Ltd. issued ₹ 10,00,000 10% debentures at par and redeemable at 25% premium. Pass journal entries in the books of X Ltd.

Solution

Books of X Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) Bank A/c Dr.		10,00,000	
	To Debenture Application A/c			10,00,000
	(Application Money Received on Debentures)			

	(ii) Debenture Application A/c	Dr.		10,00,000	
	To 10% Debentures A/c				10,00,000
	(Transfer of Application Money to 10% Debentures A/c)				
	(iii) Loss on Issue of Debentures A/c	Dr.		2,50,000	
	To Premium on Redemption of Debenture A/c				2,50,000
	(Premium on Redemption Recorded)				
	(OR)				
	(ii + iii): Debenture Application A/c	Dr.		10,00,00	
	Loss on Issue of Debenture A/c	Dr.		2,50,000	
	To 10% Debentures A/c				10,00,000
	To Premium on Redemption of Debentures A/c				2,50,000
	(Debenture Issued at Par and Redeemable at 25% Premium)				

Category V: Debentures are Issued at a Discount and Redeemable at a Premium:

Entry:

(i)	Bank A/c	Dr.	…	
	To Debenture Application A/c		…	
(ii)	Debenture Application A/c	Dr.	…	
	Discount on Issue of Debentures A/c	Dr.	…	
	To …% Debentures A/c			…
(iii)	Loss on Issue of Debenture A/c	Dr.	…	
	To Premium on Redemption of Debentures A/c			…

Illustration 4.15

AZ Ltd. issued ₹ 10,00,000 9% debentures at a discount of 5% but redeemable at a premium of 5%. Give journal entry.

Solution

Books of AZ Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Bank A/c	Dr.		9,50,000	
	Loss on Issue of Debentures A/c	Dr.		1,00,000	
	To 9% Debentures A/c				10,00,000
	To Premium on Redemption of Debentures A/c				50,000
	(Issue of Debentures at a Discount and Redeemable at Premium)				
	***Note*:** The entry may also be passed as above.				

Category VI: Debentures are Issued at a Premium and Redeemable (Repayable) at Premium:

Entry:

(i)	Bank A/c	Dr.	…	
	To Debenture Application A/c			…

(ii)	Debenture Application A/c	Dr.	…	
	To … Debentures A/c			…
	To Securities Premium A/c			…
(iii)	Loss on Issue of Debentures A/c	Dr.	…	
	To Premium on Redemption of Debentures A/c			…
	(OR)			
(ii)	& (iii) in the combined form as:			
	Debenture Application A/c	Dr.	…	
	Loss on Issue of Debenture A/c	Dr.	…	
	To …% Debentures A/c			…
	To Securities Premium A/c			…
	To Premium on Redemption of Debentures A/c			…

Illustration 4.16

Model: Debentures issued at premium and redeemable at premium

A limited company issued 1,000 14% debentures of ₹ 100 each at a premium of 5% and redeemed at 10% premium. Make journal entries.

Solution

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Bank A/c	Dr.		1,05,000	
	To Debenture Application A/c				1,05,000
	(Application Money on Debentures Received)				
	Debenture Application A/c	Dr.		1,05,000	
	Loss on Issue of Debentures A/c	Dr.		10,000	
	To 14 % Debentures A/c				1,00,000
	To Securities Premium A/c				5,000
	To Premium on Redemption of Debentures A/c				10,000
	(Issued of Debentures at 5% Premium & Repayable @ 10% Premium)				
	(OR) AS A SINGLE ENTRY				
	Bank A/c	Dr.		1,05,000	
	Loss on Issue of Debentures A/c	Dr.		10,000	
	To 14% Debentures A/c				1,00,000
	To Securities Premium A/c				5,000
	To Premium on Redemption of Debentures A/c				10,000

4.9 INTEREST ON DEBENTURES

Interest on debentures is payable by a company at a fixed percentage (Coupon rate). The rate of interest is prefixed before the name of debentures. Example: 9% debentures, 10% debentures

It is an acknowledgement of debt and hence interest is payable periodically without default. It is immaterial whether the company earns profit or incurs loss. Generally, interest is payable half-yearly on debentures. It is a charge against the profit of the company.

Interest is computed on the face value (Nominal value) of debentures, and not on the issue price. Hence, no difference on the interest amount will arise if they are issued at par or at a discount or at a premium.

A company has to deduct income tax at the prescribed rate compulsorily (TDS) on the gross amount of debentures interest and deposit with income tax authorities. The rate of tax on debentures interest varies from year to year, as it is notified in the Finance Bill every year.

Accounting Treatment:

The journal entries that are to be passed in the books of the company with respect to interest on debentures are as follows:

(A): When Interest on Debentures Becomes DUE:

Debenture Interest A/c	Dr. …		(Gross Amount of Interest Due)
To Income Tax Payable A/c		…	(income Tax Amount Deducted)
To Debenture Holders A/c		…	(Net Amount of Interest After TDS)

(B): When Interest Was Paid:

Debenture Holders A/c	Dr. …		(Net Amount of Interest = Gross – TDS)
To Bank A/c		…	

(C): When Tax Was Paid to Tax Authorities:

Income Tax Payable A/c	Dr. …		(Amount Deducted at Source – TDS)
To Bank A/c		…	

(D): When Debenture Interest A/c is Closed: (Transfer to P&L A/c)

Profit & Loss A/c	Dr. …		(Gross Amount of Interest on Debentures)
To Debenture Interest A/c		…	

Illustration 4.17

Model: Debenture interest

Riddhu Ltd. issued 10,000 10% debentures of ₹100 each on 1 January 2010 at a discount of 5% and redeemable at a premium of 20%. Tax deducted at source is 10% interest payable on 30 June and 31 December as the company adopts calendar year as accounting year.

Pass journal entries for:

(i) Issue of debentures

(ii) Debenture interest for the period ended 31 December 2010

Solution

Note

1. First, students have to pass journal entries for issue of debentures.
2. Interest on debentures has to be computed as:

Apply the Formula: Interest = $\frac{Pnr}{100}$

Where P = Principal—here (10,000 × 100) = ₹10,00,000

n = Period—here 6 months = $\frac{6}{12}$

r = rate of interest—10 % = $\frac{10}{100}$

Interest on debentures = ₹ 10,00,000 × $\frac{6}{12}$ × $\frac{10}{100}$

= ₹ 50,000—payable on 30 June and 31 December every year.

3. Tax Deducted at Source TDS:

10% (Given) on ₹ 50,000 (Gross interest: Note 2)

= $\frac{10}{100}$ × ₹ 50,000 = ₹ 5,000

4.

Journal of Riddhu Ltd.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 January 2010	(i) For Issue of Debentures:			
	Bank A/c Dr.		9,50,000	
	To Debenture Application A/c			9,50,000
	(Application Money Received on 10,000 Debentures @ ₹ 100 – 5% discount 10,000 × ₹ 95: ₹ 9,50,000)			
	Debenture Application A/c Dr.		9,50,000	
	Loss on Issue of Debentures A/c Dr.		2,50,000	
	To 10 % Debentures A/c			10,00,000
	To Premium on Redemption of Debentures A/c			2,00,000
	(Issue of Debentures at 5% Discount and Redeemable (Repayable) at 20% Premium)			
30 June 2010	For Interest on Debentures:			
	(a) Debenture Interest A/c Dr.		50,000	
	To Income Tax Payable A/c			5,000
	To Debenture Holders A/c			45,000
	(Interest Due for 6 months, i.e. up to 30 June 2010 and TDS @ 10 % on Gross Interest)			
30 June 2010	(b) Income Tax Payable A/c Dr.		5,000	
	To Bank A/c			5,000
	(TDS—Income Tax Paid to Government)			
30 June 2010	(c) Debenture Holders A/c Dr.		45,000	
	To Bank A/c			45,000
	(Net Interest (Gross – TDS) Paid to Debenture Holders) (a – b)			
31 December 2010	(d) Debenture Interest A/c Dr.		50,000	
	To Income Tax Payable A/c			5,000
	To Debenture Holders A/c			45,000
	(Interest Due on 31 December 2010 and TDS @ 10% there on Due)			

	(e) Income Tax Payable A/c Dr. To Bank A/c (Tax Paid to Government)		5,000	5,000
	(f) Debenture Holders A/c Dr. To Bank A/c (Interest on Debentures Paid to Debenture Holders) (d – e) ***Note:*** Students should note that entries (d), (e) and (f) are repetition of entries (a), (b) and (c).		45,000	45,000
31 December 2010	Profit & Loss A/c Dr. To Debenture Interest A/c (Transfer of Interest on Debentures ₹ 50,000 + ₹ 50,000 = ₹ 1,00,000 to P&L A/c)		1,00,000	1,00,000

4.9.1 Net Effective Rate of Interest

Net effective rate of interest represents the actual amount of interest paid. While determining the effective rate of interest, the actual amount received is to be taken into account. The main difference between the debenture interest calculation and net effective rate of interest is as follows:

Debenture interest is calculated on the nominal value whereas effective rate of interest is calculated on the actual amount received on debentures. That means, it has to be adjusted for premium and discount while determining the actual amount collected on debentures.

Illustration 4.18

Model: Net effective rate of interest

X Ltd. issued ₹ 10,00,000 12 % debentures of ₹ 100 each. Assuming that the debentures were issued (a) at par; (b) at a premium of 20% and (c) at a discount of 10%, calculate the net effective rate of interest on debentures.

Solution

Debentures Issued at: (1)	Normal Value (2) ₹	Amount Collected (3) ₹	Interest @ 12% on Debentures (4) ₹	Effective Rate of Interest (5) = (4) ÷ (3) × 100 %
(a) At Par	10,00,000	10,00,000 (Same)	1,20,000	$\frac{1,20,000}{10,00,000} \times 100 = 12\%$
(b) At Premium	10,00,000	12,00,000 (+20% Premium)	1,20,000	$\frac{1,20,000}{12,00,000} \times 100 = 10\%$
(c) At Discount	10,00,000	9,00,000 (–10% Discount)	1,20,000	$\frac{1,20,000}{9,00,000} \times 100 = 13.33\%$

One should note that the amount of interest on debentures is ₹ 1,20,000 in all the three cases because interest payable is calculated on the nominal value, i.e. ₹ 10,00,000 $\times \frac{12}{100}$ = 1,20,000. But the effective rate of interest varies in each case, because it is calculated on the amount collected, i.e., ₹ 10,00,000 at par, ₹ 12,00,000 at premium and ₹ 9,00,000 at discount.

4.9.2 Interest Accrued and Due

Generally, interest on debentures is paid, every six months, periodically. Depending on the accounting policy, the date of payment of debentures varies. Suppose the accounting period ends on 31 March, a company pays interest on 30 September (first half-year) and 31 March (second half-year). That means, the company has an accounting policy of paying interest on 30 September and 31 March. Further assume that the company paid interest on 30 September but did not pay an 31 March, then in such a case, the debentures interest is accrued and due. This is technically called "outstanding interest". It is important to note here that the debenture holder cannot demand the payment of interest before 31 March. If it remains unpaid only on or after such specified dates, such interest accrued and due is referred to "outstanding interest".

Entry will be:

Debenture Interest A/c	Dr.	…	
To Outstanding Debenture Interest A/c			…

In the balance sheet it will be shown as:

The outstanding interest on debenture is to be shown along with the nominal value of debentures on the liabilities side of the balance sheet under the head "Secured Loans".

4.9.3 Interest Accrued but Not Due

As already said, payment of debenture interest depends on the accounting policy. Assume that a company pays interest on debentures on 30 June and 31 December and it closes its accounts on 31 March (i.e., financial accounting year) in such a case, after six months, i.e., 30 June. Technically speaking, interest from 1 January to 31 March has to be properly accounted for. This is technically termed as "interest accrued but not due" or simply "accrued interest."

Entry:

Debenture Interest A/c	Dr.	…	
To Accrued Debenture Interest A/c			…

Even in such a situation, a debenture holder cannot claim his right to pay interest for these 3 months.

The "accrued interest" has to be shown as "Current Liability" in the balance sheet.

Students should remember that "outstanding interest" is to be shown under "Secured Loans" and "accrued interest" is to be shown under "Current Liabilities".

4.10 DISCOUNT OR LOSS ON ISSUE OF DEBENTURES

The discount on the issue of debentures or any loss on debentures is a fictitious asset. Hence, it has to be written off at an early date, by late before the expiry of the lifetime of debentures.

The following are the methods available to write off discount/loss on issue of debentures:

(i) Fixed instalment method
(ii) Equated method

4.10.1 Fixed Instalment Method

This method is applicable when the debentures are redeemed at the end of a specified period. Under this method, the total amount of discount is to be written off by equal instalments.

To illustrate, assume that the total discount allowed is ₹ 30,000 and the debentures are to be redeemed at the end of 6 years, then the amount to be written off annually will be $\frac{₹\ 30{,}000}{6 \text{ years}}$ = ₹ 5,000. At the end of sixth year, discount will be written off completely.

4.10.2 Equated Method, Fluctuating or Variable Instalment Method

Under this method, the discount is to be written off by proportionately reducing instalments. This method may be explained by the following illustration:

Illustration 4.19

Model: Discount on issue of debentures—Variable instalment method

A public limited company issued 10% debenture of the face value of ₹ 10,00,000 at a discount of 6%. The debentures were repayable by annual drawings of ₹ 2,00,000.

How would you deal with the discount on issue of debentures? Show the discount account in the company's ledger for the duration of debentures.

Solution

Note: As it is given in the problem that "the debentures were repayable by annual drawings", variable instalment method is to be adopted.

Step 1: Computation of Total Amount of Discount on Issue of Debentures:

Face Value of Debenture	= ₹ 10,00,000
Discount Rate	= 6%
∴ Discount Amount	= ₹ 10,00,000 × $\frac{6}{100}$
	= ₹ 60,000

Step 2: This Total Amount ₹ 60,000 is to be Written Off in Proportion to the Debentures Outstanding at the Beginning of Each Year.

The Ratio of the Amount in Use for Each Year is to be Determined as:

Year End of		**Amount** ₹
First Year	10,00,000 →	10,00,000
Second Year	₹ (10,00,000 – 2,00,000)	8,00,000
Third Year	₹ (8,00,000 – 2,00,000)	6,00,000
Fourth Year	₹ (6,00,000 – 2,00,000)	4,00,000
Fifth Year	₹ (4,00,000 – 2,00,000)	2,00,000

Outstanding Balance Ratio = 10,00,000 : 8,00,000 : 6,00,000 : 4,00,000 : 2,00,000

= 10 : 8 : 6 : 4 : 2

or

= 5 : 4 : 3 : 2 : 1

Step 3: Amount of Discount to be Written off Every Year:

		₹
First Year	₹ 60,000 × $\frac{1}{15}$	20,000
Second Year	₹ 60,000 × $\frac{4}{15}$	16,000
Third Year	₹ 60,000 × $\frac{3}{15}$	12,000
Forth Year:	₹ 60,000 × $\frac{2}{15}$	8,000
Fifth Year:	₹ 60,000 × $\frac{1}{15}$	4,000
	Total	60,000

Step 4: Preparation of Debenture Discount A/c:

Debenture Discount Account

Date	Particulars	₹	Date	Particulars	₹
Ist Year 1 January	10% Debentures A/c	60,000	Ist Year 31 December 31 December	P&L A/c Balance c/d	20,000 40,000
		60,000			60,000
IInd Year 1 January	Balance b/d	40,000	IInd Year 31 December	P&L A/c Balance c/d	16,000 24,000
		40,000			40,000
IIIrd Year 1 January	Balance b/d	24,000	IIIrd Year 31 December	P&L A/c Balance c/d	12,000 12,000
		24,000			24,000
IVth Year 1 January	Balance b/d	12,000	IVth Year 31 December	P&L A/c Balance c/d	8,000 4,000
		12,000			12,000
Vth Year 1 January	Balance b/d	4,000	Vth Year 31 December	P&L A/c	4,000

Illustration 4.20

Model: Fixed installment method

Usha Ltd. issued ₹ 1,00,000 debentures at a discount of 10% repayable at the end of 5 years. Prepare the discount account in the ledger for the period.

Solution

Debentures are to be redeemed at the end of 5 years.

Step 1: Determination of Total Discount Amount:

Face Value of Debentures = ₹ 1,00,000

Discount Rate = 10%

Discount Amount $= ₹ 1,00,000 \times \frac{10}{100} = ₹ 10,000$

Step 2: Amount to be Written for 1 year is to be Computed:

$$= \frac{\text{Total Value of Discount}}{\text{Number of Years}}$$

$$= ₹ \frac{10,000}{5} = ₹ 2,000$$

Every Year ₹ 2,000 Has to Be Written off.

Step 3: Preparation of Debenture Discount A/c:

Debenture Discount Account

Date	Particulars	₹	Date	Particulars	₹
Ist Year 1 January	…% Debentures A/c	10,000	Ist Year 31 December	P&L A/c	2,000
			31 December	Balance c/d	8,000
		10,000			10,000
IInd Year 1 January	Balance b/d	8,000	IInd Year 31 December	P&L A/c	2,000
				Balance c/d	6,000
		8,000			8,000
IIIrd Year 1 January	Balance b/d	6,000	IIIrd Year 31 December	P&L A/c	2,000
				Balance c/d	4,000
		6,000			6,000
IVth Year 1 January	Balance b/d	4,000	IVth Year 31 December	P&L A/c	2,000
				Balance c/d	2,000
		4,000			4,000
Vth Year 1 January	Balance b/d	2,000	Vth Year 31 December	P&L A/c	2,000

Illustration 4.21

Model: When first redemption falls in next-accounting period

A public limited company issued 10% debentures at 94% ₹ 5,00,000 on 1 July 2005 repayable by five equal annual instalments of ₹ 1,00,000. The company closes its accounts on 31 March every year. Indicate the amount of discount to be written off every accounting year assuming that the company decides to write off the debenture discount during the life of the debentures.

Solution

For each year amount outstanding has to be computed and on the basis of total amount for each year, the ratio has to be determined and finally the amount to be written off has to be ascertained on the basis of such ratio. This is done in the following three stages:

Stage I:

Year Ended 31 March	Amount Outstanding ₹	Period		Number of Months	Total Amount ₹
		From	To		
(1)	(2)	(3)	(4)	(5)	(6) = (2) × (5)
2006	5,00,000	1 July 2005	31 March 2006	9	45,00,000
2007	5,00,000	1 April 2006	30 June 2006	3	15,00,000

	(5,00,000 – 1,00,000) = 4,00,000	1 July 2006	31 March 2007	9	36,00,000
					51,00,000
2008	4,00,000	1 April 2007	30 June 2007	3	12,00,000
	(4,00,000 – 1,00,000) = 3,00,000	1 July 2007	31 March 2008	9	27,00,000
					39,00,000`
2009	3,00,000	1 April 2008	30 June 2008	3	9,00,000
	(3,00,000 – 1,00,000) = 2,00,000	1 July 2008	31 March 2009	9	18,00,000
					27,00,000
2010	2,00,000	1 April 2009	30 June 2009	3	6,00,000
	(2,00,000 – 1,00,000) = 1,00,000	1 July 2009	31 March 2010	9	9,00,000
					15,00,000
2011	1,00,000	1 April 2010	30 June 2010	3	3,00,000

Stage II: Determination of Ratio:

Year Ended	31 March 2006	31 March 2007	31 March 2008	31 March 2009	31 March 2010	31 March 2011
Total Amount (in ₹)	45,00,000	51,00,000	39,00,000	27,00,000	15,00,000	3,00,000
Ratio	45	51	39	27	15	3
(OR)	15	17	13	9	5	1

∴ The Amount of Discount: 6% of ₹ 5,00,000 = ₹ 30,000 is to be Written off in the Ratio of 15 : 17 : 13 : 9 : 5 : 1. (OR)

$$\frac{15}{60} : \frac{17}{60} : \frac{13}{60} : \frac{9}{60} : \frac{5}{60} : \frac{1}{60}$$

Stage III: Amount of Discount on Issue of Debentures to be Written off Each Year is Determined as Follows:

Year Ended 31 March	Ratio	Amount to be Written off (₹)
2006	$₹ 30,000 \times \frac{15}{60}$	7,500
2007	$₹ 30,000 \times \frac{17}{60}$	8,500
2008	$₹ 30,000 \times \frac{13}{60}$	6,500
2009	$₹ 30,000 \times \frac{9}{60}$	4,500

2010	₹ 30,000 × 5/60	2,500
2011	₹ 30,000 × 1/60	500
	Total	30,000

Illustration 4.22

Model: First redemption after few years—Discount written off

New India Ltd. issued 1,000 debentures of ₹ 100 each as a discount of 6%. The expenses of issue amounted to ₹ 3,500. The debentures have to be redeemed at the rate of ₹ 10,000 each year commencing with the end of fifth year. How much discount and expenses should be written off each year?

Solution

First total amount to be written off has to be computed as follows:

		₹
Amount of Discount = 6% of ₹ (1,000 × 100)	=	6,000
Amount of Expenses (Given)	=	3,500
Total Amount to be Written off:	=	9,500

This amount ₹ 9,500 is to be written off in the ratio of amounts of debentures in use for the years, calculated as follows:

End of the Year	Outstanding Amount	Ratio
1	1,00,000	10
2	1,00,000	10
3	1,00,000	10
4	1,00,000	10
5	1,00,000	10
6	90,000	9
7	80,000	8
8	70,000	7
9	60,000	6
10	50,000	5
11	40,000	4
12	30,000	3
13	20,000	2
14	10,000	1
15	Nil	—
	Total of Ratios	95

1. Amount of Discount & Expenses to be Written off in First 5 years (each year individually):

   ₹ 9,500 × 10/95 = ₹ 1,000

   That means, at the end of 1st year, 2nd year, 3rd year, 4th year and 5th year, ₹ 1,000 each year will be written off respectively.

From 6th year to the end of 14th year, the amount to be written off is calculated as follows:

End of the Year	Ratio	Amount to be Written off ₹
6	₹9,500 × $\frac{9}{95}$	900
7	₹9,500 × $\frac{8}{95}$	800
8	₹9,500 × $\frac{7}{95}$	700
9	₹9,500 × $\frac{6}{95}$	600
10	₹9,500 × $\frac{5}{95}$	500
11	₹9,500 × $\frac{4}{95}$	400
12	₹9,500 × $\frac{3}{95}$	300
13	₹9,500 × $\frac{2}{95}$	200
14	₹9,500 × $\frac{1}{95}$	100

4.11 LOSS ON ISSUE OF DEBENTURES

Loss on issue of debentures is incurred at the time of issue of debentures and also on redemption of debentures. This is a capital loss.

The loss occurs thus:

(i) When the debentures are issued at par but redeemable at premium. Here,
Loss = Premium payable on redemption

(ii) When the debentures are issued at discount and redeemable at premium → Loss = Amount of discount on the issue of debentures + Premium payable on redemption

Students should clearly distinguish this with "discount on issue of debentures" where it is the amount of loss incurred at the time of issue of debentures only.

Accounting treatment is very much similar to that of discount on issue of debentures.

Entry will be:

P&L A/c Dr. … {Amount Written off}
To Loss on Issue of Debenture A/c …

Illustration 4.23

Model: Loss on issue of debentures

Bala & Co. Ltd. issued 8,000 12% debentures of ₹50 each payable at a discount of 10% repayable after 5 years at a premium of 10%.

You are required to record:

(a) Journal entries at the time of issue and at the time of redemption
(b) Loss on issue of debentures account for the period

Solution

In this question,

Loss = Amount of Discount on Issue of Debenture + Premium on Redemption

= (10% of ₹ 50 × 8,000) + (10% of ₹ 50 × 8,000)

= (₹ 5 × 8,000) + (₹ 5 × 8,000)

= ₹ 40,000 + ₹ 40,000

= ₹ 80,000

Bala & Co. Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	(A) 1. At the Time of Issue of Debentures:				
	Bank A/c	Dr.		3,60,000	
	To Debentures Application A/c				3,60,000
	(Application Money Received on Debentures)				
	Debentures Application A/c	Dr.		3,60,000	
	*[1]Loss on Issue of Debentures A/c	Dr.		80,000	
	To 12% Debentures A/c				4,00,000
	To Premium or Redemption of Debentures A/c				40,000
	(8,000 12% Debentures of ₹ 50 Each Issued as 10% Discount and Repayable @ 10% Premium)				
	2. At the Time of Redemption:				
	12% Debentures A/c	Dr.		4,00,000	
	Premium on Redemption of Debentures A/c	Dr.		40,000	
	To Debenture Holders A/c				4,40,000
	(12% Debentures Repayable @ 10% Premium)				
	Debenture Holders A/c	Dr.		4,40,000	
	To Bank A/c				4,40,000
	(Amount Paid off at the End of 5 years)				

(B) Loss on Issue of Debenture:

Debenture life, i.e., to be redeemed at the end of 5 years

Loss has to be written off equally for these years.

$$\text{Loss Amount to be Written off} : \frac{\text{Total Loss}}{\text{Number of Years}}$$

$$= \frac{₹\ 80{,}000}{5 \text{ Years}}$$

= ₹ 16,000 every year.

Loss on Issue of Debenture Account

End of Year	Particulars	₹	End of Year	Particulars	₹
1	12% Debentures A/c	40,000	1	Profit & Loss A/c	16,000
	Premium on Redemption of Debenture A/c	40,000		Balance c/d	64,000
		80,000			80,000
2	Balance b/d	64,000	2	P&L A/c	16,000
				Balance c/d	48,000
		64,000			64,000
3	Balance b/d	48,000	3	P&L A/c	16,000
				Balance c/d	32,000
		48,000			48,000
4	Balance b/d	32,000	4	P&L A/c	16,000
				Balance c/d	16,000
		32,000			32,000
5	Balance b/d	16,000	5	P&L A/c	16,000

4.12 REDEMPTION OF DEBENTURES

4.12.1 Meaning and Features

Redemption of debentures means repayment of the amount due on debentures to debenture holders.

Its features are as follows:

- It is a discharge of liability
- It should be redeemed as per the terms and conditions of issue.
- Generally, debentures are to be redeemed at the expiry of the specified period mentioned in the debenture certificate or trust deed.
- At times, the debentures may be redeemed before the expiry period.
- The redemption may be made in instalments or by purchasing them in open market.
- A company can purchase is own debentures, cancel and re-issue them.
- When redeemed debentures are re-issued, no fresh mortgage is necessary
- However, a company cannot redeem and re-issue them with a different redemption date.
- Failure to redeem debentures on maturity will result in disqualification of a director for 5 years.

4.12.2 Methods of Redemption of Debentures

Debentures may be redeemed by the following methods:

(i) Redemption on maturity in one lump sum
(ii) Redemption may be made in annual instalments or by draw of lots
(iii) By purchase of its own debentures in the open market
(iv) By conversion into shares

4.12.3 Sources of Redemption of Debentures

The following are the main sources for redeeming debentures:

(i) Capital
(ii) Profits
(iii) Sale of assets
(iv) Fresh issue of shares and debentures
(v) Surplus funds

4.12.4 Debenture Redemption Reserve (DRR)

In accordance with the provisions of Section 117 C of the Companies (Amendment) Act 2000, a company must create Debentures Redemption Reserve (DRR) for the redemption of debentures that have a maturity period of 18 months or more.

Some of the important provisions envisaged in the Companies Act with respect to DRR are as follows:

(i) DRR must be created to which adequate amounts shall be credited from out of profits every year until such debentures are redeemed.
(ii) The DRR should not be utilized for any other purposes.
(iii) Transfer to DRR should be done every year continuously till the complete redemption of all debentures.
(iv) In case debentures are issued for project finance, DRR can be created up to the date of commercial production. DRR may be created in equal instalments or higher amounts of profits so permit.
(v) Creation of DRR is obligatory only for non-convertible debentures and non-convertible portion of party convertible debentures. No need arises to create DRR for fully convertible debentures.
(vi) DRR is treated as a part of "general reserve" for bonus issues and price fixation.
(vii) A company should create DRR equivalent to 50% of the amount of debenture issue before redemption begins.
(viii) Drawal from DRR is permitted only after 10% of the debentures are redeemed actually.

Accounting Entry to Create DRR:

Profit and Loss Appropriation A/c	Dr.	…
To Debenture Redemption Reserve A/c		…

Now, let us discuss the methods of redemptions of debentures one by one.

4.12.5 Redemptions in One Lump Sum After the Expiry of the Specified Period

Under this method, the repayment is made in one lump sum at the expiry of specified period, mentioned in debenture certificate. The debentures are redeemed either at par or at premium as per the terms of issue. In practice, debentures are NOT redeemed at discount.

Accounting Entries:

(A) When the Debentures are Redeemed at Par:

(i) When Debentures Become DUE for Payment on Redemption:

Debentures A/c	Dr. …		
To Debenture Holders A/c		…	{Face Value}

(ii) On Redemption (Amount Paid off):

Debenture Holders A/c	Dr.	…		
To Bank A/c			…	{With the Amount Paid}

(B) When the Debentures are Redeemed at Premium:

(i) When Payment is Due:

Debentures A/c	Dr.	…		{Face Value}
Premium on Redemption of Debentures A/c	Dr.	…		{Premium}
To Debenture Holders A/c			…	{Total}

(ii) On Redemption (Amount Paid off):

Debenture Holders A/c	Dr.	…		
To Bank A/c			…	

Under this method, the following two approaches are available for redemption of debentures:

1. Redemption out of capital
2. Redemption out of profit

1. **Redemption out of capital:** Debentures may be redeemed out of capital. Profits or money earned in course of the business is not utilized here. In such a case, no transfer is required to general reserve or DRR. Redemption out of capital results in reduction of capital.

   But, according to Section 117 C of the Companies (Amendment) Act 2000 and the SEBI Guidelines, 50% of the amount of issue of debenture is to be created under DRR before the commencement of debentures redemption. Hence, it is not possible to redeem debentures entirely out of capital. As such, this method is not in vogue.

2. **Redemption out of profit:** Redemption of debentures out of profit means redemption through DRR A/c. A certain sum of money is transferred from profit and loss appropriation A/c (Divisible profits) to a newly created account: DRR A/c. This is to be utilized exclusively for redemption of debentures.

   Accounting Treatment: When redemption of debentures is made out of profits, entries will be as follows:

   The first two entries, i.e., when debentures are redeemed at par and at premium, are the same as those discussed under the head: Redemption in One Lump Sum: A & B entries. Repeat those entries here and then proceed:

(C) On Appropriation of Divisible Profits:

P&L Appropriation A/c	Dr.	…	
To DRR A/c			…

(D) On Payment to Debentures:

Debenture Holders A/c	Dr.	…	
To Bank A/c			…

(E) Transfer of Balance in DRR A/c to General Reserve A/c:

Debentures Redemption Reserve A/c (DRR)	Dr.	…	
To General Reserve A/c			…

(F) On Closing of Premium on Redemption of Debentures A/c:

In case no entry was made for premium on redemption of debenture at the time of issue, now the following entry is to be made to close the same.

Securities Premium A/c	Dr.	…
Profit & Loss A/c	Dr.	…
General Reserve A/c	Dr.	…
To Premium on Redemption of Debentures A/c		…

Note:

1. DRR A/c is to be shown on the liabilities side of the balance sheet under the head: "Reserves & Surplus".
2. When redemption is fully completed, this account is closed and transferred to "General Reserve".

Illustration 4.24

Model: Redemption out of profits

U.V.R Ltd. had issued ₹10,00,000 12% debentures in 2006 and the same were to be redeemed on 1 January 2011, out of the profits. The DRR stood at ₹2,75,000. Show the entries assuming that the debentures were redeemed at a premium of 10%.

Solution

U.V.R. Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 January 2011	12% Debentures A/c Dr.		10,00,000	
	Premium on Redemption of Debentures A/c Dr. (10% of ₹10,00,000)		1,00,000	
	To Debenture Holders A/c			11,00,000
	(Amount Due to Debenture Holders at a Premium of 10%)			
1 January 2011	Profit and Loss Appropriation A/c Dr.		2,25,000	
	To Debenture Redemption Reserve A/c			2,25,000
	(50% of Nominal Value of Debentures to Be Redeemed, i.e., 50% of ₹10,00,000 is ₹5,00,000. Already Existing as Shown in the Problem ₹2,75,000 ∴ Balance = ₹2,25,000 Transferred to DRR)			
1 January 2011	Profit & Loss Appropriation A/c Dr.		5,00,000	
	To General Reserve A/c			5,00,000
	(Appropriation of Profits to the Extent of 50% of the Face Value of Debentures)			
1 January 2011	Debentures A/c Dr.		11,00,000	
	To Bank A/c			11,00,000
	(Amount Paid to Debenture Holders on Redemption)			

	Profit and Loss A/c Dr. To Premium on Redemption of Debentures A/c (Premium on Redemption of Debenture Account is Transferred to P&L A/c and Thereby Closed)		1,00,000	 1,00,000
	Debentures Redemption Reserve A/c Dr. To General Reserve A/c (Balance of DRR A/c Is Transferred to General Reserve Account) (₹ 10,00,000 – ₹ 5,00,000)		5,00,000	 5,00,000

Illustration 4.25

Model: Redemption out of profit

XZ Ltd. has a balance of ₹ 12,00,000 in P&L A/c. The company decided to forego payment of dividend and instead utilize the profits to repay 12% ₹ 10,50,000 debentures on 30 June 2009 as a premium of 10%. Debentures interest is payable annually on 31 December every year when the accounts are closed. The company also has a balance of ₹ 6,00,000 in the debenture redemption reserve account.

Journalize the transactions.

Solution

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
30 June 2009	* Debenture Interest A/c Dr. To Bank A/c (Payment of Interest to Debenture Holders) ***Note:*** Interest has to be paid and debentures are to be redeemed on 30 June.		63,000	 63,000
	12% Debentures A/c Dr. Premium on Redemption of Debentures A/c Dr. To Debenture Holders A/c (Amount Payable on Redemption Including Premium on Redemption)		10,50,000 1,05,000	 11,55,000
	Profit and Loss Appropriation A/c Dr. To Debentures Redemption Reserve A/c (Appropriation of Profits to Redeem the Debentures) ***Note:*** Since the debentures have been redeemed fully out of profits, transfer of ₹ 4,50,000 to DRR is made, even though the balance in DRR is more than 50% of the nominal value of debentures.		4,50,000	 4,50,000

	Debenture Holders A/c Dr.		11,55,000	
	To Bank A/c			11,55,000
	(On Redemption, the Debenture Holders Are Paid off)			
	Debenture Interest Is Calculated as:			
	$₹10,50,000 \times \frac{6}{12} \times \frac{2}{100} = ₹63,000$			
	Interest for 6 months upto 30 June			

4.12.6 Financing of Redemption of Debentures

Despite the fact that the creation of DRR A/c is aimed at protecting the debenture holders, it suffers from some serious limitations. In practice, the DRR fund may not be in the form of cash at the time of redemption. Even if it is available in cash, the companies are not able to meet the remaining 50% to redeem the debentures. Under these circumstances, it is advisable to set aside a part of divisible profits for investing outside the business. The following methods are usually adopted for investing the funds outside the business:

1. Sinking fund method
2. Insurance policy method

4.12.6.1 Sinking Fund Method (Or Debentures Redemption Fund)

Meaning: A sinking fund is a fund (i) created by an appropriation of certain profits and (ii) invested outside the business for the debentures redemption.

The following are the features of sinking fund method:

1. Under this method, a fixed amount is taken from the profits of the company, every year.
2. Such amount is invested in selected securities, outside the business.
3. Such investments are realized at the time of redemption of debentures.
4. The sinking fund may be either cumulative or non-cumulative.

Cumulative debentures redemption fund: Interest on sinking fund investment is credited to debentures redemption fund and is again re-invested.

Non-cumulative debentures redemption fund: Invest is credited to P&L A/c and not re-invested.

A fixed amount is computed on the basis of Sinking Fund Table, which is credited to debenture redemption sinking fund every year. This is like DRR.

The terms debenture redemption fund, sinking fund, debenture redemption reserve A/c, debenture sinking fund and debenture redemption sinking fund are synonymous.

These terms may be used interchangeably.

4.12.6.1.1 Cumulative Sinking Fund

Calculation of the amount to be appropriated every year:

Under this method, a certain pre-determined amount is transferred from divisible profits to sinking fund account.

This may be ascertained either by using Sinking Fund Table or by applying a formula.

Formula:

$$A = P \times \left[\frac{i}{(1+i)^n - 1}\right]$$

where A = Annual appropriation
P = Total amount to be paid on redemption
i = Per unit rate of interest
n = Number of years, after the expiry of which debentures are to be redeemed.

Sinking Fund Table: Instead of using the formula, the amount to be appropriated can easily be ascertained with the help of a mathematical table called Sinking Fund Table.

To find out the factor one has to refer the Table. For example, if i = 4 % and n = 10 years, if we refer the table, Row & Column intersects at .083291. We have to multiply the amount with this factor to arrive at the investment amount.

Illustration 4.26

Model: Sinking fund—Calculation of investment amount

A public limited company issued 5,000, 10% debentures of ₹100 each at par repayable at par after 10 years. It was decided to establish a sinking fund for their redemption and to invest in securities yielding 4% interest per annum. Compute the amount of profits to be set aside each year. (Reference to the Sinking Fund Table shows that ₹0.083291 invested at the end of year at 4% compound interest will produce ₹1 at the end of 10 years).

Solution

In the question, the factor—known as present value factor — is given. As such, no need to refer the Table.

To Receive ₹1 at the End of 10 years the Amount to be Invested @ 4% Compound Interest = ₹0.083291

∴ To Receive ₹5,00,000 (5,000 × ₹100) at the End of 10 years, the Amount to Be Invested @ 4% Compound Interest = ₹5,00,000 × 0.083291
= ₹41,645.50

Accounting Treatment

The accounting entries for maintaining a cumulative sinking fund are as follows:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
I:	At the End of First Year's Accounting Period:			
	(i) For Appropriation/Setting Aside the Required Amount for Sinking Fund and Subsequent Investment:			
	Profit and Loss A/c Dr.		…	
	To Sinking Fund A/c			…
	(ii) For Investment, the Amount:			
	Sinking Fund Investment A/c Dr.		…	
	To Bank A/c			…
II:	At the End of Second and Subsequent Years Except the Last Year:			
	(i) For Receiving Interest on Sinking Fund Investment:			
	Bank A/c Dr.		…	
	To Interest on Sinking Fund Investment A/c			…

	(ii) For Transfer of Interest in Sinking Fund A/c:			
	Interest on Sinking Fund Investment A/c Dr.		…	
	To Sinking Fund A/c			…
	OR As a Combined Entry:			
	(i) + (ii) Bank A/c Dr.		…	
	To Sinking Fund A/c			…
	(iii) For Annual Appropriation of Profit:			
	Profit & Loss Appropriation A/c Dr.		…	
	To Sinking Fund A/c			…
	(iv) For Investment, the Appropriated Profit PLUS Interest Received on Sinking Fund Investments:			
	Sinking Fund Investment A/c Dr.		…	
	To Bank A/c			…
III:	At the End of LAST YEAR Accounting Period:			
	(i) For Receiving Interest on Sinking Fund Investments:			
	Bank A/c Dr.		…	
	To Sinking Fund A/c			…
	(ii) For Annual Appropriation of Profit:			
	Profit & Loss Appropriation A/c Dr.		…	
	To Sinking Fund A/c			…
	(iii) For Realizing Sinking Fund Investments:			
	Bank A/c Dr.		…	
	To Sinking Fund Investment A/c			…
	(iv) For Transfer of Profit/Loss on Sale of Investment:			
	(a) If Profit on Sale:			
	Sinking Fund Investment A/c Dr.		…	
	To Sinking Fund A/c			…
	(b) If Loss on Sale:			
	Sinking Fund A/c Dr.		…	
	To Sinking Fund Investment A/c			…
	(v) For Amount Payable on Redemption at Par:			
	Debentures A/c Dr.		…	
	To Debenture Holders A/c			…
	(vi) For Amount Payable on Redemption at Par:			
	Debentures A/c Dr.		…	
	Premium on Redemption of Debentures A/c Dr.		…	
	To Debenture Holders A/c			…

	(vii) For Payment to Debenture Holders:			
	Debenture Holders A/c Dr.		…	
	To Bank A/c			…
	(viii) For Closing the Sinking Fund A/c:			
	Sinking Fund A/c Dr.		…	
	To General Reserve A/c			…

Illustration 4.27

Model: Sinking fund method

Rajas Ltd. issued ₹ 20,00,000, 10% debentures on 1 January 2008. They were to be redeemed on 31 December 2010. For this purpose, the company established a sinking fund. Investments were expected to earn 5% interest p.a. Sinking Fund Table show that 0.317208 invested annually at 5% amount to ₹ 1 in 3 years. On 31 December 2010, the bank balance was ₹ 8,40,000 before receipt of interest on sinking fund investments. On that date, the investments were sold for ₹ 13,12,000. Interest is payable annually. Calculate the interest to the nearest of a rupee and investments are made in multiples of ₹ 100. Ignore tax on debenture interest.

Give journal entries. Also prepare the following accounts. (i) 10% debentures A/c; (ii) sinking fund A/c; (iii) sinking fund investments A/c and (iv) bank A/c in the books of the company.

Solution

Annual Appropriation = ₹ 20,00,000 × 0.317208

Amount to Be Set Aside Annually = ₹ 6,34,416

Rajas Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 January 2008	Bank A/c Dr.		20,00,000	
	To 10% Debentures A/c			20,00,000
	(Issue of 10% Debentures for ₹ 20,00,000)			
31 December 2008	Debenture Interest A/c Dr.		2,00,000	
	To Bank A/c			2,00,000
	(Annual Interest Paid @ 10% on ₹ 20,00,000)			
31 December 2008	Profit and Loss Appropriation A/c Dr.		6,34,416	
	To Sinking Fund A/c			6,34,416
	(Annual Appropriation Created)			
31 December 2008	Sinking Fund Investments A/c Dr.		6,34,400	
	To Bank A/c			6,34,400
	(Investment Made in Multiples of ₹ 100)			

31 December 2008	Profit & Loss A/c	Dr.		2,00,000	
	To Debenture Interest A/c				2,00,000
	(Debenture Interest Transferred)				
31 December 2009	Debenture Interest A/c	Dr.		2,00,000	
	To Bank A/c				2,00,000
	(Annual Interest on ₹ 20,00,000 @ 10% Paid)				
31 December 2009	Bank A/c	Dr.		31,720	
	To Interest on Sinking Fund Investments A/c				31,720
	(Interest on ₹ 6,34,400 @ 5% Received)				
31 December 2009	Interest on Sinking Fund Investment A/c	Dr.		31,720	
	To Sinking Fund A/c				31,720
	(Interest Transferred to Sinking Fund A/c)				
31 December 2009	Profit & Loss Appropriation A/c	Dr.		6,34,416	
	To Sinking Fund A/c				6,34,416
31 December 2009	Sinking Fund Investments A/c	Dr.		6,66,200	
	To Bank A/c				6,66,200
	(Investment and Interest Received on It in Multiples of ₹ 100)				
31 December 2009	Profit & Loss A/c	Dr.		2,00,000	
	To Debentures Interest A/c				2,00,000
	(Debenture Interest Transferred to P&L A/c)				
31 December 2010	Bank A/c	Dr.		65,030	
	To Interest on Sinking Fund Investments A/c				65,030
	(Interest Received on Investments)				
31 December 2010	Interest on Sinking Fund Investment A/c	Dr.		65,030	
	To Sinking Fund A/c				65,030
	(Interest Transferred to Sinking Fund A/c)				
31 December 2010	Profit and Loss Appropriation A/c	Dr.		6,34,416	
	To Sinking Fund A/c				6,34,416
	(Annual Appropriate Made for Redemption)				
31 December 2010	Bank A/c	Dr.		13,12,000	
	To Sinking Fund Investment A/c				13,12,000
	(Sale of Sinking Fund Investments)				
31 December 2010	Sinking Fund Investments A/c	Dr.		11,400	
	To Sinking Fund A/c				11,400
	(Profit on Sale of Investment Transferred)				

31 December 2010	Debentures Interest A/c Dr. To Bank A/c (Annual Interest Paid)		2,00,000	 2,00,000
31 December 2010	10% Debentures A/c Dr. To Debenture Holder A/c (Amount Payable on Redemption)		20,00,000	 20,00,000
31 December 2010	Debenture Holders A/c Dr. To Bank A/c (Debenture Holders Paid off on Redemption)		20,00,000	 20,00,000
31 December 2010	Sinking Fund A/c Dr. To Capital Reserve A/c (Profit on Sale of Investments Transferred to General Reserve A/c)		11,400	 11,400
31 December 2010	Sinking Fund A/c Dr. To General Reserve A/c (Sinking Fund—Balance Transferred to General Reserve A/c)		20,00,000	 20,00,000
31 December 2010	Profit & Loss A/c Dr. To Debenture Interest A/c (Debentures Interest Transferred to P&L A/c)		2,00,000	 2,00,000

Ledger Accounts

10% Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2008	Balance c/d	20,00,000	1 January 2008	Bank A/c	20,00,000
31 December 2009	Balance c/d	20,00,000	1 January 2009	Balance b/d	20,00,000
31 December 2010	Debenture Holders A/c	20,00,000	1 January 2010	Balance b/d	20,00,000

Debenture Holders A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2010	Bank A/c	20,00,000	31 December 2010	10% Debentures A/c	20,00,000

Sinking Fund A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2008	Balance c/d	6,34,416	31 December 2008	P&L Appropriation A/c	6,34,416
31 December 2009	Balance c/d	13,00,552	1 January 2009	Balance b/d	6,34,416
			31 December 2009	Interest on Sinking Fund Investments A/c	31,720
			31 December 2009	P&L Appropriation A/c	6,34,416
		13,00,552			13,00,552
31 December 2010	Capital Reserve A/c	11,400	1 January 2010	Balance b/d	13,00,552
31 December 2010	General Reserve A/c	20,00,000	31 December 2010	Interest on Sinking Fund Investments	65,030
			31 December 2010	P&L Appropriation A/c	6,34,418
			31 December 2010	Sinking Fund Investment A/c	11,400
		20,11,400			20,11,400

Sinking Fund Investments A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2008	Balance A/c	6,34,400	31 December 2008	Bank c/d	6,34,400
1 January 2009	Balance b/d	6,34,400	31 December 2009	Balance c/d	13,00,600
31 December 2009	Bank A/c	6,66,200			
		13,00,600			13,00,600
1 January 2010	Balance b/d	13,00,600	31 December 2010	Bank A/c	13,12,000
31 December 2010	Sinking Fund A/c	11,400			
		13,12,000			13,12,000

Interest on Sinking Fund Investments A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2009	Sinking Fund A/c	31,720	31 December 2009	Bank A/c	31,720
31 December 2010	Sinking Fund A/c	65,030	31 December 2010	Bank A/c	65,030

Bank A/c

Date	Particulars	₹	Date	Particulars	₹
1 January 2010	Balance b/d	8,40,000	31 December 2010	Debentures Interest A/c	2,00,000
31 December 2010	Interest on Sinking Fund Investments A/c	65,030	31 December 2010	Debenture Holders A/c	20,00,000
31 December 2010	Sinking Fund Investment A/c	13,12,000	31 December 2010	Balance c/d	17,030
		22,17,030			22,17,030

Note: The appropriation for sinking fund on 31 December 2010 is adjusted as ₹6,34,418 instead of ₹6,34,416. This adjustment is made in order to maintain the balance in sinking fund equal to the nominal value of the debentures redeemed entirely out of profits.

Illustration 4.28

Model: Preparation of ledger accounts straightaway

The following balances appeared in the books of Star Ltd. as on 1 April 2010:

	₹
12% Debentures	3,00,000
Debentures Redemption Reserve	2,50,000
Debentures Redemption Fund Investments	2,50,000

The debentures redemption fund investment was represented by ₹2,60,000 9% government securities. The annual instalment amount added to the fund was ₹41,200. On 31 March 2011, the bank balance before the receipt of interest on investments was ₹80,000. On the date, the investments were sold at 84% and debentures were duly redeemed.

You are required to prepare (i) debentures A/c; (ii) debentures redemption reserve A/c; (iii) debenture redemption fund investment A/c and (iv) the bank A/c for 2010–11.

The company closes its books on 31 March every year.

Solution

Note: The terms debenture redemption reserve, debenture redemption fund and sinking fund are synonymous.

The terms debenture redemption fund investment; debenture redemption reserve investment; sinking fund investment are synonymous. Though the terms differ, the sinking fund method is to be used.

Basic Calculation:

1. Calculation of Interest:

Opening Balance = ₹2,60,000 (Given)

Interest on It for 1 year $= ₹2,60,000 \times \frac{9}{100} \times 1$

$= ₹23,400$

2. Redemption Amount:

Duly Redeemed Debentures: 84% (Given)

: 84% of ₹2,60,000

= ₹2,18,400[*1]

Ledger Accounts

12% Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
	Debenture Holders A/c	3,00,000		Balance b/d	3,00,000

Debentures Redemption Reserve A/c (DRR) (Sinking Fund A/c)

Date	Particulars	₹	Date	Particulars	₹
	Debenture Redemption Fund Investment A/c	31,600		Balance b/d	2,50,000
	General Reserve (Loss)	2,83,000		P&L Appropriation A/c	41,200
				Interest on Investment A/c	23,400
		3,14,600			3,14,600

Debenture Redemption Fund Investment A/c (DRFI)

(Sinking Fund Investment A/c)

Date	Particulars	₹	Date	Particulars	₹
	Balance b/d	2,50,000		[*1]Balance A/c	2,18,400
				DRR A/c (Loss)	31,600
		2,50,000			2,50,000

Bank A/c

Date	Particulars	₹	Date	Particulars	₹
	Debenture Holders A/c	80,000		Debentures A/c	3,00,000
	[*1] Investment—Sale Interest on DRFI	2,18,400		Balances c/d	21,800
		23,400			
		3,21,800			3,21,800

4.12.6.1.2 Non-cumulative Sinking Fund

Generally, there seems to be not much difference between two types of sinking funds—cumulative and non-cumulative—specifically with respect to profits.

The main difference between these two types lies in the treatment of interest. In cumulative sinking funds, interest received on sinking fund investments is transferred to sinking or debenture redemption account whereas in the case of non-cumulative sinking funds, the interest is transferred to P&L A/c.

Accounting Entries for Non-cumulative Sinking Funds:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
At the End of 1st Year	(i) For Appropriation of Annual Profits: Profit & Loss Appropriation A/c Dr. To Debenture Redemption Fund A/c		… 	 …
	(ii) For Investment: Debenture Redemption Fund Investments A/c Dr. To Bank A/c		… 	 …
At the End of 2nd Year Except Last Year	(iii) For Receiving Interest on Investments: Bank A/c Dr. To Interest on Debenture Fund Investments A/c		… 	 …
	(iv) For Transfer of Interest: Interest on Debenture Fund Investments A/c Dr. To P&L A/c		… 	 …
	(v) For Appropriation of Annual Profits: Profit & Loss Appropriation A/c Dr. To Denture Redemption Fund A/c		… 	 …
	(vi) For Investment: Debenture Redemption Fund Investments A/c Dr. To Bank A/c		… 	 …
	Note: Entries (v) & (vi) are entered without adding interest.			
At the End of Last Year	Entries are Similar to Those of Entries for Cumulative Sinking Fund. Hence, They are not Repeated Here.			

4.12.6.2 Insurance Policy Method

Under this method, an annual sum is appropriated out of profits as is done is sinking fund method. But, such appropriated profits are not invested in marketable securities. But, an insurance policy is taken for the required amount to redeem the debentures.

An amount equal to profit set aside is paid as premium to the insurance company. On the date of maturity, the insurance company pays the accumulated amount to redeem debentures. "Debenture redemption fund policy A/c" is opened instead of redemption fund investment A/c.

No entry for interest is recorded.

Accounting Treatment:

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	I. *First Year* to *Last Year*: (Every Year Including the Last Year) For Payment of Premium: (Beginning of the Year) Debenture Redemption Fund Policy A/c Dr. To Bank A/c For Appropriation of Profit to Be Set Aside for Premium: (End of the Year)		… 	 …

	Profit & Loss Appropriation A/c Dr.		…	
	To Debenture Redemption Fund A/c			…
	II. Last Year: (Maturity Year)			
	For Policy Amount Realized:			
	Bank A/c Dr.		…	
	To Debenture Redemption Fund Policy A/c			…
	For Transfer of Difference Between the Amount of Policy and the Total Premium Paid:			
	If Excess or Profit:			
	Debenture Redemption Fund Policy A/c Dr.		…	
	To Debenture Redemption Fund A/c			…
	If Deficit or Loss: (Reverse Entry)			
	For Transfer of Premium on Redemption:			
	Debenture Redemption Fund A/c Dr.		…	
	To Premium on Redemption of Debentures A/c			…
	For Amount Payable on Redemption:			
	…% Debenture Holders A/c Dr.		…	
	To Bank A/c			…
	For Transfer of Balance to General Reserve:			
	Debenture Redemption Fund A/c Dr.		…	
	To General Reserve A/c			…

Illustration 4.29

Model: Insurance policy method

Jasemine Ltd. issued 3,000 10% debentures of ₹100 each at par on 1 January 2007, redeemable after 3 years. The company took an insurance policy for ₹3,00,000 for the redemption of debentures and paid ₹90,000 as annual premium. At the end of the third year, policy amount was received and debentures redeemed. Show the journal entries and prepare the ledger accounts in the books of the company relating to issue and redemption of debentures.

Solution

Jasemine Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 January 2008	Bank A/c Dr.		3,00,000	
	To 10% Debentures A/c			3,00,000
	(Issue & Allotment of 3,000, 10% Debentures @ ₹100 each at par)			

1 January 2008	Debenture Redemption Fund Policy A/c Dr. To Bank A/c (Payment of Premium)		90,000	 90,000
31 December 2008	Profit & Loss Appropriation A/c Dr. To Debenture Redemption Fund A/c (Profit Transferred to Debenture Redemption Fund Account)		90,000	 90,000
1 January 2009	Debenture Redemption Fund Policy A/c Dr. To Bank A/c (Payment of Premium)		90,000	 90,000
31 December 2009	Profit & Loss Appropriation A/c Dr. To Debenture Redemption Fund A/c (Profit Transferred)		90,000	 90,000
1 January 2010	Debenture Redemption Fund Policy A/c Dr. To Bank A/c (Payment of Premium)		90,000	 90,000
31 December 2010	Profit & Loss Appropriation A/c Dr. To Debenture Redemption Fund A/c (Profit Transferred)		90,000	 90,000
31 December 2010	Bank A/c Dr. To Debenture Redemption Fund Policy A/c (Policy Amount Received on Maturity)		3,00,000	 3,00,000
31 December 2010	Debenture Redemption Fund Policy A/c Dr. To Debenture Redemption Fund A/c (Realization Amount Transferred)		30,000	 30,000
31 December 2010	10% Debenture A/c Dr. To Debenture Holders A/c (Amount Due on Redemption)		3,00,000	 3,00,000
31 December 2010	Debenture Holders A/c Dr. To Bank A/c (Debenture Holders Paid on Redemption)		3,00,000	 3,00,000
31 December 2010	Debenture Redemption Fund A/c Dr. To General Reserve A/c (Balance of DRF Transferred to General Reserve)		3,00,000	 3,00,000

Ledged Accounts

10% Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2008	Balance c/d	3,00,000	1 January 2008	Bank A/c	3,00,000
31 December 2009	Balance c/d	3,00,000	1 January 2009	Balance b/d	3,00,000
31 December 2010	Debenture Holders A/c	3,00,000	1 January 2010	Balance b/d	3,00,000

Debenture Redemption Fund A/c

Date	Particulars	₹	Date	Particulars	₹
1 January 2008	Balance c/d	90,000	31 December 2008	P&L Appropriation A/c	90,000
		90,000			90,000
31 December 2009	Balance c/d	1,80,000	1 January 2009	Balance b/d	90,000
			31 December 2009	P&L Appropriation A/c	90,000
		1,80,000			1,80,000
31 December 2010	General Reserve A/c	3,00,000	1 January 2010	Balance b/d	1,80,000
			31 December 2010	P&L Appropriation	90,000
				Redemption Fund Policy A/c	30,000
		3,00,000			3,00,000

Debenture Redemption Fund Policy A/c

Date	Particulars	₹	Date	Particulars	₹
1 January 2008	Bank A/c	90,000	31 December 2008	Balance c/d	90,000
1 January 2009	Balance b/d	90,000	31 December 2009	Balance c/d	1,80,000
	Bank A/c	90,000			
		1,80,000			1,80,000
1 January 2010	Balance b/d	1,80,000	31 December 2010	Bank A/c	3,00,000
31 December 2010	Bank A/c	90,000			
31 December 2010	Debenture Redemption Fund A/c	30,000			
		3,00,000			3,00,000

4.12.7 Redemption of Debentures by Draw of Lots

A company may redeem its debentures by payment of a certain proportion voluntarily each year. In this method, the debentures are to be redeemed, selected through lottery—Draw by lot.

Procedure: Slips containing numbers of all debentures are prepared. They are put in a drum And requisite number of slips is taken out by lot. The holders of the debentures, whose numbers are on the drawn out slips, are paid. The procedure adopted thus for redemption is known as "drawing by lot".

Illustration 4.30

Model: Redemptions by draw of lots

Evergreen Ltd. issued 9,000, 6% debentures of ₹100 each on 31 March 2006 redeemable at a premium of 10% in June 2011. The Board of Directors decided to transfer the required amount to DRR in three equal instalments starting from 31 March 2009. Pass necessary journal entries regarding issue and redemption of debentures.

Solution

Step 1: Determination of Instalment Amount:

Outstanding Amount on Debentures 9,000 × ₹100	₹9,00,000
DRR to be Created @ 50% ($\frac{50}{100}$ × ₹9,00,000) =	₹4,50,000
Total (3) Equal Instalments Value	₹4,50,000
Single Instalment Value	$\left\{\frac{₹\ 4,50,000}{3\ \text{years}}\right\}$
Amount to be Transferred Every Year for 3 years	₹1,50,000

Step 2: Value of Premium:

10% on Outstanding Debentures of ₹9,00,000	₹9,00,000 × $\frac{10}{100}$ = ₹90,000

Step 3: Passing Journal Entries

Evergreen Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2006	Issue of Debenture:				
	Bank A/c	Dr.		9,00,000	
	To Debenture Application A/c				9,00,000
	(Application Money Received)				
31 March 2006	Debenture Application A/c	Dr.		9,00,000	
	Loss on Issue of Debentures A/c	Dr.		90,000	
	To 6% Debentures A/c				9,00,000
	To Premium on Redemption of Debentures A/c				90,000
	(Issue of Debentures at Par and Redeemable at Premium)				

	Creation of DRR:				
31 March 2009	P&L Appropriation A/c	Dr.		1,50,000	
	To DRR A/c				1,50,000
	(Profit Transferred to DRR A/c)				
31 March 2010	P&L Appropriation A/c	Dr.		1,50,000	
	To DRR A/c				1,50,000
	(Profit Transferred to DRR A/c)				
31 March 2011	P&L Appropriation A/c	Dr.		1,50,000	
	To DRR A/c				1,50,000
	(Profit Transferred to DRR A/c)				
	At the Time of Redemption:				
31 March 2011	6% Debentures A/c	Dr.		9,00,000	
	Premium on Redemption of Debentures A/c	Dr.		90,000	
	To Debenture Holders A/c				9,90,000
	(Amount Payable)				
31 March 2011	Debenture Holders A/c	Dr.		9,90,000	
	To Bank A/c				9,90,000
	(Payment to Debenture Holders)				

4.12.8 Redemption Out of the Proceeds of Fresh Issue of Shares or Debentures

Another method of redemption of debentures is by issuing of new shares or debentures and create funds for the purpose. Such fresh issue of shares or debentures may be at premium or discount. Under this method, the creation of Debenture Redemption Reserve is not required.

Accounting treatment will be the same as that of made for the issue of shares and debentures.

Illustration 4.31

Model: Redemption out of fresh issue

The following is the balance sheet of Vishal Ltd. as on 31 March 2011:

Liabilities	₹	Assets	₹
1,00,000 Equity Shares of ₹ 10 Each	10,00,000	Land & Buildings	2,50,000
Profit & Loss A/c	1,00,000	Plant & Machinery	7,50,000
General Reserve	1,50,000	Furniture & Fixtures	1,00,000
3,500, 10% Debentures of ₹ 100 Each	3,50,000	Stock	4,00,000
Sundry Creditors	1,50,000	Debtors	1,00,000
		Bills Receivable	10,000
		Cash at Bank	1,10,000
		Preliminary Expenses	30,000
	17,50,000		17,50,000

The debenture trust deed provides that the company may redeem the debentures at a premium of 5% at any time before maturity. The directors decided to exercise this option and issued 25,000 shares of ₹ 10 each at ₹ 12 per share and 1,000 12% debentures of ₹ 100 each for the purpose of redemption. Show the journal entries and post-redemption balance sheet in the prescribed form.

Solution

Note: The 10% debenture to be redeemed is met out from the issue of new equity shares and 12% debentures (new). As the entire debentures are redeemed, the creation of DRR is not required. The existing capital of the company remains unaffected.

Vishal Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2011	Bank A/c Dr.		3,00,000	
	To Equity Share Application & Allotment A/c			3,00,000
	(Application Money on 25,000 Shares of ₹ 10 Each at ₹ 12 per Share)			
	Equity Share Application & Allotment A/c Dr.		3,00,000	
	To Equity Share Capital A/c			2,50,000
	To Securities Premium A/c			50,000
	(25,000 Shares of ₹ 10 Each @ ₹ 2 Premium Allotted)			
	Bank A/c Dr.		1,00,000	
	To Debenture Application & Allotment A/c			1,00,000
	(Debenture Application Money Received on 1,000 Debentures of ₹ 100 Each)			
	Debenture Application & Allotment A/c Dr.		1,00,000	
	To 12% Debentures A/c			1,00,000
	(12% Debentures of ₹ 100 Each Allotted)			
	10% Debentures A/c Dr.		3,50,000	
	Premium on Redemption of Debentures A/c Dr.		17,500	
	To Debenture Holders A/c			3,67,500
	(Amount Due on Redemption)			
	Debenture Holders A/c Dr.		3,67,500	
	To Bank A/c			3,67,500
	(Debenture Holders Paid on Redemption)			
	Securities Premium A/c Dr.		47,500	
	To Premium on Redemption on Debentures			17,500
	To Preliminary Expenses A/c			30,000
	(Premium on Redemption and Preliminary Expenses Written off Against Security Premium A/c)			

Note:

1. Securities premium to be shown in balance sheet:
   ₹ 50,000 – ₹ 47,500 = ₹ 2,500
2. Cash at bank:
   ₹ 1,10,000 + (₹ 4,00,000 – ₹ 3,67,500)
   = ₹ 1,10,000 + ₹ 32,500 = ₹ 1,42,500
   (Instead of preparing respective ledger accounts, simple calculations are made as above)

Balance Sheet of Vishal Ltd.
as at 31 March 2011

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Issued & Subscribed		Land & Buildings	2,50,000
(1,00,000 + 25,000) 1,25,000		Plant & Machinery	7,50,000
Equity Shares of ₹ 10 Each	12,50,000	Furniture & Fixtures	1,00,000
Reserves & Surplus:		Current Assets, Loans & Advances:	
Securities Premium	2,500	(a) Current Assets:	
General Reserve	1,50,000	Stock	4,00,000
P&L A/c	1,00,000	Debtors	1,00,000
Secured Loans:		Cash at Bank	1,42,500
1,000 12% Debentures of ₹ 100 Each	1,00,000	(b) Loans & Advances:	
Current Liabilities & Provisions:		Bills Receivable	10,000
(a) Current Liabilities:		Miscellaneous Expenditure	—
Sundry Creditors	1,50,000		
(b) Provisions	—		
	17,52,500		17,52,500

4.12.9 Redemption of Debentures by Conversion (Redemption of Convertible Debentures)

Generally, companies redeem their debentures in cash. But at times, debentures are redeemed by converting them into NEW CLASS OF SHARES OR DEBENTURES. Such debentures are termed "convertible debentures".

Debenture holders of convertible debentures are given the right to exercise the option to convert them into new class of shares or debentures. However, the issue of new shares and especially at a discount should be subject to the provisions of the Section 79 of the Companies Act. Such new shares/debentures may be issued at par or at premium or at discount.

Accounting Treatment:

For discharge into the obligation of redemption, journal entries for issuing of new class of shares/ debentures are given as follows:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1	When Shares are Issued at Par:			
	Debentures A/c Dr.		…	
	To Share Capital A/c			…
2	When Shares are Issued at Premium:			
	Debentures A/c Dr.		…	
	To Share Capital A/c			…
	To Securities Premium A/c			…
3	When Shares are Issued at Discount:			
	Debentures A/c Dr.		…	
	Discount on Issue of Debentures A/c Dr.		…	
	To Share Capital A/c			…
	Note: In all the cases, the nominal value of the debentures to be converted has to be debited with the debenture A/c.			
	Nominal value of shares issued has to be credited to share capital A/c.			
	I: For Amount Due on Redemption:			
	(a) Redemption at Par:			
	… % Debentures A/c Dr.		…	
	To Debenture Holders A/c			…
	(b) Redemption at Premium:			
	…. % Debentures A/c Dr.		…	
	Premium on Redemption of Debentures A/c Dr.		…	
	To Debenture Holders A/c			…
	II: For Discharging Obligation by Issue of Shares or Debentures: (New Shares or Debentures):			
	(a) At Par:			
	Debenture Holders A/c Dr.		…	
	To Equity Share Capital A/c (For Shares)			…
	Or			
	To …..% Debentures A/c (For Debentures)			…
	(b) At Premium:			
	Debenture Holders A/c Dr.		…	
	To Equity Share Capital A/c			…
	(or … Debenture A/c)			
	To Securities Premium A/c			…

	(c) At Discount:			
	Debenture Holders A/c Dr.		…	
	Discount on Issue of Shares or Debentures A/c Dr.		…	
	To … Debenture A/c			…

Illustration 4.32

Model: Conversion of debentures into equity shares at par

X Ltd. redeemed 5,000, 12% debentures of ₹ 100 each, which were issued at a discount of 10% by converting them into equity shares of ₹ 10 each at par.

Journalize for the redemption.

Solution

Note:

1. Debentures were used at discount.
2. Redemption by conversion into equity shares
3. Number of equity shares to be issued has to be determined in the following steps:

		₹
Step 1:	Face Value of Debentures (5,000 × ₹ 100)	= 5,00,000
	Less: Discount as 10% (∴ Issued at Discount)	= 50,000
	10% of ₹ 5,00,000	
	Actual Amount Received on Use of Debentures	= 4,50,000

Step 2: Face Value of Equity Shares to Be Used = ₹ 10 (∵ At Par)

Step 3: Number of Equity Shares to Be Issued $= \frac{\text{Amount Received on Debenture}}{\text{Face Value of Share}}$

$= \frac{₹\,4,50,000}{₹\,10}$

= 45, 000 Equity Shares

Journal of X Ltd.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	12% Debentures A/c Dr.		5,00,000	
	To Discount on Issue of Debentures A/c			50,000
	To Debenture Holders A/c			4,50,000
	(Amount Due to Debenture Holders)			
	Debenture Holders A/c Dr.		4, 50,000	
	To Equity Shares Capital A/c			4,50,000
	(On Redemption, 12% Debentures are Converted by Issue of 45,000 Equity Shares of ₹ 10 Each at Par)			

Illustration 4.33

Model: Conversion of debentures into equity shares at discount

Y Ltd. redeemed 9,600 14% debentures of ₹100 each which were issued at 110% by converting their into equity shares of ₹10 each issued at a discount of 4%. Journalize.

Solution

Step 1: Amount Due to Debenture Holders is Determined as:

Number of Debentures × Face Value (9,600 × ₹100)	=	₹9,60,000
Add Premium at 10%	=	₹96,000
Value of Debentures		₹10,56,000

Step 2: Determination of Number of Equity Shares to be Issued:

$$\text{Number of Equity Shares to be Issued} = \frac{\text{Value of Debentures to be Redeemed}}{\text{Issue Price of Equity Shares}}$$

$$= \frac{₹10,56,000}{(₹10 - 4\% \text{ of } ₹10)}$$

$$= \frac{₹10,56,000}{(₹10 - ₹0.40)} = \frac{₹10,56,000}{(₹9.60)}$$

= 1,10,000 Equity Shares

Journal of X Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	14% Debentures A/c	Dr.		9,60,000	
	Premium on Redemption of Debentures A/c	Dr.		96,000	
	To Debenture Holders A/c				10,56,000
	(Amount Due to Debenture Holders)				
	Debenture Holders A/c	Dr.		10,56,000	
	Discount on Issue of Shares A/c	Dr.		44,000	
	To Equity Share Capital A/c				11,00,000
	(Issue of 1,10,000 Equity Shares of ₹10 Each at 4% Discount for Redemption)				

Illustration 4.34

Model: Conversion of debentures into equity shares at a premium

Z Ltd. redeemed 5,000 12% debentures of ₹100 each which were issued at a discount of 5% by converting them into equity shares of ₹10 each issued at a premium of 25%. Journalize.

Solution

Step 1: Determination of Amount Due to Debenture Holders:

Face Value of Debentures (5,000 × ₹100)	=	₹5,00,000

	Less: Discount @ 5% (On ₹ 5,00,000)	=	₹ 25,000
∴	Amount Due to Debenture Holders	=	₹ 4,75,000

Step 2: Determination of Number of Shares to be Issued:

$$\text{Number of Equity Shares to be issued} = \frac{\text{Amount Due to Debenture Holders}}{\text{Issue Price of Shares}}$$

$$= \frac{₹\,4,75,000}{₹\,10 + 25\%}$$

$$= \frac{₹\,4,75,000}{₹\,12.50}$$

= 38,000 Equity Shares

Journal of Z Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	12.5% Debentures A/c	Dr.		5,00,000	
	To Discount on Issue of Debentures A/c				25,000
	To Debenture Holders A/c				4,75,000
	(Amount due to Debenture Holders)				
	Debenture Holders A/c	Dr.		4,75,000	
	To Equity Share Capital A/c				3,80,000
	To Securities Premium A/c				95,000
	(Issue of 38,000 Equity Shares of ₹ 10 Each at 25% Premium for Redemption)				

Illustration 4.35

Model: Conversion of debentures into equity shares at a discount

AB Ltd. redeemed 6,000, 6.25% debentures of ₹ 100 each which were issued at a discount of 5% by converting them into equity shares of ₹ 10 each at a discount of 5%.

Journalize.

Solution

Step 1: Determination of Amount Due to Debenture Holders:

	Face Value of Debentures (₹ 100 × 6,000)	=	₹ 6,00,000
	Less: Discount @ 5% 5% of ₹ 6,00,000	=	₹ 30,000
	Amount Due to Debenture Holders	=	₹ 5,70,000

Step 2: Determination of Number of Shares to be Issued:

$$\text{Number of Equity Shares to be Issued} = \frac{₹\,5,70,000}{₹\,10 - 5\% \text{ of } ₹\,10}$$

= 60,000 Shares

Journal of AB Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	6¼% Debentures A/c	Dr.		6,00,000	
	To Debenture Holders A/c				6,00,000
	(Amount Due to Debenture Holders)				
	Debenture Holders A/c	Dr.		5,70,000	
	Discount on Issue of Shares A/c	Dr.		30,000	
	To Equity Share Capital A/c				6,00,000
	(Issue of 60,000 Equity Shares of ₹ 10 Each at 5% Discount)				

Illustration 4.36

Model: Redemption of debentures—Converting into new debentures

CD Ltd. redeemed 5,000, 12% debentures of ₹ 50 each by converting them into 15% debentures of ₹ 250 each.

Journalize.

Solution

$$\text{Determination of Number of Debentures to be Issued} = \frac{\text{Total Value of Old Debentures}}{\text{Value of New Debenture}}$$

$$= \frac{5{,}000 \times ₹\,50}{₹\,250}$$

$$= 1{,}000 \text{ Debentures}$$

Journal of CD Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	12% Debentures A/c	Dr.		2,50,000	
	To Debenture Holders A/c				2,50,000
	(Amount Due to Debenture Holders)				
	Debenture Holders A/c	Dr.		2,50,000	
	To 15% Debentures A/c				2,50,000
	(Issue of 1,000 Debentures of ₹ 250 Each)				

Illustration 4.37

Model: Redemption by new issue of debentures originally issued at premium—New debentures issued at discount

EF Ltd. redeemed ₹ 1,44,000, 9% debentures of ₹ 100 each, at 102% by converting them into 11% debentures at 96%.

Journalize.

Solution

Step 1: Determination of Amount Due to Debenture Holders:

Debentures Issued at 102% Means a Premium of 2%

= ₹ 1,44,000 + 2% Premium

= ₹ 1,44,000 + ₹ 2,880

= ₹ 1,46,880

Step 2: Number of Debentures to be Issued = $\frac{₹\ 1,46,880}{₹\ 100 - ₹\ 4 \text{ i.e. } 96\%}$

= 1,530 Debentures

Journal of EF Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	9% Debentures A/c	Dr.		1,44,000	
	Premium on Redemption of Debentures A/c			2,880	
	To Debenture Holders A/c				1,46,880
	(Amount Due to Debenture Holders)				
	Debenture Holders A/c	Dr.		1,46,880	
	Discount on Issue of Debentures A/c	Dr.		6,120	
	To 11% Debentures A/c				1,53,000
	(Issue of Debentures at 96%)				

Illustration 4.38

Model: Redemption by conversion—Calculation of interest

On 1 January 2009, GK Ltd. issued ₹ 10,00,000, 10% debentures of ₹ 100 each at par repayable at 10% premium. As per terms of issue, the debenture holders had an option to convert their debentures into equity shares of ₹ 10 each at any time after 4 years.

On 31 December 2010, a holder of 100 debentures gave a notice of exercising the option.

Interest for full one year was accrued and stood unpaid till 31 December 2010

Interest for the past year was paid.

Pass necessary journal entries.

Solution

(i) Interest Rate = 10%

Interest for ₹ 10,00,000 = ₹ 10,00,000 × $\frac{10}{100}$ = ₹ 1,00,000

(ii) Number of Debentures Issued at Par = $\frac{₹\ 10,00,000}{₹\ 100}$ = 10,000

(iii) Entries for 2 years—2009 and 2010—i.e., till the date of exercising option, have to be recorded as follows:

Journal of GK Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 January 2009	Bank A/c	Dr.		10,00,000	
	Loss on Issue of Debentures A/c	Dr.		1,00,000	
	To 10% Debentures A/c				10,00,000
	To Premium on Redemption of Debentures A/c				1,00,000
	(Issue of 10% Debentures at Par Repayable @ 10% Premium)				
31 December 2010	Debenture Interest A/c	Dr.		1,00,000	
	To Debenture Interest Outstanding A/c				1,00,000
	(One year (2010) Interest Due,)				
31 December 2010	10% Debentures A/c	Dr.		1,00,000	
	Premium on Redemption of Debentures	Dr.		10,000	
	To Equity Share Capital A/c				1,10,000
	(Issue of Equity Shares @ 10% Premium in Lieu of 10% Debentures).				

Illustration 4.39

Model: Conversion of debentures into preference shares

LM Ltd. redeemed ₹5,00,000, 12% debentures at 110% by converting them into 15% cumulative preference share of ₹50 at ₹55.

Make Journal entries.

Solution

Step 1: Determination of Amount Due to Debenture Holders:

Face Value of Debentures	=	₹5,00,000
Add Premium @ 110% i.e., Add 10% of ₹5,00,000	=	₹50,000
Amount Due to Debenture Holders	=	₹5,50,000

Step 2: Number of Preference Shares to be Issued: $\frac{₹5,50,000}{₹55} = 10,000$

Journal of LM Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	12% Debentures A/c	Dr.		5,00,000	
	Premium on Redemption A/c	Dr.		50,000	
	To Debenture Holders A/c				5,50,000
	(Amount Due to Debenture Holders)				

	Debenture Holders A/c Dr.		5,50,000	
	To 15% Cumulative Preference Share Capital A/c			5,00,000
	To Securities Premium A/c			50,000
	(Issue of 10,000 Cumulative Pref. Shares of ₹50 Each at ₹55)			

Illustration 4.40

Model: Redemption before maturity

On 1 January 2010, PQ Ltd. issued 5,000, 10% debentures of ₹100 each at ₹90 each. Debenture holders were given an option to get their debentures converted into equity shares of ₹10 each at ₹50% premium per share.

On 31 December 2010, one year interest has been accrued, not paid till that date.

A holder of 500 debentures wanted to exercise the option. Those 500 debentures were redeemed by issuing equity shares with interest due on them.

Pass necessary journal entries.

Solution

Step 1: Amount Due to Debenture Holders:

Face Value: 5,000 × ₹100	=	₹5,00,000
Less: Discount @ 10%	=	₹50,000
		₹4,50,000

Step 2: Number of Equity Shares to be Issued: $\frac{₹4,50,000}{₹10 + 50\%} = \frac{4,50,000}{15}$

$= 30,000$

Step 3:

Journal of PQ Ltd.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 January 2010	Bank A/c Dr.		4,50,000	
	Discount on Issue of Debentures A/c Dr.		50,000	
	To 10% Debentures A/c			5,00,000
	(Issue of Debentures at a Discount)			
31 December 2010	Interest on Debentures A/c Dr.		50,000	
	To Debenture Holders A/c			50,000
	(Interest Due on Debentures for 1 year)			
31 December 2010	10% Debentures A/c Dr.		50,000	
	To Discount on Issue of Debentures A/c			5,000
	To Equity Share Capital A/c			30,000
	To Securities Premium A/c			15,000
	(Issue of 3,000 Shares of ₹10 Each at 50% Premium on Conversion of 500 Debentures)			

31 December 2010	Debenture Holders A/c Dr. To Bank A/c (Interest Paid on 500 Debentures, Converted into Shares)		5,000	 5,000

4.12.10 Redemption by Purchase in the Open Market

As debentures are transferable, companies can purchase their own debentures in the open market. But this has to be authorized by the Articles of Association of respective companies. By using its surplus cash, a company can purchase its own shares in the open market and they can be sold in stock exchange.

Debentures may be purchased for the following objectives:

(i) For immediate cancellation (Cancellation means redemption)

(ii) For investment—Also called "own debentures"

Companies purchase their own debentures because they can effect saving of premium and interest payable in future.

Debentures may be purchased:

(i) On the date when interest is due

(ii) On the date between two interest rates

Accounting Treatment:

I. Purchase of Debentures for Immediate Cancellation:

A. When No Sinking Fund Exists:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
(i)	At the Time of Purchase of Debentures for Immediate Cancellation:			
	Debentures A/c Dr.		…	
	To Bank A/c			….
	Note: When the face value and market price is same, this entry is sufficient for purchase and cancellation.			
(ii)	If there is any Difference Between the Face Value of and the Actual Amount Paid, Such Difference Is to Be Treated as Profit or Loss on Cancellation, as the Case may Be:			
	1. When Market Price of Debentures is Less than Face Value, it Results in Profit. Entry is:			
	(a) On Purchase:			
	Own Debentures A/c Dr.		…	
	To Bank A/c			…
	(b) On Cancellation:			
	… % Debentures A/c Dr.		….	
	To Own Debentures A/c			…
	To Profit on Cancellation of Debentures A/c			…
	The Above Two Entries may be Combined into One Entry as Follows:			

	(a + b) … % Debentures A/c		…	
	To Bank A/c			…
	To Profit on Redemption or Cancellation of Debentures A/c			…
(iii)	When Market Price of Debentures is Greater than Face Value, it Results in Loss:			
	(a) On Purchase:			
	Own Debentures A/c	Dr.	…	
	To Bank A/c			…
	(b) On Cancellation:			
	… % Debentures A/c	Dr.	…	
	Loss on Redemption or Cancellation of Debentures A/c	Dr.	…	
	To Bank A/c			…
	These Two Entries may be Combined into a Single Entry as:			
	(a + b) …% Debentures A/c	Dr.	…	
	Loss on Redemption or Cancellation of Debentures A/c	Dr.	…	
	To Bank A/c			…
(iv)	Profit or Loss on Cancellation Is a Capital Profit. When It Is Profit, It Is to Be Transferred to Capital Reserve. When It Is Loss, It Is to Be Written off Against Capital Profits.			
	Entry:			
	(a) For Profit:			
	Profit on Redemption on Cancellation of Debenture A/c	Dr.	…	
	To Capital Reserve A/c			…
	(b) For Loss:			
	Capital Reserve/Securities Premium A/c	Dr.	…	
	To Loss on Redemption or Cancellation of Debentures A/c			…
(v)	Transfer of Amount to DRR A/c:			
	Profit & Loss Appropriation A/c	Dr.	…	
	To Debenture Redemption Reserve A/c			…

B. When a Sinking Fund Exists:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
(i)	For Sale of Sinking Fund Investments:			
	Bank A/c Dr.		…	
	To Debenture Redemption Fund Investments A/c			…

(ii)	For Purchase & Cancellation of Debentures:			
	Debentures A/c Dr.		…	
	To Bank A/c			…
(iii)	For Profit/Loss on Cancellation of Debentures:			
	If Profit:			
	(a) Debenture A/c Dr.		…	
	To Bank A/c			…
	To Profit on Cancellation of Debentures A/c			…
	(b) Profit on Cancellation of Debentures A/c Dr.		…	
	To Sinking Fund A/c			…
	(OR)			
	As a Combined Entry:			
	(a) + (b) Debentures A/c		…	
	To Bank A/c			…
	To Sinking Fund A/c			…
	If Loss:			
	(a) Debentures A/c Dr.		…	
	Loss on Cancellation of Debentures A/c Dr.		….	
	To Bank A/c			…
	(b) Sinking Fund A/c Dr.		…	
	To Loss on Cancellation of Debentures A/c			…
	OR			
	As a Combined Entry:			
	(a) + (b) Debentures A/c Dr.		…	
	Sinking Fund A/c Dr.		…	
	To Bank A/c			…
(iv)	For Transfer to General Reserve:			
	Sinking Fund A/c Dr.		…	
	To General Reserve A/c			…

II. Purchase of Debentures for Investment (Own Debentures):

A. Where No Sinking Fund Exists:

Date	**Particulars**	**L.F.**	**Dr.** ₹	**Cr.** ₹
	For Purchase of Debentures as Investment			
	Own Debentures A/c Dr.		…	
	To Bank A/c			…

B. Where Sinking Fund Exists:

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
(i)	For Purchase:				
	Own Debentures A/c	Dr.		…	
	To Bank A/c				….
(ii)	For Sale:				
	Bank A/c	Dr.		…	
	To Debentures Redemption Fund Investments A/c				….
(iii)	For Profit or Loss on Cancellation:				
	(a) For Profit:				
	Debentures A/c	Dr.		…	
	To Own Debentures A/c				…
	To Profit on Cancellation of Debentures A/c				…
	(b) For Loss:				
	Debenture A/c	Dr.		…	
	Loss on Cancellation of Debentures A/c	Dr.		…	
	To Own Debentures A/c				…

Illustration 4.41

Model: Redemption by purchase in open market—Immediate cancellation

Krishan Ltd. purchased its own 1,000 debentures of the face value of ₹ 1,00,000 from the open market for immediate cancellation at ₹ 90. Make journal entries.

Solution

Note:

1. The company purchased its own debentures in the open market.
2. It is for immediate cancellation.
3. Nominal Value = $\frac{\text{Total Amount}}{\text{Number of Debentures}} = \frac{1,00,000}{1,000}$ ₹ 1,000
4. Purchase price is less than that of market price. Hence it is profit.

Journal of Krishan Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Own Debenture A/c	Dr.		90,000	
	To Bank A/c				90,000
	(Purchase of 1,000 Debentures @ ₹ 90)				

	Debentures A/c Dr.		1,00,000	
	To Own Debentures A/c			90,000
	To Profit on Cancellation of Debentures A/c			10,000
	(Purchase of Own Debentures of the Face Value of ₹ 1,00,000 and Cancelled then at ₹ 90 per Debentures, i.e. for ₹ 90,000)			
	Profit on Cancellation of Debentures A/c Dr.		10,000	
	To Capital Reserve A/c			10,000
	(Transfer of Profit to General Reserve)			

Illustration 4.42

The balance sheet of Reddy & Co. Ltd. on 31 December 2010 shows:

(i) 15% Debentures of ₹ 10,00,000

(ii) Debenture Redemption Reserve ₹ 4,00,000

(iii) Debenture Sinking Fund Investments Represented by ₹ 1,00,000

Own Debentures purchased at 90% and remaining amount by ₹ 3,20,000, 10% stock.

On 31 March 2010, the directors redeemed all the debentures for this purpose, 10% stock was realized at par, an amount of ₹ 1,40,000 out of current year's profit for redemption. Pass necessary journal entries.

Solution

Note:

1. In this question, both the factors, i.e., for cancellation and for investment purposes, can be noticed.
2. Computation of the Value of Own debentures:
   Own Debentures—90% (Given) ∴ 90% of ₹ 1,00,000 = ₹ 90,000
   This is Debenture Sinking Fund Investment
3. Computation of Cost of Investment: (10% Stock)

Debenture Redemption Reserve Fund Investment (Given)	=	₹ 4,00,000
Less: Value of Own Debenture (Ref: 2 above)	=	₹ 90,000
∴ Cost of Investment	=	₹ 3,10,000

*[1]4. Profit on Sale of 10% Stock : Sales – Cost of Investment
= ₹ 3,20,000 – ₹ 3,10,000
(Given) (Ref: 3 above)
= ₹ 10,000

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 December 2010	Bank A/c Dr.		3,20,000	
	To Debentures Sinking Fund Investment A/c			3,20,000
	(10% Stock Realized at Par)			

31 December 2010	[1]*Debentures Sinking Fund Investment A/c Dr. To Debenture Sinking Fund A/c (Profit on Sale of 10% Stock Transferred to Sinking fund)		10,000	 10,000
31 December 2010	15% Debentures A/c Dr. To Debenture Sinking Fund A/c To Capital Reserve A/c (Cancellation of Own Debentures)		1,00,000	 90,000 10,000
31 December 2010	15% Debentures A/c Dr. To Debenture Holders A/c (Amount Due to Debenture Holders)		9,00,000	 9,00,000
31 December 2010	Debenture Holders A/c Dr. To Bank A/c (Amount Paid off)		9,00,000	 9,00,000
31 December 2010	Profit & Loss Appropriation A/c Dr. To Debenture Redemption Reserve A/c (Profit Transferred to DRR A/c)		1,40,000	 1,40,000

Illustration 4.43

Model: Both for the purpose of cancellation and investment without creating DRR

Subh Ltd. issued 10,000, 12% debutantes of ₹ 300 each. The Board of Directors decided to purchase 1,000 debentures at a price of ₹ 90 each for investment purpose. After 9 months, they decided to sell off these debentures @ ₹ 110 each. Pass journal entries.

Solution

Note:

1. In this question, both the factors, i.e., purchase of own debentures and for investment purposes, are present.
2. But in this question, nothing is mentioned about debenture redemption reserve. It is silent on this. In such a case, assume that there is sufficient balance in DRR.

Journal of Subh Ltd.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1.	At the Time of Issue of Debentures: Bank A/c Dr. To Debenture Application A/c (Application Money Received on 10,000 Debentures @ ₹ 300 Each)		30,00,000	 30,00,000

	Debenture Application A/c	Dr.		30,00,000	
	To 12% Debentures A/c				30,00,000
	(Application Money Transferred to Capital A/c)				
	At the Time of Purchase:			90,000	
	Own Debentures (Investment) A/c	Dr.			
	To Bank A/c				90,000
	(1,000 Own Debentures Purchased @ ₹ 90 per Debenture)				
	On Sale:				
	Bank A/c	Dr.		1,10,000	
	To Own Debentures (Investments) A/c				90,000
	To Profit & Loss A/c				20,000
	(Profit on Sale Transferred) (1,000 × ₹ 110 – ₹ 90 Profit)				

4.12.10.1 Purchase of Debentures on a Day Other than Due Date of Interest

Usually, interest on debentures is paid on specific dates. But at times, debentures are purchased in the open market on a date other than the specified date of interest. In such a situation, accounting treatment differs. Here arises the factors: EX-INTEREST and CUM-INTEREST quotations.

Amount paid towards the cost of debentures = Capital Part + Revenue Part, i.e., amount paid towards interest from the last specified date to the actual payment.

4.12.10.1.1 Cum-interest

Where the price (quoted in the quotation) includes interest for the expired period, it is termed CUM-INTEREST

Such quotation includes:

(i) Payment of Debenture = Capital Part

and

(ii) Payment of Interest = Revenue Part

In this case,

Cost of Debenture = Price Paid – Interest for Expired Period.

4.12.10.1.2 Ex-interest

Where the price (quoted in quotation) does not include the interest for the expired period, it is termed EX-INTEREST

In this case,

Cost of Debenture = Price of Debenture + Interest Accrued

Illustration 4.44

Model: Cum-interest and Ex-interest

PQR Ltd. purchased from the market its own 1,000, 15% debentures of ₹ 100 each at ₹ 90 on 31 December 2010. Interest is paid on 31 March and 30 September every year. Journalize the entries for the quotations: (1) ex-interest and (2) cum-Interest

Solution

Step 1: Determination of Expiry Period

Interest is Paid on 31 March and 30 September (Given)

Period of Expiry = 1 October 2010 to 31 December 2010

= 3 months (or) $\frac{3}{12}$ year

Step 2: Calculation of Interest for Expired Period:

$= 1{,}000 \text{ Debentures} \times ₹\,100 \times \frac{3}{12} \times \frac{15}{100}$

$= ₹\,1{,}00{,}000 \times \frac{3}{12} \times \frac{15}{100} = ₹\,3{,}750$

Step 3: Ex-Interest:

Cost of Debenture = Price of Debentures + Interest Accrued

= (1,000 × ₹ 90) – ₹ 3,750

= ₹ 90,000 + ₹ 3,750

= ₹ 93,750

Step 4: Cum-Interest:

Cost of Debenture = Price of Debentures – Interest for Expired Period

= (1,000 × ₹ 90) – ₹ 3,750

= ₹ 90,000 – ₹ 3,750 = ₹ 56,250

Step 5:

Journal

Date	Particulars		Dr. ₹	Cr. ₹
31 December 2010	Own Debentures A/c	Dr.	86,250	
	Debenture Interest A/c	Dr.	3,750	
	To Bank A/c			90,000
	(Purchase of Own Debentures @ ₹ 90 Cum-Interest)			
31 December 2010	Own Debentures A/c	Dr.	90,000	
	Debenture Interest A/c	Dr.	3,750	
	To Bank A/c			93,750
	(Purchase of Own Debentures @ ₹ 90 Ex-Interest)			

4.12.10.2 Interest on Own Debentures

As already mentioned, by purchasing own debentures, a company saves interest that would have otherwise been paid to outsiders.

In case a company purchases its own debentures, and if they are not cancelled immediately, then interest will become due on such debentures too.

Interest is paid only to outsiders.

Interest on own debentures is retained by the company.

Interest on own debentures is credited to "interest on own debentures A/c."

Accounting Treatment:

Accounting Entries for the Interest on Own Debentures are:

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
(i)	When Interest Becomes Due:				
	Debentures Interest A/c	Dr.		…	
	To Debenture Holders A/c				…
	To Interest on Own Debentures A/c				…
(ii)	On Payment of Interest (To Outsiders)				
	Debenture Holders A/c	Dr.		…	
	To Bank A/c				…
(iii)	On Transfer of Interest (Total on All Debentures)				
	Profit & Loss A/c	Dr.		…	
	To Debentures Interest A/c				…
(iv)	On Transfer of Interest on Own Debentures				
	Interest on Own Debentures A/c	Dr.		…	
	To Profit & Loss A/c				…
	In case, if Sinking Fund Exists Entries Will Be:				
	(i) On Interest Due:				
	Debenture Interest A/c	Dr.		…	
	To Debenture Redemption Fund A/c				…
	To Debenture Holders A/c				…
	(ii) On Payment of Interest to Outsiders:				
	Debenture Holders A/c	Dr.		…	
	To Bank A/c				…

Illustration 4.45

Model: Interest on own debentures

On 31 March 2010, the balance sheet of Rukmani Ltd. showed 2,000, 12% debentures of ₹100 each outstanding. Interest on debentures is payable on 30 September and 31 March every year. On 1 August 2010, the company purchased 400 of its own debentures as investment @ ₹95 ex-interest. The company cancelled all its own debentures on 1 March 2011. Books are closed on 31 March every year. Give necessary journal entries.

Solution

Students have to compute both interest and cost of debentures purchased in detail as follows:

Step 1: Interest on Debentures Purchased on 1 August 2010:

Expiry Period = From 31 March to 1 August 2010 = 4 months

$$\text{Interest} = \frac{Pnr}{100} \text{ where } P = (400 \times ₹100);\ n = \frac{4}{12};\ r = 12\%\ \frac{12}{100}$$

$$= ₹40{,}000 \times \frac{4}{12} \times \frac{12}{100} = ₹1{,}600$$

Step 2: Interest on Debentures Payable to Outsiders:

Total Debentures = ₹ 2,00,000
Less: Debentures Held by the Company = ₹ 40,000
= ₹ 1,60,000

Interest $= ₹\,1,60,000 \times \frac{6}{12} \times \frac{12}{100}$
= ₹ 9,600

Step 3: Cost of Debentures Purchased on 1 August 2010:

$= ₹\,40,000 \times \frac{95}{100} = ₹\,38,000$

Step 4: Interest on Own Debentures Due to Company:

$= ₹\,40,000 \times \frac{6}{12} \times \frac{12}{100} = ₹\,2,400$

Step 5: Net Interest on Own Debentures:

Out of ₹ 2,400 (As in Step 4), ₹ 1,600 had Already Been Paid by the Company at the Time of Purchasing Own Debentures (As in Step 1).

∴ Net Interest on Own Debentures Credited = ₹ 2,400 – ₹ 1,600
= ₹ 800

Step 6: Interest on Debentures Payable to Outsiders on 31 March 2011:

$= ₹\,1,60,000 \times \frac{6}{12} \times \frac{12}{100}$
= ₹ 9,600

Step 7: Interest on Own Debentures Due to the Company from 30 September to 1 March

= 5 months or $\frac{5}{12}$ year
$= ₹\,40,000 \times \frac{5}{12} \times \frac{12}{100} = ₹\,2,000$

Step 8: Total Interest on Debentures = ₹ 12,000 + ₹ 11,600 + ₹ 1,600
= ₹ 25,200

Step 9: Total Interest on Own Debentures = ₹ 800 + ₹ 2,000
= ₹ 2,800

Step 10:

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 August 2010	Own Debentures A/c	Dr.		38,000	
	Debenture Interest A/c	Dr.		1,600	
	To Bank A/c				39,600
	(Purchase of Own Debentures [Ref: Step 1 and Step 3])				
1 August 2010	Debenture Interest A/c	Dr.		12,000	
	To Bank A/c				9,600
	To Interest Own Debentures A/c				2,400
	(Interest Paid for 2 months Adjusted [Ref: Step 2 and Step 4)				

2011	12% Debentures A/c	Dr.		40,000	
	To Own Debentures A/c				38,000
	To Profit on Cancellation of Debentures				2,000
	(Cancellation of Own Debentures)				
2011	Profit on Cancellation of Own Debentures A/c	Dr.		2,000	
	To Capital Reserve A/c				2,000
	(Profit on Cancellation Transferred to Capital Reserve A/c)				
31 March 2011	Debenture Interest A/c	Dr.		11,600	
	To Bank A/c				9,600
	To Interest on Own Debentures A/c				2,000
	(Interest Paid Except on Own Debentures till 1 March)				
	(Ref: Step 6 and Step 7)				
31 March 2011	Profit & Loss A/c	Dr.		25,200	
	To Debentures Interest A/c				25,200
	(Total Interest Transferred to P&L A/c[Ref: Step 8])				
31 March 2011	Interest on Own Debentures A/c	Dr.		2,800	
	To Profit & Loss A/c				2,800
	(Interest on Own Debentures Transferred to P&L A/c				
	[Ref: Step 9])				

Advanced Level

Illustration 4.46

Model: Sinking fund method

ABC Ltd. issued 4,000, 12% debentures of ₹100 each at par on 1 April 2008. These debentures are redeemable at the end of 5th year at 10% premium. It was resolved that sinking fund should be formed and invested in 10% development bonds of ₹100 each. Interest on bonds is payable on 31 March every year.

Reference to Sinking Fund Table 3 shows that ₹0.1638 invested at the end of every year at 10% compound interest will produce ₹1 at the end of 5th year.

10% Development bonds of the required amount were purchased on different dates at the following prices:

On March 2009	₹80
On March 2010	₹90
On March 2011	₹100

You are required to show debenture redemption fund A/c and debenture redemption fund investment A/c for the first 3 years in the books of ABC Ltd. Accounting year of this company ends on 31 March.

Solution

Basic Calculations:

Step 1: Determination of Value of Debentures to Be Redeemed :

Face Value of Debenture = 4,000 × ₹100 = ₹4,00,000

Add: 10% Premium = 10% of 4,00,000 = ₹40,000

Value of Debenture to be Redeemed = ₹4,40,000

Step 2: Annual Appropriation to be Created = ₹4,40,000 × 0.1638 = ₹72,072

Step 3: Determination of Number of Bonds Purchased and Their Cost Price:

(i) For Year Ended 31 March 2009: (First Year)

Number of Bonds Purchased $= \frac{₹72,072}{₹80} = 900.90$ or 901

∴ Cost Price of 901 Bonds = 901 × 80 = ₹72,080

Face Value = 901 × 100 = ₹90,100

(ii) For the Year Ended 31 March 2010 (Second Year):

Number of Bonds Purchased $= \frac{₹72,080 + 10\ \%\ \text{of. } 90,100(\text{Interest})}{90}$

$= \frac{₹72,080 + ₹9,010}{90} = \frac{81,090}{90} = 901$

Cost Price = 901 × ₹90 = ₹81,090

Face Value = 901 × ₹100 = ₹90,100

(iii) For the Year Ended 31 March 2011 (Third Year):

Number of Bonds Purchased $= \frac{₹72,080 + ₹18,020}{100} = \frac{90,100}{100} = 901$

Cost Price = 901 × 100 = ₹90,100

Face Value = 901 × 100 = ₹90,100

Step 4: **Debenture Redemption Fund A/c**

Date	Particulars	₹	Date	Particulars	₹
31 March 2009	Balance c/d	72,080	31 March 2009	P&L Appropriation A/c	72,080
			1 April 2009	Balance b/d	72,080
31 March 2010	Balance c/d	1,53,170	31 March 2010	Bank A/c (Interest) (10% of ₹90,100)	9,010
			31 March 2010	P&L Appropriation A/c	72,080
		1,53,170			1,53,170
31 March 2011	Balance c/d	2,43,270	31 March 2010	Balance b/d	1,53,170
			31 March 2011	Bank A/c (Interest) (10% on ₹1,80,200)	18,020
			31 March 2011	P&L Appropriation A/c	72,080
		2,43,270			2,43,270

Step 5:

Debenture Redemption Fund Investments A/c

Date	Particulars	₹	Date	Particulars	₹
31 March 2009	Bank A/c [Ref: Step 3 (i)] (Face Value ₹ 90,100)	72,080	31 March 2009	Balance c/d (Face Value ₹ 90,100)	72,080
1 April 2009	Balance c/d	72,080	31 March 2010	Balance c/d (Face Value ₹ 1,80,200)	1,53,170
31 March 2010	Bank A/c [Ref: Step 3 (ii)] (Face Value ₹ 90,100)	81,090			
		1,53,170			1,53,170
1 April 2010	Balance b/d (Face Value ₹ 1,80,200)	1,53,170	31 March 2011	Balance c/d (Face Value ₹ 2,70,300)	2,43,270
31 March 2011	Balance A/c (Face Value ₹ 90,100)	90,100			
		2,43,270			2,43,270

Illustration 4.47

Model: Redemption through sinking fund

In March 2011, the following balances were extracted from the books of Suraj Ltd.:

	₹
14% Mortgage Debenture	25,00,000
Debenture Redemption Fund	25,00,150
Debenture Redemption Fund Investments	21,00,000

On 1 April 2011, all the investments were sold for ₹ 20,58,000 and debentures were redeemed at par. The company had sufficient bank balance. You are required to prepare:

(i) 14% First mortgage debentures

(ii) Debenture redemption fund

(iii) Debenture redemption fund investments A/c

Solution

Note: Loss on sale of investments: ₹ 21,00,000 – ₹ 20,58,000
: ₹ 42,000

14% First Mortgage Debentures

Date	Particulars	₹	Date	Particulars	₹
1 April 2011	Sundry Debenture Holders A/c	25,00,000	1 April 2001	Balance b/d	25,00,000

Debenture Redemption Fund A/c

Date	Particulars	₹	Date	Particulars	₹
1 April 2011	Debenture Redemption Fund Investment A/c (Ref: Note)	42,000	1 April 2011	Balance b/d	25,00,150
1 April 2011	General Reserve A/c (Bal. Fig) Transfer	24,58,150			
		25,00,150			25,00,150

Debenture Redemption Fund Investments A/c

Date	Particulars	₹	Date	Particulars	₹
1 April 2011	Balance b/d	21,00,000	1 April 2011	Bank A/c (Sale—Given)	20,57,000
			1 April 2011	Debenture Redemption Fund Investment A/c (Ref: Note)	42,000
		21,00,000			21,00,000

Illustration 4.48

Model: Purchase of debenture in open market

Kamal Ltd. issued on 1 April 2007, 40,000 12% debenture of ₹ 100 each redeemable at the option of the company after the second year as ₹ 104 upon giving two months notice to the debenture holders. The company purchased the following debenture in the open market:

(i) On 12 June 2009, ₹ 8,000 nominal value as cum-interest cost ₹ 8,050

(ii) On 24 August, 2009 ₹ 14,000 nominal value as ex-interest cost ₹ 13,830

These debentures were retained as investments till 30 September 2010, on which date they were cancelled. Show the necessary ledger accounts as they would appear in the books of the company for 2009–10 and for 2010–11 assuming that the company closes its book of accounts every on 31 March. Interest is payable half-yearly on 30 September and 31 March. Ignore income tax.

Solution

Lotus Ltd.

12% Debenture A/c

Date	Particulars	₹	Date	Particulars	₹
31 March 2010	Balance c/d	40,00,000	1 April 2009	Balance b/d	40,00,000
30 September 2010	Own Debentures A/c	21,688	1 April 2010	Balance b/d	40,00,000
	Capital Reserve A/c (Profit on Redemption)	312			
31 March 2011	Balance c/d	39,78,000			
		40,00,000			40,00,000
			1 April 2011	Balance b/d	39,78,000

Own Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
12 June 2009	Bank A/c (₹ 8,050 – ₹ 190)	7,858	31 March 2010	Balance c/d	21,688
24 August 2009	Bank	13,830			
		21,688			21,688
1 April 2010	Balance b/d	21,688	30 September 2010	12% Debentures	21,688
		21,688			21,688

Interest on Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
12 June 2009	Bank A/c $\left(800 \times \frac{12}{100} \times \frac{73}{365}\right)$	192	31 March 2010	P&L A/c Transfer	4,80,000
24 August 2009	Bank A/c $\left(14,000 \times \frac{12}{100} \times \frac{146}{365}\right)$	672			
30 September 2009	Bank A/c $\left(40,00,000 \times \frac{12}{100} \times \frac{6}{12}\right)$ – 1,320	2,38,680			
30 September 2009	Interest on Own Debentures $\left(22,000 \times \frac{12}{100} \times \frac{6}{12}\right)$ – (192 + 672)	456			
31 March 2010	Interest on Own Debenture $\left(22,000 \times \frac{12}{100} \times \frac{6}{12}\right)$	1,320			
31 March 2010	Bank	2,38,680			
		4,80,000			4,80,000
30 September 2010	Bank A/c	2,38,680	31 March 2011	P&L A/c (Transfer)	4,78,680
	Interest on Own Debenture	1,320			
31 March 2011	Bank A/c	2,36,680			
		4,78,680			4,78,680

Interest on Own Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
31 March 2010	P&L A/c (Transfer)	1,776	30 September 2009	Debenture Interest	456
			31 March 2010	Debenture Interest	1,320
		1,776			1,776
31 March 2010	P&L A/c (Transfer)	1,320	30 September 2010	Debenture Interest	1,320
		1,320			1,320

Illustration 4.49

X Ltd. had issued 4,000 6% debenture of ₹ 100 each on 18 January 2006. Interest was payable half-yearly on 30 June and 31 December each year. They were repayable at par after 10 years with the option to redeem them at any time after 31 December 2010 as ₹ 103. On 1 January 2011, the balance in the debenture redemption fund A/c stood at ₹ 2,14,000 which was invested outside. On 30th June 2011, a notice was given for redemption of the above debenture with the option to receive one new 9% debenture of ₹ 100 each as ₹ 98 and ₹ 5 in cash for each 6% debenture in place of ₹ 103 in cash.

The holders of 3,600 debentures exercised this option and the remaining were paid cash. The company sold investments costing ₹ 1,44,000 for ₹ 1,74,800. The company completed the redemption. Give necessary ledger accounts offered by the above transactions. Ignore the tax.

Solution

Book of X Ltd.

6% Debenture A/c

Date	Particulars	₹	Date	Particulars	₹
30 June 2011	Debenture Holders	4,00,000	1 January 2011	Balance b/d	4,00,000

Debenture Holder A/c

Date	Particulars	₹	Date	Particulars	₹
30 June 2011	9% Debentures A/c 3,600 × ₹ 100 × 98/100	3,52,800	30 June 2011	6% Debentures A/c (Transfer)	4,00,000
	Bank A/c (3,600 × ₹ 5)	18,000	30 June 2011	Premium on Redemption of Debentures (₹ 4,00,000 × 3/100)	12,000
	Bank A/c (400 × ₹ 103)	41,200			
		4,12,000			4,12,000

Debenture Redemption Fund A/c

Date	Particulars	₹	Date	Particulars	₹
30 June 2011	Premium on Redemption of Debentures A/c (4,000 × ₹ 3)	12,000	1 January 2011	Balance b/d	2,14,000
30 June 2011	Discount on Issue of Debentures A/c (3,600 × ₹ 2)	7,200	30 June 2011	Debenture Redemption Fund Investment A/c (1,774,800 – 1,44,000)	30,800
30 June 2011	General Reserve (Bal. Fig)	2,25,600			
		2,44,800			2,44,800

Debenture Redemption Fund Investments A/c

Date	Particulars	₹	Date	Particulars	₹
1 January 2011	Balance b/d	2,14,000	30 June 2011	Bank A/c (Sale)	1,74,800
30 June 2011	Debenture Redemption Fund A/c (Profit on Sale)	30,800			
		2,44,800			2,44,800

9% Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
30 June 2011	Balance c/d	3,60,000	30 June 2011	Debenture Holders A/c	3,52,800
			30 June 2011	Discount on Issue of Debentures	7,200
		3,60,000			3,60,000

Illustration 4.50

Pass journal entries in year 1 in the case of issue of debentures by XYZ Co Ltd., which issued ₹ 5,00,000, 11% debentures as 95% redeemable at the end of 10 years (1) at 102% and (ii) at 98%.

[C.A. Modified]

Solution

XYZ Co Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
(i)	Bank A/c $\left(\frac{95}{100} \times ₹ 5,00,000\right)$	Dr.		4,75,000	
	Discount on Issue of Debentures A/c $\left(\frac{5}{100} \times ₹ 5,00,000\right)$	Dr.		25,000	

	Loss on Issue of Debentures A/c Dr. $\left(\frac{2}{100} \times ₹5,00,000\right)$		10,000	
	To 11% Debentures A/c			5,00,000
	To Premium on Redemption of Debentures A/c ($\frac{2}{100} \times ₹5,00,000$)			10,000
	(Issue of ₹5,00,000, 11% Debentures at Discount of 5%, Redeemable as 2% Premium)			
(ii)	Bank A/c Dr.		4,75,000	
	Discount on Issue of Debentures A/c Dr.		25,000	
	To 11% Debentures A/c			5,00,000
	(Issue of ₹5,00,000, 11% Debentures as a Discount of 5% Redeemable as a Discount of 2%)			

Illustration 4.51

Model: Redemption by conversion

Leo Ltd. made a public issue in respect of which the following information is available:

(a) Number of partly convertible debentures issued: 6,00,000; face value and issue price: ₹100 per debentures

(b) Convertible portion per debenture: 60%; date of conversion: on expiry of 6 months from date of allotment

(c) Date of closure of subscription: 1 May 2010; date of allotment: 1 June 2010, rate of interest on debentures: 12% payable from the date of allotment; values of equity share for the purpose of conversion: ₹60 (face value ₹10)

(d) Underwriting commission @ 2% on the amount devolving on the underwriting and @ 1% on amount subscribed for by the public

(e) Number of debentures applied for 4,50,000

(f) Interest payable on debentures half-yearly on 30 September and 31 March

Write relevant journal entries for all transactions arising out of the above during the year ended 31 March 2011 (including cash and bank entries)

[C.A. (Inter). Modified]

Solution

Leo Ltd.
Journal Entries

(₹ in 00's)

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 May 2010	Bank A/c Dr.		45,000	
	To 15% Debentures Application & Allotment A/c			45,000
	(Application Money Received on 4,50,000 15% Debentures @ ₹100 Each)			

1 June 2010	15% Debentures Application & Allotment A/c Dr. Underwriters A/c Dr. To 15% Debentures A/c (Allotment of 4,50,000 15% Debentures to Applicants & 1,50,000 15% Debentures to Underwrites)		45,000 15,000	 60,000
1 June 2010	Underwriting Commission A/c Dr. To Underwriters A/c (Commission @ 2% on ₹ 15,000,000 the Amount Devaluing on the Underwriters and @ 1% on ₹ 6,00,000 the Amount Subscribed for by the Public)		750	 750
1 June 2010	Bank A/c Dr. To Underwriters A/c (Amount Received from Underwriters in Settlement of Account)		14,250	 14,250
30 September 2010	Interest on Debentures A/c Dr. To Bank A/c (Interest Paid on Debentures for 4 months @ 12% p.a. on ₹ 6 crore)		2,400	 2,400
1 December 2010	15% Debentures A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (60% of the Amount of Debentures is Converted into Shares of ₹ 60 Each with a Face Value of ₹ 10 Each)		36,000	 6,000 30,000
31 March 2011	Interest on Debentures A/c Dr. To Bank A/c (Interest Paid on ₹ 240 lakh for 6 months and on ₹ 360 lakh for 2 months)		2,160	 2,160

Illustration 4.52

Model: Redemption by conversion

The summarized balance sheet of XY as on 31 March 2011 stood as follows:

Liabilities	₹ in Lakhs	Assets	₹ in Lakhs
Share Capital:			
20,00,000 Equity Shares of ₹ 10 Each, Fully Paid	200	Fixed Assets (as Cost Less Depreciation)	640
General Reserve	300	Debenture Redemption Fund Investment	160
Debentures Redemption Fund	200		
12.5% Convertible Debentures	400	Cash and Bank Balance	200
4,00,000 Debentures of ₹ 100 Each		Other Current Assets	800
Other Loans	200		
Current Liabilities and Provisions	500		
	1,800		1,800

The debentures are due for redemption on 1 April 2011. The terms of issue of debentures provided they were redeemable at a premium of 5% and also conferred option to the debenture holders to convent 20% of their holding into equity shares as a pre-determined price of ₹ 15.75 per share and the payment in cash.

Assuming that:

(i) Except for 1,000 debenture holders holding 1,00,000 debentures in all, the rest of them exercised the option for maximum conversion

(ii) The investments realize ₹ 176 lakh on sale

(iii) All the transactions are put though, without any lag, on 1 April 2011.

Redraft the balance sheet of the company as on 1 April 2011, after giving effect to the redemption. Show your calculation in respect of the number of equity shares to be allotted and the cash payment necessary.

[C.A. (Inter). Modified]

Solution

BASIC CALCULATIONS:

Step 1: Determination of Number of Shares to be Allotted:

Number of Debentures Opting for Conversion : 4,00,000 – 1,00,000
= 3,00,000

Number of Debentures to be Converted into Equity Shares (Entitled to 20% of Holding) : $\frac{20}{100} \times 3,00,000 = 60,000$

Amount to be Allotted to Convert 60,000 Debentures : 60,000 × ₹ 105
= ₹ 63,00,000

As the Price of One Equity Share is ₹ 15.75, Number of Equity Shares to be Allotted $= \frac{₹\ 63,00,000}{₹\ 15.75}$

= 4,00,000 Shares

Step 2: Determination of Cash to be Paid for Redemption

Number of Debentures Left After Conversion into Equity Shares = 4,00,000 – 60,000
= 3,40,000

Amount to Be Paid to Redeem As a Premium of 5% = ₹ 105 × 3,40,000
= ₹ 3,57,00,000

Step 3: Cash and Bank Balance is to be Calculated by Preparing Cashbook as Follows:

Cashbook

Particulars	₹	Particulars	₹
To Balance b/d	2,00,00,000	By Debenture Holders A/c	3,57,00,000
To Debentures Redemption Fund Investment	1,76,00,000	By Balance c/d	19,00,000
	3,76,00,000		3,76,00,000
To Balance b/d	19,00,000		

Step 4: General Reserve to be Shown in B/S is Ascertained by Preparing General Reserve A/c as Follows:

General Reserve A/c

Particulars	₹	Particulars	₹
To Balance c/d	5,16,00,000	By Balance b/d	3,00,00,000
		By Debentures Redemption Fund	2,16,00,000
	5,16,00,000		5,16,00,000
		By Balance b/d	5,16,00,000

Step 5:

Securities Premium A/c

Particulars	₹	Particulars	₹
To Premium on Redemption of Debentures A/c	20,00,000	By Bank	23,00,000
To Balance c/d	3,00,000		
	23,00,000		23,00,000
		By Balance b/d	3,00,000

Step 6:

XY Ltd.

Balance Sheet as on 1 April 2011 (₹ in Lakhs)

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
24 lakh Equity Shares of ₹ 10 Each	240	Fixed Assets (as Cost Less Depreciation)	640
Reserves & Surplus:		Current Assets, Loans & Advances:	
General Reserve	516	(A) Current Assets:	
Securities Premium	3	Cash & Bank Balance	19
Unsecured Loans:		Other Current Assets	800
Other Loans	200	(B) Loans & Advances	
Current Liabilities & Provisions	500		
	1,459		1,459

Illustration 4.53

Model: Redemption by conversion—Redemption of preferecne shares combined

The summarized balance sheet of Sri Vasudev Ltd. on 30 September 2010 was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	30,00,000
Issued and Fully Paid:		Investments	
10,000 Equity Share of ₹ 100 Each Fully Paid	10,00,000	Own Debentures of Nominal Value of ₹ 2,00,000	1,90,000

6% Redeemable Preference Share of ₹100 Each (Less Calls in Arrears on 400 Shares)	9,90,000	Other Securities	2,00,000
		Current Assets:	
Reserves & Surplus:			
Securities Premium	2,00,000	Stock	4,00,000
Capital Reserve	2,00,000	Debtors	2,00,000
General Reserve	4,00,000	Cash at Bank	12,00,000
Profit & Loss A/c	6,00,000		
10% Debentures	4,00,000		
Creditors	14,00,000		
	51,90,000		51,90,000

On 30 September 2010, the following were due for redemption:

(i) 10,000 6% Redeemable preference shares at a premium of ₹25 per share.

(ii) 4,000 10% Redeemable debentures shares at a premium of 10% the redemption was made on that date or subsequently this:

(a) For half the year ending 30 September 2010, the debentures interest and preference dividend was paid out of profits of the company

(b) On an offer made to the 10% debenture, the outsiders agreed to take new 12% debentures at par in exchange of old debentures ; the company also decided to assume the new debentures

(c) A fresh issue of 2,000 equity shares of ₹100 each was made at a premium of ₹50 per shares and subscribed in full. All moneys due were received forthwith

(d) Redemption of all preference shares was made on 10 October 2010

You are required to show all journal entries for the above transactions to give the company's opening balance sheet after giving effect to them.

[C.A. (Inter). Modified]

Solution

Sri Vasudev Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
(i)	Profit & Loss A/c Dr.		49,700	
	To Debentures Interest A/c			20,000
	To Preference Dividend A/ c			29,700
	(Debentures Interest @10% for 6 months and Dividend on Paid-up Value of Pref. Share Capital @ 6% for 6 months Created)			
(ii)	Debentures Interest A/c Dr.		20,000	
	To Bank A/c			10,000
	To Interest on Own Debentures A/c			10,000
	(Interest on Debentures Held by Outsiders –Paid)			

(iii)	Preference Dividend A/c Dr.		29,700	
	To Bank A/c			29,700
	(Pref. Dividend Paid)			
(iv)	Bank A/c Dr.		10,000	
	To Calls-in-Arrears A/c			10,000
	(Calls-in-Arrears on 400 Pref. Shares Received)			
(v)	10% Debentures A/c Dr.		4,00,000	
	Premium on Redemption of Debentures A/c		40,000	
	To Debenture A/c			4,40,000
	(Redemption of 10% Debentures as 10% Premium)			
(vi)	Debenture Holders A/c Dr.		4,40,000	
	To 12% Debentures A/c			4,40,000
	(Issue of New 12% Debentures to the Debenture Holders)			
(vii)	Investment in Own 12% Debentures A/c Dr.		2,20,000	
	To Investments in Own 10% Debentures A/c			1,90,000
	To P&L A/c			30,000
	(Exchange of Debentures, Surplus Transferred to P&L A/c)			
(viii)	Bank A/c Dr.		3,00,000	
	To Equity Share Application & Allotment A/c			3,00,000
	(Application Money Received on Fresh Issue of ₹ 100 Each at ₹ 50 Premium Each)			
(ix)	Equity Share Application & Allotment A/c Dr.		3,00,000	
	To Equity Share Capital A/c			2,00,000
	To Securities Premium			1,00,000
	(Equity Share are Allotted)			
(x)	General Reserve A/c Dr.		4,00,000	
	P&L A/c Dr.		4,00,000	
	To Capital Redemption Reserve A/c			
	(Transfer of a Sum Equivalent to the Nominal Value of Pref. Share Redeemed out of them—From the Divisible Profits)			8,00,000
(xi)	6% Pref. Share Capital A/c Dr.		10,00,000	
	Premium on Redemption of Pref. Share A/c Dr.		2,50,000	
	To Pref. Shareholders A/c			12,50,000
	(Redemption of 6 % Redeemable Pref. Share of ₹ 100 Each as a Premium of ₹ 25 Each)			
(xii)	Pref. Shareholders A/c Dr.		12,50,000	
	To Bank A/c			12,50,000
	(Payment to Pref. Shareholders on Redemption)			
(xiii)	Interest on Own Debentures A/c Dr.		10,000	
	To P&L A/c			10,000
	(Transfer of Interest to P&L A/c)			

(xiv)	Securities Premium A/c Dr. To Premium on Redemption of Debentures A/c To Premium on Redemption of Pref. Shares A/c (Premium on Redemption of Debentures & Pref. Shares Provided from Securities Premium A/c)		2,90,000	 40,000 2,50,000

Working Notes for preparation of balance sheet:

		₹	₹
1.	Calculation of Cash at Bank:		
	Opening Balance		12,00,000
	Add: Calls-in-Arrears Received		10,000
	Fresh Issue Receipts		3,00,000
			15,10,000
	Less: Pref. Dividend	29,700	
	Debentures Interest	10,000	
	Pref. Shareholders	12,50,000	12,89,700
	∴ Amount to be Shown as Cash at Bank		2,20,300

2.	Calculation of Balance in P&L A/c:		₹
	Opening Balance		6,00,000
	Add: Interest on Own Debentures		10,000
	Profit on Conversion of Debentures		30,000
	from 10% to 12%		6,40,000
	Less: Capital Redemption Reserve	4,00,000	
	Pref. Dividend	29,700	
	Interest to Debentures	20,000	4,49,700
	∴ Amount to be Shown in P&L A/c		1,90,300

Balance Sheet of Sri Vasudev Ltd.
as on 10 October 2010

Liabilities	₹	Assets	₹
Share Capital :		Fixed Assets:	30,00,000
Issued & Subscribed		Investments:	
12,000 Equity Shares of ₹ 100 Each Fully Paid up	12,00,000	Own 12% Debentures	2,20,000
Reserves & Surplus		Other Securities	2,00,000
Capital Reserve	2,00,000	Current Assets:	
Capital Redemption Reserve	8,00,000	Stock	4,00,000
Securities Premium	10,000	Debtors	2,00,000
*[2]P&L A/c	1,90,300	*[1] Cash at Bank	2,20,300
Secured Loans:			
12% Debentures	4,40,000		
Current Liabilities			
Creditors	14,00,000		
	42,40,300		42,40,300

Illustration 4.54

Model: Interest on own debentures

Kuber Ltd. has an authorized capital of ₹ 75,00,000 dividend into share of ₹ 10 each and its balance sheet as on 31 December 2010 was as follows:

(₹ in 000's)

Liabilities	₹	Assets	₹
Share Capital:		Assets	
Issued & Fully Paid up	2,500	Fixed Assets	6,000
Capital Reserve	60	Current Assets	2,100
General Reserve	1,000	Investments in Own Debentures	425
Debentures Redemption Fund	1,500	(Nominal Value ₹ 5 lakh)	
6% Debentures 2,000		Cash at Bank	375
Sunday Creditors	1,300		
	8,900		8,900

The 6% debentures were due for redemption on 30 June 2011 at a premium of 5%.

The company decided:

(i) To issue to public 1,25,000 equity shares of ₹ 10 each at ₹ 15 per share. The money was duly received.

(ii) To redeem the debentures on 30 June 2011 together with interest for 6 months.

(iii) To give the debenture holders an option to receive either cash in repayment of the amount due or new 7% debentures at par. The holders of ₹ 5 lakh of the old debentures accepted new debentures.

The debentures which the company held as an investment were cancelled. Ignore tax.

Required: Journal entries to give effect to the above transactions.

[C.A. (Inter). Modified]

Solution

Note:

1. As nothing is mentioned specific, debenture interest on ₹ 5 lakh debentures is not converted into new debentures.
2. In this case, the profit on cancellation is transferred to capital reserve A/c instead of debenture redemption fund A/c.

Kuber Ltd.

Journal Entries

(₹ in 000's)

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
30 June 2011	Bank A/c Dr. To Share Application & Allotment A/c (Application Money Received on 1,25,000 Equity Shares of ₹ 10 Each @ ₹ 15 Each)		1,875	1,875

30 June 2011	Share Application & Allotment A/c	Dr.		1,875	
	To Equity Share Capital A/c				1,250
	To Securities Premium A/c				625
	(Allotment Made)				
30 June 2011	Debenture Interest A/c	Dr.		60	
	To Debenture Holders A/c				45
	To Interest on Own Debentures A/c				15
30 June 2011	6% Debentures A/c	Dr.		1,500	
	Premium on Redemption of Debentures A/c			75	
	To Debenture Holders A/c				1,575
	(Amount Due on Redemption)				
30 June 2011	Debenture Holders A/c	Dr.		45	
	To Bank A/c				45
	(Payment of Interest to Debenture Holders)				
30 June 2011	Debenture Holders A/c	Dr.		1,050	
	To Bank A/c				1,050
	(Payment to Debenture Holders)				
30 June 2011	Debenture Holders A/c	Dr.		525	
	To 7% Debentures A/c				525
	(Issue of New 7% Debentures)				
30 June 2011	6% Debenture A/c	Dr.		500	
	To Own Debentures A/c				425
	To Profit on Redemption of Debentures A/c				75
	(Cancellation Own Debentures Including Profit)				
30 June 2011	Profit on Redemption of Debentures A/c	Dr.		75	
	To Capital Reserve A/c				75
	(Profit on Cancellation Transferred)				
30 June 2011	Securities Premium A/c	Dr.		75	
	To Premium on Redemption of Debentures A/c				75
	(Premium Paid on Redemption Transferred to Securities Premium A/c)				
30 June 2011	Interest on Own Debentures A/c	Dr.		15	
	To Debenture Redemption Fund A/c				15
	(Interest Transferred)				
30 June 2011	Debenture Redemption Fund A/c	Dr.		1,515	
	To General Reserve A/c				1,515
	(Amount Provided out of Profits for Redemption of ₹ 15 lakh Debentures)				
30 June 2011	P&L A/c	Dr.		60	
	To Debentures Interest A/c				60
	(Debenture Interest Transferred to P&L A/c)				

Illustration 4.55

Model: Redemption of debentures

Shree Ltd. had ₹ 9,00,000 14% debentures outstanding on 1 April 2010 redeemable on 31 March 2011. On 1 April 2010, the debentures redemption fund stood at ₹ 7,49,000 represented by own debentures of the face value of ₹ 1,00,000 purchased at an average price of ₹ 99 per debenture and 10% stock acquired at par for ₹ 6,50,000. The annual instalment of transfer to the fund was ₹ 71,000. In March 2011, investments were sold for ₹ 6,46,800 and the debentures were redeemed.

Show 14% debentures A/c; debentures redemption fund A/c and debentures redemption fund investments A/c

[C.S. (Inter). Modified]

Solution

Shree Ltd.

Debentures Redemption Fund A/c

Date	Particulars	₹	Date	Particulars	₹
31 March 2011	Debentures Redemption Fund Investment A/c (Loss on Sale)	3,200	1 April 2010	Balance b/d	7,49,000
			31 March 2011	Bank A/c (Interest)	65,000
31 March 2011	General Reserve	8,95,800		Interest on Own Debentures A/c	14,000
				P&L Appropriation A/c	71,000
		8,99,000			8,99,000

14% Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2010	Debentures Redemption Fund Investment A/c	99,000	1 April 2010	Balance b/d	9,00,000
	Capital Reserve A/c	1,000			
	Debenture Holders A/c	8,00,000			
		9,00,000			9,00,000

Debentures Redemption Fund Investments A/c

Date	Particulars	₹	Date	Particulars	₹
31 April 2010	Balance b/d		31 March 2010	14% Debentures A/c	99,000
	Own Debentures	99,000		Bank A/c (Sale)	6,46,800
	10% Stock	6,50,000		Debenture Redemption Fund A/c (Loss on Sale)	3,200
		7,49,000			7,49,000

Illustration 4.56

Model: Purchase and cancellation of debentures

On 31 March 2010, Gemini Ltd.'s balance sheet showed 5,00,000 12% fully paid debentures of ₹ 100 each. Interest on debentures is payable on 30 September and 31 March every year. On 1 August 2010, the company purchased 1,00,000 of its own debentures as investment ex-interest ₹ 98. However, on 31 March 2011, the company cancelled all these debentures. The company had a balance of ₹ 30 lakh in its debentures redemption reserve A/c on that date.

Pass journal entries for all the transactions during the year ended 31 March 2011.

[C.S. (Inter). Modified]

Solution

(₹ in 000's)

1. Calculation of Cum-interest Payment: ₹
   Ex-interest Price of 1,00,000 Own Debentures @ ₹ 98 = 9,800
   Add: Interest for 4 months @ 12% = 400
   Cum-interest Payment = 10,200
2. Determination of Capital Profit:
   Per value of 1,00,000 Debentures @ ₹ 20 Each = 10,000
   Less: Purchase Price of Own Debentures @ Ex-interest Price = 9,800
   Capital Profit = 200

Gemini Ltd.
Journal Entries

(₹ in 000's)

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 August 2010	Own Debentures A/c Dr.		9,800	
	Debentures Interest A/c Dr.		400	
	To Bank A/c			10,200
	(Purchase of 1,00,000 Own Debentures at ₹ 98 Ex-interest as Investments)			
30 September 2010	Debentures Interest A/c Dr.		2,600	
	To Bank A/c			2,400
	To Interest on Own Debentures A/c			200
	(Interest for 6 months on 4 lakh Debentures Payment & Recording of Interest for 2 months on 1 lakh Debentures)			
31 March 2011	Debenture Interest A/c Dr.		3,000	
	To Bank A/c			2,400
	To Interest on Own Debentures A/c			600
	(Payment for Half Yearly Interest on 4 lakh Debentures & Recording of Interest for 6 months on 1 lakh Debentures)			

31 March 2011	12% Debentures A/c	Dr.		10,000	
	To Own Debentures A/c				9,800
	To Capital Reserve A/c				200
	(Cancellation of 1 lakh Debentures; Profit Transferred)				
31 March 2011	Debentures Redemption Reserve A/c	Dr.		10,000	
	To General Reserve A/c				10,000
	(Transfer from DRR to General Reserve)				
31 March 2011	Profit & Loss A/c	Dr.		6,000	
	To Debentures Interest A/c				6,000
	(Transfer of Debentures Interest to P&L A/c)				
31 March 2011	Interest on Own Debentures A/c	Dr.		800	
	To P&L A/c				800
	(Transfer of Interest on Own Debentures to P&L A/c)				

Illustration 4.57

Model: Redemption by cancellation

X Ltd. had 6% ₹10,00,000 debentures outstanding in its books. On 1 April 2010 it had ₹4,00,000 balance in sinking fund A/c exactly represented by 8% investment (nominal values) (₹5,00,000). On 31 December .2010, it sold ₹1,00,000, 9% investments at ₹90,000 and with the amount on the same date purchased ₹1,00,000 own debentures for immediate cancellation. On 31 March 2011, it sold ₹50,000 8% investments for ₹38,000 and with that amount purchased ₹40,000 own debentures and cancelled them immediately. Interest date is 31 March 2011 for own debentures as well as for investments. Ignore tax. Annual appropriation entries for 31 March 2011 need not be passed. Prepare the necessary ledger accounts.

[C.S. (Inter). Modified]

Solution

Calculations:

1. Calculation of Amount Realized on Sale of Investments:

Sale Value	=	₹90,000 (Given)
As Sale is Cum-interest Interest is Included in Sale Proceeds: Interest	=	$₹1,00,000 \times \frac{8}{100} \times \frac{9}{2}$ (Nominal Value)
	=	₹6,000
Amount Realized on Sale of Investments	=	(₹90,000 – ₹6,000)
	=	₹84,000

2. Calculation of Profit on Sale of Investments:

Cost of Investment Sold	=	$\frac{40,00,000}{5,00,00} \times 1,00,000 = ₹80,000$
Amount Realized (Ref: 1)	=	₹84,000 – ₹80,000
Profit	=	₹4,000

3. Calculation of Amount Realized from the Sale of Investments of the Nominal Value of ₹ 50,000 : Sale Value on 31 March 2011 ₹ 38,000

   Interest Included in It $= ₹\,50{,}000 \times \frac{8}{100} = ₹\,4{,}000$ (Nominal Value)

   ∴ Amount Realized = ₹ 38,000 – ₹ 4,000

   = ₹ 34,000

4. Calculation of Loss on Sale of Investments:

   Cost Price of Investments Sold $= 50{,}000 \times \frac{4{,}00{,}000}{5{,}00{,}000} = ₹\,40{,}000$

   Amount Realized (Ref: 3) = ₹ 34,000

   ∴ Loss = ₹ (34,000 – 40,000)

   = ₹ 6,000

5. Debenture Interest:

	₹
Debenture Outstanding on 1 April 2010	= 10,00,000
Less: Debentures Purchased & Cancelled	= 1,40,000
Debenture O/S on 31 March 2011	= 8,60,000

Interest $= ₹\,8{,}60{,}000 \times \frac{6}{100} = ₹\,51{,}600 = ₹\,51{,}600$

Ledgers

X Ltd.

6% Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2010	Bank A/c	85,500	31 April 2010	Balance b/d	10,00,000
	Sinking Fund A/c (Profit on Cancellation)	14,500			
31 March 2011	Bank A/c	35,600			
31 March 2011	Sinking Fund A/c (Profit on Cancellation)	4,400			
31 March 2011	Balance c/d	8,60,000			
		10,00,000			10,00,000

Sinking Fund A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2010	General Reserve	1,00,000	1 April 2010	Balance b/d	4,00,000
31 March 2011	Sinking Fund Investments A/c (Loss on Sale)	6,000	31 December 2010	Sinking Fund Investment A/c (Profit on Sale)	4,000

31 March 2011	General Reserve	40,000		6% Debentures A/c (Profit on Cancellation)	14,500
31 March 2011	Capital Reserve	22,900		6% Debentures A/c (Profit on Cancellation)	4,400
31 March 2011	Capital Reserve	2,92,000		* Interest on Sinking Fund Investments A/c (Ref: Interest Ledger)	38,000
		4,60,900			4,60,900

Interest on Sinking Fund Investment A/c

Date	Particulars	₹	Date	Particulars	₹
31 March 2011	*1 Sinking Fund A/c	38,000	31 December 2010	Balance A/c	6,000
			31 March 2011	Bank A/c	4,000
			31 March 2011	Bank A/c	28,000
		38,000			38,000

Sinking Fund Investment A/c

Date	Particulars	₹	Date	Particulars	₹
1 April 2010	Balance b/d (Nominal Value ₹ 5,00,000)	4,00,000	31 December 2010	Balance A/c	84,000
31 December 2011	Sinking Fund A/c	4,000	31 March 2011	Bank A/c	34,000
			31 March 2011	Sinking Fund A/c	6,000
			31 March 2011	Balance c/d	2,80,000
		4,04,000			4,04,000

Debentures Interest A/c

Date	Particulars	₹	Date	Particulars	₹
31 December 2011	Balance A/c	4,500	31 March 2011	P&L A/c	58,500
31 March 2011	Bank A/c	2,400			
31 March 2011	Bank A/c	51,600			
		58,500			58,500

Summary

Debentures: A document which creates a debt and acknowledges it. Salient features of a debenture are: (i) a document; (ii) an acknowledgment of debt; (iii) periodical payment of fixed rate of interest; (iv) the sum will be repaid on a before maturity date; (v) security may be in either fixed or floating charge (vi) carries no voting rights (vii) may be convertible or partly convertible or non-convertible.

Debenture stock: Loan is consolidated into one composite debt which may be divided into small units and transferred.

Kinds of debentures: Various kinds. (Ref: Text)

Pari Passu: It means equal relating to charge and repayment.

Debenture trust deed: It is a sort of contract between the company and the trustees of debentures. SEBI imposes certain restrictions to become a debenture trustee.

Issue of debentures for cash: Debentures are issued at par or at premium or at discount. Accounting treatment is explained in detail for issue of debentures (Ref: Text).

Issue of debentures for consideration other than cash: Debentures are issued for purchase of assets instead of cash to the vendors. Debentures are issued as a collateral security. A collateral security is a subsidiary or secondary or additional security.

Terms of issue of debentures: Accounting treatment is explained in detail with illustrations in the text for the following: various categories of issue and redemption:

Issued at	Redeemable at
Par	Par
Discount	Par
Premium	Par
Par	Premium
Premium	Premium
Discount	Premium

Debenture interest: Interest is calculated at nominal value and not on the issue price. TDS is explained.

Net effective rate of interest: It is calculated on the actual amount received and not on nominal value.

Accrued interest and outstanding interest: For accounting treatment, refer text.

Redemption of debentures: Provisions of Section 117 C are explained.

Methods of redemption: (i) In one lump sum; (ii) by draw of lots (annual instalments); (iii) by conversion and (iv) by purchase of its own debentures in the open market.

Sources of redemption: (i) Out of capital; (ii) out of profits (iii) out of proceeds from fresh issue of shares and debentures and (iv) on sale of assets

Debenture Redemption Reserve (DRR): Exclusively created for debentures redemption. For SEBI Guidelines to create DRR, refer Text.

Sinking fund: This fund is created by appropriation of profits and buying from such amount investments, which will be utilized for redemption purpose. There are two types: (i) cumulative sinking fund and (ii) non-cumulative sinking fund. Accounting treatment for each is explained in detail (Ref: Text).

Insurance policy method: This is similar to sinking fund method except in respect of interest on investments.

Redemption by conversion: Convertible debentures are redeemed by conversion into shares in accordance with the provisions of Section 79 of the Companies Act.

Redemption by purchase in the open market: For this, the following are the main objectives: (i) for immediate cancellation and (ii) for investment. Debentures purchased for investment are called "own debentures".

Interest on own debentures: Interest payable held by outsiders and interest on own debentures—the two components have to be treated carefully.

Cum-interest and ex-interest quotations: When the price of the debentures includes interest, it is said to be cum-interest or cum-dividend quotation. When the price of the debentures excludes interest, it is said to be ex-interest or ex-dividend quotation. Accounting treatment is explained. (Ref: the text for illustration)

Key Terms

Debentures: A document that creates a debt secured by a charge on the assets of a company. It is the description of an instrument.

Debenture Stock: A single consolidated composite debt document instead of separate individual debentures certificate. It is a description of debt.

Convertible Debenture: Debentures that are converted into shares of a company on its maturity date.

Fixed Charge: Charge created on immovable assets.

Floating Charge: Charge created on movable assets.

Trust Deed: A contract between the company and the trustees for debenture holders.

Debenture Redemption Reserve (DRR): Creation of fund out of profits of the company for redemption of debentures.

Sinking Fund: A fund created by an appropriation of profits and purchase of investments.

Cum-Interest or Cum-Dividend Price: The price of debentures includes the interest for the expired period.

Ex-Interest or Ex-Dividend Price: The price of debentures does not include the interest for the expired period.

Own Debentures: A company that buys its debentures as investment.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. A fixed deposit receipt may also be treated as a debenture.
2. Interest on debenture is paid only when the company earns profit.
3. Debentures carry no voting rights.
4. Debentures lying idle in the company known as debentures stock.
5. Fully convertible debentures (FCD) have highly favourable debt equity ratio.
6. DRR must be created in respect of fully convertible debentures.
7. Dividend is a charge against profit.
8. There is no restriction on the purchase of is own debentures by a company.
9. A floating charge is a mortgage of property.
10. In case a trust deed is executed, then there will be no direct relationship between the shareholder and the company.
11. Technically, debentures A/c is different from that of debentures capital A/c.
12. Discount allowed on issue of debentures A/c is to be shown on the assets side of the balance sheet.
13. Convertible debentures can be issued as a discount.
14. In case of debentures redeemed as premium, then it should be treated as capital profit.
15. TDS, until it is actually paid to the government, should be treated as a liability and shown in the balance sheet of the company.
16. A company can redeem debentures and re-issue then with a different redemption date.
17. When a sinking fund A/c is created, then there is no need for creation of DRR.
18. The annual instalment for sinking fund the redeem of debentures is an appropriation of profit.
19. When a company retains its own debentures as an investment, then interest on them need not be calculated.
20. Profit on conversion of debentures is generally transferred to P&L A/c.

Answers:

1. False	2. False	3. True
4. False	5. True	6. False
7. False	8. True	9. False
10. True	11. False	12. True
13. False	14. False	15. True
16. False	17. True	18. True
19. False	20. True	

II: Fill in the blanks with apt word(s)

1. A debenture means a document which creates a _____.

2. _____ rate of interest will be paid on debentures periodically.
3. Interest is a charge on profit whereas dividend is _____ of profit.
4. A fixed charge is created on _____.
5. Debentures of a series with Pari Passu clause have to be paid _____.
6. A trust deed is a contract between a company and the _____ for the debenture holders.
7. In accordance with the SEBI Guidelines, a trust deed is to be executed by the issuing company within _____ of the closure of the issue.
8. Securities premium A/c will be shown under the head "_____" in the balance sheet.
9. Discount allowed on issue of debentures is to be treated as _____.
10. Where the value of debentures issued is more than the value of the assets acquired, the difference is to be debited to _____ A/c.
11. As a company cannot issue debentures in fraction, any fractional payment has to be made in _____.
12. Premium or redemption is to be shown under the head "_____".
13. Interest on debentures is always calculated on the _____value of debentures.
14. In case the debentures are tax free, interest payable on debentures has to be _____.
15. Net effective rate of interest is based on the _____ received on debentures and not on the nominal value.
16. DRR is created out of the _____ of the company.
17. A company should create DRR equivalent to _____ of the amount of debenture issue before redemption.
18. No DRR is required for issue of debentures with a maturity period of _____ or less.
19. The terms sinking fund, _____, debentures sinking fund or debenture redemption sinking fund are synonymous.
20. Where no sinking fund exists, an amount equal to the nominal value of debentures redeemed should be transferred out of divisible profits to _____.

Answers:

1. debt
2. fixed
3. appropriation
4. immovable assets
5. rateably
6. trustees
7. 6 months
8. Reserve & Surplus
9. capital loss
10. goodwill
11. cash
12. Current Liabilities & Provision
13. face or nominal
14. grossed up
15. grossed up
16. profits
17. 50%
18. 18 months
19. debentures redemption fund
20. DRR

III: Multiple choice questions—Choose the correct answer

1. Debenture is
   (a) document which either creates a debt or acknowledges it
   (b) a certificate of ownership of a company
   (c) a certificate to participate in the meetings of a company
   (d) a certificate to be issued to the directors of a company
2. Debenture holders are the
   (a) employees of a company
   (b) creditors of a company
   (c) customers of a company
   (d) owners of a company
3. Debentures are shown under the following heads in the balance sheet:
   (a) Reserves & Surplus
   (b) Provision
   (c) Share Capital
   (d) Secured Loan
4. Interest on debentures is payable on the basis of
   (a) profits of a company
   (b) resolution passed in annual meeting
   (c) decision of board of directors
   (d) pre-determined fixed rate
5. The role played by the trustees is crucial when
   (a) debentures stock is issued
   (b) debentures are issued at premium
   (c) debentures are issued at discount
   (d) Debentures are issued at par
6. Premium on issue of debentures is to be credited to
   (a) debentures premium A/c
   (b) securities premium A/c

(c) share capital A/c
(d) none of the above

7. Discount allowed on issue of debentures is
   (a) capital profit
   (b) revenue profit
   (c) capital loss
   (d) revenue loss
8. Which of the following terms of issue of debentures (including terms of redemption) is not possible:
   (a) issue of debentures at par, redeemable as premium
   (b) issue of debentures at discount, redeemable at premium
   (c) issue of debentures at premium, redeemable at premium
   (d) issue of debentures at par, redeemable at discount
9. The liability for outstanding debenture interest will be shown in the balance sheet under the heading:
   (a) Secured Loans
   (b) Unsecured Loans
   (c) Share Capital
   (d) Miscellaneous Expenditure
10. Which of the following is not a source of redemption:
   (a) redemption out of capital
   (b) redemption out of borrowings from financial institutions
   (c) redemption out of profits of the company
   (d) redemption by conversion
11. Debenture redemption reserve is created
   (a) out of profits
   (b) by issue of fresh shares
   (c) by issue of fresh debentures
   (d) by sale of assets
12. The balance in the sinking fund A/c is transferred to (after the redemption of debentures)
   (a) capital reserve
   (b) sinking fund investment A/c
   (c) general reserve
   (d) P&L A/c
13. After the realization of investment, the balance in sinking fund investment A/c is transferred to
   (a) capital reserve
   (b) current liability and provisions
   (c) P&L A/c
   (d) sinking fund A/c
14. Own debentures mean
   (a) debentures purchased for investment
   (b) debentures purchased for immediate cancellation
   (c) debentures owned by the directors exclusively
   (d) none of the above
15. At the time of purchase of own debentures, own debentures account is to be debited with
   (a) cum-interest price
   (b) face value
   (c) ex-interest price
   (d) issue price

Answers:

1. (a)	2. (b)	3. (c)
4. (d)	5. (a)	6. (b)
7. (c)	8. (d)	9. (a)
10. (b)	11. (a)	12. (c)
13. (d)	14. (a)	15. (c)

Short Answer Questions

1. Define: Debenture.
2. What do you mean by "debenture stock"?
3. What is a "secured debenture"?
4. What is a "naked" debenture?
5. Explain: Convertible debentures.
6. What is a "call option"?
7. What is a "put option"?
8. What is a fixed charge?
9. What is a floating charge?
10. When does a floating charge become crystallized?
11. Explain the term: "Pari Passu" clause
12. What is a debenture trust deed?
13. Who can act as a debenture trustee?
14. Name the various types of issue of debentures.
15. How interest on debentures will be calculated?

16. What do you mean by TDS?
17. Explain the term: Interest accrued and due.
18. What is the accounting entry for "accrued interest"?
19. Pass the journal entry for writing off the loss on issue of debentures.
20. What is a "sinking fund"?
21. Explain the term: Redemption by conversion.
22. Explain: Debenture redemption reserve.
23. Name the two components associated with sinking fund method.
24. What is the main difference between cumulative and non-cumulative sinking funds?
25. What are the advantages of insurance policy method?
26. What are the different options available for redemption of debentures?
27. What do you mean by "own debentures"?
28. How will you calculate interest on own debentures?
29. What is cum-dividend?
30. Explain: Ex-interest price quotations.
31. Mention any four differences between a share and a debenture.
32. Enlist the main differences between fully convertible debentures and partly convertible debentures.
33. Explain: Debentures issued as collateral security.
34. Write short notes on: Redemption by "draw of lot".
35. Explain: Redemption of debentures out of capital.
36. Write notes on: Redemption out of profits.
37. Explain: Redemption of debentures by fresh issue of capital.

Essay Type Questions

1. Define: Debenture. Enumerate the basic characteristics of debentures.
2. Distinguish between a shareholder and a debenture holder.
3. As an investor, which do you prefer: Shares or debentures? Substantiate your answer with apt reasons.
4. What are the various types of debentures which may be issued by a company? Discuss in detail.
5. What are the differences between fully convertible debentures and partly convertible debentures?
6. Describe the various categories of issue of debentures and their redemption.
7. Explain the different methods of redemption of debentures.
8. Explain with example: Redemption of debentures out of profits.
9. Write notes on:
   (i) Sinking fund
   (ii) Sinking fund investment
   (iii) Debenture redemption reserve
   (iv) Own debentures acquired as investments
10. Explain the accounting treatment for cumulative sinking fund and non-cumulative sinking fund.
11. Write short notes on:
   (i) Interest on debentures
   (ii) Ex-interest quotation
   (iii) Cum-interest quotation
   (iv) Call-option & put-option
12. What is meant by issue of debentures as a collateral security? What is the accounting treatment for it?
13. Highlight the important guidelines of SEBI with respect to accounting treatment of redemption of debentures out of profits?
14. Distinguish between sinking fund to replace an asset and sinking fund to repay a liability.
15. Explain the process of purchase of own debentures in the open market by a company.

Exercises

Part A—For Undergraduate Level

1. Moon Light Ltd. issued 10% debentures of the face value of ₹ 100 each as follows:
   (i) On 1 April 2011, 5,000 debentures at ₹ 98 each for cash to the public
   (ii) On 1 May 2011, 6,000 debentures at par to SBI as collateral security for the term loan of ₹ 5 lakh borrowed

(iii) On 1 June 2011, 8,000 debentures to the vendors of land to settle the agreed price of ₹8,50,000

You are required to pass journal entries to record the above issues of debentures. Ignore interest and tax.

[**Ans:** Discount on issue: ₹10,000; Face value: ₹6,00,000; Face value: ₹8,00,000; premium: ₹50,000]

[Model: Issue of debentures]

2. X Ltd. made the following issues of debentures:
   (i) For cash at 90% but repayable at 110% debentures of ₹50,000
   (ii) To a creditor who supplied machinery costing ₹10,00,000, 11,000 debentures of ₹100 each
   (iii) To bank for a loan of ₹21,00,000 as collateral security 30,000 debentures of ₹100 each

   Journalize the transactions.

   [**Ans:** (i) Discount on issue: ₹5,000; Loss on issue: ₹5,000; (ii) Discount on issue: ₹1,00,000; (iii) Face value: ₹30,00,000]
3. Y Ltd. acquired the business of "A" Ltd. for a consideration of ₹25,00,000. The vendors were paid ₹7,00,000 in cash and the balance in 10% debentures of ₹100 each, issued at 90%. Give journal entries.

   [**Ans:** 20,000 debentures of ₹100 each as 10% discount]
4. Z Ltd. took over the business of "B" Ltd., the assets and liabilities being valued at ₹3,20,000 and ₹1,20,000, respectively. Z Ltd agreed to pay ₹2,88,000 as the purchase price, to be settled by the issue of 12% debentures of ₹10 each at a premium of 20%. Give journal entries.

   [**Ans:** Goodwill: ₹88,000; 18,000 debentures of ₹10 each as ₹12]
5. A company purchased assets of ₹4,20,000 and took over liabilities of ₹40,000 for an agreed consideration of ₹3,60,000. The company issued debentures at 10% discount in full satisfaction of the purchase price. Give the journal entries in the book of the purchasing company.

   [**Ans:** Capital reserve: ₹20,000; Number of debentures issued: 40,000]
6. On 1 January 2009, Z Ltd. issued ₹6,60,000, 9% debentures as a discount of 5% repayable as follows:

On 31 December 2009	₹1,20,000
On 31 December 2010	₹2,40,000
On 31 December 2011	₹3,00,000

   Calculate the amount of discount to be written off in each of the three years.

   [**Ans:** 2009: ₹14,520; 2010: ₹11,880; 2011: ₹6,600]
7. A public limited company redeemed ₹50,000, 10% debentures out of capital by drawing a lot and also redeemed ₹75,000 9% debentures out of profit by drawing a lot. Journalize.

   [**Ans:** For "out-of-profit" redemption: Amount transferred to DRR ₹75,000]
8. A company issued as per 10,000, 6% debentures of ₹100 each. Interest is payable half-yearly on 30 September and 31 March. On 1 February 2011, the company purchased 100 its own debentures as investment at ₹97.

   Calculate ex-interest and cum-interest price.

   Journalize the transactions. Books are closed on 31 March. Ignore tax.

   [**Ans:** Our debentures: ₹19,400; Interest: ₹400 for ex-interest; For cum-interest price → own debentures: ₹19,000; Interest: ₹400]
9. Rose Ltd. purchased for immediate cancellation 10,000 12% own debentures of ₹100 each on 1 December 2010, the interest dates being 30 September and 31 March.

   Pass entries relating to the cancellation if
   (a) Debentures are purchased at ₹92 ex-interest
   (b) Debentures are purchased at ₹92 cum-interest

   [**Ans:** (a) ₹80,000; (b) ₹1,00,000]
10. A company has outstanding 12% debentures of ₹5,00,000 on 1 January 2010. The company pays interest on 30 June and 31 December. It purchased debentures of ₹50,000 for cancellation on 1 May 2010 @ ₹102 cum-interest. On 1 September 2010, it further purchased for redemption debentures of ₹1,00,000 @ 95 ex-interest. Journalize.

    [**Ans:** Profit on cancellation: ₹1,000 on 1 May and ₹5,000 on 1 September]

11. You are required to set out the journal entries relating to the issue of the following debentures in the books of ABC Ltd.
    (a) 10% 2,000 ₹100 debentures are issued at 5% discount and are repayable at par
    (b) Another 13% 200 ₹1,000 debentures are issued at 5% discount and repayable at 10% premium
    (c) Further, 12% 100 ₹1,000 debentures are issued at 5% premium
    (d) In addition, another 250 ₹1,000 debentures are issued as collateral securities against a loan of ₹2,50,000
12. Exee Ltd. issued 5,000 9% debentures of ₹100 each payable ₹20 on application and the balance on allotment. Applications were received for 7,500 debentures out of which applications for 4,500 were allotted fully. Applicants for 2,000 debentures were allotted 500 debentures and the remaining rejected. All sums due were received.

    Give journal entries and also show how these transactions will be reflected in the balance sheet of the company.

    [**Ans:** Application money transferred to allotment A/c: ₹30,000; Refund on rejected applications: ₹20,000]

    [Model: Discount on issue of debentures]
13. A company issued debentures of the face value of ₹8,00,000 at a discount of 6%. The debentures were repayable by annual drawings of ₹1,60,000. How would you deal with the discount on debentures?

    Show the discount account in the company's ledger for the period of duration of debentures.

    [**Ans:** Proportionately written off; Discount A/c balance: ₹48,000.

    At the end of 1st year → ₹32,000; At the end of 2nd year → ₹19,200; At the end of 3rd year → ₹9,600; At the end of 4th year → ₹3,200; At the end of 5th year → Nil]

    [Model: Redemption by conversion]
14. On 1 January 2010, X Ltd. issued 1,000 5% debentures of ₹1,000 at ₹950 each. Debenture holders had an option to convert their holdings into 6% preference shares of ₹100 each at a premium of ₹25 per share. On 31 December 2010, one year's interest has accrued on these debentures which was not paid. A holder of 100 debentures notified his intention to convert his holdings into 6% preference shares.

    Journalize the above transactions and draw the company's balance sheet as at 31 December 2010 assuming no other transactions took place.

    [**Ans:** Conversion into 760 shares of ₹100 each: ₹76,000; at premium of ₹25: ₹19,000; B/s total: ₹10,45,000]

    [Model: Redemption by purchase in the open market own debentures]
15. On 1 January, ABC Ltd. has ₹3,00,000 10% debentures. In accordance with the power under the deed, the directors have the powers to acquire the debentures in the open market for immediate cancellation.

    The following purchases, of own debentures were made by the company:

    1 March, ₹60,000 debentures @ ₹98 cum-interest

    1 August, ₹1,20,000 debentures @ ₹99 ex-interest

    Debentures interest is payable half-yearly on 30 June and 31 December every year.

    Show journal entries for purchase and cancellation of the debentures.

    [**Ans:** 1 March: Cash paid—₹58,800; Interest—₹999; Profit on cancellation—₹2,199; 1 August: Cash paid—₹11,19,799; Interest—₹999; Profit on cancellation—₹1,200]
16. On 1 January, CX Ltd. has ₹10,00,000 6% debentures. In accordance with the power under the deed, the directors acquire the debentures as follows in the open market for immediate cancellation:

    1 March, ₹2,00,000 at ₹98 cum-interest

    1 August, ₹4,00,000 at ₹100.25 cum-interest

    15 December, ₹1,00,000 at ₹98.5 ex-interest

    Debenture interest is payable half yearly on 30 June and 31 December every year.

    Show journal entries for purchase and cancellation of the debentures.

    [**Ans:** 1 March: Interest—₹2,000; Profit on cancellation—₹6,000;

    1 August: Interest—₹2,000; Profit on cancellation—₹1,000; 15 December: Interest—₹2,750; Profit on cancellation—₹1,500]

17. On 1 February 2010, a company purchased 20 of its own debentures of ₹1,000 each as investment at ₹970 and cancelled them on 30 June 2011. Rate of interest is 10% and the interest is payable on 30 June and 31 December each year.

    Give journal entries for purchase and cancellation of debentures if

    (a) The purchase price was ex-interest

    (b) The purchase price was cum-interest

    [**Ans:** (a) On 1 February 2010: Own debentures—₹19,400; Interest—₹167; Profit on cancellation of own debentures—₹600

    (b) On 30 June 2011: Profit on cancellation of own debentures—₹767]

18. X Ltd. issued on 1 January 2008, 40,000 5% debentures of ₹100 each redeemable at the option of the company after 3 years at ₹105 per debenture upon giving 3 months notice to the holders.

    The company purchased the following debentures in the open market:

    1 April 2009 ₹8,000 debentures at ₹8,050 cum-interest

    1 November 2009 ₹14,000 debentures at ₹13,830 ex-interest

    These debentures were retained as investment till 31 December 2010 on which date they were cancelled.

    Give journal entries to record the above transactions, assuming that the interest is payable half-yearly on 30 June and 31 December every year. Ignore taxation.

    [**Ans:** Own debentures purchased on 1 April 2009: ₹7,950; Own debentures purchased on 1 November 2009: ₹13,830; Debenture interest: 1 April 2009—₹100; 30 June 2009—₹900; 1 November 2009—₹234; 31 December 2010—₹766; 30 June 2010—₹1,000; 31 December 2010—₹100 Interest on own debentures: 30 June 2009—₹100; 31 December 2009—₹316; 30 June 2010—₹550; 31 December 2010—₹550; Profit on cancellation of own debentures on 31 December 2010: ₹220]

    [Model: Redemption—Sinking fund method]

19. A company issued 6% debentures of ₹5,00,000 with a condition that they should be redeemed after 3 years at 10% premium. The amount allocated for the redemption of debentures is invested in 5% state government securities. The Sinking Fund Table shows that ₹0.317209 at 5% compound interest in 3 years will become ₹1.

    Pass journal entries and prepare ledger accounts for all the three years.

    [**Ans:**Annual transfer: ₹1,74,464.95; Interest: 2nd year end—₹8,723.25; At the end of 3rd year—₹17,882.65; Amount repaid: ₹5,50,000]

20. A company issued 10,000 debentures of ₹100 each at par on 1 January 2006, redeemable at par on 31 December 2010. A sinking fund was established. Investments would earn 5% interest. Table shows that ₹0.180975 amounts to ₹1 at the end of 5 years @ 5%. On 31 December 2010, investments were realized at ₹7,80,00. The debentures were redeemed.

    Give ledger accounts in the books of the company.

    [**Ans:** Loss on sale of investments: ₹24.86; Transfer to general reserve: ₹9,99,976.24]

21. A company issued ₹4,00,000 in 5% debentures of ₹100 each at par, repayable at the end of 5 years at a premium of 6%. A sinking fund at 4% compound interest is created for redemption of debentures.

    You are required to prepare sinking fund A/c and sinking fund investment A/c for 5 years.

    (₹1 per year at 4% compound interest amounts to ₹5.4163 in 5 years)

    [**Ans:** Annual instalment: ₹78,242.22; Interest in 2nd year: ₹3,131.28; Interest in 3rd year: ₹6,387.82; Interest in 4th year: ₹9,774.64; Interest in 5th year: ₹13,296.90]

22. The following balances are extracted from the balance sheet of CY Ltd. as on 1 January 2010:

6% Debentures	₹5,00,000
Debentures Redemption Fund	₹4,25,000

    Debentures Redemption Fund Investments ₹4,50,000 (in ₹100 value 4% certificates)

    The annual investment was ₹57,000. On 31 October 2010, the investments were realized at ₹95 each and the debentures were redeemed. The bank balance on that date was ₹91,500.

    Give ledger accounts relating to the redemption of debentures.

    [**Ans:** Profit on sale of investments: ₹2,500; Transfer to general reserve: ₹5,02,500; Bank balance: ₹37,000]

23. A company has ₹3,00,000, 6% debentures outstanding on 1 January 2010. On that date, the debenture redemption fund stood at ₹2,50,000, represented by ₹2,95,000, 3% loan of Government of India. The annual instalment added to the debenture redemption fund is ₹41,150. On 31 December 2010, the balance at bank (after interest on investments has been received) was ₹78,200. On that date, the investments were sold at 83% net and the debentures were paid off.

    Show the debentures account, redemption fund account, debenture redemption fund investment account for the year 2010.

    [**Ans:** Loss on sale of investments: ₹5,150; Transfer to general reserve: ₹2,94,850; Bank balance: ₹23,050]

24. On 1 January 2010, X Ltd. had ₹4,00,00 5% debentures outstanding in its books redeemable on 31 December 2010. On 1 January 2010, the balance of sinking fund was 3,74,500 represented by

    (a) ₹50,000 own debentures purchased at an average price of ₹99

    (b) ₹3,30,000 nominal value of 3% government loan

    The amount already credited to the sinking fund was ₹14,200.

    The interest on debentures was paid by the company every year on 31 December and interest on government loan was also received on 31 December annually.

    On 31 December 2010, the outside investments were realized at 98% and all the outstanding debentures were redeemed on that date.

    You are required to write up necessary ledger accounts for the year 2010 in the books of the company.

    [**Ans:** Loss on sale of investments in government loan: ₹1,600; Profit on cancellation of own debentures: ₹500; interest received on government loan: ₹9,900; Interest on own debentures: ₹2,500; Transfer to general reserve: ₹4,00,000]

    [Model: Redemption insurance policy method]

25. Viswas Ltd. has made an issue of ₹2,00,000 5% debentures on 1 January 2006, the terms of which include that the company must provide for a sinking fund for the redemption on 31 December each year from 2008 for 3 years. The directors decide to take out an insurance policy to provide the necessary cash, the annual premium being ₹31,410.80 on which the return is at 3% p.a. at compound interest.

    Show the ledger accounts.

    [**Ans:** Balance of debenture redemption fund A/c on 31 December 2008—₹64,706.24; on 31 December 2009—₹1,31,353.68; on 31 December 2010—₹2,00,000; Balance of debenture redemption policy A/c on 31 December 2008—₹64,706.24; on 31 December 2009—₹1,31,353.68; on 31 December 2010—cash realized ₹2,00,000]

    [Model: Terms of issue and redemption—Various types]

26. Show by means of journal entries how will you record the following issues: Also show how they will appear in their respective balance sheets:

    (a) A Ltd. issued 10,000, 10% debentures of ₹100 each at a discount of 5% redeemable at the end of 5 years at par

    (b) B Ltd. issued 10,000, 11% debentures of ₹100 each at par redeemable at the end of 5 years at a premium of 5%

    (c) C Ltd issued 10,000, 12% debentures of ₹100 each at a discount of 5% redeemable at the end of 5 years at a premium of 5%

    (d) D Ltd issued 10,000, 13% debentures of ₹100 each at a premium of 5% redeemable at the end of 5 years at a premium of 5%

    [**Ans:** (a) Discount on issue: ₹50,000; (b) Loss on issue: ₹50,000; (c) Discount & loss: ₹50,000; (d) Loss on issue: ₹50,000]

    [Model: Treatment of discount]

27. A company issued ₹10,00,000 debentures at a discount of 10% on 1 April 2007. The debentures were repayable by annual drawings of ₹2,00,000. How would you deal with the discount on debentures? Show the discount account in the company's ledger for the period of duration of the debentures. Accounting period ends on 31 December.

    [**Ans:** Ratio = 15:17:13:9:5:1

    Amount of discount: I year—₹25,000, II year—₹28,333, III year—₹21,666; IV year—₹15,000; V year—₹8,333; VI year—1,666]

Exercises

Part B—For Advanced Level

28. The following balances appeared in the books of a company on 1 April 2010:

	₹
12% Debentures	12,00,000
12% Debentures Sinking Fund	9,00,000
12% Debentures Sinking Fund Investments	9,00,000– represented by 10% ₹10,80,000 secured bonds of Government of India

Annual contribution to sinking fund was ₹1,92,000 made on 31 March every year. On March 2011, balance at bank was ₹6,00,000 after receipts of interest. The company sold the investments at 80% as debentures were paid off. Journalize the transactions.

[Model: Redemption by sinking fund method]

[I.C.W.A. (Inter). Modified]

29. X Ltd. issued ₹24,00,000 debentures during 2009 on the following terms and conditions:

(i) A sinking fund to be created by yearly appropriations of profit and similar amount to be invested outside.

(ii) The company will have the right to purchase for cancellation of debentures from the market if available below par value.

(iii) The debentures are to be redeemed on 31 December 2010 at a premium of 2%. The following balances appeared in the books of the company as on 1 January 2010:

	₹
Sinking Fund Investments	17,73,000
Sinking Fund	17,73,000
Debentures A/c	18,00,000

The following transactions took place during the subsequent 12 months:

(a) On 1 July 2010 ₹1,20,000 debentures were purchased for ₹1,06,656 and cancelled immediately, the amount being provided out of sale proceeds of investments of the book value of ₹1,39,200 at ₹1,35,600.

(b) The income from sinking fund investments ₹88,800 received on 1 July 2010 was not invested.

(c) On 29 December 2010, ₹16,92,000 were received on sale of the remaining sinking fund investments.

(d) On 31 December 2010, the remaining debentures were redeemed.

You are required to show for the year ended 31 December 2010: (i) debentures A/c; (ii) sinking fund account; (iii) sinking fund investments account and (iv) debenture redemption A/c

[C.S. (Inter). Modified]

[**Ans:** Capital reserve: ₹71,544; Transfer to general reserve: ₹18,24,600]

[Model: Cum-interest and ex-interest]

30. The following balances appeared in the books of Cheerful Ltd. as on 1 April 2010:

	₹
12% Debentures (Face Value ₹100)	10,00,000
Debentures Redemption Fund	6,25,000
Debentures Redemption Fund Investments (In 8% Government Bonds of the Face Value of ₹7,50,000)	6,25,000

Interest on the debentures was payable on 30 September and 31 March and interest on government bonds was receivable on the same dates. On 31 May 2010, the company purchased for immediate cancellation 1,250 debentures in the market at ₹96 each cum-interest. The amount required for this was raised by selling 8% government bonds of the face value of ₹1,35,000 cum-interest. On 31 March 2011, ₹1,04,000 was appropriated for the sinking fund and on the same date 8% government bonds were acquired for the amount PLUS the interest on investments. The face value of government bonds acquired was 1,86,000. You are required to show the ledger accounts in the books of the company. Ignore tax.

[C.S. (Inter). Modified]

[**Ans:** Profit on cancellation of 1,250 debentures: ₹7,500; Profit on sale of government Bonds: ₹5,700; Balance in debenture redemption fund account: ₹6,55,000 after transferring ₹13,200 to capital reserve and ₹1,25,000 to general reserve account]

31. Seawage Ltd. had ₹9,00,000 14% debentures outstanding in April 2010 redeemable on 31 March 2011. On 1 April 2010, the debenture redemption fund stood at ₹7,49,000 represented by own debentures of the face value of ₹1,00,000 purchased at an average price of ₹99 per debenture and 10% stock acquired at par for ₹6,50,000. The annual instalment of transfer to the fund was ₹71,000. On 31 March 2011, investments were sold for ₹6,46,800 and the debentures were redeemed. Show 14% debentures A/c, debentures redemption fund A/c and debentures redemption fund investments A/c.

[C.S. (Inter). 2002 Modified]

[**Ans:** 14% Debentures A/c: ₹9,00,000; Debenture redemption fund A/c: ₹8,99,000; Debenture redemption fund investments A/c: ₹7,49,000]

[Model: Redemption—Sinking fund method]

32. X Ltd. has 12% ₹2,00,000 debentures outstanding in its books on 1 January 2010. It also had ₹1,20,000 balance in sinking fund A/c represented by 8% investments (Face value ₹1,50,000).

On 30 December 2010, it sold investments of face value of ₹20,000 @ ₹90 and purchased own debentures of the face value of ₹20,000 out of proceeds for immediate cancellation. The interest dates for both debentures and investments are 30 September and 31 March. All transactions are made on cum-interest basis. Show debentures A/c, sinking fund A/c and sinking fund investment A/c.

[B.Com (Hons) Delhi 2002 Modified]

[**Ans:** Profit on cancellation of debentures: ₹2,600]

[Model: Cum-interest and ex-interest]

33. Rasi Ltd. purchases from market its own 800 12% debentures of ₹100 each at ₹90 on 31 December 2010. Calculate the price paid exclusively for the debentures if the quotations are (i) cum-interest and (ii) ex-interest. Debenture interest is paid on 31 March and 30 September each year. Also journalize in both the cases assuming that these debentures are not yet cancelled.

[B.Com (Hons) Delhi 2003 Modified]

[**Ans:** (i) ₹69,000; (ii) ₹74,400]

[Model: Cum-interest and ex-interest]

34. Parker Ltd. issued 15% 20,000 debentures of ₹100 each on 1 January 2006 redeemable at a premium of 10% after 5 years. A sinking fund is created for the purpose of redemption of debentures and the money is invested in 5% government securities at par. The investments are to be made in multiples of ₹100 only. ₹1 invested p.a. at 5% over 5 years amounts to ₹5.5256. Investments were realized for ₹17,50,000 on 31 December 2010 and bank balance on that date was ₹7,50,000 before receipt of interest and sale of government securities.

Show debentures A/c, sinking fund A/c, sinking fund investments A/c, premium on redemption of debentures A/c and bank A/c.

Bank A/c is to be prepared only on 31 December 2010. All calculations are to be made in nearest rupee.

[B.Com (Hons) Delhi 2010 Modified]

[**Ans:** Debentures A/c: ₹20,00,000; Sinking fund A/c: ₹22,33,962; Sinking fund investment A/c: 1st year—₹3,98,150; 2nd year—₹8,16,000, 3rd year—₹12,55,150, 4th year—₹17,16,050; 5th year—₹17,50,000; Bank A/c: ₹25,85,802]

35. A limited company has an authorized capital of ₹20 crore in shares of ₹10 each of which 120 lakh shares have been issued and are fully paid. A summary of its balance sheet on 31 March 2010 is as follows:

Liabilities	**₹ in Lakhs**	**Assets**	**₹ in Lakhs**
Share Capital	1,200	Fixed Assets (Net)	2,200
Debenture Redemption Fund	960	Debenture Redemption Fund Investments (Cost) Market Value ₹816 lakh	960

P&L A/c	380		
12% Debentures Redeemable at 102%	10,000		
Current Liabilities	220	Current Assets	600
	3,760		3,760

Interest on debentures had been paid up to 31 March 2010. On 1 April 2010, the directors gave notice to redeem the 12% debenture holders on 1 July 2010, giving the holders the option to be repaid either wholly in cash or by issue of four shares of ₹10 each (fully paid) for every ₹100 debentures. 60% of the holders exercised the option to take shares, and the cash of the remainder was obtained by realizing a sufficient amount of the investment at their market value on 31 March 2010.

Draft journal entries to record these transactions and any consequent transfers which you consider necessary.

[C.S. (Inter). Modified]

[**Ans:** Balance of debenture redemption fund: ₹960 lakh]

36. Chand Ltd. issued on 1 April 2007 60,000, 12% debentures of ₹100 each, redeemable at the option of the company after the second year at ₹104 upon two months' notice. The following debentures were purchased in the open market:

    (i) On 12 June 2009, ₹12,000 nominal at cum-interest cost of ₹12,075

    (ii) On 24 August 2009, ₹21,000 nominal at ex-interest cost of ₹20,745

    These debentures were retained as investments till 30 September 2010 when the debentures were cancelled. Due dates for interest on debentures are 30 September and 31 March. The books of accounts are closed every year on 31 March. Show the following ledger accounts for the year 2009–10; and 2010–11.

    [C.A. (Inter). Modified and C.S. (Inter). Modified]

    [**Ans:** Profit on redemption: ₹468 or ₹1,788]

37. A company had ₹17,20,000, 14% debentures outstanding on 1 April 2010. On that date, the sinking fund was ₹14,98,000 represented by ₹3,00,000 own debentures purchased at ₹90 on an average and ₹14,00,000 10% government loan. The annual contribution to the sinking fund was ₹40,000. On 31 March 2011, the investments were realized at 90% and all debentures were redeemed at a premium of 4%.

    Pass journal entries and prepare accounts relating to the matters stated above.

    [C.A. (Inter). Modified]

    [**Ans:** Profit on cancellation: ₹30,000; Profit on sale of investments: ₹32,000]

38. A company had issued, sometime ago, 50,000 12% debentures of ₹100 each at ₹97.50 redeemable at the end of 10 years at par, or previously by 6 months' notice at ₹102 at the company's option.

    On 31 March 2010, the accounts showed balances in debenture redemption fund of ₹2,67,500 represented by 10% ₹2,14,000 nominal value government loan bonds, purchased at an average price of ₹101 and ₹51,360 uninvested in cash.

    On 1 April 2010, the company decided to purchase ₹55,000 of its own debentures at an inclusive cost of ₹51,360 instead of further government loan bonds and this was carried out forthwith. On 30 September 2010, the company gave 6 months' notice to holders of ₹2,00,000 worth of debentures and on 31 March 2011 carried out the redemption by sale of ₹2,04,000 of government loan bonds at par and cancelled the same together with their own holding.

    Journalize the forgoing transactions as well as those for interest on government loan bonds and on the company's own debentures throughout the year ended 31 March 2011. The interest on the bonds being payable on 31 March and on the debentures on 30 September and 31 March.

    [C.A. Modified]

    [**Ans:** Profit on cancellation of own debentures: ₹3,640; Loss on sale of investments: ₹2,040]

39. MM Ltd. had the following among their ledger opening balances as on 1 April 2010:

	₹
11% Debentures A/c (2,000 Issue)	25,00,000
Debenture Redemption Fund A/c	22,50,000
13.5% Debentures in XX Ltd. A/c (Face Value ₹10,00,000)	9,75,000

Own Debentures A/c 9,25,000

(Face Value of ₹ 10,00,000)

As 31 March 2011 was the date of redemption of the 2,000 debentures, the company started buying own debentures and made the following purchases in the open market:

1 May 2010 1,000 debentures at ₹ 98 cum-interest

1 September 2010 1,000 debentures at ₹ 99 ex-interest

Half-yearly interest is due on the debentures on the 30 September and 31 March in the case of both the companies.

On 31 March 2011, the debentures in XX Ltd were sold for ₹ 95 each ex-interest. On that date, the outstanding debentures of MM Ltd. were redeemed by payment and by cancellation.

Show the entries in the following ledger accounts of MM Ltd. during 2010-11:

(a) Debenture redemption fund A/c

(b) Own debenture A/c

The face value of a debenture was ₹ 100.

(Round off calculations to the nearest rupee)

[C.A. (Inter). Modified]

[**Ans:** Interest on own debentures: ₹ 1,26,500; Transfer to general reserve: ₹ 24,86,500]

40. X Ltd. issued 10,000 12% debentures of ₹ 100 each at par on 1 April 2008. These debentures are redeemed at the end of the fifth year at 5% premium. It was resolved that sinking fund should be formed and invested in 10% development bonds of ₹ 100 each. Interest of bonds is payable on 31 March every year.

Reference to Sinking Fund Table shows that ₹ 0.1638 invests at the end of every year at 10% compound interest will produce ₹ 1 at the end of the fifth year.

10% Development bonds of the required amount were purchased on different dates at the following prices:

On 31 March 2009	₹ 94
On 31 March 2010	₹ 96
On 31 March 2011	₹ 98

You are required to show debenture redemption fund, debenture redemption fund investment A/c and interest on debenture redemption fund investments A/c for the first three years in the books of X Ltd. Accounting year of the company ends on 31 March.

[**Ans:** Balances: Debenture redemption fund—₹ 5,72,370; Debenture redemption fund investment A/c—5,72,310; Interest: ₹ 18,300 and ₹ 38,100; Bonds purchased: ₹ 1,830; ₹ 1,980 and ₹ 2,145]

Acquisition of Business (Purchase of Business)

5

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Understand the meaning of acquisition.
2. Explain the term "purchase consideration" and methods of determining purchase consideration—net assets method and net payment method.
3. Treat capital reserve and goodwill.
4. Understand the accounting treatment for acquisition of company under two different approaches: (a) when new set of books is opened and (b) when the same set of books is continued.
5. Know key terms.

In corporate world, a limited company, in its later life, may acquire or purchase an existing business. The existing business may be in the form of sole proprietorship or of partnership or of a limited company. Such a process of acquiring or purchasing the business of others is termed as "acquisition of business" or "purchase of business". In this chapter, the accounting treatment for "acquisition of business" or "purchase of business" is discussed in detail.

5.1 FACTORS ASSOCIATED WITH ACQUISITION OF BUSINESS

Some important factors associated with "acquisition of business" are explained as follows:

Purchase: The company which acquires or purchases the business of others is known as purchaser.

Vendor: The organization which sells its business is known as the vendor.

Purchase consideration: Purchase price paid by the acquiring company is called "purchase consideration". The purchase price or purchase consideration will be discharged in the form of shares or debentures or cash.

5.2 DETERMINATION OF PURCHASE CONSIDERATION

Generally, the purchase price is determined at the time of negotiation and shown in the agreement itself (That means it will be given in the question itself.). If it is not given in the question, the methods of determining the purchase consideration are given in the following:

5.2.1 Method 1—Net assets method

Under this method, the purchase consideration is ascertained by adding up the assets taken over by the purchasing company minus the total amount of liabilities taken over.

Purchase consideration = Aggregate value of assets taken over – Aggregate value of liabilities taken over

At this juncture, one has to understand and distinguish between the types of assets taken over by the purchasing company and the types of assets not to be taken over by the purchasing company.

Assets to be taken over by the purchasing company: In the absence of a contract to the contrary, the purchasing company takes over the following assets:

(i) Land & Buildings
(ii) Fixtures & Furniture
(iii) Machinery & Plant
(iv) Stock in trade
(v) Book debts
(vi) Cash & Bank Balance

The following assets are not taken over by the purchasing company:

(i) All fictitious assets
(ii) All pre-paid expenses
(iii) P&L A/c (Debit balance)
(iv) Miscellaneous expenses such as discount on shares/debentures, underwriting commission, etc.

Similarly, only the external liabilities of the selling concern are undertaken by the purchasing company.

But, the internal liabilities of the selling concern such as share capital, reserve fund and undistributed profits are not to be taken by the purchasing company.

To illustrate, the balance sheet of M/s X & Y is as follows: (B/S of selling concern, i.e., vendor):

Sundry Creditors	2,00,000	Goodwill	1,00,000
Mrs. X's Loan	1,50,000	Land & Buildings	3,00,000
Mrs. Y's Loan	2,50,000	Plant & Machinery	5,00,000
X's Capital	3,00,000	Patents & Trademarks	50,000
Y's Capital	2,10,000	Stock	50,000
		Sundry Debtors	1,00,000
		Cash at Bank	10,000
	11,10,000		11,10,000

Under the net assets method, purchase consideration is computed as follows:

Purchase consideration = Various assets – Various liabilities

= ₹ 10,10,000 – ₹ 2,00,000 (creditors)

Net assets = ₹ 8,10,000

In the absence of any agreement, purchase consideration will be ₹ 8,10,000. Goodwill not included and X & Y loan and share capital are excluded.

Suppose if the company pays ₹ 7,50,000 for the business in a lump sum for net assets worth ₹ 8,10,000, then the difference is treated as capital reserve.

In case the lump sum amount is not settled, then it will be equal to the net assets, including goodwill.

In case the company agrees to take over all the assets but no liabilities, purchase price will be ₹ 11,10,000.

If the company agrees to pay creditors, then the company will have to pay ₹ 11,10,000 – ₹ 2,00,000 = ₹ 9,10,000

Or, if the company agrees to take over partner's loan, then it will have to pay ₹9,10,000 – (₹1,50,000 + ₹2,50,000), i.e. ₹5,10,000 only.

Important note

Net tangible assets ₹8,10,000 exceeds the purchase consideration ₹7,50,000. Hence, the difference (₹8,10,000 – ₹7,50,000) ₹60,000 is to be treated as capital reserve and that amount (₹60,000) is to be credited to capital reserve A/c. (Debits exceed credits)

5.2.2 Method II—Net payment method

Under this method, purchase consideration is determined according to the terms and conditions of purchase agreement, i.e., which assets to be taken over and at what value, which liabilities to be taken over.

Purchase consideration = Assets to be taken over at agreed value – Liabilities to be taken over at agreed value.

Important note

If the value of the net asset is less than the purchase price agreed to be paid, then the difference is treated as goodwill and that amount has to be debited to goodwill account. (Credits exceed debits)

For determining "capital reserve" or "goodwill", balance sheet figures of the selling concern (vendor) SHOULD NOT be taken into account. But it should be based ONLY on the figures at which the company records in its books.

5.3 ACCOUNTING ENTRIES

5.3.1 When New Set of Books is Opened

5.3.1.1 Entries in the Books of the Purchasing Company

The following are the entries to record the acquisition of business:

Particulars	L.F.	₹	₹
1. For Acquisition (or purchase) of Business: Business Purchase A/c Dr. To Vendor's A/c (Amount of Purchase Consideration Agreed Upon)		—	
2. For Assets & Liabilities taken over: Assets taken over A/c Dr. (At the value company records in its books) To Liabilities taken over A/c (as values agreed upon) To Business Purchase A/c (at purchase price) (**Note**: If the credits exceed the debits, the difference being goodwill and should be debited to goodwill A/c. If the debits exceed the credits, the difference being capital profit and should be credited to capital reserved A/c)		—

4. For Interest Due: (On purchase price)				
Interest A/c	Dr.		—	
To Vendor's A/c				—
5. Interest Paid:				
Vendor's A/c	Dr.		—	
To Bank A/c				—

Illustration 5.1

Swetha Ltd. was formed with an authorized capital of ₹ 20,00,000 divided into equality shares of ₹ 10 each, to acquire the business of L&M whose balance sheet on the date of acquisition was as follows:

Liabilities	₹	Assets		₹
Capital	10,00,000	Freehold Premises		14,00,000
General Reserve	7,00,000	Stock		2,00,000
Sundry Creditors	3,00,000	Sundry Debits	2,70,000	
		Less: Provision for Bad Debts:	20,000	2,50,000
		Cast at Bank		1,50,000
	20,00,000			20,00,000

The purchase price was agreed upon at ₹ 23,00,000 to be paid in ₹ 20,00,000 fully paid equity shares at ₹ 11 and the balance in cash.

You are required to record the above and prepare the balance sheet of Swetha Ltd. assuming the vendor's account is finally settled.

Solution

In the Books of Swetha Ltd.

Journal Entries

Date	Particulars		L.F.	Dr.	Cr.
	1. For Purchase of Business:				
	Business Purchase A/c	Dr.		23,00,000	
	To L&M A/c				23,00,000
	(Purchase of Business from L&M)				
	2. For Assets & Liabilities taken over:				
	Freehold Premises A/c	Dr.		14,00,000	
	Stock A/c	Dr.		2,00,000	
	Sundry Debtors A/c	Dr.		2,70,000	
	Cash A/c	Dr.		1,50,000	
	*[1]Goodwill A/c	Dr.		6,00,000	
	To Sundry Creditors A/c				3,00,000
	To Provision for Bad Debts A/c				20,000

	To Business Purchase A/c			23,00,000
	(Various Assets & Liabilities taken over) ₹ 26,20,000 – ₹ 20,20,000 = ₹ 6,00,000			
	*[1]Goodwill ∵ Credits Exceed Debits			
	3. Payment to Vendor (in Shares & Cash): L&M A/c Dr.		23,00,000	
	To Equality Share Capital A/c			20,00,000
	To Securities Premium A/c			2,00,000
	*[2]To Cash A/c			1,00,000
	(Purchase Price Paid in Shares: ₹ 20,00,000; Premium: ₹ 2,00,000			
	*[2]₹ 23,00,000 – ₹ 22,00,000 = ₹ 1,00,000 this balance is paid in cash)			

Balance Sheet of Swetha Ltd. as on …

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets:		
Authorize and Subscribed:		Goodwill		6,00,000
2,00,000 Equity Shares of ₹ 10 each Issued to Vendors as Fully Paid	20,00,000	Freehold Premises		14,00,000
		Current Assets:		
		Stock		2,00,000
Reserves & Surplus:		Sundry Debtors	2,70,000	
Securities Premium	2,00,000	Less: Provision	20,000	2,50,000
Current Liabilities: Sundry Creditors	3,00,000	Cash at Bank (₹ 1,50,000 – ₹ 1,00,000)		50,000
	25,00,000			25,00,000

Illustration 5.2

Mythali Ltd. was formed to take over the assets and liabilities of Mr. Ajay and to acquire the adjacent premises.

The balance sheet of Mr. Ajay on 31 March 2011 was as follows:

Liabilities	₹	Assets	₹
Trade Creditors	20,000	Cash in Hand	5,000
Capital	4,80,000	Cash at Bank	30,000
		Book Debts	25,000
		Stock-in-Trade	1,00,000
		Furniture	20,000
		Land & Buildings	3,20,000
	5,00,000		5,00,000

The purchase consideration was agreed at ₹ 6,00,000 and was to be paid as follows:

(i) 4,800 equity shares of ₹ 50 each
(ii) 3,200, 10% preference shares of ₹ 100 each issued at par
(iii) ₹ 40,000 in cash.

All the assets and liabilities were valued as per the above balance sheet except the book debts which were subject to a bad debts provision of 10%.

The company raised further capital by issue of 15,000 equity shares of ₹ 50 each.

The adjoining premises were purchased for ₹ 1,00,000 and additional stock for ₹ 50,000 was got from open market.

You are required to record the above transactions in the books of Mythali Ltd. through journal entries and draft its opening balance sheet.

Solution

Books of Mythali Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	1. For Purchase of Business:			
	Business Purchase A/c Dr.		6,00,000	
	To Ajay A/c			6,00,000
	(Purchase of Business from Mr. Ajay)			
31 March 2011	2. For Assets & Liabilities taken over:			
	Land & Buildings A/c Dr.		3,20,000	
	Furniture A/c Dr.		20,000	
	Stock A/c Dr.		1,00,000	
	Book Debts A/c Dr.		25,000	
	Cash at Bank A/c Dr.		30,000	
	Cash in Hand A/c Dr.		5,000	
	*[1] Goodwill A/c		1,22,500	
	To Trade Creditors A/c			20,000
	To Provision for Bad Debts A/c (10% on ₹ 25,000)			2,500
	To Business Purchase A/c			6,00,000
	(Various Assets & Liabilities Taken Over ₹ 6,22,500 – ₹ 5,00,000 = 1,22,500			
	*[1] Goodwill ∵ Crs. Exceed Drs.)			
	3. For Issue of Shares:			
	Bank A/c Dr.		7,50,000	
	To Equity Share Capital A/c			7,50,000
	(Issue of 15,000 Equity Shares @ ₹ 50 Each)			

	4. For Payment of Adjacent Premises & Stock:			
	Premises A/c Dr.		1,00,000	
	Stock A/c Dr.		50,000	
	To Bank A/c			1,50,000
	(Purchase of Adjacent Premises and Stock)			
	5. Purchase Consideration Paid to Vendor:			
	Vijay A/c Dr.		6,00,000	
	To Equity Share Capital A/c (4,800 shares × ₹ 50)			2,40,000
	To 10% Preference Shares A/c (3,200 × ₹ 100)			3,20,000
	To Bank A/c			40,000
	(Purchase Consideration: ₹ 2,40,000 Paid in Equity Shares ₹ 3,20,000 Paid in Pref. Shares ₹ 40,000 Paid in Cash Paid to Mr. Vijay)			

Balance Sheet of Mythali Ltd. as on 1 April 2011

Liabilities	₹	Assets		₹
Share Capital:		Fixed assets:		
Issued and Paid-Up:		Goodwill		1,22,500
15,000 + 4,800 = 19,800 Shares of ₹ 50 Each	9,90,000	Land & Buildings		3,20,000
		Adjacent Premises		1,00,000
3,200 10% Pref. Shares of ₹ 100 each	3,20,000	Furniture		20,000
Current Liabilities:		Current Assets:		
Trade Creditors	20,000	Stock (₹ 1,00,000 + ₹ 50,000)		1,50,000
		Book Debts	25,000	
		Less: Provision	2,500	22,500
		Cash at Bank ₹ 30,000 + ₹ 7,50,000 (New Issue – ₹ 1,00,000 – ₹ 50,000 – ₹ 40,000)		5,90,000
		Cash in Hand		5,000
	13,30,000			13,30,000

5.3.1.2 Accounting Entries in the Books of the Vendor

When the partnership firm is dissolved on account of conversion of firm into a limited company or purchased by a limited company, the following entries have to be passed in the books of the vendor:

In the Books of Vendor Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	1. For Assets Taken Over by the Purchasing Company:			
	Realization A/c Dr.		—	
	To Assets A/c (Assets Taken Over)			—

	2. For Liabilities Taken Over:				
	Liabilities A/c	Dr.		—	
	To Realization A/c				—
	(Liabilities Taken Over)				
	3. For Purchase Consideration:				
	Purchasing Company A/c	Dr.		—	
	To Realization A/c				—
	(Purchase Consideration Due)				
	4. For Realization Expenses Paid by Vendor:				
	Realization A/c	Dr.		—	
	To Bank A/c				—
	(Realization Expenses Met by Vendor)				
	5. For Receipt of Purchases Consideration:				
	Bank A/c	Dr.		—	
	Shares in New Company A/c	Dr.		—	
	Debentures in New Company A/c	Dr.		—	
	To Purchasing Company A/c				—
	(Purchase Consideration Received)				

Illustration 5.3

Model: Accounting entries in both the books of purchasing company and vendor.

Doss Ltd. was formed with a nominal capital of ₹ 20,00,000 consisting of 1,00,000 equity shares of ₹ 20 each and 6,000 preference shares of ₹ 100 each to acquire on 1 April 2011, the business of Yoga & Co.

Yoga's balance sheet as on 31 March 2011 was as follows:

Liabilities	₹	**Assets**	₹
Capital A/c:		Land & Buildings	5,00,000
Yoga & Co.	9,00,000	Plant & Machinery	3,00,000
Trade Creditors	2,50,000	Stock	2,00,000
Overdraft (Bank)	1,00,000	Debtors	2,50,000
	12,50,000		12,50,000

The Company took over all the assets and assumed all the liabilities and the consideration was fixed at ₹ 13,00,000.

In computing this figure, Land & Buildings were valued at ₹ 7,00,000; Plant & Machinery at ₹ 2,00,000; Stock at ₹ 1,90,000; and debtors at book value subject to an allowance of 5% to cover bad debts. The transfer of the bank overdraft to the company was agreed by the bank on condition that debentures for ₹ 1,50,000 were issued to the bank as collateral security.

The purchase price was settled by issue of 50,000 equity shares of ₹ 20 each at par, 2,000 preference shares of ₹ 100 each and the balance being paid in cash. Doss Ltd. paid the preliminary expendes of ₹ 20,000.

You are required to record journal entries in the books of Doss Ltd. and Yoga & Co.

Books of Doss Ltd.
Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 April 2011	Business Purchase A/c	Dr.		13,00,000	
	To Yoga & Co A/c				13,00,000
	(Purchase of Business from Yoga & Co.)				
1 April 2011	Land & Buildings A/c	Dr.		7,00,000	
	Plant & Machinery A/c	Dr.		2,00,000	
	Stock A/c	Dr.		1,90,000	
	Sundry Debtors A/c	Dr.		2,50,000	
	*[1]Goodwill A/c	Dr.		3,22,500	
	To Provisional for Bad Debts A/c				12,500
	To Trade Creditors A/c				2,50,000
	To Bank O/D A/c				1,00,000
	To Business Purchase A/c				13,00,000
	(Assets & Liabilities taken over)				
	*[1]Goodwill: ₹ 16,62,500 – ₹ 13,40,000 = ₹ 3,22,500)				
1 April 2011	Yoga & Co. A/c	Dr.		13,00,000	
	To Equity Share Capital A/c				10,00,000
	To Preference Share Capital A/c				2,00,000
	To Bank A/c				1,00,000
	(50,000 Equity Shares @ ₹ 20 = 10,00,000				
	2,000 Preference Shares × ₹ 100 = 2,00,000 and the Balance ₹ 1,00,000 in Cash for Purchase Consideration Settled)				
1 April 2011	Preliminary Expenses A/c	Dr.		20,000	
	To Bank A/c				20,000
	(Preliminary Expenses Paid)				
1 April 2011	Bank A/c	Dr.		12,00,000	
	To Equity Share Capital A/c				10,00,000
	To Pref. Shares Capital A/c				2,00,000
	(Issue of Equity & Pref. Shares)				

Books of Yoga & Co.
Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 April 2011	Realization A/c	Dr.		12,50,000	
	To Land & Buildings A/c				5,00,000
	To Plant & Machinery A/c				3,00,000
	To Stock A/c				2,00,000
	To Debtors A/c (Assets Transferred to Realization A/c)				2,50,000

1 April 2011	Trade Creditors A/c	Dr.		2,50,000	
	Bank Overdraft A/c	Dr.		1,00,000	
	To Realization A/c				3,50,000
	(Liabilities Transferred to Realization A/c)				
1 April 2011	Doss Ltd. A/c	Dr.		13,00,000	
	To Realization A/c				13,00,000
	(Purchase Consideration Receivable From Doss Ltd. A/c)				
1 April 2011	Equity Shares in Doss Ltd. A/c	Dr.		10,00,000	
	Preference Shares in Doss Ltd. A/c	Dr.		2,00,000	
	Cash A/c	Dr.		1,00,000	
	To Doss Ltd. A/c				13,00,000
	(Purchase Consideration Received in Shares and Cash)				
1 April 2011	Realization A/c	Dr.		4,00,000	
	To Doss Ltd.'s Capital A/c				4,00,000
	(Profit on Realization Transferred to Capital A/c)				
	(13,00,000 + 3,50,000 – 12,50,000)				
1 April 2011	Doss Ltd.'s Capital A/c	Dr.		13,00,000	
	To Equity Shares in Doss Ltd. A/c				10,00,000
	To Preference Shares in Doss Ltd. A/c				2,00,000
	To Cash A/c				1,00,000
	(Books are Closed by Transfer of Shares and Cash to Capital A/c)				

5.3.1.3 Debtors and Creditors Taken Over on Behalf of the Vendors

The purchasing company generally does not take over the debtors and creditors belonging to the vendor. The simple reason is that all book debts may not be realized and payment to creditors may not be accurately ascertained. From the vendor's viewpoint, it is an arduous task for him to realize the book debts and clear off the creditors once they sell their business concern. To overcome this position, the vendor authorizes the purchasing company for realizing book debts and discharging creditors. The vendor agrees to pay certain quantum of amount for such services to be rendered. If any loss or profit will arise in the process, it will belong to the vendor. Purchasing company opens a vendor's suspense account for this purpose.

For this process, the following are the journal entries to be passed in the books of the purchasing company:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	1. To Deal with Debtors and Creditors on Behalf of the Vendor at the Time of Acquisition of Business:			
	Vendor's Debtors A/c (Book value – Gross amount) Dr.		—	
	To Vendor's Creditor's A/c (Book Value – Gross Amount)			—
	To Vendor's Suspense A/c (Difference)			—
	Note: (The debtors and creditors should not be included when the main entries for purchase of business are passed)			

	2. On Realization of Amount of Debtors:			
	Bank A/c (With the Amount Realized) Dr.		—	
	To Vendor's Debtor's A/c			—
	3. For Loss on Realization of Debtors: (Due to Bad Debts and Discount Allowed to Debtors)			
	Vendor's Suspense A/c Dr.		—	
	To Vendor's Debtors A/c			—
	4. If Profit Arises on Realization of Debts: Reverse Entry of (3)			
	5. When Creditors are Paid:			
	Vendor's Creditor's A/c Dr.		—	
	To Bank A/c			—
	6. Gain on Payment to Creditors: (Due to Discount Received from Creditors)			
	Vendor's Creditor's A/c Dr.		—	
	To Vendor's Suspense A/c			—
	7. For Commission paid to Purchasing Company			
	Vendor's Suspense A/c Dr.		—	
	To Commission A/c			—
	8. For Payment to the Vendor (Settlement)			
	Vendor's Suspense A/c Dr.		—	
	To Bank A/c			—
	To Share Capital A/c (for issue of shares)			—
	To Debentures A/c (for Issue of Debentures)			—

Journal Entries in the Books of the Vendor

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	1. For closing Debtors Balances:			
	Purchasing Company's Suspense A/c Dr.		—	
	To Debtors A/c			—
	2. For Closing Provision for Doubtful Debts:			
	Provision for Doubtful Debts A/c Dr.		—	
	To Purchasing Company's Suspense A/c			—

	3. For Closing Creditors Balances:			
	Creditors A/c Dr.		—	
	To Purchasing Company's Suspense A/c			—
	4. For loss (Bad Debts, Discount Allowed Payment of Omitted Liabilities, Commission Due to Purchasing Company or Any Other Loss)			
	Profit and Loss Adjustment A/c Dr.		—	
	To Purchasing Company's Suspense A/c			—
	5. For any gain (Discount Received, Recovery of Bad Debts Which are Written Off):			
	Purchasing Company's Suspense A/c Dr.		—	
	To Profit and Loss Adjustments A/c			—
	6. On Distribution of Net Gain in P&L Adjustments A/c:			
	P&L Adjustment A/c Dr.		—	
	To Partner's Capital A/c (Partnership)			—
	or			
	To Capital A/c (Sole Proprietor's A/c)			—
	7. On Receipt of Amount (Debtors – Creditors) from the Purchasing Company:			
	Bank A/c Dr.		—	
	To Purchasing Company's Suspense A/c			—
	8. On Distribution of Cash Among the Partners:			
	Partner's Capital A/c (in Case of Partnership) Dr.		—	
	or			
	Capital A/c (in Case of Sole Proprietor) Dr		—	
	To Bank A/c			—

Illustration 5.4

Model: Collection and payment of vendor's debtors and creditors

On 1 October 2010, Brilliant Ltd. purchased the business of Mr. Bose, a sole trader, taking over all the assets with the exception of book debts amounting to ₹ 2,00,000 and creditors amounting to ₹ 1,00,000. The company undertook to collect all the book debts and pay off the creditors and for this service, it has to be paid a commission of $2\frac{1}{2}\%$ on the amount collected and $\frac{1}{2}\%$ on amounts paid.

The debtors realized ₹ 1,80,000, out of which ₹ 80,000 was paid to creditors in full settlement. The company was able to collect ₹ 8,000 debt which was previously written off as bad by Mr. Bose. The company was also forced to meet a contingent liability of ₹ 5,000 on account of a claim against the vendor for damages. The vendor received ₹ 20,000, 6% debentures of ₹ 100 each at ₹ 90 and the balance in cash in settlement of his account with the company.

Journalise the above transactions in the books of the company.

Solution

Books of Brilliant Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 Oct. 2010	1. For Acquisition of Debtors and Creditors: Vendor's Debtors A/c Dr. To Vendor's Creditors A/c To Vendor's Suspense A/c (Vendor's Debtors and Creditors Taken into A/c)		2,00,000	 1,00,000 1,00,000
1 Oct. 2010	2. For Realization of Amount of Debtors: Bank A/c Dr. Vendor's Suspense A/c Dr. To Vendor's Debtors A/c (Cash Realized from Vendor's Debtors ₹1,80,000 for ₹2,00,000 and the Loss of ₹20,000 Debited to Vendor's Suspense A/c)		1,80,000 20,000	 2,00,000
1 Oct. 2010	3. For Payment to Creditors: Vendor's Creditors A/c Dr. To Bank A/c To Vendor's Suspense A/c (Payment Made in Full Satisfaction of Creditors and Profit of ₹20,000 Credited to Vendor's Suspense Act)		1,00,000	 80,000 20,000
1 Oct. 2010	Bank A/c Dr. To Vendor's Suspense A/c (Previously Written off Debt Collected Now)		8,000	 8,000
1 Oct. 2010	Vendor's Suspense A/c Dr. To Bank A/c (Contingent Liability Paid Off)		5,000	 5,000
1 Oct. 2010	Vendor's Suspense A/c Dr. To Commission A/c $2\frac{1}{2}$% Commission on Collections Amounting to (₹1,80,000 + ₹8,000) ₹1,88,000 = ₹4,700 and $\frac{1}{2}$ % Commission on Payments (₹80,000 + ₹5,000) ₹85,000) = ₹425 (₹4,700 + ₹425 = ₹5,125)		5,125	 5,125
1 Oct. 2010	Vendor's Suspense A/c Dr. Discount on Debentures A/c Dr. To 6% Debentures A/c To Bank A/c (Vendor's A/c Settled in Respect of Debtors and Creditors by Issue of ₹20,000, 6% Debentures at 10% Discount and the Balance of ₹73,785 in Cash)		91, 785 2,000	 20,000 73,785

Notes:	[For Vendor's suspense amount, i.e. 91,875, prepare vendor's suspense A/c and transfer the balance amount (bal. fig) here] [For cash A/c: ₹ 91,785 + (Disc.) ₹ 2,000 ₹ 93,785 – ₹ 20,000 (Deb) = ₹ 73,785]			

Illustration 5.5

Model: Debtors and Creditors taken over

Akash Ltd. was incorporated to take over the business of Ganga on and from 1 January 2011. The following is the balance sheet of Ganga as on 31 December 2010:

Liabilities	₹	**Assets**	₹
Capital A/c	1,10,000	Land & Buildings	1,40,000
Loan Creditors	1,20,000	Plant & Machinery	80,000
Trade Creditors	40,000	Furniture	10,000
		Sundry Debtors	50,000
	2,80,000		2,80,000

The company took over the business with the fixed assets and loan creditors on the following basis:

(a) Depreciate land and buildings and plant and machinery by 10%

(b) The value of goodwill is estimated at ₹ 63,000.

The Company realized ₹ 48,000 from sundry debtors, as agent of the vendors in full settlement and discharged all the creditors by paying ₹ 36,000.

The loan creditors accepted 6% preference shares of ₹ 100 in discharge of the loans. On realization of debts and discharge of liabilities, the total amount due to the vendor was settled by issue of fully paid equity shares of ₹ 10 each.

You are required to pass the journal entries in the books of Akash Ltd.

Solution

In this question, purchase consideration is not given. As such, it has to be computed first, as follows:

Step 1:	Assets at book value:	₹
Add: All	(i) Goodwill (as in question):	63,000
	(ii) Land & Buildings (₹ 1,40,000 – ₹ 14,000) Dep	1,26,000
	(iii) Plant & Machinery (₹ 80,000 – ₹ 8,000)	72,000
	(iv) Furniture (₹ 10,000 – ₹ 1,000)	9,000
Step 2:	Aggregate of Assets:	2,70,000
Step 3:	Less: Creditors taken over (Loan):	1,20,000
***[1]Step 4:**	Purchase Consideration:	1,50,000

Books of Akash Ltd.
Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 January 2011	[*1]Business Purchase A/c	Dr.		1,50,100	
	To Ganga A/c				1,50,000
	(Purchase Consideration to be Paid)				
	Land & Buildings A/c (1,40,000 – 14,000)	Dr.		1,26,000	
	Plant & Machinery A/c (80,000 – 8,000)	Dr.		72,000	
	Furniture A/c (10,000 – 1,000)	Dr.		9,000	
	Goodwill A/c (Balancing Figure)	Dr.		63,000	
	To Loan Creditors A/c				1,20,000
	To Business Purchase A/c				1,50,000
	(Assets and Liabilities Taken Over)				
	Vendor's Debtors A/c	Dr.		50,000	
	To Vendor's Creditors A/c				40,000
	To Ganga's Suspense A/c				10,000
	(Debtors and Creditors Taken Over on Behalf of Vendor and Difference Transferred to Vendor's Suspense A/c				
	Bank A/c	Dr.		48,000	
	Ganga's Suspense A/c	Dr.		2,000	
	To Vendor's Debtors A/c				50,000
	(Amount Realized from Vendor's Debtors and Loss on Realization Transferred to Ganga's Suspense Account)				
	Vendor's Creditors A/c	Dr.		40,000	
	To Bank A/c				36,000
	To Ganga's Suspense A/c				4,000
	(Payment Made to Vendor's Creditors and Profit Transferred to Ganga's Suspense A/c)				
	Loan Creditor's A/c	Dr.		1,20,000	
	To 6% Preference Share Capital A/c				1,20,000
	(Loan Discharged by Issue of Pref. Shares)				
	Ganga's A/c	Dr.		1,50,000	
	Ganga's Suspense A/c (₹ 10,000 + 4,000 – 2000)	Dr.		12,000	
	To Equity Share Capital A/c				1,62,000
	(Amount Paid to Ganga by Issue of Equity Shares)				

Illustration 5.6

Model: Debtors and creditors taken over by the Company

Sun Ltd. acquired the business of Moon Agencies, whose debtors and creditors were taken over by the Company for collection and payment for a commission of 10% on all amount collected and 2% on amount paid. The debtors amounted to ₹ 4,50,000 and creditors to ₹ 2,20,000. There was a contingent liability of ₹ 60,000

The Company collected one-third of debtors in full, 50% of debtors at 4% discount, two-thirds of the balance at 6% discount and the remaining proved bad. A debt of ₹ 30,000 written off by the vendor in the past was collected at 80% but court expenses for that amounted to ₹ 6,000 of which ₹ 2,000 only could be recovered from the debtor.

₹ 20,000 of creditors were paid in full and the balance was paid at 97%. The contingent liability came up for payment at ₹ 40,000.

The Company settled its account with the vendor in cash. You are required to pass journal entries in the books of Sun Ltd.

Solution

(i) Amount collected from debtors has to be determined first as follows:

Particulars		Collection ₹	Book Value ₹
	Total Debtors (Given)		4,50,000
Less:	Collected – $\frac{1}{3}$rd – in full $\frac{1}{3}$ × ₹ 4,50,000)	1,50,000	–(1,50,000)
	Balance		3,00,000
Less:	Collected – 50% – @ 4% Discount		
	(50% of ₹ 4,50,000 – 4% of 2,25,000		
	₹ 2,25,000 – ₹ 9,000 = ₹ 2,16,000)	2,16,000	–(2,25,000)
	Balance		75,000
Less:	Collected – 2/3rd of ₹ 75,000 — @ 6% Discount		
	50,000 – (6%)3,000 = ₹ 47,000	47,000	(–50,000)
	Balance		25,000
	The Remaining is Treated as Bad Debt		(–25,000)
			Nil
	Collection : Total Debtors	4,13,000	
Add:	Bad Debts Recovered:		
	80% of ₹ 30,000 – (6,000 – 2,000)	20,000	
	Total Collections:	4,33,000	
	*[1] ∵ Commission @ 10%:	10% of ₹ 4,33,000	= ₹ 43,300

(ii) Amount paid to creditors is to be determined as under:

		₹	₹
	Total Creditors (Given)		2,20,000
Less:	Creditors Paid in Full	20,000	(–20,000)
	Balance:		2,00,000
	Creditors of ₹ 2,00,000 Paid at 97%	1,94,000	2,00,000
	Total Creditors	2,14,000	Nil
Add:	Contingent Liability Paid	40,000	
	Total Payments:	2,54,000	
	*2 ∵ Commission on ₹ 2,54,000 at 2%:	5,080	

(iii) Total Commission = 10% on total collections + 2% on total payments

= *1 ₹ 43,300 + *2 ₹ 5,080

= ₹ 48,380

Sun Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Vendor's Debtors A/c	Dr.		4,50,000	
	To Vendor's Creditors A/c				2,20,000
	To Moon Agencies Suspense A/c				2,30,000
	(Debtors and Creditors taken over)				
	Bank A/c	Dr.		4,13,000	
	Moon Agencies Suspense A/c	Dr.		37,000	
	To Vendor's Debtors A/c				4,50,000
	(Cash Realized and Discount Allowed, (₹ 9,000 + ₹ 3,000 + Bad debts ₹ 25,000)				
	Bank A/c	Dr.		20,000	
	To Moon Agencies Suspense A/c				20,000
	(Bad Debts Recovered, Net of Expenses)				
	Vendor's Creditors A/c	Dr.		2,20,000	
	To Bank A/c				2,14,000
	To Moon Agencies A/c				6,000
	(Payments Made to Creditors and Discount Received)				
	Moon Agencies Suspense A/c	Dr.		88,380	
	To Bank A/c				40,000
	To Commission A/c				48,380
	(Payment of Contingent Liability of ₹ 40,000 and Commission Due)				

	* Moon Agencies Suspense A/c Dr.		1,30,620	
	To Bank A/c			1,30,620
	(Final Payment Made to Moon Agencies)			

*: This amount is determined by preparing Moon Agencies suspense A/c as follows:

Dr. Moon Agencies Suspense A/c Cr.

Particulars	₹	Particulars	₹
To Vendor's Debtors A/c	37,000	By Vendor's Debtors A/c	2,30,000
To Bank A/c	40,000	By Bank A/c	20,000
To Commission A/c	48,380	By Vendor's Creditors A/c	6,000
* To Bank A/c (Balancing Figure)	1,30,620		
	2,56,000		2,56,000

Approach 2: When vendor's debtors and creditors are not taken over by the purchasing company, it may be treated by an alternative method, which is described as follows:

Books of …Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) Vendor's Debtors A/c Dr.		—	
	To Debtors' Suspense A/c			—
	(ii) Creditors' Suspense A/c Dr.		—	
	To Vendor's Creditors A/c			—
	(iii) For Collection of Amounts from Vendor's Debtors			
	(a) Bank A/c Dr.		—	
	To Vendor's A/c			—
	(b) Debtor's Suspense A/c Dr.		—	
	To Vendor's A/c			—
	(iv) For Discounts Allowed to Vendor's Debtors, Bad Debts Written off			
	Debtor's Suspense A/c Dr.		—	
	To Vendor's Debtors A/c			—
	(v) Payment to Vendor's Creditors:			
	(a) Vendor's Creditors A/c Dr.		—	
	To bank A/c			—
	(b) Vendor Debtors A/c Dr.		—	
	To Creditor's Suspense A/c			—

	(vi) For Discounts Allowed by Creditors:				
	Vendor's Creditors A/c	Dr.		—	
	To Creditors' Suspense A/c				—
	(vii) For Commission:				
	Vendor A/c	Dr.			
	To Commission A/c				

Note

Balance in vendor's debtors A/c will be equal to that of debtor's suspense A/c.

Similarly, balance in vendor's creditors A/c will be equal to that of creditor's suspense A/c.

Illustration 5.7

On 1 April 2011, a company bought certain assets from Milton. The company also undertook to collect his debts amounting to ₹ 65,000 and to pay his creditors for ₹ 15,000 for a commission of 5% on amounts collected and 1% on amounts paid. The debtors realized only ₹ 60,000 out, of which ₹ 14,000 was paid to creditors in full settlement. Milton received ₹ 20,000 in 12% debentures at 90 and the balance in cash Journalise.

Solution

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 April 2011	Vendor's Debtors A/c	Dr.		65,000	
	To Debtor's Suspense A/c				65,000
	(Vendor's Debtors to be Collected by the Company)				
	Creditors Suspense A/c	Dr.		15,000	
	To Vendor's Creditors Ass/c				15,000
	(Creditors to be Paid on Behalf of Vendor)				
	Bank A/c	Dr.		60,000	
	To Vendor's Debtors A/c				60,000
	(Amount Collected from Debtors)				
	Debtor's Suspense A/c	Dr.		60,000	
	To Vendor A/c				60,000
	(Amount Due to Vendor, i.e. Collections)				
	Debtor's Suspense A/c	Dr.		5,000	
	To Vendor's Debtors A/c				5,000
	(Loss on Vendor's Debtors) (65,000 – 60,000)				
	Vendor's Creditors A/c	Dr.		14,000	
	To Bank A/c				14,000
	(Payment Made to Vendor's Creditors)				

	Vendor A/c	Dr.		14,000	
	To Creditors' Suspense A/c				14,000
	(Amount Recoverable from Vendor)				
	Vendor's Creditors A/c	Dr.		1,000	
	To Creditor's Suspense A/c				1,000
	(Gain on Vendor's Creditors) (15,000 – 14,000)				
	Vendor A/c	Dr.		3,140	
	To Commission A/c				3,140
	(Commission Charger) 5% on ₹ 60,000 + 1% on ₹ 14,000)				
	Vendor A/c	Dr.		42,860	
	Discount on Issue of Debentures A/c	Dr.		2,000	
	To 12% Debentures A/c				20,000
	To Bank A/c				24,860
	(Vendor's Claim Settled)				

5.3.2 When the Same Account Books (Set of Books) are Continued

So far, we have discussed the accounting treatment when the purchasing company starts new books of account. Now we are going to discuss the purchasing company's decision to continue the same books of account as where being maintained by the seller.

The following steps are to be followed when the purchasing company decides to continue with the same set of books.

Step 1: In case the assets and liabilities are to be undertaken by the purchasing company, assets and liabilities are to be revalued. Profit and loss adjustment has to be prepared, and the balance (profit or loss) has to be transferred to capital accounts of partners in their old profit sharing ratio (or shareholder's account, if the vendor is a company).

Step 2: In case a certain asset or liability is not taken over by the purchasing company, they have to be transferred to the capital accounts of partners in profit sharing ratio.

A separate bank account has to be opened if the vendor is a company, the assets not taken over by the purchasing company will be realized and the liabilities not taken over by the purchasing company will be paid.

Step 3: Any balance of accumulated or undistributed profits or reserves will have to be transferred to capital accounts in profit sharing ratio.

Step 4: The capital accounts are closed by debiting the capital accounts of partners (or shareholders' A/c) and crediting share capital account (for shares issued), debentures A/c (for debentures issued) and bank A/c (for cash paid).

Important note

No entries are necessary to close the books of the vendor; to open the books of purchasing company.

Step 5: A revised balance sheet has to be prepared by incorporating the above adjustments.

Accounting treatment for debtors and creditors not taken over when same set of books are continued:

(a) Debtor's and creditor's account must not be closed
(b) Separate accounts have to be opened:
  (i) Debtors suspense A/c and
  (ii) Creditors suspense A/c

Other Important entries:

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	(i) Vendor A/c	Dr.		—	
	To Debtors Suspense A/c				—
	(ii) Creditor's Suspense A/c	Dr.		—	
	To Vendor A/c				—
	(iii) On Amount Collected from Debtors:				
	Cash/Bank A/c	Dr.		—	
	Discount Allowed A/c	Dr.		—	
	To Debtors A/c &				—
	(iv) Debtor's Suspense A/c	Dr.		—	
	To Vendor A/c				—
	To Discount Allowed A/c				—
	(v) On Amount Paid to Creditors:				
	Creditors A/c	Dr.		—	
	To Cash A/c				—
	To Discount Received A/c				—
	(vi) Vendor's A/c	Dr.		—	
	Discount Received A/c	Dr.		—	
	To Creditors Suspense A/c				—

Illustration 5.8

Model: Continuation of same set of books

A and B carrying on business in partnership, sharing profits and losses in the ratio of 2:1 decide to dissolve the firm and sell the business to a limited company on 31 March 2011, the balance sheet of the firm stood on that date as follows:

Liabilities	₹	Assets	₹
Sundry Creditors	2,25,000	Cash at Bank	40,000
Reserve Fund	2,25,000	Sundry Debtors	6,00,000
Capital Accounts:		Stock	8,10,000
A: 7,00,000		Motor Vehicle	1,20,000
B: 5,00,000	12,00,000	Furniture	80,000
	16,50,000		16,50,000

XYZ Ltd. was registered with an authorized capital of ₹ 50,00,000 in equity shares of ₹ 100 each to acquire the above business on the following terms:

(a) Goodwill is valued at ₹ 3,75,000

(b) Furniture and stock valued at ₹ 72,500 and ₹ 8,75,500, respectively

(c) Debtors are subject to $2\frac{1}{2}$% provision.

Motor vehicle is no more required by the company and A took over at ₹ 1,10,000.

The purchase price was satisfied by the issue of shares of ₹ 100 each at par.

You are required to pass journal entries and prepare balance sheet of XYZ Ltd. assuming that the same set of books is continued.

Solution

In the Books of XYZ Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2011	Goodwill A/c Dr.		3,75,000	
	To A's Capital A/c			2,50,000
	To B's Capital A/c			1,25,000
	(Goodwill ₹ 3,75,000 Credited to A's and B's Capital Accounts in 2:1 ratio)			
	Revaluation A/c Dr		32,500	
	To Provision for Bad Debts (6,00,000 @ $2\frac{1}{2}$%)			15,000
	To Furniture A/c (₹ 80,000 – 72,500)			7,500
	To Motor Vehicle A/c (₹ 1,20,000 – 1,10,000)			10,000
	(Provision Made on Debtors in Book Value of Assets)			
	Stock A/c Dr		62,500	
	To Revaluation A/c			62,500
	(Appreciation of Stock) (₹ 8,72,500 – 8,10,000)			
	Revaluation A/c Dr.		30,000	
	To A's Capital A/c			20,000
	To B's Capital A/c			10,000
	(Profit on Revaluation Credited to Partner's Capital Accounts) (₹ 62,500 – ₹ 32,500) in 2:1 ratio)			
	A's Capital A/c Dr.		1,10,000	
	To Motor Vehicle A/c			1,10,000
	(Motor Vehicle Taken Over by A)			
	Reserve Fund A/c Dr.		2,25,000	
	To A's Capital A/c			1,50,000
	To B's Capital A/c			75,000
	(Reserve Fund ₹ 2,25,000 Credited into A's and B's Capital Accounts in 2:1 Ratio)			

	A's Capital A/c (₹ 7,00,00 + ₹ 3,10,000	Dr.		10,10,000	
	B's Capital A/c (₹ 5,00,00 + ₹ 2,10,000)	Dr.		7,10,000	
	To Share Capital A/c				17,20,000
	(Purchase Consideration Paid to Partners				

Balance Sheet of XYZ Ltd. as on 1 April 2011

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets		
Authorized Capital:		Goodwill		3,75,000
50,000 Shares of ₹ 100 Each	50,00,000	Furniture		72,500
Issued & Subscribed:		Current Assets:		
17,200 Shares of ₹ 100 Each Fully Paid	17,20,000	Stock		8,72,500
		Debtors:	6,00,000	
Current Liabilities Sundry Creditors	2,25,000	Less: Provision	15,000	5,85,000
		Cash at Bank		40,000
	19,45,000			19,45,000

Illustration 5.9

Model: Debtors and creditors not taken over when same set of books is continued

Jasemine Ltd. purchased the business of Mr. Rattan. Jasemine Ltd. did not take over the debtors and creditors of Mr. Rattan amounting to ₹ 1,00,000 and ₹ 70,000, respectively, but promised to collect from debtors and pay to creditors.

Jasemine Ltd. collected all debts at a discount of ₹ 2,500 and a bad debt of ₹ 1000 and paid all creditors at a discount of ₹ 1,500. Show the entries assuming the set of books is continued.

Solution

Working Note:

Calculation of amount due to vendor on final settlement:	₹
Amount received from debtors (₹ 1,00,000 – ₹ 2,500 – ₹ 1,000):	96,500
Less: Amount paid to creditors (₹ 70,000 – ₹ 1,500):	68,500
Net amount due to vendor:	28,000

In the Books of Jasemine Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Rattan A/c	Dr.		1,00,000	
	To Debtors Suspense A/c				1,00,000
	(New Debtors Suspense A/c Opened)				
	Creditors Suspense A/c	Dr.		70,000	
	To Rattan A/c				70,000
	(New Creditors Suspense A/c Opened)				

	Cash A/c	Dr.		96,500	
	Discount Allowed A/c	Dr.		2,500	
	Bad Debt A/c	Dr.		1,000	
	To Debtors A/c				1,00,000
	(Amount Collected from Debtors)				
	Debtors Suspense A/c	Dr.		1,00,000	
	To Discount Allowed A/c				2,500
	To Bad Debt A/c				1,000
	To Rattan A/c				96,500
	(Cancellation of Debtors Suspense A/c, Bad Debt and Discount Allowed A/c)				
	Creditors A/c	Dr.		70,000	
	To Discount Received A/c				1,500
	To Cash A/c				68,500
	(Payment Made to Creditors)				
	Rattan A/c	Dr.		68,500	
	Discount Received A/c	Dr.		1,500	
	To Creditors Suspense A/c				70,000
	(Cancellation of Discount Received A/c Creditors Suspense A/c)				
	Rattan A/c	Dr.		28,000	
	To Cash A/c				28,000
	(Payment of Amount Due to Vendor)				

FOR PROFESSIONAL COURSES

Illustration 5.10

Sowmya Ltd. was formed on 1 April 2010, with an authorized capital of ₹35,00,000 divided into 25,000 equity shares of ₹100 each and 10,000 preference shares of ₹100 each, to acquire the business of Bhama as a going concern. The balance sheet of Bhama as at 31 March 2011 was as follows:

Liabilities	₹	Assets	₹
Sundry Creditors	37,500	Cash at Bank	19,000
X's Loan A/c	77,500	Sundry Debtors	48,500
Bhama's Capital A/c	7,85,000	Stock	1,80,000
		Furniture	17,500
		Plant & Machinery	3,50,000
		Land & Buildings	2,85,000
	9,00,000		9,00,000

The purchase consideration was to be discharged by Sowmya Ltd. by issue of 7,500 equity shares of ₹100 each, 2500 preference shares of ₹100 each and ₹1,00,000 in cash. Sowmya Ltd. also agreed to

discharge the sundry creditors but declined to accept X's loan. All the assets of the old company were taken over at their balance sheet values except stock which was valued at ₹ 2,00,000. A provision of 5% was also created against sundry debtors.

To provide necessary working capital and to pay to purchase consideration, the remaining equity shares were issued at a premium of 10% and the cash was duly received. The preliminary expenses amounting to ₹ 75,000 were paid by the Company immediately after the issue.

Show the opening entries in the books of Sowmya Ltd. and also the opening balance sheet.

[I.C.W.A. Modified]

Solution

Stage 1: In this question, purchase consideration is not given directly. So, it has to be determined as follows:

(i) Equity shares to be issued: 7,500 × ₹ 100 = ₹ 7,50,000
(ii) Preference shares to be issued: 2,500 × ₹ 100 = ₹ 2,50,000
(iii) Cash to be paid = ₹ 1,00,000
(iv) Purchase consideration (Add: i + ii + iii) = ₹ 11,00,000

Stage 2: Passing of Journal Entries

Books of Sowmya Ltd
Journal Entries

Date	Particular		L.F.	Dr. ₹	Cr. ₹
1 April 2010	*1 Business Purchase A/c	Dr.		11,00,000	
	To Bhama A/c				11,00,000
	(Purchase Consideration of Business)				
1 April 2010	Land & Building A/c	Dr.		2,85,000	
	Plant & Machinery A/c	Dr.		3,50,000	
	Furniture A/c	Dr.		17,500	
	Stock A/c	Dr.		2,00,000	
	Sundry Debtors A/c	Dr.		48,500	
	Cash at Bank A/c	Dr.		19,000	
	*2 Goodwill A/c (Bal. Fig)	Dr.		2,19,725	
	To Sundry Creditors A/c				37,500
	To Provision for Doubtful Debts				2,425
	To Business Purchase A/c				11,00,000
	(Assets & Liabilities Taken Over by Sowmya Ltd.				
	*2 Goodwill = (₹ 11,39,925 – ₹ 9,20,000 = ₹ 2,19,925)				
1 April 2010	Bhama A/c	Dr.		11,00,000	
	To Equity Share Capital A/c (7,500 × ₹ 100)				7,50,000
	To Pref. Share Capital A/c (2,500 × ₹ 100)				2,50,000
	To Bank A/c				1,00,000
	(Purchase Price Paid in the Form of 7,500 Equity Shares of ₹ 100 each, 2,500 Pref. Shares of ₹ 100 Each and the Balance of ₹ 1,00,000 in Cash)				

1 April 2010	Bank A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (25,000 – 7,500 = 17,500 Equity Shares @ ₹ 100 at ₹ 10 Premium)		19,25,000	 17,50,000 1,75,000
1 April 2010	Preliminary Expenses A/c Dr. To Bank A/c (Payment of Preliminary Expenses)		75,000	 75,000

Stage 3: Cash at bank (closing balance) has to be calculated by preparing cash at bank A/c as follows:

Dr. Cash at Bank A/c Cr.

Particulars	₹	Particulars	₹
To Balance b/d	19,000	By Preliminary Expenses	75,000
To Equity Share Capital	17,50,000	By Bhama A/c	1,00,000
To Securities Premium A/c	1,75,000	By Balance c/d	17,69,000
	19,44,000		19,44,000
*3 To Balance b/d	17,69,000		

Stage 4: Preparation of Balance Sheet

Balance Sheet of Sowmya Ltd. as on 1 April 2010

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets		
Authorized:		Goodwill		2,19,925
25,000 Equity Shares of ₹ 100 Each	25,00,000	Land & Buildings		2,85,000
10,000 Pref. Shares of ₹ 100 Each	10,00,000	Plant & Machinery		3,50,000
Issued and Subscribed:		Furniture		17,500
25,000 Equity Shares of ₹ 100 Each Fully Paid (Including Shares Issued to the Vendor)	25,00,000	Current Assets:		
		Stock		2,00,000
		Sundry Debtors	48,500	
		Less: Prov. for Doubtful Debts	2,425	46,075
2,500 Pref. Shares of ₹ 100 Each	2,50,000	*3 Cash at Bank		17,69,000
Reserves & Surplus: Securities Premium	1,75,000	Miscellaneous Expenditure:		
Current Liabilities:		Preliminary Expenses		75,000
Sundry Creditors	37,500			
	29,62,500			29,62,500

Illustration 5.11

A company was formed with an authorized capital of ₹ 10,00,000 divided into 50,000 equity shares of ₹ 10 each and 50,000 preference shares of ₹ 100 each to acquire the going concern of Mohan whose balance sheet stood as follows:

Liabilities	₹	Assets	₹
Bills Payable	7,000	Cash at Bank	9,000
Sundry Creditors	12,800	Book Debts	15,000
Capital	2,64,200	Insurance Policy	8,000
		Stock in Trade	62,000
		Plant & Machinery	1,00,000
		Freehold Premises	90,000
	2,84,000		2,84,000

The purchase price was agreed upon at ₹ 3,50,000 to be paid; ₹ 1,00,000 in fully paid equity shares, ₹ 1,00,000 in fully paid preference shares, ₹ 60,000 in redeemable debentures and the balance in cash. The company did not take over the insurance policy, valued the stock and plant and machinery at 10% less than the book value and the freehold premises at 20% move than the book value. The liabilities will be discharged by the company.

The balance of both kinds of shares was issued to and paid up by the public with the exception of 1,200 equity shares held by Sommath on which he did not pay the last call of ₹ 3 per share and which were subsequently forfeited and reissued at a discount of 20%.

Give journal entries to record the above and prepare the balance sheet of the company.

Solution

Books of … Ltd

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Business Purchase A/c	Dr.		3,50,000	
	To Mohan A/c				3,50,000
	(Acquisition of Business of Mohan)				
	Cash at Bank A/c	Dr.		9,000	
	Sundry Debtors A/c	Dr.		15,000	
	Stock in Trade A/c	Dr.		55,800	
	Plant and Machinery A/c	Dr.		90,000	
	Freehold Premises A/c	Dr.		1,08,000	
	*1 Goodwill A/c (Bal. fig)	Dr.		92,000	
	To Bills Payable A/c				7,000
	To Sundry Creditors A/c				12,800
	To Business Purchase A/c				3,50,000
	(Assets & Liabilities taken over				
	*1Goodwill = ₹ 3,69,800 – 2,77,800 = ₹ 92,000)				
	Equity Shares A/c	Dr.		2,80,000	
	To Equity Share Capital A/c				2,80,000
	(Remaining Equity Shares: 50,000 – 10,000 = 40,000 Shares				
	Issued to the Public @ ₹ 7 Per Share)				

	Bank A/c Dr.		2,80,000	
	To Equity Shares A/c			2,80,000
	(Amount Received on 40,000 Shares at ₹ 7 Per Share)			
	Bank A/c Dr.		4,00,000	
	To Preference Share Capital A/c			4,00,000
	(Amount Received on 4,000 Pref. Shares @ ₹ 100 Per Share)			
	Equity Shares Final call A/c Dr.		1,20,000	
	To Equity Share Capital A/c			1,20,000
	(Amount Due on Final call on 40,000 Shares @ ₹ 3 Per Share)			
	Bank A/c Dr.		1,16,400	
	To Equity Share Final call A/c			1,16,400
	(40,000 – 1,200 = For 38,800 Shares Final call Amount Received)			
	Mohan A/c Dr.		3,50,000	
	To Equity Shares Capital A/c			1,00,000
	To Pref. Shares Capital A/c			1,00,000
	To Redeemable Debentures A/c			60,000
	To Bank A/c			90,000
	(Purchase Consideration Discharged)			
	Equity Share Capital A/c Dr.		12,000	
	To Equity Share Final call A/c			3,600
	To Shares Forfeited A/c			8,400
	(1,200 Shares Forfeited for Non-Payment of Final call of ₹ 3 Per Share)			
	Bank A/c Dr.		9,600	
	Shares Forfeited A/c Dr.		2,400	
	To Equity Shares Capital A/c			12,000
	(Forfeited Shares at 20% Discount)			
	Shares Forfeited A/c Dr.		6,000	
	To Capital Reserve A/c			6,000
	(Balance in Shares Forfeited A/c Transferred to Capital Reserve A/c)			

Balance Sheet of … Ltd. as on …

Liabilities	₹	**Assets**	₹
Shares Capital:		Fixed Assets:	
Authorized:	10,00,000	Goodwill	92,000
Issued & Subscribed:		Freehold Premises	1,08,000
50,000 Equity Shares of ₹ 10 Each Fully Paid	5,00,000	Plant & Machinery	90,000

5,000 Preference Shares of ₹100 Each Fully Paid	5,00,000	Current Assets:	
Reserves & Surplus:		Stock in Trade	55,800
Capital Reserve	6,000	Sundry Debtors	15,000
Secured loans: Debentures	60,000	Cash or Bank	7,25,000
Current Liabilities:			
Sundry Creditors	12,800		
Bills Payable	7,000		
	10,85,800		10,85,800

Illustration 5.12

On 31 March 2011, the following was the balance sheet of a firm:

Liabilities	₹	**Assets**	₹
Capital Accounts		Fixed Assets:	
X: 4,40,000		Factory Building	2,64,000
Y: 4,40,000	8,80,000	Plant & Machinery	3,36,000
Sundry Creditors	3,20,000	Furniture	40,000
		Current Assets:	
		Stock at Cost	1,20,000
		Sundry Debtors	2,80,000
		Cash in hand & at Bank	1,60,000
	12,00,000		12,00,000

On 1 April 2011, the firm was converted into a limited company on the following terms:

(a) Debtors and creditors of the firm were not to be taken over as well as the cash balances.

(b) Assets were revalued as to furniture at ₹24,000; Plant & Machinery at ₹3,20,000 and the building at ₹2,80,000

(c) Preliminary expenses amounting to ₹16,000 were disbursed by the firm to be recovered from the company.

(d) As purchase consideration, the partners were to be allotted at par 10,400 equity shares of ₹100 each. They were also entitled to receive ₹1,60,000 in cash.

Given journal entries and submit the balance sheet as at 1 April 2011, of limited company, assuming the authorized capital to be ₹16,00,000 made up wholly of equity shares of ₹100 each.

[I.C.W.A. Modified]

Solution

Stage 1: As purchase price is not given directly, we have to calculate purchase consideration first.

Equity shares: 10,400 × ₹100	₹10,40,000
Cash	₹1,60,000
∴ Purchase price	₹12,00,000

Stage 2:

Preparation of Journal
Books of … Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
April 1 2011	Business Purchase A/c Dr.		12,00,000	
	To X & Y A/c			12,00,000
	(Purchase Consideration of Business of X & Y)			
April 1 2011	Building A/c Dr.		2,80,000	
	Plant & Machinery A/c Dr.		3,20,000	
	Furniture A/c Dr.		24,000	
	Stock A/c Dr.		1,20,000	
	*1 Goodwill A/c Dr.		4,56,000	
	To Business Purchase A/c			12,00,000
	(Assets & Liabilities Taken Over *1 Goodwill = ₹ 12,00,000 – 7,44,000 = ₹ 4,56,000)			
April 1 2011	X & Y A/c Dr.		12,00,000	
	To Equity Share Capital A/c (10,400 × ₹ 100)			10,40,000
	To Bank A/c			1,60,000
	(Purchase Price Paid in the form of 10,400 Equity Shares of ₹ 100 Each and Balance ₹ 1,60,000 in Cash)			
1 April 2011	Preliminary Expenses A/c Dr.		16,000	
	To Bank A/c			16,000
	(Payment of Preliminary Expenses)			

Stage 3: Preparation of Balance Sheet

Balance Sheet as on 1 April 2011

Liabilities	₹	Assets	₹
Share Capital		Fixed Assets:	2,80,000
Authorized 16,000 Equity Shares of ₹ 100 Cach	16,00,000	Buildings Plant & Machinery	3,20,000
Issued & Subscribed:		Furniture	24,000
10,400 Equity Shares of ₹ 100 each Fully Paid	10,40,000	Goodwill	4,56,000
Current Liabilities:		Current Assets:	
Bank Overdraft: ₹ 1,60,000		Stock	1,20,000
16,00	1,76,000	Misc. Expenditure: Preliminary Expenses	16,000
	12,16,000		12,16,000

Illustration 5.13

The balance sheet of Guber was as follows:

Balance Sheet on 31 March 2011

Liabilities		₹	Assets		₹
	₹		Sundry Assets	₹	21,00,000
Creditors	6,20,000		Debtors	13,44,000	
Less: Reserve	20,000	6,00,000	Less: Provision	44,000	13,00,000
Loans		4,00,000			
Guber		24,00,000			
		34,00,000			34,00,000

On 15 July 2011, Singh Ltd. was incorporated, taking over all the assets (except debtors) and the liability for loans; interest @ 12% p.a. on the purchase price to be allowed to the vendors from 1 April 2011 to the date of completion. The credit balance of Guber's capital to be satisfied by the issue of equity shares in Singh Ltd.

The loan holders accept 14% preference shares in discharge of their debts. The company, as agent for vendor, agrees to collect the debts, which realize ultimately ₹ 1,260,000 out of which they pay, as agent for the vendor, the creditors at the net figure shown in the balance sheet. Of the balance, they paid an account to Guber the sum of ₹ 2,00,000; the amount remaining undrawn by Guber, including interest, to be discharged in the form of ₹ 5,00,000 debentures at 96 and cash. The new company is entitled to all intervening profit (i.e., between 1 April 2011 and 15 July 2011).

Show the opening entries of Singh Ltd. and closing entries of Guber in respect of the above, assuming that the date of completing is 31 August 2011. Ignore Income Tax.

[C.A. (Final). Modified]

Solution

In this question, journal entries have to be passed in the books of Singh Ltd. and Guber.

First, journal of Singh Ltd. is prepared as follows:

Books of Singh Ltd.

Journal Entries

Date	Particular	L.F.	Dr. ₹	Cr. ₹
15 July 2011	Sundry Assets A/c Dr.		21,00,000	
	To Loans A/c			4,00,000
	To Guber A/c			17,00,000
	(Assets and Loan Taken Over)			
15 July 2011	Vendor's Debtors A/c Dr.		13,44,000	
	To Vendor's Creditors A/c			6,20,000
	To Guber Suspense A/c			7,24,000
	(Debtors and Creditors of the Vendor to be Collected and Paid)			

15 July 2011	Bank A/c Dr.		12,60,000	
	Guber Suspense A/c		84,000	
	To Vendor's Debtors A/c			13,44,000
	(Loss Transferred to Guber Suspense A/c)			
15 July 2011	Vendor's Creditors A/c Dr.		6,20,000	
	To Bank A/c			6,00,000
	To Guber Suspense A/c			20,000
	(Payment to Vendor's Creditors at the net Amount and the Profit Transferred to Guber Suspense A/c)			
15 July 2011	Guber Suspense A/c Dr.		2,00,000	
	To Bank A/c			2,00,000
	(Payment to Vendor on the Amount Collected from Debtors)			
31 August	Guber Suspense A/c Dr.		4,60,000	
	To Guber A/c			4,60,000
	(Balance in the Vendor's Suspense A/c Transferred to his Account)			
31 August	Interest to Vendor's A/c Dr.		85,000	
	To Guber A/c			85,000
	(Interest at 12% on 17,00,000 for 5 Months—from 1 January to 31 May Credited to the Vendor)			
31 August	Guber A/c Dr.		22,02,500	
	Discount on Issue of Debentures A/c Dr.		20,000	
	To Equities Shares Capital A/c			17,00,000
	To Debentures A/c			5,00,000
	To Bank A/c			22,500
	(Amount Due to Vendor Discharged in the form of Equity Shares: ₹ 17,00,000; Debentures: ₹ 5,00,000 @ ₹ 96 and Cash: ₹ 22,500)			
31 August	Loan A/c Dr.		4,00,000	
	To 14% Preference Share Capital A/c			4,00,000
	(Loan of ₹ 4,00,000 Discharged by Issue and Allotment of 14% Presence Shares)			

Books of Guber
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 April 2011	Realization A/c Dr.		34,64,000	
	To Sundry Assets A/c			21,00,000
	To Sundry Debtors A/c			13,44,000
	To Reserve on Creditors A/c			20,000
	(Assets and the Reserve on Creditors Transferred to Realization A/c)			

1 April 2011	Sundry Creditors A/c	Dr.		6,20,000	
	Loans A/c	Dr.		4,00,000	
	Provision on Debtors A/c	Dr.		44,000	
	To Realization A/c				10,64,000
	(Liabilities Transferred to Realization A/c)				
15 July 2011	Guber Ltd. A/c	Dr.		17,00,000	
	To Realization A/c				17,00,000
	(Amount Due on Acquisition Business)				
15 July 2011	Guber Ltd. A/c	Dr.		12,60,000	
	To Realization A/c				12,60,000
	(Amount Realized from Debtors)				
15 July 2011	Realization A/c	Dr.		6,00,000	
	To Guber Ltd. A/c				6,00,000
	(Amount Paid to Creditors)				
July 15 2011	Bank A/c	Dr.		2,00,000	
	To Guber Ltd.				2,00,000
	(Amount Received from Guber)				
31 August 2011	Guber Ltd. A/c	Dr.		85,000	
	To Realization A/c				85,000
	(Interest for 5 Months on ₹ 17,00,000 as 12% p.a.)				
31 August 2011	Shares in Guber Ltd. A/c	Dr.		17,00,000	
	Debentures in Guber Ltd.	Dr.		4,80,000	
	Bank A/c	Dr.		22500	
	To Guber Ltd. A/c				22,02,500
	(Shares, Debentures and Cash Received from Guber Ltd. as Purchase Consideration)				
31 August 2011	Realization A/c	Dr.		2,500	
	To Guber Capital A/c				2,500
	(Profit on Realization Transferred to Capital A/c)				
31 August 2011	Guber Capital A/c	Dr.		24,02,500	
	To Bank A/c				2 22 500
	To Debentures in Guber Ltd. A/c				4 80 000
	To Shares in Guber Ltd.				17 00 000
	(Shares, Debentures and Cash Delivered to Guber)				

Illustration 5.14

The following was the balance sheet of L&M as on 31 December 2010:

Liabilities	₹	Assets	₹
Bills Payable	1,00,000	Cash and Bank	60,000
Sundry Creditors	2,75,000	Bills Receivable	60,000
Capital Accounts:		Sundry Debtors	3,00,000
L 7,00,000		Stock-in-Trade	3,30,000
M 3,00,000	10,00,000	Furniture	40,000
		Plant & Machinery	2,35,000
		Land & Building	3,50,000
	13,75,000		13,75,000

On 1 January 2011, the above business was purchased by Gopal Ltd. for ₹ 13,00,000 to be paid by the issue of equity shares of ₹ 100 each credited at ₹ 50 paid upon the following terms:

(a) Land & Building and Plant & Machinery to be taken at ₹ 5,00,000 and ₹ 2,00,000, respectively.

(b) The company did not take over the furniture which were disposable at ₹ 25,000 and did not take bills payable which were taken over by L at an agreed value of ₹ 90,000.

(c) A provision for doubtful debts was to be made at 2% on debtors.

(d) There was a claim for bills discounted amounted to ₹ 10,000 which was taken by the company.

(e) The company did not take over a workers claim amounted to .₹ 10,000 due to accident.

Show the entries in the books of Gopal Ltd. assuming that same set of books is continued.

Solution

Note

When same set of books is continued and entries to be recorded in the books of company, goodwill has to be computed separately as follows:

Determination of goodwill:

			₹	
Step 1:	Assets Taken Over:			
	Land & Building		5,00,000	
	Plant & Machinery		2,00,000	
	Stock-in-Trade		3,30,000	
	Debtors :	3,00,000		
	Less: Provision:	6,000	2,94,000	
	Bills Receivable		60,000	
	Cash and Bank		60,000	14,44,000
Step 2:	Liabilities Taken Over:			
	Creditors		2,75,000	
	Claim for Bills Discounted		10,000	2,85,000
Step 3:	Net Assets Taken Over (Step 1 – Step 2)			11,59,000
Step 4:	Purchase Consideration:			13,00,000
Step 5:	Goodwill (Step 4 – Step 3):			1,41,000

Books of Gopal Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 January 2011	Realization A/c Dr.		76,000	
	To Plant & Machinery A/c			35,000
	To Provision for Doubtful Debts A/c			6,000
	To Furniture A/c			15,000
	To Claim for Bill Discounted A/c			10,000
	To Claim for Accident A/c			10,000
	(Value of Assets Decreased and Liabilities Increased)			
1 January 2011	Bills Payable A/c Dr.		10,000	
	Land & Buildings A/c Dr.		1,50,000	
	To Revaluation A/c			1,60,000
	(Value of Assets Increased and Liability Decreased)			
1 January 2011	Goodwill A/c (Ref: Note Above) Dr.		1,41,000	
	To L's Capital A/c			70,500
	To M's Capital A/c			70,500
	(Goodwill Raised) (Distributed Equally as there is no Specific Agreement)			
1 January 2011	Revaluation A/c Dr.		84,000	
	(₹ 1,60,000 – 76,000)			
	To L's Capital A/c			42,000
	To M's Capital A/c			42,000
	(Profit on Revaluation Transferred to Capital Accounts of Partners Equally)			
1 January 2011	Bills Payable A/c Dr.		90,000	
	To L's Capital A/c			90,000
	(Bills Payable Taken Over by L)			
1 January 2011	Claim for Accident A/c Dr.		10,000	
	To L's Capital A/c			6,865
	To M's Capital A/c			3,135
	(Claim for Accident Distributed:			
	Note: Ratio for Distribution will be on the Basis of their Claims Ref: Calculation at the end of Journal) 451:206			
1 January 2011	L's Capital A/c Dr.		17,161	
	M's Capital A/c Dr.		7,839	
	To Furniture A/c			25,000
	(Amount Realized on Furniture Taken Over by L & M in 451:206)			

1 January 2011	L's Capital A/c Dr. M's Capital A/c Dr. To Equity Share Capital A/c (Purchase Consideration Final Amount Settled by Issue of 26,000 Shares of ₹100 Each and ₹50 Paid up) in 451:206 Ratio		8,92,390 4,07,610	 13,00,000

Computation of final Claim Ratio:

		L	M
		₹	₹
Balance b/d (Given)		7,00,000	3,00,000
Bills Payable		90,000	—
Goodwill		70,500	70,500
		8,60,500	3,70,500
Add: Revaluation Profit:		42,000	42,000
Final Claim :		9,02,500	4,12,500
Ratio: L:M	=	9,02,500:412,500	
	=	902:412	
	=	451:206	

Summary

When a company acquires or purchases the business of others, it is termed as purchase or acquisition of business. Seller concern may be a sole trader, or a partnership firm or an already functioning limited company.

Accounting treatment

Method I: When new set of books is opened, factors to be considered are (i) Assets taken over by the purchasing company; (ii) Liabilities taken over by the purchasing company and (iii) Purchase consideration.

(a) Net assets method and (b) Net payment method are the methods used to determine purchase consideration.

Goodwill: When the value of net assets is less than the purchase considerations, the difference is debited to goodwill account capital reserve: When the value of net assets is more than the purchase consideration, the difference is credited to capital reserve A/c.

The journal entries for various transactions which have to be passed in the books of purchasing company and in the books of the vendor: Refer text.

Method of dealing with debtors and creditors is dealt with in illustrations. (Ref: Illustrations 5.1 to 5.9)

Method II: When same set of books is continued, the important steps involved in accounting treatment are discussed in detail (Ref: The text and Illustrations 5.9 to 5.14)

Key Terms

Acquisition of Business (Purchase of Business): The process of taking over the business of sole trader or firm or an already existing company by a limited company.

Purchaser: The company which acquires the business of others.

Vendor: The selling business concern in the process of acquisition of business.

Purchase Consideration: The purchase price paid by the limited company to the selling concern.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. In the absence of a contract to the contrary, miscellaneous expenses are also taken over by the purchasing company.
2. In the absence of a contract to the contrary, the purchasing company will not take over the liabilities that belong to the shareholders.
3. As purchase consideration must always be given in the question, no need to compute it arises.
4. Purchase consideration must be paid in cash only.
5. When the value of net assets is less than the purchase price, the difference has to be credited to goodwill A/c.
6. Profit at the time of acquisition, if any, has to be credited to capital reserve A/c.
7. When interest is paid on purchase price, interest account is to be debited.
8. Purchasing company is paid commission for realizing book debts and discharging liabilities by the vendor.
9. Any profit or loss that will arise in collecting debts and paying creditors must be borne by the purchaser.
10. When debtors and creditors are taken over on behalf of vendors, the debtors and creditors will be included with the main entries for acquisition of business, in the books of purchasing company.
11. When the same set of books is continued, realization A/c has to be opened.
12. When discount is allowed to vendor's debtors, it will be debited to vendor's suspense A/c

Answers:

1. False	2. True	3. False
4. False	5. False	6. True
7. False	8. True	9. False
10. False	11. True	12. True

II: Fill in the blanks with apt word(s)

1. In the process of acquisition of business, newly formed limited companies purchase the business of _____ or _____ form of business concerns.
2. The seller concern is termed as _____ in the acquisition of business.
3. Purchase price paid by the purchasing company to the selling business concern is known as____.
4. _____ assets are not taken over by the purchasing company.
5. All _____ liabilities are taken over by the purchasing company.
6. When the value of net assets is less than the purchase price, the difference is debited to _____ A/c.
7. When the value of net assets is more than the purchase price, the difference is credited to ____ A/c.
8. When debtors and creditors are taken over on behalf of vendors by the purchasing company, it has to open _____ A/c in the books.
9. When the same set of books is continued, _____ and _____ A/c should not be closed.
10. When the same set of books is continued, a separate account for debtors should be opened under the head _____ A/c.
11. The purchasing company _____ the vendor's A/c with the purchase price at the time of acquisition.

12. When shares or debentures are issued at a premium, _____ A/c has to be credited with premium amount.

Answers:

1. sole trader or firm
2. vendor
3. purchase consideration
4. Fictious
5. external
6. goodwill
7. capital reserve
8. vendor's suspense
9. debtors; creditors
10. debtor's suspense
11. creditors
12. securities premium

III: Multiple choice questions—Choose the correct answer

1. On acquisition of business, which of the following item is not taken over by the purchasing company (in the absence of contract):
   (a) profit and loss A/c (debit balance)
   (b) cash balance
   (c) bank balance
   (d) none of these
2. On purchase of business, which of the following is taken over by the purchasing company (in the absence of agreement):
   (a) share capital
   (b) external liabilities
   (c) reserve fund
   (d) undistributed profits
3. The accounting treatment with respect to acquisition of business will be by using
   (a) when new set of books is opened
   (b) when the same set of books is continued
   (c) a & b
   (d) none of these
4. Purchase consideration can be paid by the company in
   (a) shares (b) debentures
   (c) cash (d) all of the above
5. Goodwill A/c will be debited with the difference amount
   (a) when the value of net assets is less than purchase price
   (b) when the value of net assets is greater than purchase price
   (c) a & b
   (d) none of the above
6. If the interest is due on the purchase price, the account to be debited is
   (a) vendor's account
   (b) bank A/c
   (c) interest A/c
   (d) vendor's suspense A/c
7. Any profit or loss arising on account of realizing book debts and discharging creditors will be borne by
   (a) the purchasing company
   (b) the vendor
   (c) a & b
   (d) none of these
8. The excess of net assets over purchase consideration is
   (a) goodwill
   (b) net loss
   (c) capital reserve
   (d) balance in suspense A/c
9. When debtors and creditors are taken over on behalf of vendors, the account to be opened by the purchasing company in its books is
   (a) debtor's suspense A/c
   (b) creditor's suspense A/c
   (c) a & b
   (d) vendor's suspense A/c
10. When the same set of books is continued, amounts realized from the proceeds of assets taken over by partners will be distributed in the ration of
    (a) profit sharing
    (b) capitals
    (c) 1:1 (equal)
    (d) final claim

Answers:

1. (a) 2. (b) 3. (c) 4. (d)
5. (a) 6. (c) 7. (b) 8. (c)
9. (d) 10. (d)

Short Answer Questions

1. Explain the term "acquisition of business".
2. Name the two approaches for accounting treatment relating to purchase of business.
3. Name the assets not taken over in the absence of an agreement.
4. In the absence of a contract to the contrary, name the liabilities which are not taken over by the purchaser.
5. How "goodwill" will be computed?
6. How "capital reserve" will be determined?
7. What do you mean by "vendor's suspense A/c"?
8. Name the two accounts that should be opened for debtors and creditors (not taken over) when the same set of books in continued.

Essay Type Questions

1. Explain the meaning of "acquisition of business". What do you mean by conversion? What are the reasons for such conversion?
2. Explain in detail the important factors which are to be taken into account, when new set of books is opened?
3. Enumerate the journal entries that are to be passed by the purchasing company in its books on acquisition of business, when new books are opened?
4. What are the journal entries that are to be passed in the books of vendor in the process of acquisition of business when new books are opened?
5. Explain the accounting treatment for "debtors and creditors not taken over by the purchasing company," when new books of account are opened?
6. Explain the important steps to be taken when the same set of books will be continued after acquisition process.
7. What are the necessary journal entries to be passed when the same set of books is continued?
8. Explain the accounting treatment for debtors and creditors not taken over by the purchasing company when the same set of books is continued.

Exercises

Part A—For Undergraduate Level

1. X Ltd. was registered with a capital of ₹50,00,000 consisting of 25,000 equity shares of ₹100 each and 25,000 14% preference shares of ₹100 each. It purchased the going concern of M/S Tom & Dick for ₹12,50,000 on the basis of the following balance sheet:

Balance Sheet of Tom & Dick
as on …

Liabilities	₹	Assets	₹
Bills Payable	95,000	Cash at Bank	20,000
Sundry Creditors	4,00,000	Bills Receivable	25,000
Capital	11,00,000	Book Debts	2,50,000
		Stock	3,50,000
		Furniture	50,000
		Plant & Machinery	6,00,000
		Freehold Premises	3,00,000
	15,95,000		15,95,000

The purchase price was to be paid: ₹2,50,000 in fully paid equity shares; ₹2,50,000 in fully paid preference shares, ₹2,50,000 in fully paid debentures and the balance in cash. The remainder of the shares were offered to the public payable ₹20 per share on application, ₹30 on allotment and ₹40 on first call and were taken up and paid for. The vendors were duly paid the purchase consideration.

Record the above transactions by means of journal entries and draw up the company's balance sheet.

[**Ans:** Goodwill: ₹1,50,000; Final call not yet made;

Balance sheet total: ₹52,95,000]

2. Ajay & Co. Ltd. was incorporated to acquire the business of Vivek whose balance sheet was as follows:

Liabilities	₹	Assets	₹
Creditors	24,000	Land	1,44,000
Capital	4,80,000	Furniture	30,000
		Stock	2,34,000
		Debtors	54,000
		Bank	42,000
	5,04,000		5,04,000

The purchase consideration was agreed at ₹ 6,00,000 which was to be paid as:

(i) 16,800 equity shares of ₹20 each

(ii) ₹2,04,000 in preference shares of ₹100 each and

(iii) the balance in cash

The company raised further capital by issue of 45,000 equity shares of ₹20 each payable ₹10 on application and ₹10 on allotment. After receipt of all the money for shares issued, the company purchased buildings worth ₹4,80,000. Pass journal entries in the books of the company and prepare the balance sheet.

[**Ans:** Goodwill: ₹1,20,000; Balance sheet total: ₹14,64,000]

3. A company was formed with an authorized capital of ₹30,00,000 divided into 1,50,000 equity shares of ₹100 each, 15,000 9% preference shares of ₹100 each to purchase the going concern of M/s Raju & Co. the balance sheet of which stood as follows:

Liabilities	₹	Assets	₹
Bills Payable	21,000	Cash	27,000
Creditors	38,400	Debtors	45,000
Capital	7,92,600	Stock	2,10,000
		Machinery	3,00,000
		Buildings	2,70,000
	8,52,000		8,52,000

The purchase price was agreed up on at ₹10,50,000, payable as to ₹3,00,000 in fully paid up equity shares, ₹3,00,000 in fully paid preference shares, ₹1,80,000 in redeemable debenture and the balance in cash.

The remaining shares were issued to and paid for by the public with the exception of ₹30 per share on 360 equity shares which were forfeited and reissued at a discount of 20%.

Give journal entries to record these transactions in the books of the company and prepare the initial balance sheet.

[**Ans:** Goodwill: ₹2,57,400;

Balance sheet total: ₹32,57,400]

4. The balance sheet of A, B and C stood as under when they sold off their concern to newly started joint stock company:

Liabilities		₹	Assets	₹
Capital A/c	₹		Land & Buildings	2,80,000
A	4,50,000		Machinery	1,40,000
B	3,00,000		Stock	2,60,000
C	1,50,000	9,00,000	Bills Receivable	1,20,000
Creditors		80,000	Debtors	1,80,000
		9,80,000		9,80,000

The joint stock company was started with a capital of ₹20,00,000 divided into 10,000 shares of ₹200 each. It also issues debentures for ₹10,00,000 at a discount of 5%. The entire concern of A, B and C was taken up by the company on agreeing to pay them ₹9,60,000 by the issue of 2,400 shares fully paid and ₹4,80,000 in cash.

All the debentures and the remaining shares are issued to the public which are all taken up and paid for with the exception of 1,000 shares held by X on which he has not paid the final call of ₹80 per share which were forfeited and reissued as fully paid at a discount of ₹40 per share. The company paid ₹10,000 for preliminary expenses.

Pass the necessary journal entries in the books of the company and prepare its balance sheet.

[**Ans:** Goodwill: ₹60,000; Capital reserve: ₹80,000;

Balance sheet total: ₹31,60,000]

5. On 1 April 2011, a company has bought certain assets from Raghu. The company also undertook to collect his debts amounting to ₹7,80,000 and to pay his creditors of ₹1,80,000 for a commission of 3% on the amount collected and 1% on the amount paid. The debtors realized ₹7,20,000 only and the creditors were paid ₹1,68,000 in full settlement. Raghu received ₹3,00,000 8% debentures at 90% and the balance in cash.

Journalise the transactions in the books of the company

[**Ans:** Commission due from vendor: ₹23,280;
Cash paid to vendor: ₹2,58,720]

6. On 1 January 2011, Vincent Ltd. acquired the business of Sagar taking all the assets with the exception of book debts which it undertook to collect on behalf of Sagar and out of the proceeds pay the liabilities owning at the date of transfer. At that date, the book debts amounted to ₹2,70,000 and creditors ₹1,85,000. The company agreed to do the job for vendors on 3% commission on amounts collected and 1% on amount paid.

   The company could not collect ₹14,000 from the existing debtors and allowed ₹1,500 as cash discount to the remaining debtors. The company could collect the time-barred debt (which was written off as bad by the vendors) of ₹10,000. The company paid ₹1,75,000 to creditors in satisfaction of total amount due. However, the company was forced to meet a contingent liability on bills discounted by the vendors of ₹15,000. Give journal entries (including that of cash) in the books of Vincent Ltd.

   [**Ans:** Commission: ₹9,835;
   Final payment to vendors: ₹64,665]

7. A and B are in partnership in computer components manufacturers. The balance sheet of A and B as on 31 December 2010 was as follows:

Liabilities	₹	**Assets**	₹
Creditors	2,62,100	Cash at Bank	82,500
Capital Accounts:		Debtors	5,28,600
A: 7,95,100		Stock	4,40,900
B: 7,95,100	15,90,200	Plant	5,00,300
		Land & Buildings	3,00,000
	18,52,300		18,52,300

They decided to sell their business as from the above date to Chips Ltd. The Company acquires the stock, plant, Land & Buildings and goodwill for which the vendors receive ₹15,00,000 in fully paid up equity shares of ₹100 each. The Company agrees to pay creditors and collect the book debts on behalf o the vendors for a commission of 3% on cash collected and 2% on amounts paid.

By March 2011, the creditors have all been paid and the amount so paid is ₹2,76,300. Also, the book debts have all been collected or accounted for and have realized ₹5,21,300. Accordingly on 31 March, the vendors were paid the balance which the company holds to credit. Pass the journal entries in the books of the company and show the vendor's suspense account.

[**Ans:** Commission: ₹21,165; Final payments to vendors: ₹2,23,835]

8. M/s Anju & Manju carrying on business in partnership decided to dissolve the firm and sell off the business to a limited company, a newly floated one, on 31 December 2010, when the firm's position was as follows:

Liabilities	₹	**Assets**	₹
Creditors	2,55,000	Furniture	39,840
Capital Accounts		Stock	1,84,560
Anju 4,08,000		Debtors	5,81,400
Manju 2,04,000	6,12,000	Cash	61,200
	8,67,000		8,67,000

The arrangement with the limited company was as follows:

(i) Furniture and stock were purchased at balance sheet values less 10%.

(ii) Goodwill of the firm was valued at ₹1,21,440.

(iii) The firm's debtors, cash and creditors were not to be taken over by the company, but the company agreed to collect the book debts and discharge the liabilities of the vendor as agent, for which service the company was to be paid 3% on all collections from the vendor's debtors and 2% cash paid to vendor's creditors.

(iv) The purchase price was to be paid to the company in fully paid ordinary shares of ₹50 each at a premium of ₹10 per share

The company received ₹5,76,000 from vendor's debtors in full satisfaction during the first 2 months after purchase of business. The creditors were paid off, ₹3,000 being allowed by them as discount. The company paid the balance due to the vendors on 1 March 2011. (Ignore the question of in term distribution of cash.)

Write up journal entries and balance sheet in the company's books.

[**Ans:** Purchase consideration: ₹ 3,23,400;
Commission: ₹ 22,320;
Purchase price paid: 5388 shares;
Balance sheet total: ₹ 3,45,600]

9. AB & Co. is converted into a limited company but the same books of accounts are desired to be continued. The balance sheet with reference to which the conversion has taken place is given as follows:

Liabilities	₹	Assets	₹
Capital Accounts		Machinery	15,00,000
A 30,00,000		Car	5,00,000
B 20,00,000	50,00,000	Stock	25,00,000
Reserve	5,00,000	Debtors	19,00,000
Creditors	10,00,000	Cash	1,00,000
	65,00,000		65,00,000

Goodwill is valued at ₹ 12,50,000. Car is taken up by A at an agreed value of ₹ 1,50,000. Stock and machinery are valued at ₹ 27,50,000 and 17,50,000, respectively.

The partners are issued required number of shares of ₹ 100 each at par.

Pass journal entries and draft the Balance Sheet of the Limited Company.

[**Ans:** Amount payable to A is ₹ 38,00,000 and B is ₹ 29,50,000;
Balance sheet total: ₹ 77,50,000]

10. Sharma and Varma were carrying on business in partnership sharing profits and losses in the ratio 3:2. They sell their business to a limited company on 31 March 2011 and on that date their balance sheet stood as follows:

Liabilities	₹	Assets	₹
Capital Accounts		Plant & Machinery	3,60,000
Sharma 4,80,000		Land & Building	2,40,000
Varma 3,60,000	8,40,000	Investment	1,20,000
Reserve Fund	1,20,000	Stock	2,40,000
Creditors	2,40,000	Debtors	1,80,000
		Cash and Bank	60,000
	12,00,000		12,00,000

A limited company having an authorized capital of ₹ 30,00,000 in equity shares of ₹ 100 each purchased the above business under the following terms:

(a) Goodwill was valued at ₹ 2,40,000.
(b) Depreciation on plant & machinery was @ 10% and appreciation of land & buildings was by 20%.
(c) A provision of doubtful debts @ 5% on debtors was allowed.
(d) Investment was taken over by Varma at an agreed value of ₹ 96,000.
(e) Total purchase consideration was to be satisfied by the issue of fully paid equity shares of ₹ 100 each.

Show the journal entries and the revised balance sheet assuming that the same set of books is continued.

[**Ans:** Revaluation loss: ₹ 21,000;
Purchase consideration: ₹ 10,83,000;
Balance sheet total: ₹ 13,23,000]

Exercises

Part B—For Advanced Level

11. On 1 January 2010, Patel sells his business to Rao Ltd. The company took over the assets and liabilities for a purchase consideration of ₹ 4,25,000 being paid equally in cash and shares of ₹ 50 each fully paid up. Patel received ₹ 75,000 on account in 2010 from the company but no other entries have been made.

The balance sheet of Patel's business on the date of sale was as follows:

Liabilities	₹	Assets	₹
Capital	4,20,000	Fixed assets	1,40,000
Trade Creditors	1,80,000	Sundry Debtors	3,00,000
		Stock	1,60,000
	6,00,000		6,00,000

Fixed assets and stock were to be revalued at ₹ 1,25,000 and ₹ 1,40,000, respectively.

In addition to matters arising out of the above, there were the following balances in the books of Rao Ltd. as on 31 December 2010:

Sundry Assets	₹	Sundry Expenses	₹
Patel Vendor	3,45,000	Salary	90,000
Debtors	2,75,000	Shop Rent	22,000
Fixed Assets	1,40,000	Printing Charges	16,000
Stock Taken Over	1,60,000	Telephone Charges	27,000
Purchases	2,25,000	Bonus to Staff	18,000
Bank	64,000	Audit Fees	5,000
Share Capital	1,80,000		
Sales	3,29,000		
Sundry Creditors	1,90,000		

Stock on hand on 31 December 2010 ₹2,00,000.

Show the needed journal entries in the books of the company to give effect to the above arrangement and prepare the adjusted trial balance P&L A/c of the year ended 31 December 2010 and the balance sheet as at that date of Rao Ltd.

[C.A. (Inter). Modified]

[**Ans:** Goodwill: ₹40,000; Shares issued for consideration: 2,12,500;

Adjusted trial balance total: ₹10,49,000;

Gross profit: ₹1,64,000; Net loss:₹16,000;

Balance sheet total: ₹7,20,000]

[Vendor shown as creditor: ₹1,37,500]

12. M and N are proprietors of a competing business. In order to protect their business, they float a company called M&N Ltd. with an authorized capital of ₹30,00,000 divided into 1,80,000 equity shares of ₹10 each and 12,000 12% preference shares of ₹100 each.

On the date of the transfer, M's assets amount to ₹7,96,050 excluding goodwill. His liabilities at the same time amount to ₹97,800. On the same date, N's assets amount to ₹5,85,000 excluding goodwill and his liabilities to ₹45,000. It is agreed that the company will take over the assets and liabilities of both M and N and will issue to each 45,000 equity shares fully paid up and pay the balance in cash. It is also agreed that fully paid up preference shares will be issued to them on account of goodwill which is to be valued on the basis of two years' purchases of the last three year's profits which are as follows:

	M	N
	₹	₹
First year	48,000	24,000
Second year	36,000	33,000
Third year	33,000	42,000

In addition to the above, the public subscribe and pay in full for 60,000 equity shares and the remaining preference shares. The company also pays ₹45,000 as preliminary expenses.

You are required to show the vendor's accounts in the company's ledger and prepare the balance sheet of the company after these transactions are completed.

[**Ans:** Total of balance sheet: ₹28,42,800]

13. The following is the balance sheet of M/s P & Q as on 31 March 2011:

Liabilities	₹	Assets	₹
Sundry Creditors	80,000	Land & Building	4,00,000
Mrs. P's Loan	3,60,000	Plant & Machinery	3,20,000
Capital Accounts		Stock in Trade	1,20,000
P: 4,80,000		Sundry Debtors	2,00,000
Q: 3,20,000	8,00,000	Investments	1,60,000
		Cash at Bank	40,000
	12,40,000		12,40,000

Profits were shared as two-thirds to P and one-thirds to Q. On 1 April 2011, PQ Ltd. purchased the business of M/s P & Q for a payment of ₹12,00,000 to be made in the form of equity shares of ₹100 each credited as ₹80 paid. The company did not take over the investments and Mrs. P's loan. The company also decided to revalue land and buildings as ₹5,40,000, plant and machinery at ₹2,80,000; and to create a provision of doubtful debts at 5% on debtors. There was a claim by a worker for ₹12,000 for injuries in an accident. The company decided to admit the claim. Out of the investments, ₹24,000 worth are worthless. Mrs. P. agrees to receive the

remaining investments and 2,800 shares of PQ Ltd. in settlement of her loan.

The company decides to retain the books of account of the firm. Journalise.

[**Ans:** Goodwill: ₹ 1,22,000; Revaluation profit: ₹ 78,000]

14. The balance sheet of X, Y & Z stood as follows when they sold off the concern to a newly started joint stock company.

Liabilities	₹	**Assets**	₹
Capital Accounts		Land & Buildings	1,68,000
X 2,70,000		Machinery	84,000
Y 1,80,000		Stock	1,56,000
Z 90,000	5,40,000	Debtors	1,08,000
Sundry Creditors	48,000	Bills Receivable	72,000
	5,88,000		5,88,000

The joint stock company was started with a capital of ₹ 12,00,000 divided into 12,000 shares of ₹ 100 each. It also issued debentures for ₹ 6,00,000 at a discount of 5%.

The entire concern of X, Y & Z was taken by the company on agreeing to pay them ₹ 2,88,000 by the allotment of 2,880 shares fully paid and ₹ 2,88,000 in cash.

All the debentures and the remaining shares are issued to the public which were all taken up and paid for with the exception of 1,200 shares held by Mr. C on which he did not pay the final call of ₹ 40 per share which were forfeited and reissued as fully paid as ₹ 20 per share. The company paid ₹ 6,000 as preliminary expenses.

Pass the necessary entries in the books of the company and prepare the balance sheet.

[**Ans:** Balance sheet total: ₹ 18,96,000]

15. X Ltd. was incorporated for taking over the business of Y from 1 April 2011. The following was the balance sheet of Y as on 31 March 2011:

Liabilities	₹	**Assets**	₹
Capital	2,01,600	Land & Buildings	3,20,000
Loan Creditors	2,40,000	Plant & Machinery	56,000
Trade Creditors	1,42,400	Furniture	40,000
		Sundry Debtors	1,68,000
	5,84,000		5,84,000

The company took over the business with fixed assets and loans on the following terms:

(a) The fixed assets should be depreciated at 10%.

(b) The value of goodwill is estimated at Rs. 1,60,000.

The company realized ₹ 1,60,000 from sundry debtors as the agent of the vendor in full settlement and discharged all the creditors by paying ₹ 1,36,000 for a commission of 3% on the amount collected and 2% on the amount paid.

The loan creditors accepted 10% preference shares of ₹ 100 each in discharge of the loans.

After realization of the debts and discharge of the liabilities, the total amount due to the vendor was settled by payment of ₹ 10,880 in cash and the balance in the shape of fully paid equity shares of ₹ 10 each.

Show purchase consideration and pass journal entries in the books of the company. Also give the balance sheet of the company after taking over the business of Y.

[C.S. (Inter). Modified]

[**Ans:** Purchase consideration: ₹ 2,94,400;
Total of balance sheet: ₹ 5,46,520]

Profits Prior to Incorporation 6

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Understand "profits/losses prior to incorporation".
2. Treat profits and losses prior to incorporation in the books of accounts of a company.
3. Ascertain profit or loss prior to incorporation by applying various methods.
4. Understand the different "ratios" used in ascertaining profit prior to incorporation.
5. Apportion various expenses and incomes between pre- and post-incorporation periods using different bases.
6. Allocate certain expenses wholly to pre- or post-incorporation periods directly.
7. Prepare profit and loss account and balance sheet in addition to the statement of profit/loss prior to and after incorporation.
8. Appreciate and comply with the provisions envisaged in Accounting Standard-5, while solving problems.

Companies may absorb or acquire the business of other companies in case if a company acquires the business of another business concern (sole proprietorship or partnership firm), it is referred to as "acquisition" of business. In such cases, the question of determining profit or loss prior to incorporation arises. This question arises due to the fact that the date of acquisition may differ from the date of incorporation. In this chapter, such tricky problem of ascertaining profit or loss prior to incorporation is explained in detail.

6.1 MEANING

A company, generally, is floated by promoters. Sometimes, a running business may be acquired by another company. A new company may also be formed by acquiring the running business of a sole trader or partnership firms. A public limited company has to get (1) Certificate of Incorporation and (2) Certificate of Commencement of Business. So, it is natural that some momentary transactions will occur resulting in profit/loss even before the company attains the legal status. Only after getting the Certificate of Incorporation that the company comes into existence. But it should be noted here that a public limited company cannot commence its business till the Certificate of Commencement of Business is obtained.

Under such circumstances, the new company is entitled to all profits earned after the purchase or conversion of business till the date of incorporation. Such profit is referred to as "profit prior to incorporation".

Such profit is not to be taken as "normal trading profit" or "revenue profit". All profits/losses before the commencement of business are treated as "capital" item, which will increase/decrease the "net assets" of the company. For all practical accounting purposes, "Profit prior to incorporation denotes the profits earned up to the date of incorporation and not up to the date of commencement of business". Though the requirement of Certificate of Commencement of Business is a legal necessity, the profits are ascertained up to the date of incorporation. This is due to the reason that a company has got inherent powers to carry on a business "relates back" to the date of incorporation, once the certificate to commence business is obtained.

6.2 ACCOUNTING TREATMENT OF PROFITS/LOSSES PRIOR TO INCORPORATION IN THE BOOKS OF THE COMPANY

6.2.1 Profits Prior to Incorporation

1. Such profit should not be taken to profit and loss account of the company, the reason being capital in nature.
2. (i) Such profit should be credited to "Capital Reserve Account". (This is utilized to write off: (a) capital losses, (b) preliminary expenses, (c) discount on issue of debentures and (d) undertaking commission)
   (ii) Unutilized part of capital reserve is to be shown on the liabilities side of the balance sheet under the head, "Reserves & Surpluses".

6.2.2 Losses Prior to Incorporation

1. Such loss should not be taken to profit and loss account because it is a capital loss and not revenue loss.
2. This may be treated in one of the following ways:
   (i) This may be debited to "Loss prior to incorporation account" as a separate account.
   This should be shown on the assets side of the balance sheet under the head "Miscellaneous Expenditure."

   (OR)

   (ii) The loss may be treated as goodwill and debited to goodwill account.

   (OR)

   (iii) Such loss may be treated as "Deferred Revenue Expenditure" to be written off out of the profits of the company over a number of accounting years.

6.3 METHODS OF ASCERTAINING PROFIT OR LOSS PRIOR TO INCORPORATION

6.3.1 Method 1: Period: Up to the Date of Incorporation

Desired Account: Trial balance and profit and loss account. Under this method, first a trial balance is to be prepared up to the date of incorporation of the company. On that date, closing stock is to be valued. Then in usual way, trading and P&L A/c is to be prepared to ascertain profit or loss. Again, at the end of the year, P&L A/c is to be prepared to ascertain profit/loss for the post-incorporation period. Although an accurate way of ascertaining the net result, this method is not in practice as it affects the normal course of business operations.

6.3.2 Method 2: Period: For the Whole Year up to the End of an Accounting Year

Desired Account: Trading and profit and loss account. Under this method, only at the end of the accounting period, trading and profit and loss account is prepared in the usual manner.

A separate statement (depicting pre- and post-incorporation profit) is to be prepared in which the expenses incurred are apportioned between the pre- and post-incorporation periods.

The profit or loss (post-incorporation period) is to be incorporated in the P&L A/c and the profit (prior to incorporation) is to be shown as Capital Reserve A/c in the balance sheet. The loss prior to incorporation may either be separately shown in the balance sheet or debited to goodwill account.

6.3.3 Method 3: Period: For the Whole Year up to the End of the Accounting Year

Under this method, Trial balance and trading account are prepared.

Here, profit and loss account is prepared in columnar form, with columns for pre- and post-incorporation periods. All expenses and gross profit are to be apportioned on a suitable basis for pre- and post-incorporation periods.

6.4 BASIS OF APPORTIONMENT OF EXPENSES

6.4.1 Sales Ratio

Sales ratio is the ratio of sales of the company prior to incorporation and post-incorporation.

To illustrate: sales before incorporation are ₹2,00,000 and sales after incorporation are ₹3,00,000, sales ratio is 2,00,000:3,00,000 (or) 2:3.

All expenses associated with sales are to be allocated in the ratio of the sales. For example, carriage outwards, discount allowed, commission to salesman, sales promotion expenses, bad debts, etc.

Gross profit is to be allocated on the basis of sales ratio.

6.4.2 Weighted Sales Ratio

In case sales are not uniform throughout the accounting year, weightage should be given to the trends observed in the sales. Adjustments have to be made based on the charge in trend. The resultant is due to weighted sales ratio.

6.4.3 Time Ratio

Time ratio is the ratio of periods (months or days) prior incorporation and post-incorporation in an accounting period.

To illustrate: A company was acquired on 1 April 2010, incorporated on 1 June 2010 and accounts closed on 31 March 2011, the time ratio is:

1 April 2010 to 1 June 2010: (Prior incorporation)	2 months
1 July 2010 to 31 March 2011: (Post-incorporation)	10 months
The time ratio is	2:10 or 1:5

Expenses incurred with respect to time are to be allocated on the basis of the time ratio, e.g., salaries, rent, interest, depreciation, bank charges, stationery postage, etc.

6.4.4 Weighted Time Ratio

In case of any changes made to the number of employees, weightage should be give to such changes by arriving at the time ratio. Also, when some expenses are incurred specifically pertaining to a part of the accounting period, separate ratio has to be ascertained.

6.4.5 Specific Expenses and Specific Allocation

Some specific expenses which are related to the respective period (pre- or post-incorporation) may be allocated to the respective period. For example, preliminary expenses written off, debenture interest, director's fees and the like are associated only with post-incorporation period and hence should be allocated only to post-incorporation period. Similarly, interest or purchase price is to be allocated entirely to the pre-incorporation period.

6.4.6 Actual Expenses With Respect To Items

In case of availability of details on how much was spent on each item or activity in pre- or post-incorporation period specifically, then that actual expense should be directly allotted to that particular period.

6.4.7 Various Items and Their Bases of Apportionment

Various items and their bases for apportionment are shown in the following:

Item	Basis for Apportionment
1. Gross profit/loss	Sales ratio/weighted sales ration
2. Variable expenses that vary in direct proportion to sales	Sales ratio/weighed sales ratio
3. All fixed expenses	Time ratio/weighted time ratio
4. Expenses specifically related to pre-incorporation period	Allocation to the pre-incorporation period only
5. All expenses specifically related to post-incorporation period	Allocation to post-incorporation period only
6. Actual expenses that are explicitly and specifically related to pre- or post-incorporation period	Allocation to respective periods only

Illustration 6.1

Model: Time ratio basis of apportionment

Niwas, an industrialist (SME category), decided to convert his firm into a limited company from 1 July 2010. He obtained the Certificate of Incorporation on 1 October 2010 and the Certificate of Commencement of Business on 1 December 2010. His accounts were to be closed on 31 March 2011.

Compute the time ratio to ascertain pre-incorporation profit.

Solution

Step 1: First, Calculate the Pre-incorporation Period as:

Pre-incorporation Period (from 1 July 2010 to 1 October 2010) = 3 months

Step 2: Calculate Post-incorporation Period as:

Post-incorporation Period (from 1 October 2010 to 31 March 2011) = 6 months

Step 3: Time ratio = Pre-incorporation period:Post-incorporation period

= 3 months:6 months

= 3:6 (or) 1:2

Illustration 6.2

Model: Weighted time ratio

Based on the same figures as in Illustration 6.1, there were 20 employees in the firm on 1 July 2010 and 10 more employees were appointed on 1 October 2010.

You are required to ascertain the weighted time ratio for allocating salaries of employees between pre- and post-incorporation period.

Solution

Step 1: Time Ratio is to be Ascertained as in Illustration No.1

Step 2: Now, this time ratio has to be adjusted or the weightage has to be given on the number of employees as:

(i) Number of employees in pre-incorporation period of 3 months}: 20

(ii) Number of employees in the post-incorporation period of 6 months}: 20 + 10 = 30

Step 3: Weighted Time Ratio

Time Ratio = 3:6

Weighted Time Ratio = 3×20 (Number of Employees in Pre-incorporation Period) : 6×30 (Number of Employees in Post-incorporation Period)

= 60:180 (or) 1:3

Step 4: Salaries of employees for the accounting year, i.e. 2010–11, has to be divided on the basis of 1:3

Illustration 6.3

Model: Weighted sales ratio (Uniform sales)

Mr. X and Mr. Y, partners of a business firm, agreed to sell the firm to a limited company on 1 April 2010. It was incorporated on 1 June 2010. It got Certificate of Commencement of Business on 1 August 2010. Final accounts were prepared on 31 March 2011. It was found that the sales were uniform up to the date of incorporation but went up by 50% on an average thereafter.

Compute the weighted sales ratio.

Solution

Step 1: Assume and give weightage of "1' to each month before incorporation

Step 2: Sales went up by 50% on an average after incorporation. So weightage will increase by 50% for each month 1 + 50% = 1 + 0.5 = 1.5

Step 3: Pre-incorporation Period: From 1 April to 1 June — 2 months

Step 4: Post-incorporation Period: From 1 June to 31 March — 10 months

Step 5: Weighted Sales Ratio = (2 months × 1):(10 months × 1.5)

(Pre-incorporation Period × Weightage):[(Post-incorporation Period × Weightage)]

= 2:15

Illustration 6.4

Model: Weighted sales ratio (Sales are not uniform)

Devi Ltd. was formed on 1 October 2010 to acquire the business of Raju & Co. with effect from 1 April 2010. When the company's first accounts were prepared on 31 March 2011, the following were noted:

1. Sales for the year: ₹ 3,60,000.
2. Sales in April, May, July and August were only 50% of the annual average.
3. Sales in November, December and March were twice the annual average.

You are required to compute the weighted sales ratio.

Solution

Step 1:	Calculation of Average Sales Per Months:		₹
	$= \frac{\text{Sales for the year}}{\text{Number of months}} = \frac{₹\,3,60,000}{12}$	=	30,000
Step 2:	Sales for April, May, July and August 50% of annual average $= ₹\,30,000 \times \frac{50}{100} \times 4$ months (Step 1)	=	60,000
Step 3:	Sales for November, December and March Twice the annual average $2 \times ₹\,30,000 \times 3$ months	=	1,80,000
Step 4:	Total Sales for 7 months (Step 2 + Step 3)	=	2,40,000
Step 5:	Sales for Remaining 5 Months Sales for the year – Sales for 7 months (Given) (Step 4) ₹ 3,60,000 – ₹ 2,40,000	=	1,20,000
Step 6:	Average Sales for the Remaining 5 Months ₹ 1,20,000 ÷ 5	=	24,000
Step 7:	Pre-incorporation Period 1 April 2010 to 1 October 2010 1. Pre-incorporation Sales for the months of April, May, July and August (Ref: Step: 2)	=	60,000
	2. Remaining months during pre-incorporation period are June and September: 2 months sales for these two months at average sales (Ref: Step 6) – 48,000 ∵ ₹ 24,000 × 2	=	48,000
Step 8:	Total Pre-incorporation Sales	=	1,08,000
Step 9:	Post-incorporation Sales: Yearly Sale – Pre-incorporation Sale ₹ 3,60,000 – ₹ 1,08,000 (Given) (Step 8)	=	2,52,000

Step 10: Weighted Sales Ratio = Step 8:Step 9
= ₹1,08,000: ₹2,52,000 (or) 18:42 (or) = 3:7

Illustration 6.5

Model: Pre- and post-incorporation profits (statement method) time and sales ratios and allocation

Thambu Ltd. was registered on 1 October 2009 to acquire the running business of Shetty & Co. with effect from 1 April 2009. The following was the profit and loss account of the company as on 31 March 2010:

Particulars	₹	Particulars	₹
To Office Expenses	70,000	By Gross Profit b/d	3,00,000
To Formation Expenses (Written off)	20,000		
To Stationery and Postage …	10,000		
To Selling Expenses	90,000		
To Director's Fees	30,000		
To Net Profit	80,000		
	3,00,000		3,00,000

You are required to prepare a statement showing profit earned by the company in the pre- and post-incorporation periods. The total sales for the year took place in the ratio of 1:2 before and after incorporation, respectively.

[Madras University Modified]

Solution

Statement showing pre- and post-incorporation profits for the year ended 31 March 2010.

Particulars	Basis of Apportionment	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Step 1 GROSS PROFIT	Sales Ratio 1:2 (Given)	3,00,000 —	1,00,000 $\left(3,00,000 \times \frac{1}{3}\right)$	2,00,000 $\left(3,00,000 \times \frac{2}{3}\right)$
Step 2 Expenses:				
(i) Office Expenses	Time Ratio 6:6 (Or) 1:1	70,000	35,000 $\left(70,000 \times \frac{1}{2}\right)$	35,000 $\left(70,000 \times \frac{1}{2}\right)$
(ii) Formation Expenses	Allocation	20,000	5,000	20,000
(iii) Stationery & Postage	Time Ratio 1:1	10,000	30,000	5,000
(iv) Selling Expenses	Sales Ratio 1:2	90,000	30,000 $\left(90,0000 \times \frac{1}{3}\right)$ —	60,000 $\left(90,000 \times \frac{2}{3}\right)$
(v) Director's Fees	Allocation	30,000		30,000
Step 3 Total Expenses Add (i) to (v)	—	2,20,000	70,000	1,50,000
Step 4 Net Profit (Step 1 – Step 3)		80,000	30,000	50,000

Note:

1. Formation expenses (written off) and director's fees are allocated straightly to post-incorporation period.
2. Gross profit and selling expenses are apportioned on the basis of sales ratio 1:2 (Given in the question).
3. All the other expenses are apportioned on the basis of time ratio, which is calculated as follows:
   Pre-incorporation period: 1 April 2009 to 1 October 2009 = 6 months
   Post-incorporation period: 1 October 2009 to 31 March 2010 = 6 months
   ∴ Time ratio = 6:6 (or) 1:1

Illustration 6.6

Model: Statement method. (Time and sales ratios; allocation and actual)

Shiva Co. Ltd. was incorporated on 31 July 2009 to acquire the business of Bhagya & Co. as on 1 April 2009. The books of accounts disclosed the following on 31 March 2010:

1. Sales for the year were ₹ 24,20,000 (From 1 April 2009 to 31 July 2009 ₹ 6,05,000; from 1 August 2009 to 31 March 2010 ₹ 18,15,000)
2. Gross profit for the year 2009–10: ₹ 4,00,000
3. Preliminary expenses written off: ₹ 12,000; Managing director's salary: ₹ 20,000; Company secretary's salary: ₹ 60,000
4. Bad debts written off: ₹ 12,520 (Prior to 31 July 3,020; after 31 July ₹ 9,500)
5. Depreciation: ₹ 18,000; General expenses: ₹ 42,000; Advertising: ₹ 6,000; Interest on debentures: ₹ 20,000

   You are required to prepare a statement apportioning properly the net profit of the company as between

   (a) Profits available for distribution
   (b) Profits prior to incorporation

[Madras University Adapted]

Solution

Step 1: Computation of Time Ratio:

Pre-incorporation Period from 1 April 2009 to 31 July 2009 = 4 months

Post-incorporation Period from 31 July 2009 to 31 March 2010 = 8 months

∴ Time Ratio = 4 months : 8 months

= 4 : 8 (or) 1 : 2

Step 2: Computation of Sales Ratio:

Sales in Pre-incorporation Period:	₹ 6,05,000
Sales in Post-incorporation Period:	₹ 18,15,000
Sales Ratio =	₹ 6,05,000 : ₹ 18,15,000
	6,05,000:18,15,000
	(or)
	1:3

Step 3: Classification

(i) Gross profit and advertising are to be apportioned on the basis of sales ratio

(ii) Depreciation and general expenses are to be apportioned on the basis of time ratio

(iii) Bad debts → Actual apportioned as mentioned in question

(iv) All other expenses → Direct allocation to post-incorporation period

Step 4: Statement showing pre- and post-incorporation profits for the year ending 31 March 2010

Particulars	**Basis of Apportionment**	**Total** ₹	**Pre-incorporation** ₹	**Post-incorporation** ₹
Step A Gross Profit	Sales Ratio 1:3	4,00,000	1,00,000 $\left(4,00,000 \times \frac{1}{4}\right)$	3,00,000 $\left(4,00,000 \times \frac{3}{4}\right)$
Step B Expenses:				
(i) Advertising	Sales Ratio 1:3	6,000	1,500 $\left(6,000 \times \frac{1}{4}\right)$	4,500 $\left(6,000 \times \frac{3}{4}\right)$
(ii) Depreciation	Time Ratio 1:2	42,000	6,000 $\left(18,000 \times \frac{1}{3}\right)$	12,000 $\left(18,000 \times \frac{2}{3}\right)$
(iii) General Expenses	Time Ratio 1:2	42,000	14,000 $\left(42,000 \times \frac{1}{3}\right)$	28,000 $\left(42,000 \times \frac{2}{3}\right)$
(iv) Bad Debts Written off	Actual (As Given in Question)	12,520	3,020	9,500
(v) Managing Director's Salary	Allocation	20,000	—	20,000
(vi) Company Secretary's Salary	Allocation	60,000	—	60,000
(vii) Preliminary Expenses	Allocation	12,000	—	12,000
(viii) Interest on Debentures	Allocation	20,000	—	20,000
Step C Total Expenses (Step B (i) to (viii))		1,90,520	24,520	1,66,000
Step D Net Profit (Step A – Step C)		2,09,480	75,480	1,34,000

6.5 ADVANCED PROBLEMS—PROFESSIONAL COURSE LEVEL

Illustration 6.7

Model: Statement method and weighted sales ratio)

A company was incorporated on 18 May 2010 to take over a business from the proceeding 1 January. The accounts were made up to 31 December 2010 as usual and the trading and profit and loss account gave the following results:

Particulars	₹	**Particulars**	₹
To Opening Stock	1,00,000	By Sales	12,00,000
To Purchases	8,00,000	By Closing Stock	1,00,000
To Gross Profit c/d	4,00,000		
	13,00,000		13,00,000

To Rent, Rates and Insurance	15,000	By Gross Profit b/d	4,00,000
To Director's Fees	25,000		
To Salaries	60,000		
To Office Expenses	51,000		
To Traveller's Commission	16,000		
To Discounts	20,000		
To Bad Debts	4,000		
To Audit Fees	12,000		
To Depreciation	15,000		
To Debenture Interest	9,000		
To Net Profit	1,73,000		
	4,00,000		4,00,000

It is ascertained that the sales for November and December are one and half times the average of those for the year, whilst those for February and April are only half the average, all the remaining months having average sales.

Apportion the year's profit between pre- and post-incorporation periods.

[C.S. Modified]

Solution

Step 1: Calculation of Time Ratio

Pre-incorporation period from 1 January 2010 to 1 May 2010	=	4 months
Post-incorporation period from 1 May 2010 to 31 December 2010	=	8 months
Time ratio	=	4:8 (or) 1:2

Step 2: Computation of Sales Ratio (Weighted Average):

			₹
(i)	Total Sales for the year (Given)	=	12,00,000
(ii)	Average Sales per month (12,00,000 ÷ 12)	=	1,00,000
(iii)	Sales in Pre-incorporation Period:		
	January – Average Sale – 1,00,000		
	February – Half the Average – 50,000		
	March – Average Sale – 1,00,000		
	April – Half the Average – 50,000		
	Total Sales in pre-incorporation period:	=	3,00,000
(iv)	Sales in Post-incorporation Period:		₹
	May to October: 6 months at an average sale of ₹ 1,00,000	=	6,00,000
	November and December at $1\frac{1}{2}$ times the average	=	3,00,000
	1.5 × ₹ 1,00,000 × 2 months		
	Total Sales in Post-incorporation Period	=	9,00,000
(v)	Sales Ratio (Weighted)	= 3,00,000:9,00,000	
		= 3:9 or 1:3	

Step 3: Classification—Basis of Apportionment:

(i) Gross profit, traveller's commission, discounts and bad debts are to be apportioned on the basis of sales ratio 1: 3

(ii) Rent, salaries, office expenses and depreciation are to be apportioned on the basis of time ratio 1:2.

(iii) Director's fees and debenture are to be allocated to post-incorporation period straightaway.

(iv) Audit fee is to be apportioned on the basis of time ratio, here. But some accountants prefer to allocate, i.e., charge fully, to post-incorporation period.

Step 4: Preparation of statement showing pre- and post-incorporation profits:

Statement showing pre- and post-incorporation profits for the year ended 31 December 2010

Particulars	**Basis of Apportionment**	**Total** ₹	**Pre-incorporation** ₹	**Post-incorporation** ₹
Step A GROSS PROFIT	Sales Ratio 1:3	4,00,000	1,00,000 (4,00,000 × 1/4)	3,00,000 (4,00,000 × 3/4)
Step B Expenses:				
(i) Traveller's Commission	Sales Ratio 1:3	16,000	4,000 (16,000 × 1/4)	12,000 (16,000 × 3/4)
(ii) Discounts	Sales Ratio 1:3	20,000	5,000 (20,000 × 1/3)	15,000 (20,000 × 3/4)
(iii) Bad Debts	Sales Ratio 1:3	4,000	1,000 (4,000 × 1/4)	3,000 (4,000 × 3/4)
(iv) Rent, Rates and Insurance	Time Ratio 1:2	15,000	5,000 (15,000 × 1/3)	10,000 (15,000 × 2/3)
(v) Salaries	Time Ratio 1:2	60,000	20,000 (60,000 × 1/3)	40,000 (60,000 × 2/3)
(vi) Office Expenses	Time Ratio 1:2	51,000	17,000 (51,000 × 1/3)	34,000 (51,000 × 2/3)
(vii) Audit Fees	Time Ratio 1:2	12,000	4,000 (12,000 × 1/3)	8,000 (12,000 × 2/3)
(viii) Depreciation	Time Ratio 1:2	15,000	5,000 (15,000 × 1/3)	12,000 (15,000 × 2/3)
(ix) Director's Fees	Allocation	25,000	—	25,000
(x) Debenture Interest	Allocation	9,000	—	9,000
Step C Total Expenses (Add (i) to (x))		2,27,000	61,000	1,66,000
Step D Net Profit (Step A – Step C)		1,73,000	39,000	1,34,000

Illustration 6.8

Model: Profits prior to and post-incorporation—Weighted sales ratio and actual basis apportionment and account closed less than a year

A company was incorporated on 1 August 2010 acquiring the business of a sole trader with effect from 1 April 2010. The accounts of the company were closed for the first time on 31 December 2010, disclosing a profit of ₹2,10,000. The establishment expenses were ₹54,000; director's fees: ₹4,000 per month; preliminary expenses written off: ₹5,000; rent up to September 2010 was ₹500 per month which was thereafter increased to ₹1,000 per month. Salary to the manager was at ₹3,000 per month who was appointed a director at the time of incorporation of the company.

You are required to prepare a statement showing profits prior and subsequent to incorporation, assuming that the net sales were ₹32,40,000, the monthly average of which for the first 4 months was half of that of the remaining period.

[Madras University Modified]

Solution

Step 1: Calculation of Time Ratio

(i) Pre-incorporation Period from 1 April 2010 to 1 August 2010 = 4 months

(ii) Post-incorporation Period from 1 August 2010 to 31 December 2010 = 5 months

(iii) Time Ratio = 4 : 5

Step 2: Computation of Sales Ratio (Weighted):

(i) Given in the question: Monthly average sales for the first 4 months was half of that of the remaining 5 months 1

(ii) Assume that the average sales for the remaining 5 months (Post-incorporation period) and the weightage may be given

(iii) Hence, for the first 4 months, the weightage will be "half" of that in (ii) $= \frac{1}{2}$

(iv) (Weighted) Sales Ratio $= 4 \times \frac{1}{2} : 5 \times 1$ = 2 : 5

Step 3: Calculation of rent: (Specific amount for specific period → actual)

(i) Rent → Prior to incorporation = 4 months × ₹500 = ₹2,000

(ii) Rent → Post-incorporation = 5 months × ₹1,000 = ₹5,000

Step 4: Allocation → Manager's salary to pre-incorporation period and director's fees and preliminary expenses written off are to be allocated straight to post-incorporation period.

Step 5: Preparation of Statement

Statement showing profits prior and subsequent to incorporation during 9 months ended 31 December 2010

Particulars	Basis of Apportionment	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Step 1 GROSS PROFIT	Sales Ratio 2:5	2,10,000	60,000 (2,10,000 × 2/7)	1,50,000 (2,10,000 × 5/7)
Step 2 Expenses:				

(i) Establishment Expenses:	Time Ratio 4:5	54,0000	24,000 (54,000 × 4/9)	30,000 (54,000 × 5/9)
(ii) Rent	Actual (as given) (Ref: Step 3)	7,000	2,000	5,000
(iii) Director's Fees	Allocation	20,000 (5 × ₹ 4,000)	—	20,000
(iv) Preliminary Expenses Written off	Allocation	5,000	—	5,000
(v) Manager's Salary	Allocation	12,000 (4 × 3,000)	12,000	—
Step 3 Total Expenses (Step 2: (i) to (vi))		98,000	38,000	60,000
Step 4 Net Profit (Step 1 – Step 3)		1,12,000	22,000	90,000

Illustration 6.9

Model: Time ratio, adjusted time ratio, weighted sales ratio and preparation of statement

Kapur Ltd. was incorporated on 1 May 2009 to take over the running business of Sunil & Bros. with effect from 1 January 2009. From the following details for the year ended 31 December 2009, you are required to prepare a statement showing profit or loss made during the pre- and post-incorporation periods:

		₹			₹
(i)	Gross Profit	5,00,000	(vi)	Depreciation	21,000
(ii)	Salaries	90,000	(vii)	Provision for Doubtful Debts	6,000
(iii)	Advertising	9,000	(viii)	Undertaking Commission	30,000
(iv)	Commission to Partners	12,000	(ix)	Insurance Premium paid for the year ending 31 March 2010	18,000
(v)	Carriage Outward	15,000	(x)	Interest on Loan taken (Including ₹ 6,000 on Loan taken after Incorporation)	24,000

Additional data:

1. Average monthly sales during the first 4 months of the year were twice the average monthly sales during each of the remaining 8 months.
2. 30% of the underwriting commission is to be written off
3. Commission to partners was paid for their work before incorporation
4. Salaries include salary paid to a director of a company ₹ 12,000.

[Delhi University Modified]

Solution

Step 1: Calculation of Time Ratio:

(i) Pre-incorporation Period from 1 January 2009 to 1 May 2009 = 4 months

(ii) Post-incorporation Period from 1 May 2009 to 31 December 2009 = 8 months

(iii) Time Ratio = 4 : 8 (or) 1 : 2

Step 2: (i) Let average sale per month of the post-incorporation period be taken as 1 weightage for each month = 1

(ii) As per the direction in the problem, pre-incorporation average monthly sale is twice the post-corporation. = $1 \times 2 = 2$

Hence the weightage per month will be = $(8 \times 1) : (4 \times 2)$

(iii) (Weighted) Sales Ratio = 8 : 8

= 1 : 1

Step 3: Treatment for Insurance:

(a) Insurance Premium (Given): = ₹ 18,000

This is for 12 months ending on 31 March 2010, starting from 1 April 2009. But the accounting year ends on 31 December 2009. Hence, expenses on insurance premium should be confined to current accounting year only.

Expense on insurance premium to be taken into account for 2009 = $₹ 18,000 \times \frac{9}{12}$

= ₹ 13,500 only

(b) Adjusted Time Ratio for Insurance Premium:

(i) As worked out in the above Step 3 (a), the number of months in the current year = 9 months

(ii) of those, pre-incorporation period is April only = 1 months

(iii) Post-incorporation period from 1 May 2009 to 31 December 2009 (or) 9 – 1 = 8 months) = 8 months

(iv) Adjusted time ratio

(v) Insurance premium ₹ 13,500 has to be apportion) on 1:8 (adjusted time ratio basis) = 1:8

Step 4: (a) Gross profit, advertising, carriage outwards, provision for doubtful debts have to be apportioned on the basis of sales ratio

(b) Other salaries and depreciation have to be made on time ratio basis and insurance premium on adjusted time ration basis.

(c) Other expenses are to be allocated straightaway

Step 5: Preparation of Statement of Profit/loss:

Statement showing pre- and post-incorporation profits for the year ended 31 December 2009

Particulars	Basis Of Apportionment	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Step 1 GROSS PROFIT	Sales Ratio 1:1	5,00,000	2,50,000	2,50,000
Step 2 Expenses				
(i) Advertising	Sales Ratio 1:1	9,000	4,500	4,500
(ii) Carriage Outwards	Sales Ratio 1:1	15,000	7,500	7,500
(iii) Provision for Doubtful Debts	Sales Ratio 1:1	6,000	3,000	3,000
(iv) Other than Director's Salaries	Time Ratio 1:2	78,000 (90,000 –12,000)	26,000 (78,000 × 1/3)	52,000
(v) Depreciation	Time Ratio 1:2	21,000	7,000	14,000
(vi) On other Loans Interest (Pre-incorporation only)	Time Ratio 1:2	18,000 (24,000 – 6,000)	6,000	12,000
(vii) Insurance Premium (Ref: Step b (v))	Adjusted Time Ratio 1:8	13,500 (18,000 – 4,500)	1,500 (13,500 × 1/9)	12,000
(viii) Interest on Post-incorporation Loan	Allocation	6,000	—	6,000
(ix) Director's Salary	Allocation	12,000	—	12,000
(x) Underwriting Commission (To be Written off 30% only)	Allocation	9,000 (30% of 30,000)	—	9,000
(xi) Commission to Partners	Allocation	12,000	12,000	—
Step 3 Total Expenses (Step 2 (i) to (xi))		1,99,500	67,500	1,32,000
Step 4 Net Profit (Step 1 – Step 3)		3,00,500	1,82,500	1,18,000

Illustration 6.10

Model: Comprehensive

Bright Ltd. was incorporated on 1 July 2009 with on authorized capital consisting of 1,00,000 equity shares of ₹ 10 each to take over the running business from White Bros. from 1 April 2009. The following is the summarized profit and loss account for the year 3 ended 31 March 2010:

Particulars	₹	Particulars		₹
Cost of Sales for the Year	2,50,000	Sales:	₹	
Administrative Expenses	15,000	1 April 2009 to 30 June 2009 :	80,000	
Selling Commission	10,000	1 July 2009 to 31 March 2010 :	3,20,000	4,00,000
Goodwill Written off	5,000			
Interest Paid to Vendors (Loan Repaid on 1 February)	8,000			
Distribution Expenses (60% Variable)	10,000			
Preliminary Expenses Written off	4,000			
Debentures Interest	5,000			
Depreciation	6,000			
Director's Fees	2,000			
Net Profit	85,000			
	4,00,000			4,00,000

The company deals in one type of product. The unit cost of sales was reduced by 10% in post-incorporation period as compared to the pre-incorporation period in the year.

You are required to apportion the net profit amount between pre-incorporation and post-incorporation periods showing the basis of apportionment.

How will pre-incorporation profit be dealt with in the books of account of the company?

[C.S. (Inter). Modified]

Solution

Step 1: Calculation of Time Ratio:

(i) Pre-incorporation period from 1 April to 1 July = 3 months

(ii) Post-incorporation period from 1 July to 31 March 2010 = 9 months

(iii) Time Ratio = 3 : 9 (or) 1 : 3

Step 2: Time Ratio for Interest to Vendors:

Interest paid on 1 February as loan was settled

So, post-incorporation period from 1 July 2009 to 1 February 2010 = 7 months

Hence, time ratio = 3 : 7

Step 3: Computation of Sales Ratio: **₹ (in '000s)**

Sales during pre-incorporation period: = ₹ 80,000

Sales during post-incorporation period: = ₹ 3,20,000

Hence, sales ratio = 8 : 32 (or) 1 : 4

Step 4: Preparation of Statement of Profit

Statement showing profit for the pre- and post-incorporation periods for the year ended 31 March 2010

(₹ '000s)

Particulars	Basis of Apportionment	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
Step 1 SALES (Given)	Actual	4,00,000	80,000	3,20,000
Step 2 Expenses:				
(i) Cost of Sales	Sales Ratio 1:4	2,50,000	50,000 (2,50,000 × 1/5)	2,00,000 (2,50,000 × 4/5)
(ii) Selling Commission	Sales Ratio 1:4	10,000	2,000 (10,000 × 1/5)	8,000 (10,000 × 4/5)
(iii) Distribution Expenses:				
(a) Variable 60% of 10,000	Sales Ratio 1:4	6,000	1,200 (6,000 × 1/5)	4,800 (6,000 × 4/5)
(b) Fixed 40% of 10,000	Time Ratio 1:3	4,000	1,000 (4,000 × 1/4)	3,000 (4,000 × 3/4)
(iv) Administrative Expenses	Time Ratio 1:3	15,000	3,750 (15,000 × 1/4)	11,250 (15,000 × 3/4)
(v) Depreciation	Time Ratio 1:3	6,000	1,500 (6,000 × 1/4)	4,500 (6,000 × 3/4)
(vi) Interest to Vendors	Adjusted Time Ratio 3:7	8,000	2,400 (8,000 × 3/10)	5,600 (8,000 × 7/10)
(vii) Goodwill	Allocation	5,000	—	5,000
(viii) Preliminary Expenses	Allocation	4,000	—	4,000
(ix) Debenture Interest	Allocation	5,000	—	5,000
(x) Director's Fees	Allocation	2,000	—	2,000
Step 3 Total Expenses (Step 2 (i) to (x): Add)		3,15,000	61,850	2,53,150
Step 4 Net Profit (Step 1 – Step 3)		85,000	18,150	66,850

Pre-incorporation profit ₹ 18,150 (in '000s) is a capital profit.

Hence, it has to be credited to capital reserve account.

Illustration 6.11

Model: Computation of pre- and post-incorporation profit through columnar P&L A/c

Mr. Raj formed a private limited company under the name and style of Raj Pvt. Ltd. to take over his existing business as from 1 April 2009, but the company was not incorporated until 1 July 2009. No entries relating to transfer of the business are entered in the books. This was carried on without a break until 31 March 2010.

The following balances were extracted from the books on 31 March 2010:

Particulars	Dr. ₹	Cr. ₹
Opening Stock	25,000	—
Purchases	1,75,000	—
Carriage Outwards	4,000	—
Travelling Commission	7,000	—
Office Salaries	30,000	—
Administrative Expenses	25,000	—
Rent and Rates	15,000	—
Director's Fees	25,000	—
Fixed Assets	1,50,000	—
Current Assets Excluding Stock	40,000	—
Preliminary Expenses	6,000	—
Sales	—	3,00,000
Mr. Raj's Capital A/c on 1 April 2009	—	2,70,000
Current Liabilities	—	40,000

You are also given that:

(a) Stock on 31 March 2010 was ₹ 20,000.

(b) The gross profit ratio is constant and monthly sales in April 2009, February 2010 and March 2010 are double the average monthly sales for the remaining months of the year.

(c) The purchase consideration was agreed to be satisfied by the issue of 50,000 equity shares of ₹ 10 each.

(d) The preliminary expenses are to be written off.

(e) You are to assume that carriage outwards and traveller's commission vary in direct proportion to sales.

You are required to prepare P&L A/c for the year ended 31 March 2010 apportioning the profit or loss of the periods before and after incorporation. Depreciation is to be provided @ 20% p.a. on fixed assets.

[C.A. Modified]

Solution

Step 1: Calculation of Time Ratio:

(i) Pre-incorporation Period From 1 April 2009 to 1 July 2009 = 3 months

(ii) Post-incorporation Period From 1 July 2009 to 31 March 2010 = 9 months

(iii) Time Ratio = 3:9 (or) 1:3

Step 2: Calculation of Sales Ratio:

Assume and give weightage for average sales as 1.

Then Pre-incorporation Sales =

April = 2

May = 1

June = 1 — 4

Post-incorporation sales:

July to January: 7 months = 7 × 1 (weightage)	= 7	
February and March: 2 months = 2 × 2	= 4	11
∴ Sales ratio		= 4:11

Step 3: Computation of Gross Profit:

	₹
Sales (Given):	3,00, 000
Add: Closing Stock	20,000
	3,20,000
Less: Opening Stock:	25,000
	2,95,000
Less: Purchases:	1,75,000
Gross Profit:	1,20,000

Step 4: Preparation of P&L A/c

Profit and Loss Account of Raj Ltd.
for the Year Ended 31 March 2010

Particulars	Basis of Apportionment	Total ₹	Pre-incorporation ₹	Post-incorporation ₹	Particulars	Basis of Apportionment	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
To Carriage Outwards	Sales Ratio 4:11	4,000	1,067 (4000 × 4/15)	2,933 (4,000 × 11/15)	Gross profit b/d	Sales ratio 4:11	1,20,000	32,000 (1,20,000 × 4/15)	88,000 (1,20,000× 11/15)
To Travelling Commission	Sales Ratio 4:11	7,000	1,867	5,133	By net loss	—	22,000	—	26,066
To Office Salaries	Time Ratio 1:3	30,000	7,500	22,500					
To Administrative Expenses	Time Ratio 1:3	25,000	6,250	18,750					
To Rent and Rates	Time Ratio 1:3	15,000	3,750	11,250					
To Depreciation (₹ 1,500,000 @ 20%)	Time Ratio 1:3	30,000	7,500	22,500					
To Director's Fees	Allocation (Post-incorp.)	25,000	—	25,000					
To Preliminary Expenses		6,000	—	6,000					
To Net Profit		—	4,066	—					
		1,42,000	32,000	1,14,066			1,42,000	32,000	1,14,066

Illustration 6.12

Model: Trading A/c; P&L A/c and balance sheet preparations

The following trial balance was extracted from the books of M/s Subbu Pvt. Ltd. formed by Mr. Vivek on 1 April 2009, but was incorporated on 1 July 2009. No entries relating to the transfer of the business were entered in the books. This was carried on until 31 March 2010.

Trial balance as on 31 March 2010.

Particulars	₹	Particulars	₹
Stock (1 April 2009)	12,400	Sales:	2,82,300
Purchases	2,20,000	Capital A/c of Mr. Vivek	2,00,000
Carriage Outwards	2,250	Current Liabilities	32,700
Travelling Commission	6,000		
Office Salaries	24,000		
Rents and Taxes	1,600		
Office Expenses	3,600		
Director's Salary	20,000		
Fixed Assets	1,50,000		
Current Assets (Other than Stock)	74,000		
Preliminary Expenses	1,150		
	5,15,000		5,15,000

Further information:

(i) Stock on 31 March 2010 ₹ 30,000

(ii) Purchase consideration ₹ 3,00,000 to be paid by the issue of 3,000 equity shares of ₹ 100 each

(iii) Gross profit percentage is fixed, turnover is double in April, November and December

(iv) Preliminary expenses are to be written off

(v) Carriage outward and travelling commission vary in direct proportion to sales

You are required to prepare trading and profit and loss account for the year ended 31 March 2010 appropriating between pre- and post-incorporation periods and a balance sheet as on 31 March 2010.

[C.S. Modified]

Solution

Step 1: Calculation of Time Ratio:

(i) Pre-incorporation Period From 1 April 2009 to 1 July 2009 = 3 months

(ii) Post-incorporation Period From 1 July 2009 to 1 March 2010 = 9 months

(iii) Time Ratio = 3:9 (or) 1:3

Step 2: Calculation of Weighted Sales Ratio

Let us assume and assign weightage 1 to normal turnover months (turnover uniform in 9 months) Turnover is given as double for three specific months and hence the weightage will be $1 \times 2 = 2$

Pre-incorporation Period:

2009 April = 2

2009 May = 1

2009 June = 1 — 4

Post-incorporation Period:

July to October 2009: 4 normal months	= 4 × 1 = 4	
November to December 2009: 2 special months	= 2 × 2 = 4	
January to March 2009: 3 normal months	= 3 × 1 = 3	11
∴ (Weighted) Sales Ratio		= 4:11

Step 3: Treatment for Goodwill:

(i) Computation: Goodwill = Purchase Consideration – Capital

= ₹ 3,00,000 – ₹ 2,00,000

= ₹ 1,00,000

(ii) Profit prior to incorporation is to be adjusted with this in the balance sheet.

Step 4: Preparation of Trading A/c:

Trading A/c of M/s Subbu Pvt. Ltd.
for the Year Ended 31 March 2010

Particulars	₹	Particulars	₹
To Opening Stock	12,400	By Sales	2,82,300
To Purchases	2,20,000	By Closing Stock	30,100
To Gross Profit c/d	80,000		
	3,12,400		3,12,400

Profit and Loss Account of Subbu Ltd.
for the Year Ended 31 March 2010

Particulars	Basis of Apportionment	Total ₹	Pre-incorporation ₹	Post-incorporation ₹	Particulars	Basis of Apportionment	Total ₹	Pre-incorporation ₹	Post-incorporation ₹
To Carriage Outwards	Sales Ratio 4:1	2,250	600 (2,250 × 4/15)	1,650 (4,000 ×11/15)	By Gross Profit b/d	Sales Ratio 4:11	80,000	21,333 (80000 × 4/15)	88,000 (80,000 × 11/15)
To Travelling Commission	Sales Ratio 4:1	6,000	1,600 (6000 × 4/15)	4,400 (6000 × 11/15)					
To Office Salaries	Time Ratio 1:3	24,000	6,000 (24,000 ×1/4)	18,000 (24,000 × 3/4)					
To Rent and Taxes	Time Ratio 1:3	1,600	4,00	1,200					
To Office Expenses	Time Ratio 1:3	3,600	900 (3,600 × 1/4)	2,700 (3,600 × 3/4)					
To Director's Salary	Allocation (Post-in-corp.)	20,000	—	20,000					
To Preliminary Expenses	Allocation (Post-in-corp.)	1,150	—	1,150					
To Net Profit c/d		21,400	11,833	9,567					
		80,000	21,333	58,667			80,000	21,333	58,667

Step 5: Preparation of Balance Sheet

Balance Sheet of M/s Subbu Pvt. Ltd.
as on 31 March 2010

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets:		1,50,000
3,000 Equity Shares of ₹ 100 each (These Shares are Issued for Consideration Other Than Cash)	3,00,000	Goodwill:	1,00,000	
		Less: Profit Prior to Incorporation	11,833	88,167
Reserves & Surplus:		Current Assets (Other than Stock)		74,000
P&L A/c (Profit After Incorporation)	9,567	Closing Stock		30,100
Current Liabilities:	32,700			
	3,42,267			3,42,267

6.6 ACCOUNTING STANDARD AS-5 REVISED

6.6.1 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

The AS-5 (Revised) ensures uniform classification and disclosure of certain items, so that profit and loss statements are prepared on uniform basis. The statement deals with the classification and disclosure of prior period and extraordinary items and also the disclosure of certain items within profit or loss from ordinary activities.

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

1. Profit or loss from ordinary activities
2. Extraordinary items

AS-5 defines extraordinary items as income or expenses which arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise. They are not expected to recur frequently or regularly.

Example:

(i) Losses due to natural calamities, disasters
(ii) The expropriation of assets by state
(iii) A change in the basis of taxation or government fiscal policy.

As per AS-5 (Revised), extraordinary items should be disclosed in the statement of profit and loss in such a manner that its impact on current profit or loss can be perceived at ease. Such amount should form a part of the net profit or loss period.

AS-5 requires separate disclosure of certain items separately. They are ordinary activities. As explained by it, ordinary activities are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to or arising from their activities.

The items which may require separate disclosure are:

1. Disposals of items of fixed assets
2. Disposals of long-term investments
3. Reversal of any provisions

4. Legislative changes having retrospective applications
5. Litigation, settlements

AS-5 requires separate disclosure of the nature and amount of prior period items in the statement of profit or loss in a manner that their impact on the current profit or loss can be perceived at ease.

Prior period items are normally included in the determination of net profit or loss for the current period.

An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss.

Here one important difference between "an estimate" and "an error" must be understood.

The revision due to estimates does not come under the purview of extraordinary item or prior period item as per the standard.

However, when income or expenses arise in the current period as a result of errors or omissions in the preparation of financial statements of one or more periods, the said income or expenses have to be classified as prior period items. The errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misrepresentation of acts or oversight.

Any change in accounting policies should be disclosed.

Summary

Profit prior to incorporation is capital profit, which has to be credited to "Capital Reserve A/C". This may be utilized to write off capital losses and certain expenses. The balance, if any, is to be shown on the liabilities side of the balance sheet under "Reserve & Surpluse".

Loss prior to incorporation is capital loss, which has to be debited to "Loss prior to incorporation A/c". This is to be shown on the assets side of the balance sheet under "Miscellaneous Expenditure".

Methods of ascertaining profit/loss prior to incorporation:

1. Preparation of Trading and Profit & Loss A/c for the period upto the date of incorporation.
2. Preparation of Trading and Profit & Loss A/c for the whole accounting period and apportionment of the profit/loss between pre- and post-incorporation periods.
3. Preparation of Common Trading and Profit & Loss A/c in "Columnar Form".

Basis of apportionment of different items is explained in detail in the text.

Accounting Treatment: Various stages involved in the determination of pre- and post-incorporation profit/loss and explained in steps. Refer the illustrations No. 1 to 12.

Key Terms

Acquisition: Acquiring a running business of a sole trader or partnership firm by a company.

Profit Prior to Incorporation: Profits earned up to the date of incorporation of business.

Time Ratio: Ratio of period (months or days) before and after incorporation during an accounting period.

Sales Ratio: Ratio of sales or turnover of the company before and after incorporation.

Weighted Sales Ratio: Sales ratio adjusted for the change in trend in sales.

Allocation: Expenses that are fully charged to either pre- or post-incorporation period. (need not get apportioned on any other basis).

QUESTION BANK

Objective Questions

I: State whether the following statements are True or False

1. Profit prior to incorporation forms part of P & L A/c.
2. Capital profit is not utilized for payment of dividend to shareholders.
3. Unutilized part of capital reserve appears on the assets side of the balance sheet.
4. Capital loss should be shown on the assets side of the balance sheet.
5. Capital loss may also be treated as Goodwill.
6. The date of Certificate of Commencement of business is not taken into account for ascertaining prior incorporation profit.
7. Basis of apportionment of stationery expenses is sales ratio.
8. Gross profit is apportioned on the basis of sales ratio.
9. Basis of apportionment of "bad debts" is time ratio.
10. Director's remuneration is not at all connected with pre-incorporation period.
11. Basis of apportionment of "insurance premium" is sales ratio.
12. Vendor's salary is to be apportioned on the basis of adjusted time ratio.
13. Debenture interest is wholly allocated to post-incorporation period.
14. Formation expenses written off shall be allocated only to pre-incorporation period.
15. Profit prior to incorporation is always to be adjusted against Goodwill.

Answers:

1. False	6. True	11. False
2. True	7. False	12. False
3. False	8. True	13. True
4. True	9. False	14. False
5. True	10. True	15. True.

II: Fill in the blanks with suitable word(s)

1. For ascertaining pre-incorporation profits, the important ratios used are _____ and _____.
2. The profit made from the date of business purchase till the date of incorporation is termed as _____.
3. Pre-incorporation profit is treated as ____.
4. Post-incorporation profit is treated as _____.
5. Profit/loss prior to incorporation is ascertained on the basis of transactions between the date of purchase of business and the date of obtaining the certificate _____.
6. Capital profit is generally credited to _____A/c.
7. Unutilized part of capital reserve is to be shown in the balance sheet under the heading _____.
8. Capital loss appears in the balance sheet under the head _____.
9. _____ is the ratio of the period before and after incorporation during the accounting period.
10. _____ is the ratio of turnover of the company before and after incorporation.
11. When sales are not uniform during an accounting period, ____ratio is used for apportioning expenses.
12. All variable expenses directly varying with turnover are to be apportioned on the basis of _____.
13. _____ is the basis of apportionment for fixed expenses.
14. Basis of apportionment of all expenses relating to pre-incorporation period is ____.
15. Gross profit is to be divided between pre- and post-incorporation periods in _____ ratio.

Answers:

1. time ratio; sales ratio
2. profit prior to incorporation
3. capital profit 4. revenue profit
5. of incorporation 6. capital reserve
7. reserve & surplus
8. miscellaneous expenditure
9. Time ratio 10. Sales ratio
11. weighted sales 12. sales ratio
13. Time ratio 14. allocation
15. sales

III: Multiple choice questions—Choose the correct answer

1. Profit prior to incorporation belongs to:
   (a) the vendor
   (b) the newly formed company
   (c) both (a) & (b)
   (d) none of these
2. The relevant date for ascertaining capital profit is the date of
   (a) acquisition of business
   (b) incorporation
   (c) obtaining certificate to commence business
   (d) entering into preliminary contract
3. When sales are not uniform in an accounting period, the ratio that should be used is
   (a) time ratio
   (b) sales ratio
   (c) weighted sales ratio
   (d) adjusted time ratio
4. Profit prior to incorporation is
   (a) debited to P&L A/c
   (b) credited to goodwill A/c
   (c) credited to capital reserve A/c
   (d) shown directly in the balance sheet.
5. Loss prior to incorporation is
   (a) debited to P&L A/c
   (b) debited to goodwill A/c
   (c) debited to capital reserve A/c
   (d) shown directly in the balance sheet.
6. Salesmen's remuneration is to be apportioned on the basis of
   (a) time ratio
   (b) adjusted time ratio
   (c) allocation to post-incorporation period
   (d) sales ratio
7. Basis of apportionment of salary will be
   (a) time ratio
   (b) sales ratio
   (c) allocation to pre-incorporation period
   (d) allocation to post-incorporation period
8. Audit fees is to be apportioned on the basis of
   (a) time ratio
   (b) allocated fully to post-incorporation period
   (c) (a) and (b)
   (d) (a) or (b)
9. Capital reserve A/c may used
   (a) for payment of dividend
   (b) to write off capital losses
   (c) to acquire fixed assets
   (d) as deferred revenue expenditure
10. If specific details are available with respect to any item of expenditure or time spent, then
    (a) no apportionment is necessary, may be allocated accordingly
    (b) to be apportioned on time ratio
    (c) weighted sales ratio basis is suitable
    (d) adjusted time ratio is to be used.

Answers:

1. (a)	4. (c)	7. (a)	10. (a)
2. (b)	5. (b)	8. (d)	
3. (b)	6. (d)	9. (b)	

Short Answer Questions

1. What is meant by "acquisition" of business?
2. Explain the term "profit prior to incorporation".
3. What will be effect of capital profit or loss on the net assets acquired by the company?
4. How would you treat capital profit?
5. How would you treat capital loss?
6. "Date of certificate to commence business is immaterial for ascertainment of profit prior to incorporation"—Why?
7. What is time ratio? Give any four items of expenses that are to be apportioned on the basis of time ratio.
8. What do you mean by "weighted" or "adjusted" time ratio?
9. Explain "sales ratio". Give any four items of expenses which are to be apportioned on the basis of sales ratio.
10. Give any four items of expenses that are to be allocated fully to pre-incorporation period.
11. How "audit fees" will be apportioned?
12. How would you treat "actual expenditure"?
13. How "weightage" is assigned while computing weighted sales ratio?

14. How do you treat profit prior to incorporation against goodwill?
15. Purchase consideration and capital are given in the question. How will you compute "goodwill"?

Essay Type Questions

1. Explain "profit prior to incorporation". Explain in detail how will you treat profit or loss prior to incorporation in the books of accounts of a company.
2. Discuss the possible methods of ascertaining profit or loss prior to incorporation
3. Enlist the various "ratios" used in ascertaining profit prior to incorporation and describe each of them in detail.
4. Mention the important items of expenses and explain the proper basis of apportionment of such items.
5. Describe the important steps used in computation of weighted sales ratio with an imaginary figure.

Exercises

Part A—For Undergraduate Level

1. You are required to compute time ratio for the pre- and post-incorporation periods from the following data:
   (a) Date of incorporation: 1 June 2009
   (b) Period of financial accounts: April 2009 to March 2010
   (c) Total wages: ₹ 24,000
   (d) Number of workers: Pre-incorporation period = 5

   Post-incorporation period = 25

   Also, divide the total wages between pre- and post-incorporation periods.

   [**Ans:** 1:Time ratio: 1:5; Weighted time ratio: 1:25; Wages: Pre-incorporation: ₹ 925; Post-incorporation: ₹ 23,075]
2. Kamala Ltd. was incorporated on 1 April 2010 to take over the business of Vikas Brothers from 1 January 2010. From the following information, calculate sales ratio and gross profit:
   (i) Sales during the period January to December 2010 amounted to ₹ 3,60,000. The trend of the sales was as follows:

   January and February: half the average sales in each month

   May, June and July: average sales in each month

   October: average sale

   November and December: half the average sales in each month

   (ii) Cost of goods sold: ₹ 90,000.

   [**Ans**: Sales ratio: 5:19; Gross profit: ₹ 2,70,000]
3. A company was incorporated on 1 August 2010 in order to purchase a running business from 1 April 2010. The following particulars are available from its records:

		₹
(i)	Total sales for 2010–11:	2,40,000
(ii)	Sales from 1 April 2010 to 31 July 2010	60,000
(iii)	Gross profit for the whole year	90,000
(iv)	Total expenses of 2010–11 (including director's fees ₹ 3,000)	75,000
(v)	Company's share capital	2,25,000

   You are required to calculate profit prior to incorporation and after incorporation by preparing profit and loss account.

   [**Ans**: Loss prior to incorporation: ₹ 7,500;

   Profit after incorporation: ₹ 22,500]
4. Lalli Ltd. was incorporated on 1 July 2010 which took over a running concern with effect from 1 January 2010. The sales for the period up to 1 July 2010 was ₹ 10,80,000 and the sales from

1 July 2010 to 31 December 2010 amounted to ₹13,20,000.

The expenses debited to profit and loss account included:

		₹
(i)	Director's fees	60,000
(ii)	Bad debts	7,200
(iii)	Advertisement (₹2,000 per month)	24,000
(iv)	Salaries and general expenses	1,28,000
(v)	Preliminary expenses written off	12,000
	The gross profit for the period from 1 January 2010 to 31 December 2010	9,60,000

You are required to compute profit prior to incorporation.

[**Ans**: Profit prior to incorporation: ₹3,52,760]

5. A company was incorporated on 30 June 2010 to acquire the business of Veer Singh as from 1 January 2010. The accounts for the year ended 31 December 2010 disclosed the following:
   (a) There was a gross profit of ₹14,40,000
   (b) The sales for the year amounted to ₹72,00,000, of which ₹32,40,000 were for the first 6 months.
   (c) The expenses debited to profit and loss account included:

	₹
Director's Fees	90,000
Bad Debts	21,600
Advertising (Under a monthly Contract of ₹6,000)	72,000
Salaries	3,84,000
Preliminary Expenses Written off	30,000
Donation to Political Parties by Company	30,000

   You are required to prepare a statement showing profit made before and after incorporation.

   [**Ans**: Profit before incorporation: ₹4,10,280;
   Profit after incorporation: ₹4,02,120]

6. X Ltd. was registered on 1 January 2010 to buy the business of M/s Y Brothers as on 1 October 2009 and the Certificate of Commencement of Business on 1 February 2010. The accounts of the company for the period of 12 months ended 30 September 2010 disclosed the net profit of ₹1,25,000 after having charged the following amounts:

   Salary: ₹30,000 (There were four employees in the pre-incorporation period and seven in the post-incorporation period)

   Wages: ₹10,920 (There were four workers in the pre-incorporation period and five in the post-incorporation period and the rate of wages were ₹160 and ₹200 per month per worker in the pre- and post-incorporation periods, respectively)

   Sales: ₹ 4,80,000 of which ₹80,000 relates to pre-incorporation period.

   Director's fees: ₹16,000

   You are required to calculate profit for pre- and post-incorporation periods separately.

   [Madras University]

   [**Ans**: Profit prior to incorporation: ₹23,600;
   Profit after incorporation: ₹1,01,400;
   Adjusted time ratio for salaries: ₹4:21;
   Wages: Pre-incorporation: ₹1,920;
   Post-incorporation: ₹9,000;
   Gross profit before charging wages:
   ₹1,81,920;
   Sales ratio: 1:5]

7. Riddhima Co. Ltd. was incorporated on 30 September 2009 to take over the business of M/s Parul & Co. as from 1 April 2009. The financial accounts of the business for the year ended 31 March 2010 disclosed the following information:

Particulars	₹	₹
Sales:		
April to September	3,60,000	
October to March	5,40,000	9,00,000
Less: Purchases:		
April to September	2,25,000	
October to March	3,60,000	5,85,000
Gross Profit		3,15,000

Less:		
Salaries	45,000	
Selling Expenses	9,000	
Depreciation	4,500	
Director's Remuneration	2,250	
Debenture Interest	270	
Administration expenses (Rent, Rates, etc.)}	13,500	74,520
Profit for the year 2009–10		2,40,480

You are required to prepare a statement apportioning the balance of profit between the periods prior to and after incorporation and show the profit and loss appropriation account for the year ended 31 March 2010.

[**Ans**: Profit prior to incorporation: ₹ 99,900;

Profit after incorporation: ₹ 1,40,580]

8. Thomas Co. Ltd. purchased a business on 1 April 2009. The company obtained Certificate of Incorporation on 31 July 2009. From the following particulars for the year ending 31 March 2010, ascertain profit prior to incorporation and divisible profits:
   (a) Total sales up to 31 March 2010 ₹ 30,00,000; Sales from 1 April 2009 to 31 July 2009 ₹ 7,50,000.
   (b) Gross profit for the year ₹ 6,36,000
   (c) Expenses debited to profit and loss account were as under:

Particulars	₹	**Particulars**	₹
Rent	18,000	Interest on Debentures	12,000
Insurance	4,500	Printing & Stationery	12,600
Salaries	81,000	Depreciation on Machinery	90,000
Selling Expenses	27,000	Commission on Sales	37,800
Advertisement	24,000		
Audit Fees	3,600		
Bad Debts (₹ 2,550 Related To Pre-incorporation)	7,200		
General Expenses			
Director's Fees	14,400		
Preliminary Expenses	7,800		
	21,600		

Interest Paid to Vendors (up to 1 September 2009)	15,000		

[**Ans:** Adjusted time ratio for interest paid to vendors: 4:1; Profit prior to incorporation: ₹ 47,550; Divisible profit: ₹ 2,11,950]

9. Byhagya Ltd. was incorporated on 1 March 2010 and received the Certificate of Commencement of Business on 1 April 2010. The company acquired the business of Viswas with effect from 1 November 2009. From the following figures relating to the year ending October 2010, find out the profits available for dividend.
   (a) Sales for the year were ₹ 30,00,000; Out of which sales up to 1 March 2010 were ₹ 12,50,000.
   (b) Gross profit for the year was ₹ 9,00,000.
   (c) The expenses debited to profit and loss account were:

	₹
Rent	45,000
Salaries	75,000
Directors' fees	22,000
Interest on debentures	25,000
Audit fees	7,500
Discount on sales	18,000
Depreciation	1,20,000
General expenses	22,000
Advertising	90,000
Printing & Stationery	18,000
Commission on sales	30,000
Bad debts (₹ 2,500 relates to prior incorporation period)	7,500
Interest to vendors on purchase consideration up to 1 May 2010	15,000

[**Ans:** Profit available for dividend: ₹ 1,92,500; Profit prior to incorporation: ₹ 2,08,500]

10. X Ltd. was incorporated on 1 April 2010 with an authorized capital of 20,000 equity shares of ₹ 100 each to take over the running business of Y Ltd. from 1 January 2010.

The following is the summarized profit and loss account for the year ended 31 December 2010.

Particulars	₹	₹
Sales: 1 January 2010 to 31 March 2010	24,000	
1 April 2010 to 31 December 2010	76,000	1,00,000
Cost of Sales	64,000	
Administrative Expenses	7,072	
Selling Commission	3,500	
Goodwill Written off	800	
Interest Paid to Vendors (Loan Repaid on 1 May 2010)	1,492	
Distribution Expenses (60% Variable)	5,000	
Preliminary Expenses Written off	1,320	
Debenture Interest	1,280	
Depreciation	1,776	
Director's Fees	400	86,640
Profit		13,360

The company deals with one type of product.

The unit cost of sales was reduced by 10% in the post-incorporation period as compared to the pre-incorporation period. Apportion the net profit between pre-incorporation and post-incorporation periods showing the basis of apportionment.

[**Ans:** Cost of sales ratio: 60:171; Time ratio: 1:3; Sales ratio: 6:19; Adjusted time ratio: 3:1;

Pre-incorporation profit: ₹ 1,984

Post-incorporation profit: ₹ 11,376]

Exercises

Part B—For Advanced Level

11. A company was incorporated on 1 August 2009 to take over a business from the preceding 1 April. The accounts were made up to March 2010 as usual and the trading and profit and loss account gave the following result:

Particulars	₹ '000	Particulars	₹ '000
To Opening Stock	7,000	By Sales	6,00,00
To Purchases	45,500	By Closing Stock	7,500
To Gross Profit	15,000		
	6,75,00		6,75,00
To Rent, Rates and Insurance	9,00	By Gross Profit b/d	1,50,00
To Director's Fees	10,00		
To Salaries	25,50		
To Office Expenses	24,00		
To Traveller's Commission	6,00		
To Discounts	7,50		
To Bad Debts	1,50		
To Audit Fee	3,75		
To Depreciation	3,00		
To Debenture Interest	2,25		
To Net Profit	5,750		
	1,50,00		1,50,00

It is ascertained that the sales for February 2010 and March 2010 are one and half times the average for the year. Apportion the year's profit between the pre-incorporation and post-incorporation period.

[C.S. (Inter). Modified]

[**Ans:** Time ratio: 1:2; Sales ratio: 1:3

Profit prior to incorporation: ₹ 13,75,000;

Profit after incorporation: ₹ 91,25,000]

12. Jasemine Company Ltd. was formed to take over a running business with effect from 1 April 2009. The company was incorporated on 1 August 2009, and the Certificate of Commencement of Business was received on 1 October 2009. The following profit and loss account has been prepared for the year ended 31 March 2010.

Profit and Loss Account for the Year Ended 31 March 2010

Particulars	₹	Particulars	₹
To Salaries	1,20,000	By Gross Profit b/f	8,00,000
To Printing and Stationery	12,000		
To Travelling Expenses	42,000		
To Advertisement	40,000		

To Miscellaneous Trade Expense	94,500		
To Rent (Office Building)	66,000		
To Electricity Charges	10,500		
To Director's Fees	28,000		
To Bad Debts	8,000		
To Commission: Selling Agents	40,000		
To Audit Fees	15,000		
To Debenture Interest	7,500		
To Interest Paid to Vendors	10,500		
To Selling Expenses	63,000		
To Depreciation on Fixed Assets	24,000		
To Net Profit c/f	2,19,000		
	8,00,000		8,00,000

Additional information:

(i) Total sales for the year, which amounted to ₹48,00,000 arose evenly up to the date of the Certificate of Commencement of Business, where after they spurted to record an increase of two-thirds during the rest of the year.

(ii) Rent of office building was paid @ ₹5,000 per month up to September 2009 and thereafter it was increased by ₹1,000 per month.

(iii) Travelling expenses include ₹12,000 towards sales promotion.

(iv) Depreciation includes ₹1,500 for assets acquired in the post-incorporation period.

(v) Consideration was discharged by the company on 30 September 2009, by issuing equity shares of ₹10 each.

You are required to prepare the profit and loss account in columnar form showing distinctly the allocation of profits between pre-incorporation and post- incorporation periods, indicating the basis of allocation regarding each item.

[C.S. (Inter). Modified]

[**Ans:** Time ratio: 1:2; Sales ratio: 1:3

Pre-incorporation profit: ₹30,750;

Post- incorporation profit: ₹1,88,250]

13. A public limited was incorporated on 1 October 2009 to take over a business as a going concern as from 1 April 2009. The purchase price of the business for such acquisition was fixed on the basis of the balance sheet of the firm as at 31 March 2009 but the agreement provided that the vendors would get 80% of the profits earned prior to 1 October 2009 as compensation. The company's accounts were made up to 31 March each year and the summarized trading and profit and loss accounts for the year ended 31 March 2010, disclosed the following results:

Particulars	₹	**Particulars**	₹
To Materials Consumed	3,72,000	By Net Sales	5,20,000
		By Stock:	
To Manufacturing Wages	97,000	Finished Goods	98,000
		Incomplete	12,000
To Misc. Expenses of Manufacture	37,200	Goods	
To Carriage Inwards	12,600		
To Gross Profit c/d	1,11,200		
	6,30,000		6,30,000
To Salaries & Establishment Charges	36,600	By Gross Profit b/d	1,11,200
To Office Expenses	5,500		
To Director's Fees	3,600		
To Bad Debts	4,600		
To Debentures Interest	2,500		
To Commission & Discounts	15,600		
To Carriage Outwards	3,200		
To Depreciation	20,600		
To Net Profit for the Year	19,000		
	1,11,200		1,11,200

Further information available was that sales made by the company amounted to ₹2,32,000. Bad debts amounting to ₹2,200 were written off prior to 1 October 2009.

Prepare a statement showing the profits earned prior to and after incorporation. State also the amount of profits prior to 1 October 2009 payable to the vendors.

How should the company deal with its share of profits in the year ending 31 March 2010.

[C.A. (Inter). Modified]

[**Ans:** Profit prior to incorporation ₹17,626 before paying the vendor]

14. Ramkumar Industries Pvt. Ltd. was incorporated on 1 May 2009. It took over Ramkumar's sole proprietary business with effect from 1 April 2009. Ramkumar's balance sheet as at 31 March 2010 is as follows:

Liabilities	₹	Assets	₹
Capital Account	21,57,500	Building	5,50,000
Loan	42,500	Machinery	15,00,000
Trade Creditors	85,000	Debtors	1,28,500
Creditors for Expenses	12,500	P & L A/c	1,19,000
	22,97,500		22,97,500

It was agreed to pay ₹22,50,000 in the form of equity shares of the company. The company decided to close its books of account for the first time as at 31 March 2010. The following further details are furnished to you:

	₹
Sales for full year	15,00,000
Purchases	7,00,000
Salaries & Wages	2,00,000
General Expenses	1,60,000
Carriage Inwards	23,500
Interest Paid	40,000
Stocks as at 31 March 2010	1,10,000
Additions to Building	1,90,000

Depreciation is to be provided @ 10% on assets including additions.

Make a provision for income tax @ 35%

The company requests you to:

(i) pass journal entries for the take over

(ii) prepare P&L A/c showing separately pre-incorporation and post-incorporation profits

[C.A. (Inter). Modified]

[**Ans:** Goodwill on acquisition: ₹2,11,500;

Pre-incorporation profit: ₹1,56,406;

Post-incorporation profit: ₹14,218]

15. The promoters of proposed Prosperity Ltd. purchased a running business on 1 April 2009 from Mr. Alphonse and was incorporated on 1 August 2009. The combined P&L A/c of the company prior to and after the date of incorporation is as under:

Profit and Loss Account
for the Year Ended 31 March 2010

Particulars	₹	Particulars	₹
To Rent, Rates, Insurance Electricity & Salaries	36,000	By Gross Profit	4,50,000
To Director's Sitting Fees	10,800	By Discount Received from Creditors	18,000
To Preliminary Expenses	14,700		
To Carriage Outwards and Selling Expenses	16,500		
To Interest Paid to Vendors	30,000		
To Net Profit	3,60,000		
	4,68,000		4,68,000

Further information:

1. Sales up to 31 July 2009 were ₹9,00,000 out of total sales of ₹45,00,000 of the year.
2. Purchases up to 31 July 2009 were ₹9,00,000 out of the total purchases of ₹27,00,000.
3. Interest paid to vendors on 1 February 2010 (@12% p.a. on ₹3,00,000 being purchase consideration).

From the above information, prepare P&L A/c for the year ended 31 March 2010, showing the profit earned prior to and after incorporation and also show the transfer of the same to the appropriate accounts.

[I.C.W.A. (Inter). Modified]

[**Ans:** Pre-incorporation profit: ₹68,700;

Post-incorporation profit: ₹2,91,300]

Final Accounts of Companies 7

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Understand the statutory provisions relating to the preparation of profit and loss A/c of the limited companies.
2. Differentiate the preparation of final accounts of companies from other form of business organizations.
3. Understand some important and fundamental principles for the preparation of final accounts: materiality; prior period items; extraordinary items; changes in accounting policies; contingencies; debentures—(i) interest on debentures, (ii) income tax on interest on debentures and (iii) discount or cost of issue of debentures—remuneration to directors, managers and managing director; commission to managerial personnel; dividends and divisible projects.
4. Understand the contents and importance of Schedule V1.
5. Know and apply the provisions envisaged in Accounting Standards AS-4(Revised) and AS-5(Revised).
6. Prepare profit and loss A/c, profit and loss appropriation A/c and the balance sheet of companies in compliance with the provision of the Companies Act, Accounting Standards and the Income Tax Act.
7. Understand the importance of director's report, auditor's report and filing of P&L A/c and balance sheet.
8. Explain the meaning of key terms used in this chapter.

Each and every form of business organization has to assess the achievements of the concern at specified intervals. The business concerns present the profit earned or loss suffered during the particular period and all the relevant and significant factors contributing to such result, i.e., profit or loss. Students are already well acquainted in assessing the profit and loss of sole (trader) proprietorship and (firm) partnership form of business concerns at regular intervals by preparing the final accounts. However, the preparation of final accounts of the companies (Joint stock company—another form of business organization) requires the skill of understanding and applying the salient provisions of the Companies Act, Accounting Standards issued there and there by ICAI, and the Income Tax Act in order to present a true and fair view of the company for the particular period. This chapter aims at explaining all the relevant factors relating to the preparation and presentation of final accounts of companies in a crystal clear manner.

7.1 MEANING OF FINAL ACCOUNTS

The term "final accounts" generally denotes trading and profit & loss account and the balance sheet in case of sole traders and partnership firms. One should observe here that the same principles that have been

used in the preparation of final accounts of sole proprietorship or a partnership firm will hold good for the company accounts also. However, there are some similarities and few differences in the preparation of final accounts of partnership firms and joint stock companies.

The following factors are similar to both forms of businesses:

1. The main principle applied is that of matching revenue and expenditure.
2. Expenditure of revenue nature alone should be debited.
3. Expenses and revenue pertaining to that accounting period alone are to be taken into account.
4. All incomes with respect to that accounting period are to be credited to P&L A/c.
5. Any losses suffered by some other reasons are also to be debited to P&L A/c.
6. Depreciation on fixed assets is also to be charged to P&L A/c.
7. Adjustments for prior years are to be shown separately.

The main differences in the preparation of final accounts with respect to company and partnership firms are as follows:

Particulars or Item	Company	Partnership Firm
1. Heading of the Account	Profit & Loss A/c	Trading and Profit & Loss A/c
2. Appearance of Special Items	Some Items such as Debentures, Director's Fees Appear in Company's P&L A/c	Such Items Will Not Appear in Accounts of a Partnership Firm
3. Transfer of Profit or Loss	Profit or Loss of a Company is Not Transferred to (Share) Capital A/c	Profit or Loss of a Firm is Transferred to the Capital Accounts of the Partners (Current A/cs)
4. Appropriation (Divisible Profits)	There Are Special Features to the Appropriation of Profits of the Company	There Are No Such Special Features in Firms
5. Above the Line and Below the Line Items	Some Items are Shown "Above the Line" and Some Items are Shown "Below the Line" in Company Accounts	There is No Such Procedure in Partnership Firms

To explain in detail, in other than joint stock company forms of business concerns, the final accounts of such entities are split into two sections, viz. trading account and profit & loss account. But in company's final accounts, there is only account but comprises all the following in a single Profit & Loss A/c: Trading A/c; Profit & Loss A/c and Profit & Loss Appropriation A/c. An imaginary line is presumed to exist between Profit & Loss A/c and Profit & Loss appropriation A/c. Items that are to be shown in Trading and Profit & Loss A/c are called "above the line" items and the items that are to be shown in Profit & Loss appropriation A/c are called "below the line" items in company Accounts.

Now, we have to study the statutory provisions relating to P&L A/c & balance sheet of the companies. The Company's Act stipulates certain provisions regarding this. Some of these are as follows:

1. **Section 209** deals with "books of account" to be kept by the company.
2. **Section 210**
   (i) Stipulates that at every annual general meeting of a company held in pursuance of Section 166, the Board of Directors of the company shall lay before the company
      (a) A balance sheet as at the end of the period specified in Sub-section (3)
      (b) A profit and loss account for that period
   (ii) In the case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its general meeting instead of a profit and loss account.
   (iii) The profit and loss account shall relate

(a) In the case of the first annual general meeting of the company, to the period beginning with the incorporation of the company and ending with a day which shall not precede the day of the meeting by more than nine months

(b) 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 a day which shall not precede the day of the meeting by more than six months, or in case where an extension of time has been granted for holding the meeting under the second proviso to Sub-section (1) of Section 166, by more than six months and the extension so granted.

(iv) The period to which the account aforesaid relates is referred to in this Act as a "financial year"; and it may be less or more than a calendar year, but it shall not exceed 15 months. Provided that it may extend to 18 months, where special permission has been granted in that behalf by the Registrar.

3. **Section 211** deals with forms and contents of balance sheet and profit and loss account.
4. **Section 211**(1)
   1. Every balance sheet of 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 Part I of Schedule V1… and in preparing the balance sheet due regard shall be had, as far as may be, to the general instructions for preparation of balance sheet under the heading "Notes" at the end of that part.
   2. Every profit and loss account of a company shall give true and fair view of the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part II of Schedule V1.

   3A. Every profit and loss account and balance sheet of the company shall comply with the accounting standards.

   3B. Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose the following in its profit and loss account and balance sheet:
      (a) The deviation from the accounting standards
      (b) The reasons for such deviation
      (c) The financial effect, if any, arising to such deviation
5. **Section 212** stipulates that the balance sheet of holding company to include certain particulars as to its subsidiaries.
6. **Section 213** provides the financial year of holding company and subsidiary.
7. **Section 215** speaks about authentication of balance sheet and profit and loss account. In case of a company other than a banking company, every balance sheet and every profit and loss account shall be signed on behalf of the Board of Directors by its manager or secretary, if any, and by not less than two directors of the company, one of whom shall be managing director where there is one. The balance sheet and profit and loss account shall be approved by the Board of Directors before they are signed.

According to Section 216, the profit and loss account shall be annexed to the balance sheet and the auditor's report shall be attached.

According to Section 220, after the balance sheet and the profit and loss account have been laid before a company at an annual general meeting as aforesaid, three copies of the balance sheet and the profit and loss account signed by the managing director, manager or secretary or director of the company together with three copies of all documents which are required by this Act to be annexed or attached to the balance sheet or profit and loss account. These should be filed within 30 days from the date on which the balance sheet and the profit and loss account were so said.

Schedule V1—Part I (Section 211) exposes the format of balance sheet: Horizontal form and vertical form, which are shown in page 4 & 15 of this chapter.

Schedule V1—Part II: The provisions of this part relate to "Requirements As To Profit and Loss Account".

These two parts are reproduced from the bare Acts as it is:

SCHEDULE VI
[SEE SECTION 211]

[1][*PART I*

FORM OF BALANCE SHEET

[2][*The balance sheet of a company shall be either in horizontal form or in vertical form:*

A. HORIZONTAL FORM

BALANCE SHEET OF ……

[Here enter the name of the company]

AS AT ……

[Here enter the date as at which the balance sheet is made out]

Instructions in accordance with which liabilities should be made out	**LIABILITIES**		**ASSESTS**		***Instructions in accordance with which assets should be made out***
	Figures for the previous year ***₹ (b)***	***Figures for the current year*** ***₹ (b)***	***Figures for the previous year*** ***₹ (b)***	***Figures for the current year*** ***₹ (b)***	
*Terms of redemption or conversion (if any) of any redeemable preference capital to be [1]stated, together with earliest date of redemption of conversion.	*SHARE CAPITAL Authorized….shares of Rs……each †Issued (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class)…..shares of Rs. ……each.		*FIXED ASSETS Distinguishing as far as possible between expenditure upon (a) goodwill, (b) land, (c) buildings, (*d*) leaseholds, (*e*) railway sidings, (*f*) plant and machinery, (*g*) furniture and fittings, (*h*) development of property, (*i*) patent, trademarks and design, (*j*) livestock, and (*k*) vehicles, etc.		*Under each head the original cost, and the additions thereto and deductions there from during the year, and the total depreciation written off or provided up to the end of the year to be stated.
†Particulars of any option on unissued share capital to be specified. †Particulars of the different classes of preference shares to be given.	†Subscribed (distinguished between the various classes of capital and stating the particulars specified below, in respect of each class). (c)…….shares of Rs. …..each. Rs. ……called up. Of the above shares…… shares are allotted as fully paid-up pursuant to a contract without payments being received in cash].				

[1]. Substituted by the companies (Amendment) Act. 1960.

[2]. Inserted by Notification No. GSR 220(E), dated 12-3-1979.

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSESTS		Instructions in accordance with which assets should be made out
	Figures for the previous year ₹ (b)	Figures for the current year ₹ (b)	Figures for the previous year ₹ (b)	Figures for the current year ₹ (b)	
[3][*Specify the source from which the bonus shares are issued, e.g., capitalization of profits or Reserves or from Share Premium Account.]	[4][Of the above shares…..shares are allotted as fully paid-up by way of bonus shares*] Less: Calls unpaid; [5][(i) By managing agent or secretaries and treasures and where the managing agent or secretaries and treasurers are a firm, by the partners thereof, and where the managing agent or secretaries and treasuries are a private company, by the directors or members of that company.] (ii) By directors. (iii) By others.				[5][Where the original cost of aforesaid and additions and deductions thereto, relate to any fixed asset which has been acquired form a country outside India, and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment towards the whole or a part of the cost of the asset of for repayment of the whole or a part of money borrowed by the company form any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the assets (being in either case the liability existing immediately before the date on which the change in rate of exchange takes effect), the amount by which the
[6][†Any capital profit on reissue of forfeited shares should be transferred to Capital Reserve.]	[7][†Add: Forfeited shares (amount originally paid-up.)]				

3. Inserted by Notification No. GSR 414 dated 21.3.1961.
4. Substituted, ibid.
5. Inserted by Notification No. GSR 129 dated 3.1.1968.
6. Inserted by Notification No. GSR 414 dated 21.3.1961.
7. Substituted, ibid.

Instructions in accordance with which liabilities should be made out	**LIABILITIES**		**ASSESTS**		*Instructions in accordance with which assets should be made out*
	Figures for the previous year ₹ *(b)*	*Figures for the current year* ₹ *(b)*	*Figures for the previous year* ₹ *(b)*	*Figures for the current year* ₹ *(b)*	
					liability is so increased or reduced during the year, shall be added to, or, as the case may be, deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed asset. *Explanation* 1: This paragraph shall apply in relation to all balance-sheets that may be made out as at the 6th day of June, 1966, or any day thereafter and where, at the date of issue of the notification of the Government of India, in the Ministry of Industrial Development and Company Affairs (Department of Company Affairs), G.S.R. No. 129, dated the 3rd day of January, 1968, any balance sheet, in relation to which this paragraph applies, has already been made out and laid before the company in Annual General Meeting, the adjustment referred to in this paragraph may be made in the first balance sheet made out after the issue of the said notification *Explanation* 2: In this paragraph unless the context

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSESTS		Instructions in accordance with which assets should be made out
	Figures for the previous year ₹ (b)	Figures for the current year ₹ (b)	Figures for the previous year ₹ (b)	Figures for the current year ₹ (b)	
					otherwise requires the expression "rate of exchange", "foreign currency" and "Indian currency" shall have the meanings respectively assigned to them under subsection (1) of section 43A of the Income-Tax Act, 1961 (43 of 1961), and *Explanation* 2 and *Explanation* 3 of the said sub-section shall, as far as may be, apply in relation to the said paragraph as they apply to the said sub-section (1). [8][In every case where the original cost cannot be ascertained, without unreasonable expense or delay, the valuation shown by the books shall be given. For the purpose of this paragraph, such valuation shall be the next amount at which an asset stood in the companies book at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold, the amount of sale proceeds shall be shown as deduction.]

[8]. Substituted by Notification No. GSR 414 dated 21.3.1961.

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSESTS		Instructions in accordance with which assets should be made out
	Figures for the previous year ₹ *(b)*	*Figures for the current year* ₹ *(b)*	*Figures for the previous year* ₹ *(b)*	*Figures for the current year* ₹ *(b)*	
					Where sums have been written off on a reduction of capital or a revaluation of assets, every balance sheet, (after the first balance sheet) subsequent to the reduction or revaluation shall show the reduced figures and with the date of the reduction in place of the original cost. Each balance sheet for the first five years subsequent to the date of the reduction, shall show also the amount of the reduction made. Similarly, where sums have been added by writing up the assets, every balance sheet has subsequent to such writing up shall show the increased figures with the date of the increase in place of the original cost. Each balance sheet for the first five years subsequent to the date of writing up shall also show the amount of increase made. [9]Explanation: Nothing contained in the preceding two paragraphs shall apply to any adjustment made in accordance with the second paragraph.

[9]. Inserted by Notification No. GSR 129 dated 31.3.1968.

Instructions in accordance with which liabilities should be made out	**LIABILITIES**		**ASSESTS**		*Instructions in accordance with which assets should be made out*
	Figures for the previous year ₹ *(b)*	*Figures for the current year* ₹ *(b)*	*Figures for the previous year* ₹ *(b)*	*Figures for the current year* ₹ *(b)*	
*Additions and documents since last balance sheet to be shown, under each of the specified heads. The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by earmarked investments.	***RESERVE AND SURPLUS:** [10][(1) Capital Reserves. (2) Capital Redemption Reserve. (3) Share Premium Account (cc). (4) Other reserves specifying the nature of each reserve and the amount in respect thereof. Less: Debit balance in profit and loss account (if any) (b). (5) Surplus, i.e., balance in profit and loss account after providing for proposed allocations, namely: - Dividend, bonus or reserves. (6) Proposed additions to reserves. (7) Sinking Funds.]		**INVESTMENTS:** Showing nature of investments and mode of valuation, for example, cost or market value and distinguishing between- *(1) Investments in Government or Trust Securities. *(2) Investments in shares, debentures or bonds (showing separately shares, fully paid-up and also distinguishing the different classes of shares, debentures or bonds of subsidiary companies. (3) Immovable properties. [11][(4) Investments in the capital of partnership firms.] [13][(5) Balsance of unutilized monies raised by issue.]		*Aggregate amount of companies quoted investment and also the market value thereof shall be shown. Aggregate amount of company's unquoted investments shall also be shown. [12][All unutilized monies out of the issue must be separately disclosed in the balance sheet of the company indication the form in which such unutilized funds have been invested.]
[14][Loans from Directors, [5][the Managing Agents, Secretaries and Treasurers,] Manager should be shown separately. Interest accrued and due on Secured Loans should be included under the appropriate sub-heads under the head "SECURED LOANS".] *The nature of the security to be specified in each case.	**SECURED LOANS:** *(1) Debentures-† *(2) Loans and advances from banks. *(3) Loans and advances from subsidiaries. *(4) Other loans and advances.		**CURRENT ASSETS, LOANS AND ADVANCES:** (A) CURRENT ASSETS (1) Interest accrued on Investments. ††(2) Stores and spare parts. [14][(3) Loose tools.] ††(4) Stock-in-trade. **(5) Works-in-progress. ††(6) Sundry debtors- (a) Debts outstanding for a period exceeding six months. (b) Other debts. [14][*Less*: Provision]		††Mode of valuation of stock shall be stated and the amount in respect of raw material shall also be stated separately. where practicable. **Mode of valuation of works-in-progress shall be stated. †In regard to sundry debtors particulars to be given separately of-(a) debts considered good and in respect of which the company is fully

10. Substituted by Notification No. GSR 414 dated 21.3.1961.
11. Inserted by Notification No. GSR 494(E) dated 9.11.1973.
12. Inserted by Notification No. GSR 423(E) dated 13.6.1996.
13. Inserted by Notification No. GSR 423(E) dated 13.6.1996.
14. Inserted by Notification No. GSR 414 dated 21.3.1961.

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSESTS		Instructions in accordance with which assets should be made out
	Figures for the previous year ₹ *(b)*	*Figures for the current year* ₹ *(b)*	*Figures for the previous year* ₹ *(b)*	*Figures for the current year* ₹ *(b)*	
Where loans have been guaranteed by [5][managing agents, secretaries and treasurers] managers and/or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head.					secured; and (b) debts considered good for which the the company holds no security other than the debtor's personal security; and (c) debts considered doubtful or bad. Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated. [15][Debts due from other companies under the same management within the meaning of sub-section (1B) of section 370, to be disclosed with the name of the companies.]
			[17][(7A)Cash balance on hand [(7B) Bank balances- (a) with Scheduled banks; and (b) with others.]		The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note. The [16][provisions] to be shown under this head should not exceed the

15. Substituted by Notification No. GSR 78, dated 4.1.1963.
16. Substituted by Notification No. GSR 414, dated 21.3.1961.
17. Substituted by Notification No. GSR 78, dated 4.1.1963.

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSESTS		*Instructions in accordance with which assets should be made out*
	Figures for the previous year ₹ *(b)*	*Figures for the current year* ₹ *(b)*	*Figures for the previous year* ₹ *(b)*	*Figures for the current year* ₹ *(b)*	
					amount of debts stated to be considered doubtful or bad and any surplus of such [16][provisions], if already created, should be shown at every closing under "Reserve for Doubtful or Bad Debts". [17][*In this regard to bank balances, particulars to be given separately of- (a) the balances lying with Scheduled Banks on current accounts, call accounts, and deposit accounts; (b) the names of the bankers other than the Scheduled Banks and the balance 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 banker; and (c) the nature of interest, if any, of any director or his relative $[or the managing agent/secretaries and treasurers of any associate of the latter] in

[18] Inserted by Notification No. GSR 494(E) dated 9.11.1973.

Instructions in accordance with which liabilities should be made out	LIABILITIES		ASSESTS		Instructions in accordance with which assets should be made out
	Figures for the previous year ₹ *(b)*	*Figures for the current year* ₹ *(b)*	*Figures for the previous year* ₹ *(b)*	*Figures for the current year* ₹ *(b)*	
[18][Loans from Directors, $[the Managing Agents, Secretaries and Treasures,] Manger should be shown separately. Interest accrued and due on Unsecured Loans should be included under the appropriate sub-heads under the head "UNSECURED LOANS".] †Where loans have been guaranteed by $[managing agents, secretaries and treasures,] managers and/or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head. *See note (d) at foot of Form. [21][The name(s) of small scale industrial undertakings) to whom the company owe any sum together with interest outstanding for more than thirty days, are to be disclosed]	**UNSECURED LOANS:** (1) Fixed deposits. †(2) Loans and advances from subsidiaries. †•(3) Short-terms loans and advances: (a) From Banks. (b) From others. †(4) Other loans and advances: (a) From Banks. (b) From others. **CURRENT LIABILITIES AND PROVISIONS:** **A. CURRENT LIABILITIES:** [22][(1) Acceptances. (2) Sundry creditors. [22a][(i) Total outstanding to dues to small scale industrial undertaking(s); and (ii) Total outstanding dues of creditors other than small scale industrial undertaking(s);] (3) Subsidiary companies. (4) Advance payments and unexpired discounts for the portion for which the value has still to be given e.g., in the case of the following classes of companies:- Newspaper, Fire Insurance, theaters, clubs, banking, steam- ship companies etc. [22a][(5) Investor Education and Protection Fund shall be credited by the following amounts namely:- (a) Unpaid dividend; (b) Unpaid application money received by the companies for the allotment of securities and due for refund;		†**(B) LOANS AND ADVANCES** (8) [20][(a) Advances and loans to subsidiaries. [20][(b) Advances and loans to partnership firms in which the company or any of its subsidiaries is a partner.] (9) Bills of Exchange. (10) Advances recoverable in cash or in kind or for value to be received, e.g., rates, taxes, insurance, etc. $(11) [Balances on current account with managing agents or secretaries and treasurers.] (12) Balances with customs, port trust, etc. (where payable on demand.)	each of the bankers (other than Schedule Banks) referred to in (b) above. [19][All unutilized monies out of the issue must be separately disclosed in the balance sheet of the company indicating the form in which such unutilized funds have been invested.] †The above instructions regarding "Sundry Debtors" apply to "Loans and Advances" also.

[19.] Inserted by Notification No. GSR 423(E) dated 13.6.1996.
[20.] Existing item 8 lettered as sub-item (a) and sub-item (b) inserted by Notification No. GSR 494(E).
[21.] Substituted by Notification No. GSR 376(E) dated 22.5.2002.
[22.] Substituted by Notification No. GSR 78 dated 4.1.1963.
[22a.] Inserted by Notification No. GSR 129(E) dated 22.2.1999.

Instructions in accordance with which liabilities should be made out	**LIABILITIES**		**ASSESTS**		*Instructions in accordance with which assets should be made out*
	Figures for the previous year ₹ *(b)*	*Figures for the current year* ₹ *(b)*	*Figures for the previous year* ₹ *(b)*	*Figures for the current year* ₹ *(b)*	
	(c) Unpaired Matured Deposits; (d) Unpaid Matured Debentures; (e) Interest accrued on (a) to (d) above.] (6) Other liabilities (if any) (7) Interest accrued but not due on loans.]				
††The period for which the dividends are in arrear or if there is more than one class of shares, the dividends on each such class are in arrear, shall be stated. The amount shall be stated before the 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 shall be stated. †The amount of any guarantees given by the company on the behaL.F. of directors or other officers of the company shall be stated and where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified.	**A. PROVISIONS** [23][(8) Provision for taxation. (9) Proposed dividends. (10) For contingencies. (11) For provident fund scheme. (12) For insurance, pensions and similar staff benefit schemes. (13) Other provisions.] [A foot note to the balance-sheet may be added to show separately :- (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.]		**MISCELLANEOUS EXPENDITURE:** (to the extent not written off [24] [or adjusted]): (1) Preliminary expenses. (2) Expenses including commission or brokerage on underwriting or subscription of shares or debentures. (3) Discount allowed on the issue of shares or debentures. (4) Interest paid out of capital during construction (also stating the rate of interest). (5) Development expenditure not adjusted. (6) Other items (specifying nature).		
			[25][†PROFIT AND LOSS ACCOUNT]		[26][†Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any.]

23. Substituted by Notification No. GSR 414 dated 21.3.1961.
24. Inserted by Notification No. GSR 414 dated 21.3.1961.
25. Substituted, ibid.
26. Inserted, ibid.

NOTES

General instruction for preparation of balance sheet

(a) The information required to be given under any of the items or sub-items in this Form, if it cannot be conveniently included in the balance sheet itself, shall be furnished in a separate Schedule or Schedules to be annexed to and to form part of the balance sheet. This is recommended when items are numerous.

(b) Naye Paise can also be given in addition to Rupees, if desired.

(c) In the case of subsidiary companies, the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated.

[27][(cc) The item "Share Premium Account" shall include details of its utilization in the manner provided in section 78 in the year of utilization.]

(d) Short-term loans will include those which are due for not more than one year as at the date of the balance sheet.

(e) Depreciation written off or provided shall be allocated under the different asset heads and deducted in arriving at the value of fixed assets.

(f) Dividends declared by subsidiary companies after the date of the balance sheet [should] not be included unless they are in respect of period which closed on/ or before the date of the balance sheet.

(g) Any reference to benefits expected from the contacts to the extent not executed shall not be made in the balance sheet but shall be made in the Board's report.

[28][(h) The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserves, if any.]

(i) As regards Loans and Advances, [amounts due by the Managing Agents or Secretaries and Treasure, either severely or jointly with any persons to be separately stated;] [the amounts due from other companies under the same management within the meaning of sub-section (1B) of section 370 should also given with the names of the companies] the maximum amount due from everyone of these at any time during the year must be shown.

(j) Particulars of any redeemed debentures which the company has power to issue should be given.

(k) 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 books of the company shall be stated.

[29][(l) A statement of investments (whether shown under "Investment" or under "Current Assets" as stock-in-trade) separately classifying trade investments and other investments should be annexed to the balance sheet, showing the names of the body's corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate; provided that in case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms the names of the firms (with the names of all their partners, total capital and the shares of each partner), shall be given in the statement.]

[27] Substituted by Notification No. GSR 414, dated 21.3.1961.

[28] Inserted, ibid.

[29] Substituted by Notification No. GSR 414, dated 21.3.1961

(m) If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realization in the ordinary case of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated.

(n) Except in the case of the first balance sheet laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the balance sheet shall be also given in the balance sheet. The requirement in this behalf shall in the case of companies preparing quarterly or half yearly accounts, etc., relate to the balance sheet for the corresponding date in the previous year.

(o) The amounts to be shown under the Sundry Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances.

[30][(p) Current accounts with directors [managing agents, secretaries and treasurers] and manager, whether they are in credit, or debit, shall be shown separately.]

[31][(q) A small scale industrial undertaking has the same meaning as assigned to it under clause (*j*) of section 3 of the Industries (Development and Regulation) Act, 1951.]

Note: [1$]References to managing agents, secretaries & treasurers should be omitted.

[32][B.VERTICAL FORM

Name of the Company…….

Balance Sheet as at ……

		Schedule No.	*Figures as at the end of current financial year*	*Figures as at the end of previous financial year*
	1 2	3	4	5
I	**Sources of Funds** (1) *Shareholder's 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			

[1$] Words need be deleted

[30.] Substituted by Notification No. GSR 414 dated 21.3.1961.

[31.] Substituted by Notification No. GSR 129(E) dated 22.2.1999.

[32.] Substituted by Notification No. GSR 545(E) dated 1.8.2002.

	(d) Other current assets (e) Loans and advances *Less*: *Current liabilities and provisions*: (a) Liabilities (b) Provisions Net current assets (4) (a) Miscellaneous expenditure to the extent nor 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.
2. The Schedules, referred to above, accounting policies and explanatory notes may be attached shall form an integral part of the balance sheet.

[32a][3. *The figures in the balance sheet may be rounded off as under:-*

Where the turnover of the company in any financial year is:	Round off permissible
(i) *less than one hundred crore rupees*	to the nearest hundreds or thousands, or decimals thereof.
(ii) *one hundred crore rupees or more but less than five hundred crore rupees*	to the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(iii) *five hundred crore rupees or more*	to the nearest hundreds, thousands, lakhs or millions, or crores, or decimals thereof.

3. A footnote to the balance sheet may be added to show separately contingent liabilities.]

3. 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."

PART II

REQUIREMENTS AS TO PROFIT AND LOSS ACCOUNT

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-section (2) of section 210 of the Act, in like manner as they apply to a profit and loss account, but subject to the modification of references as specified in that sub-section.
2. The profit and loss account
   (a) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account; and
   (b) shall disclose every material failure, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.
3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads; and in particular, shall disclose the following information in respect of the period covered by the account:

[33][(i) (a) The turnover, that is, the aggregate amount for which sales are affected by the company, giving the amount of sales in respect of each class of goods dealt with by the company, and indicating the quantities of such sales for each class separately.]

[34][(b) Commission paid to sole selling agents within the meaning of section 294 of the Act.

(c) Commission paid to other selling agents.

(d) Brokerage and discount on sales, other than the usual trade discount.]

[34a][(ii) (a) In case of manufacturing companies

[35](1) The value of the raw materials consumed, giving item-wise break-up and indicating the quantities thereof. In this break-up, as far as possible, all important basic raw materials shall be shown as separate items. The intermediates or components procured from other manufacturers may, if their list is too large, to be included in the break-up, be grouped under suitable headings without mentioning the quantities, provided all those items which in value individually account for 10% or more of the total value of the raw material consumed shall be shown as separate and distinct items with quantities thereof in the break-up.

(2) The opening and closing stocks of goods produced, giving break-up in respect of each class of goods and indicating the quantities thereof.

(b) In the case of trading companies, the purchases made and the opening and closing stocks, giving break-up in respect of each class of goods traded in by the company and indicating the quantities thereof.

(c) In the case of companies rendering or supplying services, the gross income derived from services rendered or supplied.

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if the till amounts are shown ill respect of the opening and closing stocks, purchases, sales and consumption of raw material with value and quantitative break-up and the gross income from services rendered is shown.

(e) In the case of other companies, the gross income derived under different heads.

Note 1: The quantities of raw materials, purchases, stocks and the turnover, shall be expressed in quantitative denominations in which these are normally purchased or sold in the market.

Note 2: For the purpose of items (ii) (a), (ii) (b) and (ii) (d), the items for which the company is holding separate industrial licences, shall be treated as separate classes of goods, but where company has more than one industrial licence for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class. In the case of trading companies, the imported items shall be classified in accordance with the classification adopted by the Chief Controller of Imports and Exports in granting the import licences.

Note 3: In giving the break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break-up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10% or more of the total value of the purchases, stocks, or turnover, as the case may be, are shown as separate and distinct items with quantities thereof in the break-up.]

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33. Substituted by Notification No. GSR 494(E) dated 30.10.1973.
34. Substituted by Notification No. GSR 414 dated 21.3.1961.
34(a). Substituted by Notification No. GSR 494(E) dated 30.10.1973.
35. Vide SO 400(E) dated 19.4.1988.

(iii) In the case of all concerns having works-in-progress, the amounts for which [36][such works have been completed] at the commencement and at the end of the accounting period.

(iv) 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.

If no provision is made for depreciation, the fact that no provision has been made shall be stated [37][and the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act shall be disclosed by way of a note].

(v) The amount of interest on the company's debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any, [37] [paid or payable] to the managing director [2$][the managing agent, the secretaries and treasurers] and the manager, if any.

(vi) The amount of charge for Indian income-tax and other Indian 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.

(vii) The [38][amounts reserved for-]

(a) repayment of share capital; and

(b) repayment of loans.

(viii) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(ix) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(x) Expenditure incurred on each of the following items, separately for each item:-

(a) Consumption of stores and spare parts.

(b) Power and fuel.

(c) Rent.

(d) Repairs to buildings.

(e) Repairs to machinery.

(f) (1) Salaries, wages and bonus.

(2) Contribution to provident and other funds.

(3) Workmen and staff welfare expenses [39][to the extent not adjusted from any previous provision or reserve.

Note [40][1: Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account.]

Note 2: [41][***]

(g) Insurance.

[2$] Words need to be deleted

[36.] Substituted by Companies (Amendment) Act, 1960.

[37.] Inserted by Notification No. GSR 414, dated 21.3.1961.

[38.] Substituted, ibid.

[39.] Substituted by Companies (Amendment) Act, 1960.

[40.] Inserted by Notification No. GSR 1665, dated 9.10.1971.

[41.] Omitted by Notification No. SO 723(E) dated 18.9.1990.

(h) Rates and taxes, excluding taxes on income.

(i) Miscellaneous expenses:

[42][Provided that any item under which the expenses exceed 1 per cent of the total revenue of the company or ₹ 5,000, whichever is higher, shall be shown as a separate and distinct item against an appropriate account head in the Profit and Loss Account and shall not be combined with any other item to be shown under 'Miscellaneous expenses'.]

(xi) (a) The amount of income from investments, distinguishing between trade investments and other investments.

(b) Other income by way of interest, specifying the nature of the income.

(c) The amount of income tax deducted if the gross income is stated under sub-paragraphs (a) and (b) above.

(xii) (a) Profits or losses on investments [42][showing distinctly the extent of the profits or losses earned or incurred on account of membership of a partnership firm] [43][to the extent not adjusted from any previous provision or reserve.

Note: Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account.]

(b) Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount

(c) Miscellaneous income.

(xiii) (a) Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(xiv) The aggregate amount of the dividends paid, and proposed, and stating whether such amounts are subject to deduction of income-tax or not.

(xiv) Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting.

[44][**4.**[45][The profit and loss account shall also contain or give by way of a note detailed information, showing separately the following payments provided or made during the financial year to the directors (including managing directors) [the managing agents, secretaries and treasurers] or manager, if any, by the company, the subsidiaries of the company and any other person:-]

(h) [45] [managerial remuneration under section 198 of the Act paid or payable] during the financial year to the directors (including managing directors), [3$][the managing agent, secretaries and treasurers] or manager, if any;

[$][(ii) expenses reimbursed to the managing agent under section 354;

(iii) commission or other remuneration payable separately to a managing agent or his associate under sections 356, 357 and 358;

[4$][[45][(iv) commission received or receivable under section 359 of the Act by the managing agent or his associate as selling or buying agent of other concerns in respect of contracts entered into by such concerns with the company;]]

(v) the money value of the contracts for the sale or purchase of goods and materials or supply of services, entered into by the company with the managing agent or his associate under section 360 during the financial year;]

[3$] Words need to be deleted.

[45] Words need to be deleted.

[42.] Inserted by Notification No. GSR 494(E) dated 30.10.1973.

[43.] Inserted by Companies (Amendment) Act, 1960.

[44.] Substituted by Companies (Amendment) Act, 1960.

[45.] Substituted by Notification No. GSR 414 dated 21.3.1961.

[46][(vi) other allowances and commission including guarantee commission (details to be given);]

(vii) any other perquisites or benefits in cash or in kind (stating approximate money value where practicable);

(viii) pensions, etc.,-

(a) pensions,

(b) gratuities,

(c) payments from provident funds, in excess of own subscriptions and interest thereon,

(d) compensation for loss of office,

(e) consideration ill connection with retirement from office.]

4A. The profit and loss account shall contain or give by way of a note a statement showing the computation of net profits in accordance with section 349 of the Act with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors (including managing director), [55][the managing agents, secretaries and treasurers] or manager (if any).

4B. The profit and loss account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, [47][whether as fees, expenses or otherwise for services rendered-]

(a) as auditor; [48][***]

[49][(b) as adviser, or in any other capacity, in respect of –

(i) taxation matters;

(ii) company law matters;

(iii) management services; and

(c) in any other manner.]]

[50][**4C.** In the case of manufacturing companies, the profit and loss account shall also contain, by way of a note in respect of each class of goods manufactured, detailed quantitative information in regard to the following, namely:-

(a) the licensed capacity (where licence is in force);

(b) the installed capacity; and

(c) the actual production.

Note 1: The licensed capacity and installed capacity of the company as on the last date of the year to which the profit and loss account relates, shall be mentioned against items (a) and (b) above, respectively.

Note 2: Against item (c), the actual production in respect of the finished products meant for sale shall be mentioned. In cases where semi-processed products are also sold by the company, separate details thereof shall be given.

Note 3: For the purposes of this paragraph, the items for which the company is holding separate industrial licences shall be treated as separate classes of goods but where company has more than one industrial licence for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class.

4D. The profit and loss account shall also contain by way of a note the following information, namely:

(a) value of imports calculated on C.I.F. basis by the company during the, financial year in respect of:-

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[55] Words need to be deleted.

[46.] Substituted by Notification No. GSR 78 dated 4.1.1963.

[47.] Substituted by Notification No. GSR 78 dated 4.1.1963.

[48.] "and" omitted by Notification No. GSR 455 dated 27.4.1974.

[49.] Substituted, ibid.

[50.] Substituted by Notification No. GSR 494(E) dated 30.10.1973.

(i) raw materials;
(ii) components and spare parts;
(iii) capital goods;

(b) expenditure in foreign currency during the financial year on account of royalty, know-how, professional, consultation fees, interest, and other matters;

(c) value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) the amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) earnings in foreign exchange classified under the following heads, namely:-
(i) export of goods calculated on F.O.B. basis;
(ii) royalty, know-how, professional and consultation fees;
(iii) interest and dividend;
(iv) other income, indicating the nature thereof.]

5. The Central Government may direct that a company shall not be obliged to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value or assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.

6. (1) Except in the case or the first profit and loss account laid before the company after the commencement of the Act, the corresponding amounts fir the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account.

(2) The requirement in sub-clause (1) shall, in the case of companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period which entered on the corresponding date or the previous year.

Note: Reference to managing agents, secretaries & treasurers should be omitted.

After having discussed the Statutory Provisions, now we have to understand the Accounting Standards, AS-4 (Revised) and AS-5 (Revised) relates to "Contingencies and Events Occurring After the Balance Sheet Date" and "Net Profit or Loss For the Period, Prior Period Items and Changes in Accounting Policies", respectively. The original text, issued by the Council of the Institute of Charted Accountants of India, is reproduced as follows:

AS-5 (REVISED)—NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

The following is the text of the revised Accounting Standard (AS)-5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, issued by the Council of the Institute of Chartered Accountants of India.

This revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1996, and is mandatory in nature. It is clarified that in respect of accounting periods commencing

on a date prior to 1.4.1996. Accounting Standard (AS) 5 as originally issued in November 1982 (and subsequently made mandatory) will apply.

OBJECTIVE

The objective of this Statement is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Statement requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items, within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

SCOPE

1. This Statement should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.
2. This Statement deals with, among other matters, the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.
3. This Statement does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

DEFINITIONS

4. The following terms are used in this Statement with the meanings specified:

Ordinary activities are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

NET PROFIT OR LOSS FOR THE PERIOD

5. All items of income and expenses which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

6. Normally, all items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.

7. The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

(a) Profit or loss from ordinary activities and

(b) Extraordinary items.

EXTRAORDINARY ITEMS

8. Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

9. Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item.

10. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

11. Examples of events or transactions that generally give rise to extraordinary items for most enterprises are:—

Attachment of property of the enterprise; or an earthquake.

PROFIT OR LOSS FROM ORDINARY ACTIVITIES

12. When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

13. Although the items of income and expense described in paragraph 12 are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is sometimes made in the notes to the financial statements.

14. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 include:

(a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions.

PRIOR PERIOD ITEMS

15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

16. The term ‘prior period items’, as defined in this statement, refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by

circumstances, which though related to prior periods, are determined in the current period *e.g.,* arrears payable to workers as a result of revision of wages with retrospective effect during the current period.

17. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight.

18. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

CHANGES IN ACCOUNTING ESTIMATES

20. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgements based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence, or the useful lives of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

21. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

22. Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

23. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

(a) the period of the change, if the change affects the period only; or

(b) the period of the change and future periods, if the change affects both.

24. A change in an accounting estimate may affect the current period only or both the current period and future periods. For example, a change in the estimate of the amount of bad debts is recognised immediately and, therefore, affects only the current period. However, a change in estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

25. The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

26. To-ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is

included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

27. The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

CHANGES IN ACCOUNTING POLICIES

28. Users need to be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

29. A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

30. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.

31. The following are not changes in accounting policies:

(a) the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions *e.g.,* introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement; and

(b) the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

32. Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such a change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

33. [6*]A change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by paragraph 32 of this Standard should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard.

5. Contingencies and Events Occurring after the Balance Sheet Date.

In its Accounting Standard 4 (Revised), the Institute of Chartered Accountants of India deals with these two classes of events. Results of contingencies, as the term implies, lie in the future though the seed is already sown, *i.e.,* the ultimate outcome, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events. Contingencies are disclosed by way of notes at the foot of the balance sheet. But if there is a probability of a loss arising, it would be better to make a provision in this regard; judgment of management is naturally to be relied upon.

"Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors...". Such events are of two types:

[6*] This paragraph has been added in this Standard pursuant to a limited revision made in 2001.

(i) those that provide further evidence of conditions that existed at the balance sheet date, and

(ii) those that are indicative of conditions that arose subsequent to the balance sheet date.

The former type of events are considered for preparing estimates etc. relating to the year under report; for example, insolvency of a debtor after the balance sheet date is considered for estimating the doubtful debts so that a proper provision is made. Proper provision for taxation cannot be made till the profit before tax is known. Events of the second type generally are not considered, though the Directors in their report to the shareholders should touch upon the important events. "Proposed dividend" is an event after the balance sheet date but it is required to be statutorily disclosed. Also, if the event concerned is so serious as to affect the existence of substratum of the enterprise (*e.g.,* destruction of a major factory by fire), disclosure is usually made.

Now study the revised Accounting Standard-4.]

AS-4 (REVISED)[7*]—CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

The following is the text of the revised Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date" issued by the Council of the Institute of Chartered Accountant of India.

This revised standard comes into effect in respect of accounting periods commencing on or after 1 April 1995 and is mandatory in nature. It is clarified that in respect of accounting periods commencing on a date prior to 1 April 1995, Accounting Standard 4 as originally issued in November 1982 (and subsequently made mandatory) applies.

Introduction

1. This Statement deals with the treatment in financial statements of:
   (a) contingencies, and
   (b) events occurring after the balance sheet date.
2. The following subjects, which may result in contingencies, are excluded from the scope of this Statement in view of special considerations applicable to them;
   (a) liability of life assurance and general insurance enterprises arising from policies issued;
   (b) obligations under retirement benefit plans; and
   (c) commitments arising from long-term lease contracts.*

Definitions

3. The following terms are used in this Statement with the meanings specified:

3.1 A *contingency* is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

3.2 *Events occurring after the balance sheet date* are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and by the corresponding approving authority in the case of any other entity.

Two types of events can be identified:

(a) those which provide further evidence of conditions that existed at the balance sheet date; and

(b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Explanation

4. Contingencies.

4.1 The term "contingencies" used in this Statement is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

[7*] Revised in January 1995,

4.2 Estimates are required for determining the amounts to be stated in the financial statements for many ongoing and recurring activities of an enterprise. One must, however, distinguish between an event which is certain and one which is uncertain. The fact that an estimate is involved does not, of itself, create the type of uncertainty which characterizes a contingency. For example, the fact that estimates of useful life are used to determine depreciation, does not make depreciation a contingency; the eventual expiry of the useful life of the asset is not uncertain. Also, amounts owed for services received are not contingencies as defined in paragraph 3.1, even though the amounts may have been estimated, as there is nothing uncertain about the fact that these obligations have been incurred.

4.3 The uncertainty relating to future events can be expressed by a range of outcomes. This range may be presented as quantified probabilities, but in most circumstances, this suggests a level of precision that is not supported by the available information. The possible outcomes can, therefore, usually be generally described except where reasonable quantification is practicable.

4.4 The estimate of the outcome and of the financial effect of contingencies are determined by the judgement of the management of the enterprise. This judgement is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

5. *Accounting Treatment of Contingent losses*

5.1 The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

5.2 The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on information referred to in paragraph 4.4.

5.3 If there is conflicting or insufficient evidence for estimating the amount of a contingent Loss, then disclosure is made of the existence and nature of the contingency.

5.4 A potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. Suitable disclosure regarding: Mature and gross amount of the contingent liability is also made.

5.5 The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote

5.6 Provisions for contingencies are not made in respect of general or unspecified business risks, Since they do not relate to conditions or situations existing at the balance sheet date.

Accounting Treatment of Contingent Gains

6. Contingent gains are not recognized in financial statements since their recognition may result in the recognition of revenue which may never be realized. However, when the realization of again virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

7. *Determination of the amounts at which Contingencies are included in Financial Statements*

7.1 The amount at which a contingency is stated in the financial statement is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in financial statements.

7.2 In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the amount of contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progress of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

7.3 If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. An example of such contingencies may be the estimated uncollectable portion of accounts receivable. Another example of such contingencies may be the warranties for products sold. These costs are usually incurred frequently and experience provides a means by which the amount of the liability or loss can be estimated with reasonable precision although the particular transactions that may result in a liability or a loss are not identified. Provision for these costs results in their recognition in the same accounting period in which the related transactions took place.

8. *Events Occurring after the Balance Sheet Date*

8.1 Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

8.2 Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

8.3 Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date, but reflect circumstances which have occurred in the following period.

8.4 Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

8.5 There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.

8.6 Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

9. *Disclosure*

9.1 The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.

9.2 If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote (other than the circumstances mentioned in paragraph 5.5). If a reliable estimate of the financial effect cannot be made, this fact is disclosed.

9.3 When the events occurring after the balance sheet date are disclosed in the report of the approving authority, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Accounting Standard

Contingencies

10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:
    (a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and
    (b) a reasonable estimate of the amount of the resulting loss can be made.
11. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote.
12. Contingent gains should not be recognized in the financial statements.

Events Occurring after the Balance Sheet Date

13. Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.
14. Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.
15. Disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise.

Disclosure

16. If disclosure of contingencies is required by paragraph 11 of this Statement, the following information should be provided:
    (a) the nature of the contingency;
    (b) the uncertainties which may affect the future outcome.
    (c) an estimate of the financial effect, or a statement that such an estimate cannot be made.
17. If disclosure of events occurring after the balance sheet date in the report of the approving authority is required by paragraph 15 of this Statement, the following information should be provided:
    (a) the nature of the event;
    (b) an estimate of the financial effect, or a statement that such an estimate cannot be made.

7.2 PREPARATION OF FINAL ACCOUNTS

7.2.1 Stage I—Preparation of Profit and Loss Account

To comply with the statutory provisions of the Companies Act, every company has to prepare the profit and loss of the company at the end of financial year periodically. In order to prepare and present a fair and true view of the profit and Loss of the company, one has to understand the following principles and treatment of various items

7.2.2 Principles

7.2.2.1 Materiality

The concept of materiality is very important for the term preparation of final accounts of a company. But the term "materiality" is a relative term. That means what is to be considered as material for one company may not be considered as material for another company. For instance, a loss of ₹ 2,000 in the transit of goods if the value of goods is in the order of millions of rupees, then ₹ 2,000 is a negligible amount for that company. But the same will not be the situation if the value of goods runs only into thousands. To overcome this, the following guidelines may help in the preparation of the final accounts:

(a) Figures requiring adjustments, relating to previous years, should be shown as an item separately "below the line". That means they should be shown preferably in the profit and loss appropriation account

(b) Items have to be judged on the quantum of the net profit and the size of the sub-group to which they belong

7.2.2.2 Extraordinary Items

The Institute of Chartered Accountants of India defines extraordinary items as, "income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are no expected to recur frequently or regularly." Examples: Profit or loss on speculation, which is not a regular occurrence; Profit or loss on sale of raw materials (that should not occur frequently); Loss due to natural calamities; upward revision of wages with retrospective effect and the like.

Treatment: It should be separately disclosed preferably "below the line", i.e., profit and loss appropriation account.

7.2.2.3 Prior Period Items

The Institute of Chartered Accountant of India defines prior period items as "income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements one or more periods".

Treatment: It will be suffice if these items are shown separately in the profit and loss account. However, such items are to be shown "below the line", preferably. Prior period items should not be confused with the revision of any estimates because revision of estimates is not to be treated as prior period items.

Illustration 7.1

Model: Treatment of (extraordinary) items in the final accounts of the company

The draft accounts of Balaji Ltd. showed a profit for the year ended 31 March 2011 of ₹ 10,00,00 after tax but before taking into account the following items. It had retained earnings of ₹ 7,50,000 at the beginning of the year.

(a) Cost of closing a plant during the year was ₹ 1,25,000. Another plant was closed 6 years ago.

(b) The directors have decided to write off goodwill appearing ₹ 1,00,000 in the beginning of the year.

(c) The sale for ₹ 1,00,000 of an investment acquired 5 years ago at a cost of ₹ 30,000.

(d) A debt of ₹ 1,90,000 from a customer company (now in liquidation) has remained outstanding since 31 March 2010, when no provision was made; the expected dividend is 20p. in the rupee.

(e) The taxation liability for prior year was agreed, and showed that ₹ 20,000 had been underprovided; the provision for tax for the year was ₹ 5,00,000.

(f) It was announced on 15 April 2011, by a foreign Govt., that one of the overseas plants would be nationalized, but compensation has been promised based on five items of the expected annual profit. This has averaged ₹ 60,000 for the last 5 years. The net assets attributable to the plant and included in the balance sheet as on 31 March 2000 are ₹ 5, 00,000.

(g) A professional valuation of buildings owned by the company has shown a surplus over book values of ₹ 3,00,000.

(h) Research and development expenditure carried forward at the beginning of the year amounted to ₹ 4,00,000. The previous policy has not changed and on the new basis only ₹ 2,75,000 would have been carried forward.

You are required to state how the above items will be dealt with in final statements of account.

Solution

(a) Cost of Closing a Plant: ₹ 1,25,000

Accounting Treatment: This is an "extraordinary item".
Hence, it should be shown separately in P&L A/c.

Reasons:
(i) This item is "material" in nature.
(ii) This is an unusual activity, which did not occur often.
The same category of event happened 6 year ago.
(iii) Abnormal expense

(b) Writing Off "Goodwill": ₹ 1,00,000

Accounting Treatment: This is an "extraordinary item".
Hence, it should be shown separately in P&L A/c.

Reasons:
(i) This item is "material" in nature, i.e., it has material effect
(ii) It is not related to ordinary activities of the business

(c) Sale of an Investment: ₹ 1,00,000 – Purchase Cost ₹ 30,000.
A profit of ₹ 70,000 on this sale occurred.

Accounting Treatment: Profit of ₹ 70,000 on sale is an extraordinary item.
It should be shown separately in P&L A/c.

Reasons:
(i) It is "material" is nature
(ii) It is not an ordinary event
(iii) Abnormal income of ₹ 70,000, which will not occur regularly

(d) Bad Debt:

Debt	= ₹ 1,90,000
Less: Divided Yield @ 20p in Rupee	= ₹ 38,000
Bad Debt	= ₹ 1,52,000

Accounting Treatment: Extraordinary item should be shown separately in P&L A/c.

Reasons:
(i) It has material effect to the tune of ₹ 1,52,000
(ii) It is not an ordinary event
(iii) Abnormal

(e) Under Provision of Tax in Previous Years: ₹ 20,000

Accounting Treatment: It is not an extraordinary or exceptional item.
₹ 20,000 should be included with the tax.
Should not be shown separately.

Reasons: It is NOT material.

(f) Nationalization of Overseas Plant:

Net Assets:	₹ 5,00,000
Less: Compensation: (₹ 60,000 × 5)	₹ 3,00,000
Loss:	₹ 2,00,000

Accounting Treatment: It is to be included (₹ 2,00,000) in the director's report.

Reasons: (i) It is a significant event after the balance sheet date.
(ii) It will not affect the substratum of the company

(g) Surplus on revaluation of building: ₹ 3,00,000

Accounting Treatment: The entire amount has to be taken to capital reserves.

Reasons: (i) It is capital gain
(ii) It is not available for payment of dividend

(h) R&D expenditure:

Previous Reserve:	₹ 4,00,000
Less: To Be Carried Forward:	₹ 2,75,000
Reduced Amount on Opening Reserve:	₹ 1,25,000

Accounting Treatment: Opening Reserves Reduced by ₹ 1,25,000.
Should be shown "below the line", as prior year adjustment.

Reason: This previous year adjustment is due to change in accounting policy.
Because of this adjustment, the current year's result will not get affected.

7.2.2.4 Transfer of Profit

In case of sole proprietor of partnership firm, the net profit/loss is transferred to the capital account.

But, in case of a company, the balance of profit in profit and loss appropriation A/c is to be transferred and shown in the balance Sheet under the head "Reserves and Surplus".

7.2.2.5 Preliminary Expenses

Expenses incurred at the time of formation of a company are called preliminary expenses. There are two ways of dealing with these expenses:

(i) Profit and loss account is to be debited with a part amount of expenses and written off; the remaining part amount which is not written off is to be shown in balance sheet under the head "Miscellaneous Expenditure".

(ii) No part is taken to P&L A/c; the entire amount is to be shown in the balance sheet under the head "Miscellaneous Expenditure".

7.2.2.6 Tax Adjustments

7.2.2.6.1 Tax Deducted at Source

A company in the course of running a business makes payment on various items such as interest on securities, dividends, salaries to employees and the like. While making such payments, the company usually deducts tax on the amount paid. Such deduction on the amount is to be made "at the rate in force". The rate is being determined by the Finance Bill passed by the parliament every year.

Accounting treatment: While making payment for interest on debentures, the tax deducted at source (TDS) is to be shown on the liabilities side of the balance sheet till it is paid to the Government by the company. While receiving interest on securities, TDS is shown as an asset in the company's balance sheet. Later, this is to be adjusted with income tax payable after the assessment is over. It is to be deducted from current year's provision for tax, shown on the liabilities side of the balance sheet.

7.2.2.6.2 Advance Payment of Tax

(i) When tax is paid in advance, the journal entry to be passed is:

Advance Payment of Income Tax A/c	Dr.	…	
To Bank A/c			…

(ii) Advance payment of income tax is to be shown as an asset in the balance sheet

(iii) Later, it is adjusted towards income tax payable, after the assessment has been completed

7.2.2.6.3 Income Tax

Income tax payable is to be debited to income tax A/c and TDS and advance payment of tax is to be adjusted in this account.

For instance, if the tax payable on assessed income is ₹2,00,000 and the company has already paid ₹1,40,000 in advance, the balance tax amount payable is ₹60,000. The following is the journal entry that has to be passed:

Income Tax A/c	Dr.	₹2, 00,000	
To Advance Payment of Tax			₹1, 40,000
To Bank A/c			₹60,000

In case the assessment is not completed, then TDS and advance payment of tax are to be shown on the asset side of the balance sheet under the head "Current Asset Loans and Advance".

7.2.2.6.4 Provision for Taxation

Provision for taxation is to be made on the basis of estimate of profit. This is to be debited to P&L A/c "above the line" and credited to "Provision for Taxation A/c" shown in the balance sheet under the head "Current Liabilities and Provisions". Journal entry is:

Profit and Loss A/c	Dr.	…	
To Provision for Taxation A/c			…

The above discussion relates to provision made in the current accounting year .Such provision, which is known as "existing provision", would have been made in the previous year also. This generally appears on the credit side of trial balance. In such a case, income tax paid is to be debited to provision for taxation account. In case the existing provision exceeds the income tax paid, that excess is to be shown on the credit side of P&L appropriation account. If the existing provision is less than the income tax paid, that difference is to be debited further to P&L appropriation A/c.

Illustration 7.2

Model: Tax adjustments

On 31 December 2010, the trial balance of ABC Ltd shows provision for tax of ₹2,50,000 representing the provision for the previous year. The trial balance also shows income tax paid of ₹2,00,000.

It is estimated than a provision of ₹3,00,000 is required for the current year's income. Tax deducted as source while receiving interest on investments amounted to ₹65,000. The gross amount of interest was shown in P&L A/c.

Write the provision for income tax account incorporating the above details.

Solution

Books of ABC Ltd

Provision for Income Tax A/c

Date	Particulars	₹	Date	Particulars	₹
31 Dec. 2010	To Income Tax A/c	2,00,000	1 Jan. 2010	By Balance b/d	2,50,000
	To P&L Appropriation A/c (Bal. Fig.)	50,000			
		2,50,000			2,50,000
31 Dec. 2010	To Tax Deducted at Source A/c	65,000	31 Dec. 2010	By P&L A/c (Current Year Provision)	3,00,000
31 Dec. 2010	To Balance c/d	2,35,000			
		3,00,000			3,00,000
			1 Jan. 2011	By Balance b/d	2,35,000

Illustration 7.3

Model: Tax adjustments—Journal and final

The following are the extracts from the trial balance of a limited company on 31 December 2010:

Particulars	Dr. ₹	Cr. ₹
Provision for Taxation (2009)	—	1,00,000
Advance Tax Paid for 2009	90,000	—
Advance Tax Paid for 2010	1,00,000	—
Tax Deducted at Source 2010	8,000	12,000
Profit & Loss A/c Balance 2009	—	2,00,000

Assessment for the year 2009 was finalized during the year 2010.The final total tax liability for that year was fixed at ₹ 1,10,000. The net profit earned by the company during 2010 before tax amounts to ₹ 3,50,000. The company is in 50% tax bracket.

You are required to pass the necessary journal entries and show how the various items will appear in the company's final accounts.

Solution

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Profit & Loss Appropriation A/c Dr.		10,000	
	To Provision for Taxation A/c: 2009			10,000
	(Extra Provision Made for 2009: ₹ 1,10,000 – ₹ 1,00,000)			

	Provision for Taxation A/c: 2009 Dr.		1,10,000	
	To Advance Income Tax A/c 2009			90,000
	To Tax Payable A/c: 2009			20,000
	(Advance Tax Paid Adjusted Against Prov. for Tax 2009)			
	Profit & Loss A/c Dr.		1,87,500	
	To Provision for Taxation A/c 2010			1,87,500
	(Provision for Tax Made for 2010)			
	50% of ₹ 3,75,000			

Profit & Loss A/C
For the Year Ended 31 December 2010

Date	Particulars	₹	Date	Particulars	₹
	To Provision for Taxation	1,87,500		By Net Profit Before Tax	3,75,000
	To Net Profit After Tax	1,87,500			
		3,75,000			3,75,000

P&L Appropriation A/C
For the Year Ending 31 December 2010

Date	Particulars	₹	Date	Particulars	₹
	To Provision for Taxation 2009			By Balance b/d	2,00,000
	To Balance of Profit Taken to Balance Sheet	10,000		By Net Profit After Tax 2010	1,87,500
		3,77,500			
		3,87,500			3,87,500

Extracts from Balance Sheet
as on 31 December 2010

Liabilities	₹	Assets	₹
Reserves & Surplus Profit & Loss A/c	3,77,500	Loans & Advances:	
Current Liabilities & Provisions: Provision for Taxation 2010 ₹ 1,87,500		Advance Tax Paid	1,00,000
Less: TDS ₹ 8,000	1,79,500		
Tax Payable 2009	20,000		
Tax Deducted at Source	12,000		

Illustration 7.4

Model: Tax adjustments

From the following items found in the trial balance of Exe Ltd on 31 December 2010 and the adjustment given in the following, show how the items would appear in the relevant accounts:

Trial Balance

Particulars	₹	₹
Advance Tax Paid (2009)	50,000	
Provision for Taxation (2009)	—	75,000
Tax Deducted at Source (TDS)	10,000	

Adjustments:

(i) Income tax for 2009 has been assessed at ₹ 90,000 against which the advance payment of tax and TD are to be adjusted

(ii) Provide ₹ 50,000 for taxation on current profits

Solution

Stage I:

Journal Entries to Be Passed:

Books of Exe Ltd

Journal

Date	Particulars	L.F	Dr. ₹	Cr. ₹
	Income Tax A/c Dr.		90,000	
	To Advance Tax A/c			50,000
	To Tax Deducted at Source A/c			10,000
	To Tax Payable A/c (Bal. Fig)			30,000
	(Advance Payment of Tax and TDS are Adjusted Against Income Tax)			

Stage II: Preparation of Provision for Taxation A/c:

Provision for Taxation A/c

Date	Particulars	₹	Date	Particulars	₹
	To Income Tax A/c	90,000		By Balance b/d	75,000
				By P&L Appropriation A/c (Bal. Fig)	15,000
		90,000			90,000
	To Balance c/d	50,000		By P&L A/c (Current Year's Provision)	50,000
		50,000			50,000
				By Balance b/d	50,000

Stage III: Preparation of P&L A/c:

Profit and Loss A/c

For the Year Ended 31 December 2010

Particulars	₹	Particulars	₹
To Provision for Taxation	50,000		

Stage IV: Preparation of Balance Sheet:

(Extracts of) Balance Sheet of Exe Ltd

(As on 31 December 2010)

Liabilities	₹	Assets	₹
Current Liabilities and Provision:			
Provision for Taxation	50,000		
Income Tax Payable	30,000		

Important notes for taxation adjustments:

1. Income tax payable is to be arrived at by deducting advance tax and TDS from the assessed amount and this is again to be shown in the balance sheet.
2. Provision for taxation for the concerned accounting period is to be taken to P&L A/c.
3. TDS (Cr.) is a current liability.
4. TDS (Dr.) may be treated in either of the following ways:
   (i) It may be deducted from current year's provision
   (ii) It may be shown directly on the assets side of the balance sheet

7.2.2.7 Debentures

7.2.2.7.1 Interest on Debentures

The company should provide interest on debentures for the full year even if a part or whole of interest is not paid. Interest on debentures is a charge against profit. Total amount of interest is to be debited to P&L A/c and it is immaterial whether the company has earned profit or suffered loss during that accounting period.

To illustrate, following is the extract of a limited company's trial balance at the end of the year:

	Dr. (₹)	Cr. (₹)
12 % Debentures	—	5, 00,000
Interest on Debentures	25,000	—

The accounting treatment will be as follows:

Step 1: Interest for the Full Year: ₹ 5,00,000 × $\frac{12}{100}$ = ₹ 60,000

Step 2: From the Trial Balance, It Can Be Understood that the Amount Paid as Interest on Debentures is ₹ 25,000. But for the Whole Year It Is ₹ 60,000. Balance (₹ 60,000 – ₹ 25,000) ₹ 35,000 is due.

Step 3: Usually, Interest on Debentures Is Paid Half Yearly.

Step 4: Hence for 6 months, Interest of ₹ 30,000 is Already Due for Payment. Apart from this, ₹ 25,000 is also yet payable.

Step 5: At this juncture, one should understand the following terms:
(a) "Accrued & Due" or "Outstanding"
(b) "Accrued" or "Accrued but Not Due"

Step 6: Now Go to Step 4 again:
₹ 30,000 is to be termed as "Accrued & Due" and
₹ 25,000 is to be termed as "Accrued but Not Due"

Step 7: Accounting Treatment:
(a) "Accrued & Due" and "Accrued but Not Due" are both to be treated as short-term liabilities

(b) However, ₹ 30,000, i.e., "Accrued & Due" or "Outstanding", Is to Be Shown in the Balance Sheet Along with Debentures

(c) ₹ 25,000, i.e., "Accrued but Not Due" or "Accrued" Is to Be Shown as a Current Liability in the Balance Sheet

(d) Profit and Loss A/C Is to Be Debited by the Total Amount, i.e., ₹ 60,000

Important note: It is to be noted with CAUTION. If interest paid on money borrowed for construction of an asset is to be ADDED TO THE COST OF THE ASSET, when such asset comes in to use, the interest paid is to be debited to P&L A/C.

7.2.2.7.2 Income Tax on Interest on Debentures

As per the Income Tax Act provisions, interest on securing has to be deducted at "source". While paying interest on debentures, the company must deduct tax "at rate in force" envisaged in the Finance Act, which tends to vary from year to year. To explain the concept here, the tax rate is assumed as 20% and surcharge and education cess combined together at 5% on tax and calculated as follows:

Example: A person holds ₹ 25,000 12% debentures of a company.

Step 1: Then, Interest Payable to Him by the Company $= 25{,}000 \times \frac{12}{100}$

$= ₹\ 3{,}000.$

Step 2: Company Has to Deduct Tax as Source $= ₹\ 3{,}000 \times 20\% + 5\%$ of 20%

$= ₹\ 3{,}000 \times (20 + 1\%) = 21\%$

$= ₹\ 3{,}000 \times \frac{21}{100}$

$= ₹\ 630$

Step 3: The Company Must Deduct as TDS $= ₹\ 630$

Step 4: Hence, Interest Payable to Debenture Shareholder (Interest – TDS) $= ₹\ 3{,}000 - ₹\ 630$

$= ₹\ 2{,}370$

Step 5: **Accounting Treatment:**

(a) Journal Entry:

Interest on Debentures A/c	Dr.	₹ 3,000	
To Sundry Debentures Holders A/c			₹ 2370
To Income Tax Payable A/c			₹ 630

(b) Balance Sheet:

As Income Tax Payable is a Liability, It Is to Be Shown on the Liabilities Side of the Balance Sheet till It Is Paid Off to the Government.

Sometimes, the interest on debentures is shown in trial balance directly. (We calculated in the above illustration.) Then the amount given in the trial balance has to be taken as the gross amount of interest.

Accounting treatment: This gross amount has to be debited to P&L A/c and the tax deducted at source is to be credited to "Income Tax Payable A/c".

On the other hand, if net interest is given in the trial balance, the amount should be grossed up. The gross interest in such a situation has to be computed by applying the formula as:

$$\text{Gross Interest} = \frac{\text{Interest (Net) Shown in Trial Balance}}{100 - 20\% + 5\% \text{ of } 20\%} \times 100$$

(As explained in above illustration)

Note: 20%—Rate of income tax

5%—Surcharge + Cess on tax

This will vary from year to year as per the latest Finance Act

After determining gross interest (as explained above), accounting treatment is to be carried out.

(c) Discount or Cost of Issue of Debentures:

Discount or commission or cost of issue of debentures is to be shown in the assets side of the balance sheet under the head "Miscellaneous Expenditure".

In practice, a part of the amount is written off and this written off part is to be debited to P&L A/c; the remaining unwritten part is to be shown on the assets side of the balance sheet under "Miscellaneous Expenditure".

To illustrate, the following is the extract of a trial balance on 31 March 2011:

	₹	₹
12% Debentures (to Be Redeemed on 31 March 2015)	—	5,00,000
Discount on Issue of Debentures	50,000	—

Note that the debentures are to be redeemed in 2015, i.e., five years' time (from 1 April 2010).

One-fifth of the amount of ₹ 50,000, i.e. ₹ 10,000, written each year is to be debited to P&L A/c and the unwritten part, i.e., ₹ 40,000, is to be shown in the balance sheet as "Miscellaneous Expenditure" in the first year. In the second year, ₹ 10,000 is to be written off and debited to P&L A/c and the balance ₹ 30,000 is to be shown in the balance sheet under the head "Miscellaneous Expenditure" and so on for the next three more years, till it is written off completely.

7.2.2.8 Managerial Remuneration

The term "managerial remuneration" denotes a wider concept which covers remuneration payable to the (a) manager, (b) managing director and (c) directors, including part-time directors. Remuneration to such personnel is governed by various sections of the Company's Act namely Sections 198 and 200, Section 309, Sections 349 to 351 and Section 387, which imposes a number of restrictions.

Remuneration payable to different categories of managerial personnel are as follows:

(a) **Manger:** Section 387 governs the remuneration to a manger. The manger is an employee of a company. According to Section 387, a manger is entitled to receive remuneration—The remuneration may be in the form of (i) monthly payment or (ii) a specific percentage of the net profits of the company or (iii) partly monthly payment and partly percentage of profits of the company. However, in any form, the total remuneration should not exceed 5% of the net profits of the company, subject to Section 198

(b) **Managing director (whole-time director):** The Company Act prohibits to have both a manger and managing director at a single time. A managing director may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly a monthly payment and partly as a specified percentage of net profits.

(i) If there is only one managing director, or whole time director, the remuneration cannot exceed 5% of the net profits

(ii) If there are more than one whole time directors or managing directors, the remuneration cannot exceed 10% of the net profits for all them together.

(c) **Part-time directors:** They are neither whole time directors nor managing directors. They receive monthly, quarterly or annual payment with the approval of the Central Government. They may also receive commission, if the company authorizes it by passing a special resolution to that effect.

The total remuneration cannot exceed 1% of the net profits of the company, if the company has a managing or whole time director or manager; [OR] 3% of the net profits if the company has no manager, managing director or whole time director. The specified rates may be increased in general meeting with the approval of the Central Government.

Overall managerial remuneration: According to Section 198, maximum remuneration payable to different categories of managerial personnel (as explained so far) is tabulated as follows:

Managerial Personnel (Category)	Max. Percentage
All Managerial Personnel	11%
Manager	5%
Managing Director or Whole-time director	5%
Managing Director or if there Is More than One	10%
Part-time Directors if the Company is Not Having Manager or Managing Director or Whole-time Director	3%
Part-time Directors if Assisted by a Manager or Managing Director or Whole-time Director	1%

Appointment and remuneration of managing director—Conditions and guidelines are provided in Schedule XIII, Part I & Part II, respectively [Companies (Amendment Act 1988)].

Schedule XIII, Part II—Section I deals with remuneration payable by companies having profits: According to this, a company having profits in a financial year may pay any remuneration, by way of salary, dearness allowance, perquisites, commission and other allowance, which shall not exceed 5% of its net profits if there is one such managerial person. If there is more than one managerial person, it cannot exceed 10% of its net profits for all of them together.

Section II deals with remuneration payable by companies having no or insufficient profits:

In case a company has no profits or inadequate profits, it may pay remuneration by way of salary, dearness allowance, perquisites and any other allowances which must be limited to amounts varying from ₹ 75,000 to ₹ 2,00,000 per month, to be fixed as per the following table , in accordance with Press Note No. 3/2000 dated 6 March 2000, issued by Ministry of Law, Justice and Company Affairs (Department of Company Affairs):

Where the "Effective Capital" of the Company is	Monthly Remuneration Limit ₹
(i) Less than ₹ 1 crore	75,000
(ii) ₹ 1 crore or more but less than ₹ 5 crore	1,00,000
(iii) ₹ 5 crore or more but less than ₹ 25 crore	1,25,000
(iv) ₹ 25 crore or more but less than ₹ 100 crore	1,50,000
(v) ₹ 100 crore or more	2,00,000

Effective capital: For the purposes of Section II of this Part, "effective capital" means the aggregate of the paid-up share capital (excluding share application money or advances against shares); amount standing to

the credit of securities premium account; reserves and surplus (excluding revaluation reserve); long-term loans and deposits repayable after one year (excluding working capital loans, overdrafts, interest due on loans unless funded, bank guarantee, etc. and other short-term arrangements); accumulated losses and preliminary expenses not written off.

If the appointment of the managerial person is made in the year in which the company has been incorporated, their effective capital is to be calculated as on the date of such appointments.

In all other cases, the effective capital is to be calculated on the last date of the financial year preceding the financial year in which the appointment of the managerial person is made.

Perquisites: A managerial person is entitled to enjoy the following perquisites which should not be included in the computation of ceiling on remuneration as explained above.

(i) Contribution to provident fund, superannuation fund or annuity fund to the extent that either singly or put together are not taxable under the Income Tax Act

(ii) Gratuity payable at a rate not exceeding half a month's salary for each completed year of service

(iii) Encashment of leave at the end of the tenure

Perquisites for expatriates: In addition to the above, an expatriate managerial person is eligible for the following which should not be included in the computation of ceiling on remuneration:

(a) **Children's education allowance:** For children studying in India or abroad, an allowance of ₹5,000 per child per month or actual expenses whichever is less, subject to a maximum of two children.

(b) **Leave travel concession:** Return passage for self and family members in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India. Here, family means the spouse, dependent children and dependent parents of the managerial person.

Section III: Remuneration payable to a managerial person in two companies:

Subject to the provisions of Sections I and II, a managerial person shall draw remuneration from one or both companies provided the total remuneration drawn from the companies does not exceed the higher maximum limit admissible from any one of the companies of which he is a managerial person.

7.2.2.8.1 Ascertainment of Net Profits for Managerial Remuneration

Section 349 lays down certain provisions as to how the net profits of the company should be ascertained for the purpose of the calculation of remuneration to directors, managers and managing directors.

The profit for managerial remuneration has to be calculated before deducting director's remuneration, in general.

1. Items to be included in profits:
   (i) Gross profit
   (ii) In addition to gross profit, the following credits or incomes should be included: Bounties and subsidies received from any government or any public authority in this behalf by any government unless and except in so far as the Central Government otherwise directs.
2. Items not to be included in profits:
   The following "incomes" or credits should not be included:
   (i) Premium on shares or debentures issued or sold by the company
   (ii) Profits on sale of forfeited shares
   (iii) Profits of a capital nature including profits from the sale of undertaking or any of the undertaking of the company, or any part thereof
   (iv) Profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking of any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling such property or assets

But where the amount for which any fixed asset is sold exceeds its written down value (calculated as per Section 350), credit should be given for so much of the excess as is not higher than the difference between the original cost, that is, fixed asset and its written down value.

To illustrate, a machine purchased for ₹1,00,000, written down to ₹60,000 by writing off depreciation, is sold for ₹1,25,000. The managerial personnel are entitled to commission on (₹1,00,000 – ₹60,000) ₹40,000, i.e., excluding the profit over and above the original cost. (Even if it is sold for ₹1,25,000 it is limited to its original cost ₹1,00,000 only)

3. Items to be deducted from the incomes of the company: From the incomes of the company, the following have to be deducted:
   (i) All the usual working charges
   (ii) Director's remuneration
   (iii) Bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or personally employed or engaged by the company, whether on a whole-time or on a part-time basis
   (iv) Any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits
   (v) Any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf
   (vi) Interest on debentures issued by the company
   (vii) Interest on mortgages executed by the company and loans and advances secured by a charge on its fixed or floating assets
   (viii) Interest on unsecured loans and advances
   (ix) Expenses on repairs, whether to immovable property or to movable property, provided the repairs are not of a capital nature
   (x) Contributions to charitable and other funds not directly relating to the business of the company not exceeding ₹50,000 or 5% of its average net profits during the three financial years immediately preceding, whichever is greater. These limits can be exceeded with the consent of the company in general meeting
   (xi) Depreciation as stipulated in Section 350. Depreciation is to be calculated as per the rates given in Schedule XIV of the Companies Act.

   According to Section 350, the deductions are allowed on Normal depreciation (including extra and multiple shift allowance), excluding any special, initial or other depreciation or any development rebate) calculated at WDV at specified rates.
   (xii) The excess of expenditure over income which arises in computing the net profit in accordance with Section 349
   (xiii) Any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract
   (xiv) Any sum paid by way of insurance risk of meeting, any liability such as is referred to in (xiii)
   (xv) Debts considered bad and written off or adjusted during the year of account
4. Items not to be deducted:
   (i) Income tax, super tax and other taxes on income
   (ii) Any compensation, damages or payments made voluntarily
   (iii) Losses of capital nature including the loss on sale of the undertakings of the company or of any part there of not including any excess of written down value over its sales proceeds or scrap value of any asset sold, discard, demolished or destroyed

Note:

1. The profit and loss account should have a statement attached showing how the profit has been ascertained for the purpose of commission due to directors, managing directors or managers.
2. The company is empowered to ascertain the managerial remuneration on the net profit of the company:
   (i) before charging such commission or
   (ii) after charging such commission

Illustration 7.5

Model: Computation of managerial remuneration

From the particulars given below, determine the maximum remuneration available to a full-time director of a manufacturing company:

The P&L A/c showed a net profit of ₹ 65,00,000 after taking into account the following terms:

		₹
(i) Depreciation (Including Special Depreciation of ₹ 60,000)	:	1,50,000
(ii) Provision for Income Tax	:	2,25,000
(iii) Donation to Political Parties	:	25,000
(iv) Ex-gratia Payment to a Worker	:	25,000
(v) Capital Profit on Sale of Assets	:	30,000

Solution

First choose the items to be added to net profit:

(i) Special depreciation only, i.e., ₹ 60,000
(ii) Provision for income tax
(iii) Ex-gratia payment to worker

Next, items to be deducted have to be picked. Here capital profit is the only item.

Statement of Profit for the Purpose of Managerial Remuneration as per Section 349:

Particulars		₹	₹
Step 1:	NET PROFIT (Given in the Question)		65,00,000
Step2:	ADD: (Items to Be Added)		
	(i) Special Depreciation	60,000	
	(ii) Provision for Income Tax	2,25,000	
	(iii) Ex-gratia Payment to a Worker	25,000	3,10,000
Step 3:	Sub-total (Step 1 + Step 2)		68,10,000
Step 4:	Less: (Items to be Deducted) Capital Profit on Sale of Assets		30,000
Step 5:	Net Profit Available for Managerial Remuneration (Step 3 – Step 4)		67,80,000

As he is a full time director, remuneration is allowed at a maximum of 5% on net profits, as per the statutory provisions.

Hence, Remuneration = ₹ 67,80,000 × $\frac{5}{100}$

= ₹ 3,39,000

Illustration 7.6

Model: Remuneration to the managing director

The following is the profit and loss A/c of X Ltd for the year ended 31 March 2011:

Particulars	₹	Particulars	₹
To Salaries and Wages	2,56,000	By Gross Profit b/d	12,16,000
To Director's Fees	2,000	By Profit on Sale of Company's Land	50,000
To Repairs	54,000	By Profit on Sale of Company's Land	50,000
To Depreciation	1,80,000	By Subsidy Received from State Government	1,00,000
To Scientific Research	40,000		
To General Charges	36,000		
To Interest on Debentures	48,000		
To Income Tax	2,32,000		
To Proposed Dividend	2,00,000		
To Provision for Corporate Dividend Tax	22,000		
To Balance c/d	2,96,000		
	13,66,000		13,66,000

The amount of depreciation is ₹ 1,64,000 as per schedule XIV.

Calculate the remuneration payable to the managing director

Solution

Calculation of Profit (As per Section 349)

Particulars		₹	₹
Step 1:	Gross Profit (Shown in P&L A/c)		12,16,000
Step 2:	Add: (Items to be Added) Subsidy Received from the State Govt.		1,00,000
Step 2A:	Sub-total (Step 1 + Step 2)		13,16,000
Step 3:	Less: (Items to Be Deducted)		
	(i) Salaries & Wages	2,56,000	
	(ii) Director's Fees	2,000	
	(iii) Repairs	54,000	
	(iv) Depreciation (As per Schedule XIV) (Given Information)	1,64,000	
	(v) General Charges	36,000	
	(vi) Interest on Debenture	48,000	5,60,000
Step 4:	Profit Available for Calculation of Remuneration U/S 349 (Step 2A – Step 3)		7,56,000

Hence, remuneration payable to managing director @ 5% = ₹ 7,56,000 × $\frac{5}{100}$

= ₹ 37,800

Approach II: The same may be calculated by taking the balance of profit as the base. Then the following adjustments will have to be made:

Particulars		₹	₹
Step 1:	Balance of Profit as per P&L A/c		2,96,000

Step 2:	ADD: (Items to Be Added)		
	(i) Proposed Dividend (Appropriation)	2,00,000	
	(ii) Provision for Corporate Dividend Tax	22,000	
	(iii) Income Tax	2,32,000	
	(iv) Scientific Research (Capital Nature)	40,000	
	(v) Excess Depreciation (₹ 1,80,000 – ₹ 1,64,000)	16,000	5,10,000
Step 3:	Sub-total (Step 1 + Step 2)		8,06,000
Step 4:	Less: (Items to Be Deducted) Capital Profit on Sale of Land		50,000
Step 5:	Profit Available for Determination of Managerial Remuneration According to Section 349		7,56,000

Hence, remuneration payable to managing director at 5% according to statutory = ₹ 7,56,000 × $\frac{5}{100}$
= ₹ 37,800

Calculation of commission to managerial personnel: Commission is calculated on net profit in the following two ways:

1. Calculation of commission on net profit before taking into account the commission:
   (i) To illustrate, if the profits are ₹ 6,20,000, then the managing director is entitled (if there is only one) to receive 5% of net profit, i.e., ₹ 6,20,000 × $\frac{5}{100}$ = ₹ 31,000.
   (ii) In case there are more than one whole-time directors, the total remuneration to all of them cannot exceed 10%, i.e., ₹ 6,20,000 × $\frac{10}{100}$ = ₹ 62,000.
   (iii) If there is no whole-time director or manager, the part-time directors put together can receive 3% of the net profits, i.e., 3% of ₹ 6,20,000 = ₹ 18,600.
   (iv) If there are two full-time directors and others are part-time directors, the full-time directors put together can be paid up to 10%, i.e., 10% of ₹ 6,20,000 = ₹ 62,000 of all; and all part-time directors put together can get 1%, i.e., 1% of ₹ 6,20,000 = ₹ 6,200.
2. The company is empowered to calculate the commission on profits remaining after charging commission:

   Formula: Commission = $\frac{\text{Rate of Commission}}{100 + \text{Rate of Commission}} \times$ Net Profit

   Take the case of (i) above, if there is only one managing director, under this method, commission will be:

   $= \frac{5\%}{100 + 5}$ on net profit

   = ₹ 6,20,000 × $\frac{5}{105}$ = ₹ 29,523.80

   In the same way, for (ii), (iii) and (iv), commission can be computed and the students can do themselves.

Illustration 7.7

Model: Calculation of commission

Determine the maximum remuneration payable to the part-time directors and manager of Tex Mills Ltd (a manufacturing company) under Sections 309 and 387 of the Companies Act, 1956 from the following particulars:

Before charging any commission, the profit and loss account showed a credit balance of ₹ 25,00,000 for the year ended 31 March 2011, after taking into account the following matters:

	₹
(a) Capital Expenditure	3,10,000
(b) Subsidiary Received from Government	5,20,000
(c) Special Depreciation	80,000
(d) Bonus to Foreign Technician	2,25,000
(e) Provision for Taxation	2,15,000
(f) Compensation Paid to Injured Workman	90,000
(g) Ex-gratia to an Employee	30,000
(h) Multiple Shift Allowance	1,10,000
(i) Loss on Sale of Fixed Assets	50,000
(j) Profit on Sale of Investments	1,70,000

The company is providing depreciation as per Section 350 of the Company's Act, 1956.

Solution

Calculation of profit for the purpose of ascertaining managerial remuneration:

Particulars		₹	₹
Step 1:	Net Profit (Shown in P&L A/c)		25,50,000
Step 2:	ADD: (Items to Be Added in Admissible Items)		
	(i) Capital Expenditure	3,10,000	
	(ii) Provision for Taxation	2,15,000	
	(iii) Special Depreciation	80,000	
	(iv) Ex-gratia to an Employee	30,000	6,35,000
Step 3:	Sub-total (Step 1 + Step 2)		31,85,000
Step 4:	*LESS*: (Items to Be Deducted: Admissible Items)		1,70,000
	Profit on Sate of Government		
Step 5:	Net Profit		30,15,000
Step 6:	*Less*: Part-time Director's Commission @ 1%		30,150
Step 7:	Net Profit for Section 387		29,84,850
Step 8:	Manager's Remuneration @ 5% on ₹ 29,84,850		= ₹ 1,49,242.50
Step 9:	Total Managerial Remuneration (Step 6 + Step 8)		= ₹ 1,79,392.50
	₹ 30,150 + ₹ 1,49,242.50		

Illustration 7.8

Model: Managerial remuneration salary as part of commission

From the following profit and loss account of Seven Hills Ltd for the year ended 31 December 2010 and additional data given, calculate commission due to managing director @ 5% of net profit. Salary of managing director is to be treated as part statement of the commission.

Particulars	₹	Particulars	₹
To Opening Stock	25,000	By Sales	2,10,000
To Bonus (Including ₹ 2000 for 2009)	15,000	By Closing Stock	35,000
To Director's Fees	4,000	By other incomes:	
To Managing Director:		Discount	3,000
Salary	3,000	Profit on Sale of investments	2,000
Commission	1,000		
To Development Rebate Reserve	1,000		
To Provision for Tax	5,000		
To Establishment Expenses	50,000		
To Loss of Sale of Investments	1,000		
To Net Profit c/d	1,45,000		
	2,50,000		2,50,000

The book value of fixed assets sold was ₹ 4,000 and their original cost was ₹ 5,000.

Solution

Statement Showing Managing Director's Remuneration

Particulars		₹	₹
Step 1:	Net Profit (As Shown in P&L A/c)		2,50,000
Step 2:	ADD: (Items Not to Be Deducted)		
	(i) Development Rebate Reserve	1,000	
	(ii) Bonus Related to Previous Year (2009)	2,000	
	(iii) Provision for Tax	5,000	
	(iv) Loss on Sale of Investments	1,000	
	(v) Managing Director's Remuneration		
	(As Shown in P&L A/c: Salary + Commission: 3,000+1,000)	4,000	13,000
Step 3:	Sub-total		2,63,000
Step 4:	Less: (Items to Be Deducted)		
	Capital Profit(Sale of Fixed Assets: (2,000 + 4,000 – 5,000))		1,000
Step 5:	Net Profit Available for Remuneration		2,62,000
Step 6:	Commission to Managing Director @ 5%		13,100
Step 7:	Less: Remuneration Already Paid (₹ 3,000 + ₹ 1,000)		4,000
Step 8:	Remuneration Due to Managing Director (Step 6 – Step 7)		9,100

Illustration 7.9

Model: Managerial commission—Excess remuneration after charging commission

The manager of M/S Rainbow Ltd is entitled to get a salary of ₹ 10,000 per month plus 1% commission on the net profits of the company after such salary and commission.

The following is the profit and loss A/c of the company for the year ended 31 March 2011:

Particulars	₹	Particulars	₹
To Salaries Wages and Bonus	7,70,000	By Gross Profit b/d	36,00,000
To General Expenses	2,96,000	By subsidy from Govt.	2,40,000
To Depreciation	3,28,000	By Profit on Sale of Assets (Cost Price Rs. 10,00,000 and WDV Rs. 7,00,000)	4,00,000
To Expenditure on Scientific Research (Cost of Apparatus)	56,000		
To Manger's Salary	1,20,000		
To Commission to Manager	24,000		
To Provision for Bad Debts	70,000		
To Provision for Income Tax	9,60,000		
To Proposed Dividend	4,00,000		
To Balance c/d	12,16,000		
	42,40,000		42,40,000

Depreciation as per income tax rules amount to ₹ 3,24,000. Calculate the remuneration payable to the manager.

[C.S. (Inter). Modified]

Solution

Commission has to be calculated on the net profits of the company, after charging salary and commission. Hence the formula Commission = Net Profit $\times \frac{5}{100+5}$ has to be applied.

Calculation of Managerial Remuneration

Particulars		₹	₹
Step1:	Net Profit (As per P&L A/c)		12,16,000
Step2:	ADD: (Items Not to Be Deducted)		
	(i) Excess Depreciation Above Income Tax Limit (₹ 3,28,000 – ₹ 3,24,000)	4,000	
	(ii) Expenditure on Scientific Research (Capital Nature)	56,000	
	(iii) Manager's Salary	1,20,000	
	(iv) Commission to Manager	24,000	
	(v) Provision for Bad Debts	70,000	
	(vi) Provision for Income Tax	9,60,000	
	(vii) Proposed Dividend	4,00,000	16,34,000
Step3:	Sub-total (Step 1 +Step 2)		28,50,000
Step4:	Less: (Items to Be Deducted)		
	Capital Profit on Sale of Asset (₹ 7,20,000 + ₹ 4,00,000 – ₹ 10,00,000)		1,20,000
Step5:	Net Profit Available for Remuneration		27,30,000

Step 6: Maximum Commissions as per Statutory Provision

After Charging Commission = Net Profit $\times \frac{5}{105}$

$$= ₹\,27,40,000 \times \frac{5}{105}$$

$$= ₹\,1,30,000$$

		₹
Step 7:	(a) Salary Already Paid =	1,20,000
	(b) Commission Payable (₹ 27,30,000 – 1,20,000) $\times \frac{1}{101}$ =	25,840
	Total (Step 7(a) + 7(b)) =	1,45,840
Step 8:	The manager should get as per agreement, ₹ 1,840 only.	1,45,840

$$\underset{\text{(step 7)}}{\text{Rs. } 1,45,840} - \left(\underset{\text{salary}}{\text{Rs.}1,20,000} + \underset{\text{salary}}{\text{Rs. } 24,000}\right) = ₹\,1,840$$

Step 9: Payment of Commission of ₹ 14,000 (₹ 1,44,000 – ₹ 1,30,000) Is Excess. Hence the Company Has to Recover from the Manger the amount of ₹ 14,000.

7.2.2.9 Depreciation

The company law does not make it compulsory for a company to provide for depreciation on fixed assets. However, Section 205 of the Company's Act requires that dividends cannot be declared without providing for depreciation. Before the commencement of the Companies (Amendment) Act, 1960, the companies could declare dividends without writing off depreciation on fixed assets and without providing for previous losses. But for financial years falling after the commencement of the Companies (Amendment) Act of 1960, dividends cannot be declared unless

(i) Depreciation has been written off the fixed assets in respect of the financial year for which dividend is to be declared as per Section 205(2)

(ii) Arrears of depreciation on fixed assets in respect of any previous year, falling after the commencement of the Companies (Amendment) Act of 1960, have been deducted from the profits

(iii) Losses incurred by the company in the previous years falling after the commencement of the Companies (Amendment) Act of 1960 or the amounts of depreciation provided whichever are less have been deducted

Further, Section 205(2) of the Companies Act stipulates the following methods of providing for depreciation:

1. **The written down value (WDV) method to the extent specified in Section 350:** A company may provide for depreciation on the W.D.V of fixed assets at the end of the financial year at the rates specified for the assets by the Income Tax Act and Rules and at rates specified in Schedule XIV
   - Normal depreciation is to be provided
   - Extra and multiple shift allowances have to be included
   - Any special or initial depreciation need not be provided
   - Similarly, development rebate also may not be provided
   - When an asset is sold, discarded, demolished or destroyed, the excess of WDV over its sale proceeds or over its scrap value should be written off in the financial year in which such thing occurred.
2. **Straight line method (SLM):** Under this method, depreciation may be calculated by dividing 95% of the original cost of a depreciable asset by its specified period. Here, specified period means the number of years at the end of which at least 95% of the original cost of an asset is written off by way of depreciation, if depreciation is to be computed U/S 350.

To illustrate, cost of an asset is ₹ 1,00,000 and the prescribed rate of depreciation on this category of assets is 25%. It will require about 11 years to write off 95% of the original cost by way of depreciation.

$$\text{Amount of Depreciation} = \frac{\text{95\% of Original Cost of Asset}}{\text{Specified Period}}$$

$$= \frac{95\% \text{ ₹}1,00,000}{11 \text{ years}}$$

$$= \frac{95,000}{11} = \text{₹}\,8,636.36$$

Any other basis: Any other method approved by the Central Govt. which has the effect of writing off by way of depreciation 95% of the original cost to the company of each such depreciable assets on the year of the specified period.

Accounting treatment:

The amount of depreciation is debited to depreciation A/c and credited to provision for depreciation A/c (This provision accumulates from year to year). Then depreciation A/c is to be transferred to P&L A/c. (It may also be debited to P&L A/c directly). The balance of provision for depreciation A/c is to be shown in the balance sheet by way of a deduction from the cost of fixed assets.

During the process of accounting treatment, care must be taken to distinguish between "depreciation provided for" and not provided for. After the commencement of the Companies (Amendment) Act, 1960, depreciation not provided for should be first deducted before paying dividend out of the profits of the year for which dividend is to be paid or out of profits of any of the previous years. If there is loss in a year, the amount of depreciation or the amount of total loss is to be deducted out of subsequent profits before payment of dividend. Dividend may be declared out of past profits without providing for subsequent depreciation or losses.

To illustrate, the proper amount of depreciation to be written off for the year ended 31 March 2010 comes out to be ₹ 19,00,000, out of which the company provides for only ₹ 12,00,000, leaving depreciation amounting to ₹ 7,00,000 unprovided for and the P&L A/c shows a loss of ₹ 16,00,000. Further, it is assumed that for the year ended 31 March 2011, the P&L A/c shows a profit of ₹ 30,00,000 after providing in full for the depreciation for 2010–11. Suppose, if the company wants to declare a dividend out of the profits for the year 2010–11, the company has to deduct the following from the profits:

(a) ₹ 7,00,000, depreciation not provided for 2009–10

(b) Either ₹ 16,00,000, the loss for 2010–11; or ₹ 12,00,000 the amount of depreciation actually provided for 2010–11 fair accounting policy may permit to deduct the loss of ₹ 16,00,000 there by leaving the profit for 2010–11 at ₹ 7,00,000 only. But, here the statutory provision permit to deduct only ₹ 12,00,000 leaving profit for 2010–11 at ₹ 11,00,000. The remaining loss of ₹ 4,00,000 may be provided out of profits for the later years before a dividend for that later year is declared.

The companies have been asked to adhere to the recommendations of ICAI'S Guidance Notes on "Accounting for Depreciation in Companies" by the Ministry of Law Justice & Company Affairs, Department of Company Affairs in its Notification dated 4 November 1994. They are:

(a) A company following the WDV method of depreciation in respect of its assets should apply the relevant WDV rates prescribed in Schedule XIV to WDV at the end of the previous financial year as per the books of the company.

(b) A company following the SLM method of depreciation in respect of its assets existing on the date of Schedule XIV into force may adopt any of the following alternative bases of computing the depreciation charge:

  (i) The specified period may be recomputed by applying to the original cost, the revised rate as prescribed in Schedule XIV and depreciation charge calculated by allocating the unamortized value as per the books of account over the remaining part of the recomputed specified period.

  (ii) The company can continue to charge depreciation on straight line basis at old rates in respect of assets existing on the date on which the new provision relating to depreciation came into force.

  (iii) The SLM rates prescribed in Schedule XIV can be straightaway applied to the original cost of all the assets including the existing assets from the year of change of rate.

7.2.2.10 Dividends

According to the provisions of Section 205, the dividend can be declared or paid by a company for any financial year only:

(i) Out of current year's or previous year's profit after providing for depreciation
(ii) Out of both current and previous years' profits
(iii) Out of moneys provided by the Central Government or a state government for the payment of dividend in pursuance of guarantee given by that government.

However, the Central Govt. may permit a company to declare or pay dividend without providing for depreciation. Dividend payable in cash can be made by cheque or warranty to the concerned shareholders.

According to Section 205A (Companies Amendment Act, 1974), a dividend has been declared by the company but has not been paid or claimed, within 30 days from the date of the declaration to any shareholder entitled, to the payment of the dividend, the company shall within 7 days from the date of expiry of the said period of 30 days, transfer the total amount of such dividend to a special account called "unpaid dividend account". Further, if any money transferred to this account remains unpaid of unclaimed for a period of 7 years from the date of transfer, it will be transferred by the company to the "Investor Education & Protection Fund" established as per Section 205(c), subsection (1). Once it gets transferred to this account, such unpaid dividend cannot be claimed as per the Company's (Amendment) Act, 1999.

7.2.2.10.1 Dividends on Paid-up Capital

Declaration of dividend is done in the general meeting of shareholders. However, the rate of dividend cannot be enhanced beyond the level of Board of Directors' recommendation. If the articles permit, interim dividend can be declared by the Board of Directors. The rate of dividend is determined on the paid- up capital. To illustrate, if a company has issued 1,00,000 shares of ₹ 10 each on which ₹ 8 per share has been paid up and if the dividend declared is 10%, total dividend payable will be 10% of ₹ 8,00,000 (the paid-up capital). i.e., ₹ 80,000. If the articles permit, dividend can be declared on the memorial value of shares, i.e. on ₹ 10,00,000, and in such a case, the dividend will be ₹ 1,00,000.

Calls-in-advance cannot be treated as part of paid-up capital. Similar is the treatment for calls-in-arrear. If the articles permit, payment of dividend can be made on shares on which there are calls-in-arrear.

As per Table A, the period is also to be taken into account for calculation of dividend. To illustrate, X Ltd has issued 1,00,000 equity of shares of ₹ 10 each, on which ₹ 7.50 per share was paid on 1 April 2010 and the call on ₹ 2.50 per share was made and paid on 1 July 2010, a dividend of 20% for 2010–11 is to be calculated as follows:

(a) 20%—1 year(April 2010 t0 March 2011): ₹ 1,00,000 × ₹ 7.5 = ₹ 7,50,000
20% of ₹ 7,50,000 = ₹ 1,50,000

(b) 20%—9 months (1 July to 31 March): ₹ 1,00,000 × 2.50

For 9 months, $₹ 2,50,000 \times \frac{9}{12}$

i.e., 20% of ₹ 1,87,500 = ₹ 37,500

Total dividend = $(a + b)$ = ₹ 1,50,000 + ₹ 37,500
= ₹ 1,87,500

7.2.2.10.2 Interim Dividend

Dividend paid for the current year before the year is closed is termed as interim dividend. The profits of the company may not be ascertained accurately before the end of the year because accounts are not closed. In such a situation, the directors have to exercise caution. If an interim dividend is paid arbitrarily, it will

result in inadequate company's profits. Then the directors will have to make good the amount, as they are responsible for declaration of interim dividend.

Interim dividend is paid for a period of 6 months. Hence, the declaration of interim dividend should be carefully "worded". When a company pays interim dividend @ 9% *per annum* on a capital of ₹ 10,00,000, total dividend (interim) on ₹ 10,00,000 for 6 months is ₹ 45,000 only. When the company declares the interim dividend simply as 9%, then total interim dividend is ₹ 90,000. Hence, it should be mentioned carefully. To avoid this sort of affairs, the directors mention the interim, dividend in amount such as so many paise or rupees per share.

According to Section 205(1A), the Board of Directors is empowered to declare interim dividend, and such interim dividend has to be deposited in a bank within 5 days from the date of its declaration.

Accounting treatment: Interim dividend is to be recorded in the debit side of profit and loss appropriation A/c.

7.2.2.10.3 Final Dividend

Final dividend is the dividend declared in the general meeting of a company, after scrutinizing the final figures for the profit available at the end of accounting year.

The final dividend is paid in addition to interim dividend.

Interim dividend is not adjusted against unless the resolution mentions it specifically.

Total dividend is to be calculated as follows:

A company pays dividend at 10% p.a. on its paid-up capital of ₹ 10,00,000 as interim dividend and final dividend of 20%, their the total amount of dividend = Interim dividend on ₹ 10,00,000 at 10% for 6 months:

$$₹\,10,00,00 \times \frac{10}{100} \times \frac{6}{12} = ₹\,50,000 + \text{Final Dividend: 20\% on } ₹\,10,00,000 \text{ for 1 year}$$

$$= ₹\,2,00,000$$

$$= ₹\,50,000 + ₹\,2,00,000 = ₹\,2,50,000.$$

Accounting treatment:

(i) If final dividend paid is given in the trial balance itself, it is to be recorded on the debit side of P&L appropriation A/c.

(ii) If final dividend proposed for the current year is given in adjustments, it is to be recorded in the debit side of P&L appropriation A/c and again it is to be shown on the liabilities side of the balance sheet under the heading "PROVISIONS".

Dividend: Income tax on dividends with respect to shareholders and the company.

Any release of assets in favour of shareholders (to the extent of profits in the respective accounting period) is to be treated as dividend in the eyes of IT Department. Usually, dividend is paid in the form of cash. But here, one has to observe that even if cash is paid not as dividend but as return of capital, it is to be treated as dividend according to IT laws. Issue of bonus shares is not to be treated as dividend as it is not related to release of assets. However, bonus debentures should be treated as dividend.

Dividends are not subject to TDS. They are free from tax for the shareholders.

7.2.2.10.4 Corporate Dividend Tax

Tax on (declaration, distribution or payment of) dividend is called "corporate dividend tax". The Finance Act 1997, imposed additional income tax—tax on distributed profit, on joint stock companies on the amounts of profits distribution by then among the shareholders as dividends, which is called dividend tax.

According to Section 115–0(1) of the Income Tax Act, any amount declared distributed or paid by a domestic company by way of dividends interim or otherwise shall be charged tax @ 10%. The rate varies from year to year as per the provisions envisaged in the Finance Act.

Corporate Dividend Tax was withdrawn in the year 2002, but reintroduced in 2003 (the rate was 12.52% plus surcharge).

Accounting treatment: It should be shown "below the line". For interim dividend, it is to be taken to P&L appropriation A/c. For proposed dividend, it is to be shown as proposed dividend in the P&L appropriation A/c and it should be shown under the heading "Provisions" along with provision for income tax.

7.2.2.10.5 Dividends Paid Out Of Revenue Reserves

A company can declare dividend out of reserves subject to the following as per Section 205 A (3) of the Company Act:

(i) The rate of dividend should be 10% (or) the average of the rates of the five preceding years, whichever is less;

(ii) The amount drawn from such reserves should not exceed an amount equal to one-tenth of the sum of the paid-up capital and free reserves. The amount so drawn should be utilized in the following order:

(a) To set off losses incurred in that financial year, if any

(b) To declare dividend from the balance, if any

(iii) The balance of reserves after such draw should not fall below 15% of its paid up share capital.

The reserves include amounts transferred from the development rebate reserve and should not include all capital reserves.

7.2.2.10.6 Dividends Paid Out Of Capital Profits

Capital profits arise on account of transactions of capital nature items and they are not connected to ordinary course of business transactions of the company.

Capital profits can be distributed only if:

(i) They are realized in cash

(ii) Surplus remains after a revaluation of all assets

(iii) The Articles do not forbid such distribution

In case if it is to be utilized for dividend distribution, then they cannot be transferred to capital reserve.

Capital profits that cannot be used for payment of dividend are as follows:

(i) Profits prior to incorporation

(ii) Premium on issue of shares. This amount has to be credited to "Securities Premium A/c" which in turn can be utilized as per the provisions envisaged in the Section 78 of the Companies Act

(iii) Profit left out on the reissue of forfeited shares

(iv) Capital redemption reserve

(v) Profit on issue and redemption of debentures

(vi) Profit on acquisition of business, i.e., excess of the value of tangible assets acquired over the liabilities taken over

(vii) Profit on sale of fixed assets (to the extent the sale value exceeds the book value of the assets).

7.2.2.10.7 Interest on Capital

As already mentioned, the capital must not be used for divided purposes. However, interest can be paid out of capital U/S 208 of the Companies Act, subject to the following conditions:

(i) The articles should permit

(ii) The rate of interest should not exceed 4%

7.2.2.10.8 Preference Share Dividend

The rate of dividend for preference shares is to be predetermined. The preference share dividends can be paid only if there are adequate profits. If the preference shares are of cumulative type, dividends shall be payable in future when there are sufficient funds available.

7.2.2.10.9 Profit from Subsidiary Companies

Profits of subsidiary companies cannot be in divisible profit unless the subsidiary company paid dividend.

Journal entries that are to be passed with respect to dividend are as follows:

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
I	Interim Dividend:				
	(a) Interim Dividend Paid During the Year:				
	Interim Dividend A/c	Dr.		—	
	To Bank A/c				—
	(b) Interim Dividend Transfer:				
	P&L Appropriation A/c	Dr.		—	
	To Interim Dividend A/c				—
II	Final Dividend:				
	(a) For Recommending Dividend: (Proposal)				
	P&L Appropriation A/c	Dr.		—	
	(or)				
	Dividend Equalization Reserve A/c	Dr.		—	
	(or)				
	General Reserve A/c	Dr.		—	
	To Proposed Dividend A/c				—
	(b) For Declaring Dividend:				
	Proposed Dividend A/c	Dr.		—	
	To Dividend Payable A/c				—
	(c) For Earning Amount of Pay Dividend:				
	Dividend Bank A/c	Dr.		—	
	To Bank A/c				—
	(d) For Payment of Dividend:				
	Dividend Payable A/c	Dr.		—	
	To Dividend Bank A/c				—
	(e) For Providing Corporate Dividend Tax:				
	P&L Appropriation A/c	Dr.		—	
	To Corporate Dividend Tax A/c				—

	(f) For Transfer *to* Unpaid Dividend:				
	Dividend Payable A/c	Dr.		—	
	To Unpaid Dividend A/c				—
	(g) For Transfer *of* Unpaid Dividend:				
	Unpaid Dividend A/c	Dr.		—	
	To Investor Education and Protection Fund A/c				—

7.2.3 Stage II—Profit and Loss Appropriation Account

So far we have discussed some important terms to be dealt with for the preparation of the first stage of preparation of final accounts—the Profit and Loss A/c.

Now, we proceed to the next stage—preparation of profit and loss appropriation A/c. Though it is not recognized as a separate account in company account/c, for the sake of better understanding of students, it is discussed here as a second part of P&L A/c.

The P&L appropriation account mainly deals with the net profit/loss made during the year and appropriations made during the year. This is mainly concerned with "divisible profits". P&L appropriation A/c shows how the profits are disposed off.

How to prepare P&L appropriation account?

Step 1: Any Amount Brought Forward from the Previous Year Is to Be Recorded on the Credit Side of P&L Appropriation A/c.

Step 2: Net Profit of the Current Year Is to Be Shown on the Credit Side.

Step 3: Transfer *from* General Reserve or Any Other Reserve Will Be Shown on the Credit Side.

Step 4: Provisions that Are No Longer Required Have to Be Shown on the Credit Side.

Step 5: On the Debit Side of P&L Appropriation A/c, the Following Items Are to Be Shown:

(i) Transfer *to* General Reserve
(ii) Income Tax for the Previous Year Not Provided
(iii) Dividend (Interim, Final, Paid, Proposed, etc.)
(iv) Corporate Dividend Paid
(v) Transfer *to* Sinking Fund for Redemption of Debentures
(vi) Surplus (Balancing Figure)—the Balance That Is to Be Transferred to Balance Sheet

7.2.3.1 Proforma of Profit & Loss Appropriation Account

(Students should note that this is not a separate account but continued part of Profit & Loss A/c. At the same time this account alone can be prepared separately)

Particulars	₹	**Particulars**	₹
To Transfer *to* General Reserve	—	By Balance b/d (Last Year's Profit)	—
To Income Tax for Provision (Previous year Not Provided)	—	By Net Profit (Current Year's Profit)	—
To Dividend (Interim, Final, Paid, Proposed, Equity, Reference)	—	By Transfer (From Any Reserve)	—
To Corporate Dividend Tax (paid)	—	By Provisions (No Longer Required)	—

To Debenture Redemption Reserve	—		
To Transfer to Sinking Fund	—		
To Balance c/d			
(Balancing Figure)			
Carried to Balance Sheet	—		
	xx		xx

7.2.3.2 Transfer to Reserves

The Companies Rules 1975 stipulate the companies to transfer to reserves (a certain percentage of profits). Such transfer to reserve should be out of after-tax profits. The Central Government framed the rules regarding transfer to reserves which are reproduced as follows:

1. No dividend shall be declared or paid by a company for any financial year out of the profits of a company for their year arrived at after providing for depreciation in accordance with the provisions of Sub-section (2) of Section 205 of the Companies Act except after the transfer to the reserves of the company of a percentage of its profits for that year as specified below:
   (i) If the dividend proposed exceeds 10% but not 12.5% of the paid-up capital, the amount to be transferred to the reserves shall not be less than 2.5% of the current profits
   (ii) If the dividend proposed exceeds 12.5% but does not exceed 15% of the paid-up capital, the amount to be transferred to the reserves shall not be less than 5% of the current profits
   (iii) If the dividend exceeds 15%., but does not exceed 20% of the paid-up capital, the amount to be transferred to the reserves shall not be less than 7.5% of the current profits
   (iv) If the dividend proposed exceeds 20% of the paid-up capital, the amount to be transferred to reserves shall not be less than 10% of the current profits
2. Nothing in (1) above shall be deemed to prohibit the voluntary transfer by a company of a percentage higher than 10% of its profits to its reserves for any financial year so, however, that:
   (i) Where a dividend is declared,
      (a) a minimum distribution sufficient for the maintenance of dividends to shareholders at rate equal to the average of the rates as which dividends declared by it over the three years immediately preceding the financial year; or
      (b) In a case where bonus share have been issued in the financial year in which the dividend is declared or in the three years immediately preceding the financial year, a minimum distribution sufficient for the maintenance of dividends to shareholders at an amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial year is ensured.

      Provided that a case where the net profits after tax are lower by 20% or more than the average net profits after tax of the two financial years immediately preceding, it shall not be necessary to ensure such minimum distribution
   (ii) Where no dividend is declared, the amount proposed to transfer to its reserves from the current profits shall be lower than the average amount of the dividends to the shareholders declared by it over the three years immediately preceding the financial year.

7.2.3.3 Declaration of Dividend Out of Reserve

The Government have promulgated the following rules regarding utilization of reserves for payment of dividend. In the event of inadequacy or absence of profits in any year, dividend may be declared by a company for that year out of the accumulated profits earned by it in previous years and transferred by

it to the reserves, subject to the conditions that:(i) The rate of the dividend declared shall not exceed the average rates at which dividend was declared by it in five years immediately preceding that year or 10% of its paid-up capital; whichever is less(ii) The total amount to be drawn from the accumulated profit earned in previous years and transferred to the reserves shall not exceed the amount equal to one-tenth of the sum of its paid-up capital and free reserves and the amount so drawn shall first be utilized to set off the losses incurred in the financial year before any dividend in respect of preference or equity shares is declared (iii) The balance of reserves after such drawal shall not fall below 15% of its paid-up capital

7.2.3.3.1 Explanation

The rule "Profits earned by a company in previous years and transferred by it to the reserves" means the total amount of net profits after tax, transferred to reserves at the beginning of the year for which the dividend is to be declared. To compute the amount, all items of capital reserves including reserves created by revaluation of assets should not be included. "Transfer to reserve" is clearly explained by way of illustrations. (Ref: Illustrations 7.17, 7.18, 7.21 and 7.22.)

Illustration 7.10

Model: P &L appropriation A/c

M/s Yogan Ltd had ₹ 40, 00,000 profit on 31 March 2011 after making provision for depreciation and taxation ₹ 2,10,000. Profit was brought forward from last year following recommendations made by the directors of the company to appropriate the profits:

(i) To transfer to general reserve: ₹ 10,25,000
(ii) To pay ₹ 1,45,000 as ex-gratia bonus to employee of the company
(iii) To declare dividend @ 5% on equity shares
(iv) To transfer ₹ 80,000 to staff gratuity reserve
(v) To transfer ₹ 95,000 to development rebate reserve
(vi) To transfer ₹ 1, 20,000 to deferred taxation reserve

The company's capital consisted of 20,000 equity shares of each fully paid. For the year ended 31 March 2011, the directors transferred ₹ 90,000 to dividend equalization reserve and ₹ 75,000 to debenture redemption fund. You are required to prepare profit and loss appropriation A/c.

Solution

Profit brought forward from last year and current year's profit are to be taken to the credit side and all the other items (in this problem) are to be shown on the debit side of the P&L appropriation A/c.

Profit & Loss Appropriation A/c
for the Year Ended 31 March 2011

Particulars	₹	Particulars	₹
To Proposed Transfer to General Reserve	10,25,000	By Balance b/d (Last Year's Profit)	2,10,000
To Proposed Ex-gratia Bonus	1,45,000	By Net Profit (Profit for Current Year)	40,00,000
To Proposed Dividend (₹ 20,000 × ₹ 100 × 5/100)	1,00,000		
To Corporate Dividend Tax (₹ 1,00,000 @ 10%)	10,000		
To Staff Gratuity Reserve	80,000		

To Development Rebate Reserve	95,000		
To Deferred Taxation Reserve	1,70,000		
To Dividend Equalization Reserve	90,000		
To Debenture Redemption Fund	75,000		
To Balance Carried Forward to Balance Sheet (Balancing Figure)	24,20,000		
	42,10,000		42,10,000

Illustration 7.11

Model: Appropriation of profits

Senthil Ltd. had a credit balance of P&L A/c of ₹ 9,00,000 on 1 April 2010 and the net profit for the year 2010–11 is ₹ 90,00,000. It was decided that the following decisions be carried out regarding provisions, reserves and dividends:

(i) General reserve: ₹ 10,50,000
(ii) Investment allowance reserve: ₹ 10,50,000
(iii) Provision for taxation @ 50%
(iv) Dividend equalization fund A/c ₹ 6,00,000
(v) Dividend on 10% preference shares of ₹ 60,00,000
(vi) Dividend at 15% on 9,000 equity shares of ₹ 100 each fully paid

You are required to give P&L appropriation A/c and journal entries for payment of dividend.

[B.Com (Hons). Delhi Modified]

Solution

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Proposed Equity Dividend A/c	Dr.		13,50,000	
	Proposed Preference Dividend A/c	Dr.		6,00,000	
	To Equity Dividend Payable A/c				13,50,000
	To Preference Dividend Payable A/c				6,00,000
	(Equity Dividend: ₹ 90,00,000 × 15% = 13,50,000 Pref. Dividend: ₹ 60,00,000 × 10% = 6,00,000 Declared)				
	Dividend Bank A/c	Dr.		19,50,000	
	To Bank A/c				19,50,000
	(Amount for Payment of Dividend Transferred to Dividend Bank A/c)				
	Equity Dividend A/c	Dr.		13,50,000	
	Preference Dividend A/c	Dr.		6,00,000	
	To Dividend Bank				19,50,000
	(Equity &Preference Dividend Paid)				

	Profit & Loss Appropriation A/c Dr.		1,95,000	
	To Corporate Dividend Tax A/c			1,95,000
	(Provision for Corporate Dividend Tax ₹ 13,50,000 + ₹ 6,00,000) × 10/100 = ₹ 1,95,000)			

Step 1: Provision for Taxation has to be calculated as:

Provision for Taxation = 50% (Given)

Net Profit Before Tax = ₹ 90, 00,000 (Given)

∴ Provision for Taxation = 50% of ₹ 90, 00,000

= ₹ 45, 00,000.

Step 2: This Provision for Taxation is a Charge Against Profit. It has to be subtracted from Current Year's Profit.

₹ 90, 00,000 – ₹ 45, 00,000 = ₹ 45,00,000, which is the Net Profit After Tax.

The same may be depicted through P&L A/c as follows:

P&L A/c for the Year Ended 31 March 2011

Particulars	₹	Particulars	₹
To Provision for Taxation (50% of ₹ 90,00,000)	45,00,000	By Net Profit Before Tax	90,00,000
To Net Profit c/d (Balancing Figure)	45,00,000		
	90,00,000		90,00,000

Step 3:

Profit & Loss Appropriation A/c
for the Year Ended 31 March 2011

Particulars	₹	Particulars	₹
To General Reserve	10,50,000	By Balance b/d (Previous Year Profit)	9,00,000
To Investment Allowance Reserve	10,50,000	By Net Profit (Current Year's Profit After Tax)	45,00,000
To Dividend Equalization Fund	6,00,000		
To Proposed Equity Dividend (Ref: Journal)	13,50,000		
To Proposed Preference Dividend (Ref: Journal)	6,00,000		
To Corporate Dividend Tax (Ref: Journal)	1,95,000		
To Balance c/d (Carried to Balance Sheet Bal. Fig)	5,55,000		
	54,00,000		54,00,000

7.2.4 Stage III—Preparation of Balance Sheet

According to Section 210 of the Companies Act, Balance Sheet has to be prepared at the end of each specific period. Further, Section 211 requires the balance sheet to be prepared in the prescribed form. But, banking, insurance and electricity companies and companies governed by special acts are exempted from this.

The form of the balance sheet as shown in Schedule VI of the Companies Act is to be adopted. The main object of insisting such a prescribed form is that every company has to present a true and fair view of the state of affairs of the company as at the end of each specific period. In case adequate information cannot be provided for any items in the balance sheet itself, then it can be shown in a separate schedule which has to be annexed to the balance sheet.

Illustration 7.12

Model: Preparation of P&L A/c and balance sheet

The following is the trial balance of Vir Ltd. as on 31 March 2011:

Particulars	₹	Particulars	₹
Stock as on 1 April 2010	7,50,000	Purchase Returns	1,00,000
Purchase	24,50,000	Sales	34,00,000
Wages	3,00,000	Discount	30,000
Carriage Inwards	9,500	Profit & Loss Account	1,59,000
Furniture	1,70,000	Share Capital	10,00,000
Salaries	75,000	Sundry Creditors	1,75,000
Rent	40,000	General Reserve	1,55,000
Sundry Trade Expenses	60,500	Bills Payable	70,000
Dividend Paid for 2009–10	90,000		
Corporate Dividend Tax Paid	9,000		
Sundry Debtors	2,85,000		
Plant & Machinery	2,90,000		
Cash at Bank	4,62,000		
Patents	48,000		
Bills Receivable	50,000		
	50,89,000		50,89,000

Prepare the profit and loss account for the year ended 31 March 2011 and a balance sheet as on that date after considering the following adjustments:

(i) Stock as on 31 March 2011 was valued at ₹ 8,81,000

(ii) Make a provision for income tax as 35%

(iii) Depreciate plant and machinery at 15%; furniture at 10% and patents at 5%

(iv) On 31 March 2011, outstanding rent amount to ₹ 8,000

(v) The Board recommends payment of dividend @15% p.a. Then transfer the minimum amount required to general reserve. Also make a provision for corporate dividend tax @10% of the amount proposed to be distributed.

(vi) Provide ₹ 3,100 for doubtful debts

(vii) Provide ₹ 52,000 for managerial remuneration [C.S. (Inter). Modified]

Solution

From the particulars given in trial balance, first the P&L A/c has to be prepared comprising (i) trading, (ii) P&L A/c and (iii) P&L appropriation A/c; and then the balance sheet has to be prepared as follows.

Profit and Loss Account
For the Year Ended 31 March 2011

Particulars		₹	Particulars	₹
To Opening Stock		7,50,000	By Sales	34,00,000
To Purchases:	24,50,000		By Closing Stock	8,81,000
Less: Returns	1,00,000	23,50,000		
To Wages		3,00,000		
To Carriage Inwards		9,500		
To Gross Profit c/d		8,71,500		
		42,81,000		42,81,000
To Salaries		75,000	By Gross Profit b/d	8,71,500
To Rent	40,000		By Discount	30,000
Add: Outstanding	8,000	48,000		
To Sundry Trade & Expenses				
To Depreciation on:				
Plant & Machinery:	43,500			
Furniture	17,000			
Patents	2,400	62,900		
To Provision for Bad Debts		3,100		
To Managerial Remuneration o/s		52,000		
To Provision for Income Tax @ 35%		2,10,000		
To Net Profit c/d		3,90,000		
		9,01,500		9,01,500
To Dividend Paid (2009–10)		90,000	By Balance b/d	1,59,000
To Corporate Dividend Tax Paid		9,000	By Net Profit (Current Year)	3,90,000
To General Reserve (5% on ₹ 3,90,000)		19,500		
To Proposed Dividend @ 15%		1,50,000		
To Provision for Corporate Dividend Tax @ 10% on Proposed Dividend		15,000		
To Balance c/d (Carried to Balance Sheet)		2,65,500		
		5,49,000		5,49,000

Balance Sheet
as at 31 March 2011

Liabilities		₹	Assets		₹
Share Capital: Authorized		…	Fixed Assets:	₹	
Issued and Subscribed		10,00,000	Plant & Machinery:	2,90,000	
Reserves & Surplus:			Less: Depreciation	43,500	2,46,500
General Reserve:	₹ 1,55,000		Furniture:	1,70,000	
Add: Additions	₹ 19,500	1,74,500	Less: Depreciation	17,000	1,53,000
Surplus:			Patents:	48,000	
Credit Balance of P&L			Less: Depreciation	2,400	45,600
Appropriation A/c		2,65,500			
Current Liabilities & Provisions:			Current Assets, Loans and Advances:		
(A) Current Liabilities:			(A) Current Assets:		
Bills Payable		70,000	Stock		8,81,000
Creditors		1,75,000	Debtors	2,85,000	
Rent Outstanding		8,000	Less: Provisions	3,100	2,81,900
Managerial Remuneration o/s		52,000	Cash at Bank		4,62,000
(B) Provisions:			(B) Loans & Advances:		
Provision for Taxation		2,10,000	Bills Receivable		5 0,000
Provision for Corporate Dividend Tax on Proposed Dividend		15,000			
Proposed Dividend @ 15%		1,50,000			
		21,20,000			21,20,000

Illustration 7.13

Netaji Co. Ltd. had an authorized capital of ₹ 25,00,000 divided into 2,50,000 equity shares of ₹ 10 each on 31 December 2010 of which 1,25,000 shares were fully called up. The following are the balances extracted from the ledger as on 31 December 2010:

Trial Balance of Netaji Co. Ltd.
as on 31 December 2010

Dr.			Cr.
Particulars	₹	**Particulars**	₹
Opening Stock	2,50,000	Sales	16,25,000
Purchases	10,00,000	Discount Received	15,750
Wages	3,50,000	Profit & Loss A/c	31,100
Discount Allowed	21,000	Creditors	1,76,000
Insurance (Up To 31 March 2011)	33,600	Reserves	1,25,000

Salaries	92,500	Loan from Managing Directors	78,500
Rent	30,000	Share Capital	12,50,000
General Expenses	44,750		
Printing	12,000		
Advertisements	19,000		
Bonus	52,500		
Debtors	1,93,500		
Plant	9,02,500		
Furniture	85,500		
Bank	1,73,500		
Bad Debts	16,000		
Calls-in-Arrears	25,000		
	33,01,350		33,01,350

Further information:

(i) Closing stock was valued at ₹ 9,57,500
(ii) Depreciate plants @ 15% and furniture @10%
(iii) Provide a tax provision of ₹ 40,000
(iv) The directors declared an interim dividend on 15 August 2010 for 6 months ending June 2010 @ 6%.

You are required to prepare P&L A/c for the year ended 31 December 2010 and a balance sheet on that date.

[Madras University Modified]

Profit and Loss Account of Netaji Co. Ltd.
As on 31 December 2010

Particulars		₹	**Particulars**	₹
To Opening Stock		2,50,000	By Sales	16,25,000
To Purchase		10,00,000	By Closing Stock	9,57,500
To Wages		3,50,000		
To Gross Profit c/d		9,82,500		
		25,82,500		25,82,500
To Discount Allowed		21,000	By Gross Profit b/d	9,82,500
To Insurance:	33,600		By Discount Received	15,750
Less: Prepaid for 3 months:	8,400	25,200		
To Salaries		92,500		
To Rent		30,000		
To General Expenses		44,750		
To Printing		12,000		

To Advertising		19,000		
To Bonus		52,500		
To Bad Debts		16,000		
To Depreciation on:				
Plant	1,35,375			
Furniture	8,550	1,43,925		
To Provision for Tax		40,000		
To Net Profit c/d		5,01,375		
		9,98,250		9,98,250
To Interim Dividend			By Balance b/d	31,100
(₹ 12,50,000 – ₹ 25,000) ×		73,500	By Net Profit b/d	5,01,375
To Corporate Dividend Tax @ 10%		7,350		
To Balance Carried Forward to Balance Sheet		4,51,625		
		5,32,475		5,32,475

Balance Sheet of Netaji Co. Ltd
as on 31 December 2010

Liabilities		₹	**Assets**		₹
Share Capital:			Fixed Assets:	₹	
Authorized:			Plant:	9,02,500	
2,50,000 Equity Shares of ₹ 10 Each		25,00,000	Less: Depreciation @ 15%	1,35,375	7,67,125
Issued Subscribed and Called-up Capital:			Furniture:	85,500	
1,25,000 Equity Shares			Less: Depreciation @ 10%	8,550	76,950
of ₹ 10 Each	12,50,000		Current Assets:		
Less: Calls-in-Arrears	₹ 25,000	12,25,000	Loans & Advances		
Reserves & Surplus:			Closing Stock		9,57,500
Reserve		12,5,000	Debtors		1,93,500
Profit & Loss A/c		4,51,625	Bank		1,73,500
Unsecured Loans:		78500	Prepaid Insurance		8,400
Current Liabilities & Provisions			Miscellaneous Expenditure		Nil
Creditors		1,76,000			
Provisions for Tax		40,000			
Interim Dividend Payable		73,500			
Dividend Tax Payable		7,350			
		21,76,975			21,76,975

Illustration 7.14

The authorized capital of Durai Ltd. is ₹24,00,000 consisting of 12,000 equity shares of ₹100 each and 12,000 preferences shares of ₹100 each. The balances appearing in the books on 31 December 2010 were given as follows:

Debit	₹	Credit	₹
Investment in Shares at Cost	2,00,000	Sundry Creditors	3,51,400
Purchase	19,62,000	6% Preference Share Capital	8,00,000
Packing Charges	72,000	Equity Share Capital	8,00,000
Delivery Expenses	1,41,600	5% Mortgage Debentures Secured on Freehold Properties	6,00,000
Stock (1 January 2010)	5,80,800	Dividend Interest	17,000
Salaries & Wages	2,08,000	Profit & Loss A/c	1,14,000
Rents & Rates	70,000	Sales (Net)	26,81,400
Freight & Carriage Outward	32,800	Bank O/D by Hypothecation of Stocks and Receivables	6,00,000
Final Dividend for 2009	48,000		
Preference Dividend for 6 months to 30 June 2010	24,000		
Discount on Issue of Debenture	8,000		
Preliminary Expenses	4,000		
Bills Receivable	1,66,000		
Interest on Bank O/D	31,200		
Debenture Interest HaL.F. Year Up To 30 June 2010	15,000		
Sundry Debtors	2,00,400		
Freehold Property at Cost	14,00,000		
Furniture at Cost Less Depreciation of Rs. 60,000	1,40,000		
Taxation Advance of 2010	60,000		
Technical Know-How at Cost	6,00,000		
	59,63,800		59,63,800

You are required to prepare profit and loss account for the year ended 31 December 2010 and balance sheet as on that date after taking into account the following:

(i) Closing stock was valued at ₹5,70,000
(ii) Purchases included ₹20,000 worth of goods and articles for distribution among valued customers
(iii) Salaries and wages include ₹8,000 being wages incurred for installation of electrical fittings in the factory. Electrical fittings have been recorded under "Furniture"
(iv) Bills receivable include ₹6,000 which has been considered to be irrecoverable
(v) Bills of ₹8,000 maturing after December 2010 were discounted
(vi) Charge depreciation @20% on furniture
(vii) Write off 50% of discount on debenture
(viii) Dividend as 5% proposed on equity share capital
(ix) Provision for taxation ₹32,000

(x) Technical know-how is to be written off over a period of 15 years
(xi) Salaries and wages include ₹ 40,000 being the director's remuneration
(xii) Previous year's figures not to be mentioned.

Solution

Profit & Loss A/c of Durai Ltd.
for the year ended 31 December 2010

Particulars		₹	Particulars	₹
To Opening Stock		5,80,800	By Sales (Net)	26,81,400
To Purchases:	19,62, 000		By Closing Stock	5,70,000
Less: Returns:	20,000	19,42,000		
To Gross Profit c/d		7,28,600		
		32,51,400		32,51,400
To Packing Charges		72,000	By Gross Profit b/d	7,28,600
To Delivery Expenses		1,41,600	By Dividends & Interests	17,000
To Salaries & Wages		1,60,000		
To Directors Remuneration		40,000		
To Rent & Rates		70,000		
To Freight & Carriage Outward		32,800		
To Discount on Debentures		4,000		
To Interest on Bank O/D		31,200		
To Debenture Interest		30,000		
To Technical Know-How				
(Rs. 6,00,000 ÷ 15 years)		40,000		
To Bills Irrecoverable		3,000		
To Depreciation: Furniture		30,800		
To Free Distribution Goods		20,000		
To Provision for Taxation		32,000		
To Net Profit c/d		39,400		
		7,45,600		7,45,600
To Final Dividend for 2009		48,000	By Balance b/d	1,14,000
To Proposed Dividend for HaL.F. Year		24,000	By Net Profit b/d	39,400
To Proposed Dividend:				
Preference Shares		24,000		
Equity Shares @5%		40,000		
To Dividends Tax (₹ 88,000 × $\frac{10}{100}$)		8,800		

To Surplus Carried to Balance Sheet	8,600		
	1,53,400		1,53,400

Important notes:

1. Preference dividend for the next half-year is provided. The reason being that pref. dividend is payable before equity dividend.
2. Dividend tax is provided on current year's pref. and equity dividends.

Balance Sheet of Durai Ltd.
as on 31 December 2010

Liabilities	₹	**Assets**		₹
Authorized Capital		Fixed Assets:		
12,000 Equity Shares of ₹ 100 Each	12,00,000	Freehold Property at Cost		14,00,000
12,000 6% Pref. Shares of ₹ 100 Each	12,00,000	Furniture at Cost	2,00,000	
Issued & Subscribed:		Add: Addition	8,000	
8,000 6% Pref. Shares of ₹ 100 Each Fully Paid	8,00,000	Less: Depreciation	89,600	1,18,400
		Investment:		
8,000 Equity Shares of ₹ 100 Each Fully Paid	8,00,000	In Shares at Cost		2,00,000
		Current Stock:		
Reserves & Surplus:		Stock		5,70,000
Profit & Loss A/c	8,600	Sundry Debtors		2,03,400
Secured Loans		Bills Receivable:	1,66,000	
5% Mortgage Debentures Secured on Freehold Properties	6,00,000	Less: Dishonoured	6,000	1,60,000
		Advance Tax		60,000
Interest Accrued Thereon	15,000	Technical Know-How:	6,00,000	
Bank Overdraft on Hypothecation of Stock & Receivables	6,00,000	Less: Written Off	40,000	5,60,000
		Miscellaneous Expenditure		
Current Liabilities & Provision		Discount on Debentures		4,000
(A) Current Liabilities		Preliminary Expenses		4,000
Sundry Creditors	3,51,400			
(B) Provisions:				
Provision for Taxation	32,000			
Proposed Dividend	64,000			
Dividend Tax Payable	8,800			
	32,79,800			32,79,800

Note: Bills receivable discounted, maturing after the balance sheet date 31 December 2010 are to be treated as "contingent liabilitiy". Hence it is not shown in the balance sheet, above.

Illustration 7.15

The following balances were extracted from the books of M/s Madhura Co. Ltd. as on 30 September 2010:

Particulars	Dr. ₹	Particular	Cr. ₹
Plant (Cost Less Depreciation)	90,000	Share Capital	6,00,000
Furniture (Cost Less Depreciation)	24,000	Development Rebate Reserve	8,100
Motor Car (Cost Less Depreciation)	48,000	Profit & Loss A/c	9,000
Sundry Debtors	3,60,000	Shares Forfeited A/c	3,000
Closing Stock	2,10,000	Sundry Creditors	66,000
Selling Expenses	60,000	Liabilities for Expenses	21,000
Rent & Taxes	48,000	Gross Profit	324,900
Administrative Expenses	72,000	Bank Overdraft	1,50,000
Advance Payment of IT	54,000		
Voluntary Compensation to Employee	12,000		
Cash in Hand	15,000		
Bank Balance	1,65,000		
Security Deposits	24,000		
	11,82,000		11,82,000

The following further particulars were available:

(i) Share Capital is represented by 3,000 equity shares of ₹100 each fully called up; 3,000 8% cumulative preference shares of ₹100 each fully called up.

(ii) Amounts of development rebate reserve and P&L A/c are as at 30 September 2009.

(iii) ₹5,400 to be transferred to development rebate reserve for the year ended 30 September 2010.

(iv) Bank overdraft is secured by hypothecation stock.

(v) The managing director is entitled to a remuneration of 5% on the yearly net profits of the company.

(vi) Addition made to plant during the year ended 30 September 2010 was ₹48,000.

(vii) Depreciation written off up to last year at rates mentioned against each are as follows:

Asset	Amounts (₹)	Rate %
Plant	12,000	15
Furniture	6,000	10
Motor Car	60,000	20

(viii) Provisions for taxation to be made at ₹57,600.

(ix) The amount shown against share forfeited account represents unadjusted profit on re-issue of forfeited shares made during the year.

(x) Recommendation for payment of dividend on preference shares had been made.

(xi) Of sundry debtors, ₹6,000 is outstanding for more than 6 months.

(xii) Administrative expenses include ₹9,000 paid to the auditor as audit fee and ₹3,000 as his expenses.

You are required to draw up the P&L A/c for the year ended 30 September 2010 and the balance sheet on that date. [Madras University Modified]

Solution

P&L A/c of Madura Co. Ltd.
as on 30 September 2010

Particulars		₹	Particular	₹
To Administrative Expenses		60,000	By Gross Profit	3,24,900
To Rent & Taxes		48,000		
To Selling Expenses				
To Payment to Auditors				
Audit Fees	₹ 9,000			
Expenses	₹ 3,000	12,000		
To Depreciation		25,500		
Annual Profit:				
(₹ 3,24,900 – ₹ 2,05,500)		1,19,400		
To Managerial Remuneration				
5% on ₹ 1,19,400		5,970		
To Provision for Taxation		57,600		
To Development Rebate Reserve		5,400		
To Voluntary Compensation to Employee		12,000		
To Net Profit c/d		38,430		
		3,24,900		3,24,900
To Proposed Dividend on Preference Shares		24,000	By Balance b/d By Net Profit b/d	9,000 38,430
To Corporate Dividend Tax @ 10% on ₹ 24,000		2,400		
To Surplus Carried to Balance Sheet		21,030		
		47,430		47,430

Balance Sheet of M/s Madhura Co. Ltd.
as on 30 September 2010

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets:	₹	
3,000 Equity Shares of ₹ 100 Each Fully Paid	3,00,000	Plant at Cost	54,000	
		Add: Additions	48,000	
3,000 8% Cumulative Pref. Shares of ₹ 100 Each Fully Paid	3,00,000	Less: Depreciation	1,02,000	
		90,000 @ 15% + 12,000	25,500	76,500
Reserves & Surplus:		Furniture at Cost	30,000	
Capital Reserve	3,000	Less: Dep. 10% on		
Development Rebate Reserve	9,500	₹ 24,000 + ₹ 6,000	8,400	21,600

Profit & Loss A/c	21,030	Motor Car at Cost	1,08,000	
Secured Loans:		Less: Dep. @ 20%		
Bank o/d (Hypothecation of Stock)	1,50,000	on 48,000 + 60,000	69,600	38,400
Current Liabilities & Provisions		Current Assets, Loans & Advances		
(A) Current Liabilities		(A) Current Assets:		
Sundry Creditors for Goods	66,000	Stock in Trade at Cost		2,10,000
Creditors for Expenses	26,970	Outstanding for		
Provisions:		Exceeding 6 months	60,000	
Provision for Taxation	57,600	Others	3,00,000	3,60,000
Proposed Dividend on Preference Shares	24,000	Cash in Hand		15,000
Dividend Tax Payable	2,400	Cash at Bank		1,65,000
		(B) Loans & Advances:		
		(Unsecured, Considered Good)		
		Security Deposit		24,000
		Income Tax Paid in Advance		54,000
	9,64,500			9,64,500

Illustration 7.16

Cauvery Tex Ltd. Tiruchirapalli was registered with a nominal capital of ₹ 36,00,000 in equity shares of ₹ 100 each. The following is the list of balances extracted from its books on 31 March 2011:

Particulars	₹	Particulars	₹
Premises	18,00,000	Sales	24,90,000
Stock (1 April 2010)	4,50,000	6% Debentures	18,00,000
Furniture	43,200	P&L A/c (Cr.)	87,000
Calls-in-Arrears	45,000	Bills Payable	2,28,000
Plant & Machinery	19,80,000	Sundry Creditors	3,00,000
Interim Dividend Paid	2,25,000	General Reserve	1,50,000
Sundry Debtors	5,22,000	Provision for Doubtful Debts (1 April 2010)	21,000
Goodwill	2,04,000		
Cash & Bank Balances	1,89,900	Subscribed, Called-up and Paid-up Capital	24,00,000
Purchases	11,10,000		
Preliminary Expenses	30,000		
Wages	5,09,190		
General Expenses	41,010		
Advertising	60,000		
Freight	78,690		
Salaries	87,000		
Director's Fees	34,350		

Bad Debts	12,660		
Debenture Interest Paid	54,000		
	74,76,000		74,76,000

The following adjustments have to be made:

(i) Stock on 31 March 2011 was valued at ₹ 5,70,000
(ii) Write off ₹ 6,000 from preliminary expenses
(iii) Provide for half year's debenture interest
(iv) The provision for doubtful debts on 31 March 2011 should be equal to 1% on sales
(v) Director's is are outstanding to the extent of ₹ 1,650 and salaries ₹ 3,000
(vi) Depreciate plant and machinery by 5%; premises by 2% and write off ₹ 7,200 on furniture
(vii) Goods to the value of ₹ 9,000 were distributed as free samples during the year. But no entry in this respect has been made

You are required to prepare the trading and profit and loss account, profit and loss appropriation account for the year ended 31 March 2011 and the balance sheet as on that date.

Solution

Cauvery Tex Ltd.
Trading and Profit & Loss Account
for the Year Ended 31 March 2011

Particulars		₹	Particulars	₹
To Opening Stock	₹	4,50,000	By Sales	24,90,000
To Purchase:	11,10,000		By Closing Stock	5,70,000
Less: Free Samples	9,000	11,01,000		
To Wages		5,09,190		
To Freight		78,690		
To Gross Profit c/d		9,21,120		
		30,60,000		30,60,000
To Salaries	87,000		By Gross Profit b/d	9,21,120
Add: Outstanding	3,000	90,000		
To General Expenses		41,010		
To Director's Fees:	34,350			
Add: Outstanding:	1,650	36,000		
Advertising	60,000			
Add:	9,000	69,000		
To Debentures Interest	54,000			
Add: Outstanding	54,000	1,08,000		
To Bad Debts	12,660			
Add: Additional New Provisions	24,900			
	37,560			
Less: Existing Provision	21,000	16,560		
To Preliminary Expenses Written Off		6,000		

To Depreciation on:				
Furniture:	7,200			
Plant & Machinery:	99,000			
Premises	36,000	1,42,200		
To Net Profit c/d		4,12,350		
		9,21,120		9,21,120

P&L Appropriation A/c

Particulars	₹	Particulars	₹
To Interim Dividend	2,25,000	By Balance b/d	87,000
To Dividend Tax @10%	22,500	By Net Profit b/d	4,12,350
To Surplus Carried to Balance Sheet	2,51,850		
	4,99,350		4,99,350

Note:

1. P&L appropriation A/c may be shown separately as above or the continuation of trading and P&L A/c.
2. Interim dividend pertains to current year. Hence, dividend tax is also to be provided.
3. Ignore surcharge on dividend tax, as this is illustrated for the level of students only.

Cauvery Tex Ltd.
Balance Sheet
as on 31 March 2011

Liabilities		₹	Assets		₹
Share Capital:			Fixed Assets:		
Authorized:			Goodwill		2,04,000
36,000 Shares of ₹ 100 Each		36,00,000	Premises:	18,00,000	
Issued & Paid up:			Less: Depreciation	36,000	17,64,000
24,000 Shares of ₹ 100 Each			Plant & Machinery:	19,80,000	
Fully Paid and Called up	₹ 24,00,000		Less: Depreciation	99,000	18,81,000
Less: Calls-in-Arrears	₹ 45,000	23,55,000	Furniture	43,200	
Reserves & Surplus:			Less: Depreciation	7,200	36,000
General Reserve		1,50,000	Current Assets:		
P&L (Appropriation) A/c		2,51,850	Stock		5,70,000
Secured Loans:			Debtors	5,22,000	
6% Debentures		18,00,000	Less: Provision	24,900	4,97,100
Debenture interest O/s		54,000	Cash & Bank balances		1,89,900
Current Liabilities and Provisions:			Miscellaneous Expenditure		

Creditors	3,00,000	Preliminary Expenses	30,000	
Bills Payable	2,28,000	Less: Written Off	6,000	24,000
Salaries Outstanding	3,000			
Directors Fees Outstanding	1,650			
Dividend Tax Payable	22,500			
	51,66,000			51,66,000

Illustration 7.17

The following is the trial balance of Naveen Ltd. as on 31 March 2011:

(Rs. in 000's)

Particulars	₹	₹
Stock: 1 April 2010	15,000	—
Purchase Returns	—	2,000
Purchases & Sales	49,000	68,000
Wages	6,000	—
Discount	—	600
Carriage Inwards	190	—
Furniture & Fittings	3,400	—
Salaries	1,500	—
Rent	800	—
Sundry Expenses	1,410	—
Profit & Loss Appropriation A/c (31 March 2010)	—	3,180
Dividend Paid for 2009–10	1,800	—
Corporate Dividend Tax Paid	180	—
Equity Share Capital	—	20,000
Debtors and Creditors	5,500	3,500
Plant & Machinery	5,800	—
Cash at Bank	9,240	—
General Reserve	—	3,100
Patents & Trademarks	960	—
Bills Receivable & Bills Payable	1,000	1,400
	1,01,780	1,01,780

Prepare trading account, profit & loss A/c, profit & loss appropriation A/c for the year ended 31 March 2011 and balance sheet at that date. Take into consideration the following adjustments:

(i) Stock on 31 March 2011 was valued at ₹1,58,48,000

(ii) Make a provision for income tax @35%

(iii) Depreciation plant & machinery @15%; furniture & fitting @10% and patents and trademarks @5%

(iv) On 31 March 2011, outstanding rent amounted to ₹1,60,000 while outstanding salaries totaled ₹1,30,000

(v) Provide managerial remuneration @10% of the net profits before tax but after such managerial remuneration

(vi) The directors propose a dividend @15% p.a. for the year ended 31 March 2011 after the minimum transfer to general reserve as required by law

(vii) Make a provision for corporate dividend tax @10%

Solution

Trading and Profit & Loss A/c
for the Year Ended 31 March 2011

Dr. (₹ in 000's) **Cr.**

Particulars		₹	**Particulars**	₹
To Stock on 1 April 2010		15,000	By Sales	68,000
To Purchases	49,000		By Stock on 31 March 2011	15,848
Less: Returns	2,000	47,000		
To Wages		6,000		
To Carriage Inwards		190		
To Gross Profit c/d		15,658		
		83,848		83,848
To Salaries	15,00		By Gross Profit b/d	15,658
Add: O/s	1,30	1,630	By Discount Received	600
To Rent	8,00			
Add: O/s	1,60	960		
To Sundry expenses		1,410		
To Depreciation on:				
Plant and Machinery	8,70			
Furniture Fittings	3,40			
Patents Trademarks	4,8	1,258		
To Managerial Remuneration		1,000		
To Provision for IT @ 35%		3,500		
To Net Profit		6,500		
		16,258		16,258

P&L Appropriation A/c
for the Year Ended 31 March 2011

(Rs. in 000's)

Particulars	₹	**Particulars**	₹
To Dividend Paid (2009–10)	1,800	By Balance c/d	3,180
To Corporate Dividend Tax	180	By Net Profit b/d	6,500
To General Reserve 5% of ₹ 65,00,000	325		
To Proposed Dividend @15%	3,000		

To Provision for Corporate Dividend Tax @10%	300		
To Balance Carried to Balance Sheet	4,075		
	9,680		9,680

Balance Sheet
as on 31 March 2011

(Rs. in 000's)

Particulars		₹	Particulars		₹
Share Capital:	₹		Fixed Assets:	₹	
Authorized:			Plant & Machinery	5,800	
Issued & Subscribed:			Less: Depreciation	870	4,930
Equity Share Capital		20,000	Furniture & Fittings	3,400	
Reserve & Surplus:			Less: Depreciation	340	3,060
General Reserve	3,100		Patents & Trade marks	960	
Add: Additions	325	3,425	Less: Depreciation	48	912
Surplus:			Current Assets, Loans & Advances		
P&L Appropriation A/c		4,075	(A) Current Assets:		
Current Liabilities and Provisions:			Stock		15,848
(A) Current Liabilities:			Debtors		5,500
Bills Payable		1,400	Cash at Bank		9,240
Creditors		3,500	(B) Loans & Advances:		
Outstanding Expenses:			Bills Receivable		1,000
Rent	1,60				
Salaries	1,30				
Managerial Remuneration	10,00	1,290			
(C) Provisions:					
Provision for Income Tax		3,500			
Provision for Corporate Dividend Tax		300			
Proposed Dividend		3,000			
		40,490			40,490

Illustration 7.18

The articles of association of Kavya Ltd. provide for the following:

1. That 10% of the profits of each year shall be transferred to reserve fund
2. That an amount equal to 10% of the equity dividend shall be set aside for bonus to staff
3. That the balance available for distribution shall be applied:
   (a) In paying 7% on cumulative preference shares
   (b) In paying 10% on equity shares
   (c) One-third of the balance available as additional dividend on preference shares and two-third as additional equity dividend

Further condition was also imposed by the Articles, viz. that the balance carried forwards shall not-be reduced by the provisions under (2), (3b) or (3c) below a sum equal to 6% of the preference share capital.

The Company has issued 78,000 7% cumulative participating preference shares of ₹100 each fully paid up, and 7,80,000 equity shares of ₹10 each fully paid up. The profit for the year 2010–11 was ₹43,28,967 and the balance brought forward from the previous year was ₹4,71,510. Provide ₹18,81,900 for taxation before making other appropriations.

Prepare the profit and loss appropriation account. Ignore corporate dividend tax.

[C.A. (Final). Modified]

Solution

Profit & Loss Appropriation A/c

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
To Provision for Taxation	18,81,900	By Balance b/d	4,71,510
To Transfer to Reserve Fund		By Profits for the Year	43,28,967
10% of Profit at This Stage (₹ 43,28,967 – ₹18,81,900)10/100	2,44,707		
To Provision for Staff Bonus			
10% of Equity Dividend ₹78,000			
10% of Additional Equity Dividend ₹49,500	1,27,500		
To Preference Shares dividend:	5,46,000		
7% of ₹78,000,000			
Additional Dividend	2,47,500		
To Equity Dividend			
10% on ₹78,00,000	7,80,000		
Additional Dividend	4,95,000		
To Balance c/fd	4,77,870		
	48,00,477		48,00,477

CALCULATIONS:

(i) Without taking into account (a) the additional dividends; and (b) the bonus payable to the staff on additional equity dividend, the remaining amount in P&L appropriation A/c is ₹12,69,870. Out of this, as per articles, 6% on ₹78,00,000 is to be carried forward, i.e. ₹4,68,000. In this question, the amount has been increased to ₹4,77,870.

(ii) After ₹4,77,870 is carried forward to balance sheet, the balance of ₹7,92,000 is to be shared among the preference shareholders, equity shareholders and the staff.

As per articles, preference shareholders get half of what equity shareholders get by way of additional dividend. Assume, equity shareholders get 'x'.

Then, preference shareholders will get x

The staff will get x

Put altogether we get:

$x + x + x =$ ₹ 7,92,000

or, = ₹ 7,92,000

or, $10x + 5x + x = 10 \times$ ₹ 7,92,000

$16x =$ ₹ 7,20,000

$x =$ ₹ 4,95,000

∴ Additional Equity Dividend = ₹ 4,95,000 (x)

Additional Preference Dividend = ₹ 2,47,5000 $\left(\frac{1}{2}x\right)$

Additional Staff Bonus = ₹ 49,500 $\left(\frac{1}{10}x\right)$

Illustration 7.19

Due to inadequacy of profit during the year, the company proposes to declare dividend out of general reserves, from the following particulars. You are required to ascertain the amount that can be drawn by applying the Companies (Declaration of dividend out of reserves) Rules 1975:

		₹
(i) 52,500 % Preference shares of ₹ 100 each fully paid	=	52,50,000
(ii) 21,00,000 Equity shares of ₹ 10 each fully paid	=	2,10,00,000
(iii) Capital reserve on revaluation of assets	=	10,50,000
(iv) General reserve	=	63,00,000
(v) Securities Premium	=	10,50,000
(vi) P&L A/c balance (Cr.)	=	1,89,000
(vii) Net profit for the year	=	10,71,000

Average rate of dividend during the last five years is 15%.

[C.S. (Inter).Modified]

Solution

(i) First condition: 10% is lower than average rate 15% . Hence, only 10% dividend can be declared

(ii) Second condition: Maximum amount that can be drawn must not exceed 10% of Paid up capital + Reserves, i.e. ₹ 2,10,00,000 + ₹ 52,50,000 + ₹ 63,00,000

= ₹ 3,25,50,000 × 10% = ₹ 32,55,000

(iii) Third condition:

$Q = FR - \frac{3}{20}C$

where Q = quantum of dividend

FR = free reserve

C = paid-up capital

Substituting the figures in the above equation we get:

$Q =$ ₹ $63,00,000 - \frac{3}{20} \times 2,62,50,000$

₹ 63,00,000 – 39,37,500 = ₹ 23,62,500

		₹	₹
10% Dividend on Equity Share Capital: 2,10,00,000 × 10%	=		21,00,000
Profits Available (1,89,000 + 10,71,000)	=	12,60,000	

Less: Preference Dividend 52,50,000 × 8%	=	4,20,000	
	=	8,40,000	
Less: Dividend Tax (21,00,000 + 4,20,000)10%	=	2,52,000	5,88,000
∴ Transfer Needed from Reserve	=		15,12,000

* 10 % Dividend Needs Transfer of ₹ 15,12,000 from Reserves.
* This amount, i.e. ₹ 15,12,000 is less than condition (ii)

  i.e. 32,55,000 and condition (iii) ₹ 23,62,500.
* Therefore, 10% dividend can be easily paid.

Illustration 7.20

Prepare the profit and loss account for the year ended 31 March 2011 and a balance sheet as on that date from the following ledger balances:

Particulars	₹	Particulars	₹
Opening Stock:		Sales	49,50,000
Finished Goods:	3,60,000	Export Subsidy & Drawback	1,50,000
Work-in-Progress	1,65,000	Share Capital	14,70,000
Raw Material Consumed	10,50,000	General Reserve	2,25,000
Stores Consumed	52,50,000	P&L A/c (1 April 2010)	30,000
Wages	1860,000	Secured Loans	11,55,000
Closing Stock:		Sundry Creditors	4,05,000
Raw Material	60,00,000	Outstanding expenses	2,46,000
Stores	45,000	Proposed Dividend	90,000
Staff Salary	60,000	Motor Car Sales A/c	27,000
Audit Fees	15,000	Provision for Bad Debts	45,000
Sundry Debtors	7,65,300	Interest Received	24,000
Bad Debts	24,000		
Cash & Bank Balances	4,68,600		
Fixed Deposit	4,05,000		
Income Tax Advance Payment	6,00,000		
Fixed Assets	10,50,000		
Managing Director's Remuneration	36,000		
General Expenses	6,94,500		
Director's Fees	3,600		
Dividend Paid	90,000		
	88,17,000		88,17,000

Further available information:

(i) Closing stock valued at cost:

Finished Goods ₹ 2,01,000

Work-in-Progress ₹ 2,85,000

(ii) Managing director is entitled to a maximum commission @5% of profits as per Companies Act, subject to a minimum of ₹ 3,000 per month.

(iii) Details of fixed assets;

Assets	Original Cost Up To Last Year ₹	Depreciation Up To Last Year ₹	Additional on 1 April 2010 ₹	Rate of Depreciation %
Machinery	10,50,000	1,50,000	—	15
Furniture	50,000	54,000	—	10
Motor Car	99,000	75,000	90,000	20

(iv) An old motor car having original cost of ₹ 54,000 and depreciation allowed ₹ 45,000 up to last year was sold on 30 September 2010 for ₹ 27,000 and proceeds were credited to Motor Car Sales A/c without any adjustment.

(v) Depreciation allowed under income tax rule is ₹ 1,35,000.

(vi) Provision for taxation to be made at 50%.

(vii) Directors recommend payment of dividend @10% on paid-up capital.

(viii) Excess provision for doubtful debts is no longer required.

[I.C.W.A. Modified]

Solution

Calculations:

Stage I: Computation of managerial remuneration:

Particulars		₹	₹
Step 1:	Sales		49,50,000
Step 2:	Add: Items to be Added:		
	(i) Subsidy & Duty Drawback	1,50,000	
	(ii) Interest	24,000	
	(iii) Profit on Sale of Motor Car	18,000	
	(iv) Closing Stock:		
	Finished Goods	2,01,000	
	WIP	2,85,000	6,78,000
Step 3:	(Step 1 + Step 2)		56,28,000
Step 4:	Less: (Items to be Deduced)		
	(i) Opening Stock:		
	Finished Goods:	3,60,000	
	WIP:	1,65,000	
	(ii) Raw Material Consumed:	10,50,000	
	(iii) Stores Consumed:	525,000	
	(iv) Wages:	18,60,000	
	(v) General Expenses:	6,94,500	
	(vi) Staff Salary:	60,000	
	(vii) Audit Fee:	15,000	
	(viii) Directors Fee:	3,600	

	(ix) Depreciation as per Income Tax Rules:	1,35,000	
	(x) Actual Bad Debts:	24,000	48,92,100
Step 5:	Profit for Managerial Remuneration (Step 3 – Step 4)		7,35,900
Step 6:	Managing Director's Remuneration at 5% on ₹ 7,35,900		₹ 36,795

Stage II: Computation of Provision for Taxation: ₹

Step 1: Profit (Ref: Stage I Step 5) = 7,35,900

Step 2: Less: Managing Director's Remuneration = 36,795
(Ref: Stage I Step 6)

Step 3: Profit Available for Taxation = 6,99,105

Step 4: ∴ Provision for Taxation = 3,49,553
(at 50% on ₹ 6,99,105)

Stage III:

Profit and Loss Account
for the year Ended 31 March 2011

Dr. **Cr.**

Particulars		₹	Particulars		₹
To Opening Stock:			By Sales		49,50,000
Finished Goods	3,60,000		By Export Subsidy and Duty Drawback		1,50,000
WIP	1,65,000	5,25,000	By Interest		24,000
To Raw Material Consumed		10,50,000	By Profit on Sale of Motor Car		18,000
To Stores Consumed		5,25,000	By Provision for Excess Bad Debts Written Back		
To Wages		1860,000	Existing Provision:	45,000	
To Staff Salary		60,000	Less: Bad Debts:	24,000	21,000
To Audit Fee		15,000	By Closing Stock:		
To General expenses		694,500	Finished Goods	2,01,000	
To Directors Fee		3,600	WIP	2,85,000	4,86,000
To Depreciation on:					
Machinery		135,000			
Furniture		3,600			
Motor Car (3,000 + 18,000)		2,100			
To Managing Director's Remuneration (Ref: Stage I Step 6)		36,795			
To Provision for Taxation (Ref: Stage II Step 4)		3,49,553			
To Net Profit c/d		3,69,952			
		56,49,000			56,49,000

To Proposed Dividend	1,47,000	By Balance b/d	30,000
To Corporate Dividend Tax @10% on 1,47,000	14,700	By Net Profit b/d	3,69,952
To Surplus Carried to Balance Sheet	2,38,252		
	3,99,952		3,99,952

Stage IV: Preparation of Balance Sheet

Balance Sheet
as on 31 March 2011

Particulars	₹	**Particulars**		₹
Share Capital:		Fixed Assets:	₹	
Issued & Subscribed & Paid up	14,70,000	Machinery	10,50,000	
Reserve & Surplus:		Less: Depreciation	2,85,000	7,65,000
General Reserve	2,25,000	(₹ 1,35,000 + ₹ 1,50,000)		
Profit & Loss A/c	2,38,252	Motor Cars	99,000	
Secured Loan:	11,55,000	Less: Sold	54,000	
			45,000	
Current Liabilities & Provisions		Add Addition	90,000	
(A) Current Liabilities		Less: Depreciation	135,000	
Sundry Creditors	4,05,000	(₹ 30,000 + ₹ 21,000)	51,000	84,000
Outstanding Expenses	2,46,000	Furniture	90,000	
Managing Director's		Less: Depreciation	57,600	32,400
Commission Outstanding	795	(₹ 54,000 + ₹ 36,00)		
(B) Provisions:		Current Assets and Loans & Advances:		
Provision for Taxation	3,49,553			
Proposed Dividend	1,47,000	(A) Current Assets:		
Dividend Tax Payable	14,700	Closing Stock at Cost		
		Finished Goods	2,01,000	
		WIP	2,85,000	
		Stores	45,000	
		Raw Materials	6,00,000	11,31,000
		Sundry Debtors		7,65,300
		Cash at Bank Balances		4,68,600
		(B) Loans & Advances		
		Fixed Deposit		4,05,000
		Tax Paid in Advance		6,00,000
	42,51,300			42,51,300

Illustration 7.21

Trial Balance of Nirmal Ltd. as on 30 September 2010

Particulars	₹	Particulars	₹
Preference Share Redemption	24,000	Share Capital (Authorized & Issued)	
Land (cost)	1,00,000	Equity Share 75,000 Shares	7,50,000
Building (Cost Less Depreciation)	3,50,000	8% Redeemable Preference Shares (200	
Furniture (Cost Less Depreciation)	10,000	Shares)	20,000
Motor Vehicle (Cost Less Depreciation)	17,500	Securities Premium	12,500
Establishment Expenses	1,25,000	General Reserve	50,000
Rent, Taxes & Insurance	6,000	Trading A/c—Gross Profit	4,00,000
Commission	2,000	Discount Received	2,500
Directors' Fees	1,000	Interest on Investments Tax Free	4,000
Depreciation	30,000	Sundry Creditors	12,800
Sundry Expenses	30,000	Profit & Loss A/c (30 September 2009)	5,000
Payment to Auditors	2,000	Unpaid Dividend	1,000
Interim Dividend	38,300	Outstanding Expenses	3,000
Sundry Debtors	15,000	Provision for Taxation	35,000
Cash in Hand	6,000		
Cash as Bank in Current A/c	97,500		
Security Deposit	5,000		
Investment in GI Notes	1,00,000		
Stocks at or Below Cost	1,76,500		
Income Tax Paid Under Dispute	50,000		
Advance Payment of IT	1,10,000		
	12,95,800		12,95,800

The following additional information is available:

(i) The preference shares were redeemed on 1 April 2010 at a premium of 20% but no entries were passed for giving effect there to except payment standing to the debit of preference share redemption account.

(ii) Depreciation as per income tax rules provided up to 30 September 2010 is as follows: Building: ₹1,05,000; furniture: ₹10,000; Motor vehicles: ₹30,000.

(iii) Payment to auditors includes ₹500 for taxation work in addition to audit fees.

(iv) Market value of investment as on 30 September 2010 ₹90,000.

(v) Interim dividend includes dividend on equity shares ₹37,500 and dividend on preference shares ₹800.

(vi) Sundry debtors include ₹10,000 due for a period exceeding 6 months.

(vii) All receivables and deposits are considered good.

(viii) Income tax demand for provided for in full against which an appeal is pending.

(ix) Directors have recommended payment of a further dividend on equity shares at ₹0.50 per share after appropriating ₹15,000 to general reserve.

(x) Ignore previous year's figures.

Prepare the profit and loss account for the year ended 30 September 2010 and the balance sheet on that date.

[I.C. W.A. Modified]

Solution

Profit & Loss A/c of Nirmal Ltd.
for the Year Ended 30 September 2010

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Establishment Expenses	1,25,000	By Gross Profit	4,00,000
To Rates, Taxes & Insurance	6,000	By Discount Receives	2,500
To Commission	2,000	By Interest on Investments	4,000
To Directors' Fees	1,000		
To Depreciation	30,000		
To Sundry Expenses	30,000		
Auditor's Fees	1,500		
Taxation Fees	500		
Provision for Tax	1,15,775		
To Net Profit c/fd	94,725		
	4,06,500		4.06,500
To Interim Dividend:	800	By Balance b/d	5,000
On Preference Shares on Equity Shares	37,500	Pay Net Profit b/d	94,725
To General Reserve	15,000		
To Proposed Equity Dividend	37,500		
To Corporate Dividend Tax			
(₹ 75,800 × 10%)	7,580		
To Surplus Carried to Balance Sheet	1,345		
	99,725		99,725

Balance Sheet of Nirmal Ltd
as on 30 September 2010

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Authorized & Issued:		Land at Cost	1,00,000
75,000 Equity Shares of ₹ 10 Each	7,50,000		
Reserves & Surplus:	8,500	Building Less Depreciation	3,50,000
Securities Premium A/c			
General Reserve			
(₹ 50,000 + ₹ 15,00 – ₹ 20,000)	45,000	Furniture Vehicle Less Depreciation	10,000
Profit & Loss A/c	1,345	GI Notes (Market Value Rs. 90,000	1,00,000
Capital Redemption Reserve	20,000	Current Assets, Loans and	
		Advances:	

Current Liabilities & Provision:			Sundry Debtors	15,000
Trade Creditors		12,800	(Due for More than 6 Months ₹ 10,000)	
Unpaid dividend		1,000	Stocks-in-Trade	1,76,500
Outstanding expenses		3,000	Security Deposit	5,000
Provision for taxation			Cash in Hand	6,000
₹ 35,000 + ₹ 1,15,775):	1,50,775			
Less: Advance Tax	1,10,000	40,775		
Proposed equity dividend		37,500	Cash in Bank	97,500
Dividend tax payable		7,580	Income tax paid (under dispute)	50,000
		9,27,500		9,27,500

Illustration 7.22

Vas Ltd closes its accounts on 31 March each year. Its paid-up share capital consists of:

(a) 10 lakh 11% Preference shares of ₹ 10 each fully paid ₹ 1 crore

(b) 40 lakh Equity shares of ₹ 10 each fully paid ₹ 4 crore

The profit earned after tax and dividends paid by the company have been given in the following:

Year	Profit ₹ (In Lakhs)	Total Dividend Paid ₹ (In Lakhs)
2005–06	104	51
2006–07	96	51
2007–08	106	59
2008–09	112	63
2009–10	120	67

During 2010–11, the company earned a profit of ₹ 108 lakh

The Company desires to transfer ₹ 50 lakh each to reserves because of a contemplated project. Comment on the proposal.

Will your answer differ if the profit earned during 2010–11 was only ₹ 90 lakh?

Solution

Step 1:

Year	Total Dividend ₹ in Lakhs	Equity Dividend ₹ in Lakhs	Rate of Equity Dividend	Rate of Equity Dividend
2007–08	59	11	48%	12%
2008–09	63	11	52%	13%
2009–10	67	11	56%	14%

[Pref. dividend: 11% on ₹ 1 crore: 11 lakh

Equity Dividend: Total Dividend – Pref. Dividend

Rate of Equity Dividend: Equity Dividend Equity Share Capital × 100]

Step 2: The Average of Equity Dividend for the Preceding Three
Years = = 13%

Step 3: The Minimum Distribution Required as per the Government Rules Is a Rate Equal to the Average for the Three Immediately Preceding Years Is 13% here.

Step 4: The Minimum Distribution Required is:

11% on ₹ 1 crore Preference Capital	= ₹ 11 lakh
13% on ₹ 4 crore Equity Capital	= ₹ 52 lakh
Total	= ₹ 63 lakh

Step 5: The Average of the Profit for 2008–09—₹ 112 and 2009–10—₹ 120
₹ 232/2 = ₹ 116 lakh.
The Profit for 2010–11 = ₹ 108 lakh.
This is Less than the Average by Only 10%

Step 6: Coming to the Question,
If the Company Transfers ₹ 50 lakh to Reserves, it Is Not in Accordance with the Govt. Rules with Respect to Transfer to Reserve.
As per the Rules, the Company Must Pay ₹ 63 lakh on (Ref: Step 4) Dividend and the Balance (₹ 108 – ₹ 63): ₹ 45 lakh to Reserves.

Step 7: If the Profit Earned Is ₹ 90 lakh (As Desired in Question), the Company Need Not Be Required to Adopt Minimum Distribution as Computed Above. The Reason Is that the Profit Is Below the Average Profit for Two Years by More than 20%.

Illustration 7.23

Z Ltd. has only one type of capital, viz. 40 lakh equity shares of ₹ 10 each. It has got reserves totaling ₹ 2 crore. The company closes its books every year on 31 March. It has been paying dividends at the rate of 12.5% up to 2007–08 and 15% thereafter. In 2010–11, the company suffered a loss of ₹ 25 lakh. Hence, it wants to draw from reserves on account to pay dividend at 12%.

You are required to advise the Company.

Solution

Step 1: What does the Government Rule say on this, i.e., Declaration of Dividend Out of Reserve'':
The Rule Restricts the Withdrawal from Reserves to the Lower of:

(i) An Amount Sufficient to Declare Dividend at the Average Rate of Preceding Five Years or 10% Whichever is Less

(ii) One-Tenth of Paid-up Capital and Free Reserves Subject to the Remaining Balance in Reserves Being at least 15% of the Paid-up Capital.

Step 2: Compute the Average Rate of Dividend for Preceding 5 Year as Follows:

(i) First 3 Years = 12.5%

(ii) Next 2 Years = 15 %

(iii) Average for 5 Years $= \frac{12.5\ \% \times 3+15 \times 2}{5} = \frac{37.5\% + 30\%}{5\%} = \frac{67.5\%}{5} = 13.5\%$

Step 3: How much can it absorb?
Because Only 10% Dividend Can Be Possible, It Will Absorb ₹ 65 lakh. (Loss ₹ 25 lakh + Dividend as 10% ₹ 40 lakh = ₹ 65 lakh)

Step 4: But, the Other Condition Stipulates that More than One-Tenth of the Paid-up Capital and Reserve Cannot Be Withdrawn from Reserve.

Here, the Paid-up Capital Is ₹ 4 crore and the Reserve ₹ 2 crore. Total Is ₹ 6 crore. One-Tenth of 6 crore = ₹ 60 lakh. Hence, the Amount that Can Be Withdrawn Is ₹ 60 lakh.

Step 5: ₹ 60 Lakh: Out of This, First Loss Has to Be Made Set off; ₹ 60 lakh—₹ 25 Lakh; Balance ₹ 35 lakh: Which May Be Utilized to Pay Dividend.

Step 6: The Rate of Dividend Will Be 8%.

Step 7: Advise: Feasible and Satisfactory Solution to the Company.

Summary

Final accounts of companies comprise profit and loss A/c and balance sheet. Profit and loss A/c of companies differ from other forms of business organizations. Here, P&L A/c consists of P&L A/c an P&L appropriation A/c. Items that are shown in P&L A/c are referred to as "above the line" items and that shown in P&L appropriation A/c are called "below the line" items.

The form, contents and preparation of final accounts are governed by the Companies Act, Income Tax Act and The Accounting Standards issued by ICAI.

The relevant sections of the companies Act, AS-4 (Revised), AS-5 (Revised) (issued by ICAI) and relevant provision of the IT Act with respect to dividend, interest there on and net profit before tax all are explained in detail (Ref: the text).

Preparation of P&L A/c: Treatment of certain items such as (i) depreciation; (ii) interest on debentures; (iii) dividends; (iv) preliminary expenses; (v) extraordinary items; (vi) tax adjustment—TDS, advance payment of tax, provision for taxation, income tax, tax on dividends, corporate dividends tax; (vi) transfer to reserves and (vii) managerial remuneration including computation of profits to assess their remuneration are all discussed with apt illustrations (Ref: main part of text).

Preparation of P&L appropriation A/c: Meaning of divisible profits, appropriation of profits and the items that are to be included in P&L appropriation A/c are explained in the text.

Preparation of balance sheet: Forms of balance Sheet Schedule VI Sec.211 are shown.

Assets that are to be grouped under the main headings fixed assets, investments, current assets, loans & advances (I:—current assets II: loans & advances), miscellaneous expenses (to the extent not written off) and P&L A/c (Dr.); and the liabilities that are to the be grouped under headings share capital, reserves & surplus, secured loan, unsecured loans and current liabilities & provisions (I: Current liabilities II: Provision) are discussed in detail (Ref: the text).

Rules governing transfer to reserves and declaration of dividend on of reserves are explained by way of illustrations (Ref: Illustrations 7.17, 7.18, 7.21 and 7.22).

Key Terms

Above the Line & Below the Line: Presumption of an imaginary line between P&L and P&L appropriation A/c. Items shown in P&L are termed as "above the line" items and that shown in P&L appropriation A/c are termed as "below the line" items.

Contingent Liability: Amounts which shall become payable on the happening of unforeseen event.

Corporate Dividend Tax: Tax on dividend declared, distributed or paid.

Extraordinary Items: Transactions that do not occur often and distinct from ordinary activities of an enterprise.

Interim Dividend: Dividend paid (before the ascertainment of profit) in the middle of an accounting period.

Miscellaneous Expenditure: A separate head under which preliminary expenses of a company are to be shown in the balance sheet.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. The Companies Act has made mandatory for a company to prepare final accounts in the prescribed format.
2. While preparing P&L accounts of companies, it is necessary to split it into three parts, viz. trading accounts; P&L A/c and P&L appropriation A/c.
3. It is not necessary to provide for depreciation before declaration of dividend.
4. No other method, other than written down value and straight line method, has seen prescribed by the Government.
5. Interest on debentures is a charge against profit.
6. When net interest is given in the trial balance, it is not necessary to gross up.
7. All companies are permitted to make political contribution.
8. After ascertaining the gross dividend, is will be debited to P&L.
9. Items of abnormal nature should be shown as separate item and should not be combined with any other item.
10. Provision for taxation is made after computing the net profits of the company.
11. Provision for taxation made in the previous year is termed as "Existing Provision".
12. A company cannot pay dividend other than its profits.
13. Dividend is computed on authorized capital of a company.
14. Directors are empowered to declare interim dividend.
15. Calls-in-advance shall have to be considered for paying any dividend.
16. Until dividend on preference share capital is paid, it has to be shown as a contingent liability.
17. Corporate Dividend Tax is to be recorded in P&L appropriation A/c.
18. A public limited company must have at least two directors.
19. Loss making companies or companies with inadequate profits need not be compelled to pay remuneration to their managers.
20. It is the company's option to compute the managerial remuneration either before charging such commission or after charging such commission.

Answers:

1. True	2. False	3. False
4. True	5. True	6. False
7. False	8. False	9. True
10. False	11. True	12. False
13. False	14. True	15. False
16. True	17. True	18. False
19. False	20. True	

II: Fill in the blanks with apt word(s)

1. The statutory form of balance sheet is set out in Part I _____ of the Companies Act. 1956.
2. According to Section 216 of the Companies Act, _____ A/c shall be treated as an annexure to the balance sheet.
3. Section _____ of the Companies Act deals with the preparation of profit & loss A/c and the balance sheet of a joint stock company.
4. The items that are shown in the profit & loss A/c are known as items "_____".
5. The items which are shown in the profit & loss appropriation A/c are known as "_____" items.
6. All expenses which are more than 1% of the total revenue of the company or Rs. 5,000 (whichever is more) should not be grouped under _____ but should not be stated _____.
7. According to Section 205 of the Companies Act, it is compulsory to provide for _____ before dividends are declared out of the profits.
8. Discount and cost of issue of debentures should be shown in the balance sheet under the heading "_____".
9. TDS is shown as an _____ in the balance sheet.
10. Provision for taxation is to be _____ to P&L A/c.
11. U/S 205 A (3) of the Companies Act, dividend can be declared out of _____ subject to certain conditions.

12. In general, dividend is computed at the rate recommended by the Board on its _____ capital.
13. Interim dividend paid is to be recorded on the debit side of _____ A/c.
14. Tax on dividend is known as _____.
15. According to the Companies Rules 1975, companies are required to transfer a certain percentage of profits to_____.
16. According to Section 198 of the Companies Act, the total managerial remuneration should not exceed _____ of the net profits.
17. The remuneration payable to the managing director shall not exceed _____ of the net profits.
18. Contingent liabilities shall be shown as _____.
19. Unclaimed dividend is shown under the heading _____.
20. Securities premium A/c is shown under the heading _____.

Answers:

1. Schedule VI
2. profit & loss A/c
3. 210
4. above the line
5. below the line
6. miscellaneous expenditure; separately
7. depreciation
8. miscellaneous expenditure
9. asset
10. debited
11. revenue reserve
12. paid-up
13. P&L appropriation A/c
14. corporate dividend tax
15. reserves
16. 11%
17. 5%
18. footnote to balance sheet
19. current liabilities; balance sheet
20. reserve & surplus

III: Multiple choice questions—Choose the correct answer

1. Balance of profit in P&L appropriation A/c has to be carried to balance sheet under the heading
   (a) share capital
   (b) reserves & surplus
   (c) provision
   (d) miscellaneous expenditure
2. Which of the following method is used to provide for depreciation; according to the provision of the Companies Act:
   (a) written down value method
   (b) straight line method
   (c) method prescribed by the Govt
   (d) one of the above
3. TDS on interest on debentures is
   (a) current asset
   (b) reserve
   (c) current liabilities
   (d) appropriation of profit
4. Interest paid on money borrowed for construction is a
   (a) capital expenditure
   (b) revenue expenditure
   (c) deferred revenue expenditure
   (d) none of these
5. Speculation loss is
   (a) preliminary expense
   (b) extraordinary item
   (c) miscellaneous expenditure
   (d) contingent liability
6. For which of the following purpose, capital profit can be used:
   (a) issue of bonus shares
   (b) write off fictitious assets
   (c) provide premium on redemption of shares and debentures
   (d) all of the above
7. Dividend is computed on
   (a) paid-up capital
   (b) issued capital
   (c) authorized capital
   (d) subscribed capital
8. The power to declare interim dividend lies with the
   (a) government
   (b) SEBI
   (c) board of directors
   (d) shareholders in general meeting

9. Corporate dividend tax is shown in
   (a) profit & loss A/c
   (b) profit & loss appropriation A/c
   (c) trading A/c
   (d) all of these
10. When the proposed dividend is more than 10% but more than of the paid-up capital, the percentage of profits to be transferred to reserve is
   (a) 10%
   (b) 5%
   (c) 7½%
   (d) 2½%
11. Where the directors are assisted by whole-time directors or managers or managing directors, remuneration shall not exceed
   (a) 3% of net profits
   (b) 1% of net profits
   (c) 11% of net profits
   (d) 5% of net profits
12. Which one of the following perquisites may be included in computing ceiling on remuneration of managerial personnel:
   (a) dearness allowance
   (b) gratuity
   (c) encashment of leave
   (d) leave travel concession
13. According to Section 350 of the Companies Act, which of the following is allowed as deduction:
   (a) special depreciation
   (b) initial depreciation
   (c) normal depreciation
   (d) development rebate reserve
14. According to Section 349, which of the following items is not allowed as deduction from the profits of the company:
   (a) all taxes and income
   (b) managerial remuneration
   (c) any compensation paid voluntarily
   (d) all of these
15. Unclaimed dividend is to be shown under the heading
   (a) current asset
   (b) provision
   (c) current liabilities
   (d) miscellaneous expenditure
16. Calls-in-arrears are to be shown under the heading
   (a) reserves & surplus
   (b) deducting from called-up capital
   (c) secured loans
   (d) provisions
17. Forfeited shares A/c is to be shown under the heading
   (a) current assets
   (b) current liabilities
   (c) adding with paid-up capital
   (d) secured loans
18. Which one of the following is not included in "divisible profits" of a company:
   (a) revaluation reserve
   (b) reserve fund
   (c) insurance fund
   (d) none of these
19. Debentures are shown in the balance sheet under
   (a) authorized capital
   (b) issued capital
   (c) current liabilities
   (d) secured loans
20. Securities premium A/c is to be shown under the heading
   (a) share capital
   (b) reserves & surplus
   (c) secured loans
   (d) currents assets

Answers:

1. (b)	6. (d)	11. (b)	16. (b)
2. (d)	7. (a)	12. (a)	17. (c)
3. (c)	8. (c)	13. (c)	18. (a)
4. (a)	9. (b)	14. (d)	19. (d)
5. (b)	10. (d)	16. (c)	20. (b)

Short Answer Questions

1. What do you mean by "above the line" items?
2. What do you mean by "below the line" items?
3. Explain the provisions of Section 211 of the Companies Act?

4. Name the items that are to be recorded in the P&L appropriation A/c?
5. Explain the important provision of Section 205 of the Companies Act.
6. How would you compute gross interest?
7. Write a short note on "extraordinary items".
8. How would you treat items of abnormal nature?
9. How would you treat TDS?
10. How would you treat advance payment of tax?
11. How would you treat provision for taxation?
12. Name the important sources for declaration of dividend.
13. Write a short note on "payment of interest out of capital".
14. How will you deal will preference share dividend?
15. Explain: Corporate dividend tax.
16. Name the perquisites to the included in ascertaining managerial remuneration.
17. What are the items that cannot be included in the net profits of the company while determining remuneration of managerial personnel?
18. According to Section 349, what are the items that cannot be deducted from profits?
19. Name the main headings for grouping assets in the balance sheet.
20. Name the main headings for grouping liabilities.
21. How will you treat "calls-in-arrears" while drafting the balance sheet of a company?
22. What is meant by "interim dividend"?
23. Write a short note on "contingent liabilities".
24. How does "reserve" differ from "reserve fund"?
25. What is meant by "unclaimed dividend"? How is it treated?

Essay Type Questions

1. Explain the relevant provisions of the Companies Act with respect to form, content and preparation of final accounts of a joint stock company.
2. Draw a format of P&L A/c and P&L appropriation A/c.
3. Draw the two formats of the balance sheet as shown in Schedule VI (Section 211) of the Companies Act.
4. Explain the legal provisions relating to "managerial remuneration".
5. Explain in detail how will you deal with "tax adjustments" while preparing the final accounts of companies?
6. Explain the term "dividend". Explain the legal provisions for (i) declaring dividend out of revenue reserve and (ii) out of capital profits of a company.
7. Explain the legal provisions for transfer to reserves.
8. How will you compute net profits for remuneration of managerial personnel?
9. How will you deal will the following items while preparing the P&L A/c of a company:
   (i) Depreciation
   (ii) Interest on debentures
   (iii) Dividend received
   (iv) Interest received
   (v) Interim dividend
   (vi) Preference share dividend
   (vii) Tax on dividends
   (viii) Political contribution
   (ix) Preliminary expenses
   (x) Extraordinary items
10. How will you treat the following items white preparing the balance sheet of a company?
    (i) Forfeited shares A/c
    (ii) Goodwill
    (iii) Calls-in-arrears
    (iv) Unclaimed dividend
    (v) Securities premium A/c
    (vi) Discounts on issue of shares & debentures
    (vii) Underwriting commissions
    (viii) Sinking fund and
    (ix) Export subsidy &drawback

Exercises

Part A—For Undergraduate Level

[Model: Profit for managerial remuneration

1. From the following particulars of Everest Ltd, compute profit for managerial remuneration:

		₹
Net Profit Before Provision of Income Tax and		
Managerial Remuneration but After Depreciation	=	12,50,720
Deprecation Provided in the Books	=	2,70,000
Depreciation Allowable under Schedule XIV	=	2,15,000

[**Ans:** ₹ 13,05,720]

[Model: Calculation of managerial remuneration]

2. From the following particulars relating to a public limited company, calculate the managerial remuneration assuming that there are two whole-time directors, a part-time director and a manager:

Profit Earned by the Company		₹
During the Year Ended 31 March 2011	=	10,00,000
After Taking into Account the Following:		
Depreciation on fixed Assets:	=	1,91,200
(Depreciation Admissible as per Income Tax Rules is ₹ 1,31, 200)	=	4,90,000
Provision for Income Tax:		
Capital Expenditure Included in General Expenses Charged to P&L A/c	=	50,000

[**Ans:** Managerial remuneration: ₹ 1,76,000]

3. From the following particulars, calculate the maximum commission permissible to directors when not assisted by managing director, or manager or whole-time directors:

Profit & Loss A/c

Particulars	₹	Particulars	₹
To Bonus to Foreign Technician	10,000	By Gross Profit A/c	18,20,500
To Repairs	2,500	By Profit on sale	40,000
To Interest on Debentures	5,000	of land cost price 45,000	
To Donation	37,500	WDV 35,000	
To Compensation to Injured Workers	2,500		
To Provision for Taxation	4,25,000		
To Loss on Sale of Car (WDV ₹ 5, 500)	3,000		
To Net Profit	13,75,000		
	18,60,5000		18,60,5000

[Madras University Modified]

[**Ans:** Max. commission at 3% = ₹ 80,100]

4. The following profit & Loss A/c is presented by CD Ltd for the year ended 31 March 2011:

Profits & Loss A/c (₹ in 000's)

To Salaries & Wages	2,560	By Gross Profit b/d	12,160
To Director's Fees	20	By Profit on Sale of Company's Land	500
To Repairs	540		
To Depreciation	1800	By Subsidiary	10,000
To Scientific Research (New Lab Set Up)	400	Received from State Govt.	
To General Changes	360		
To Interest on Debenture	480		

To Income Tax	2,320		
To Proposed Dividend	2,000		
To Provision for Corporate Dividend Tax	220		
To Balance A/c	2,960		
	13,660		13,660

The amount of depreciation as per Schedule XIV comes to ₹ 16,40,000. The effective capital of the company is ₹ 80,00,000.

You are required to calculate the remuneration payable to the managing director of the company.

[**Ans:** Remuneration payable to the managing director at 5% is ₹ 3,78,000]

[Model: P&L appropriation A/c]

5. On 1 April 2010, the subscribed capital of M/s Swamy Ltd. stood at ₹ 1.25 crore divided into 10 lakh fully paid equity shares of ₹ 10 each and 25,000 fully paid 12% preference shares of ₹ 100 each.

On the same date, profit and loss appropriation A/c showed an opening balance of ₹ 14,20,000.

During the year ended 31 March 2011, the company paid an interim dividend @ 10% on its equity shares, paying preference dividend for the entire year 2010–11. On 31 March 2011, the company's profit and loss A/c showed that the company had earned for the year ₹ 37,00,000 as profit after tax. The Board of Directors decided to transfer ₹ 6,00,000 to debenture redemption reserve and 10% of the net profit to general reserve. The Board also decided a final dividend @ 11% on equity shares over and above the interim dividend already distributed. The Company is required to pay corporate dividend tax @ 10.2%

You are required to prepare P&L appropriation A/c for the year ended 31 March 2011.

[**Ans:** Balance carried to balance sheet: ₹ 15,05,200]

6. The accounts of X Ltd showed amounts of ₹ 9,00,000 to the credit of profit and loss A/c on 31 March 2010 out of which the directors decided to transfer ₹ 1,80,000 to general reserve and ₹ 1,26,000 to debenture redemption fund. At the annual general meeting held on 15 June 2010, it was decided to place ₹ 60,000 to of development reserve and to pay a bonus of 2½% of the profit to the directors as additional remuneration. The payment of the half-yearly dividends on ₹ 15,00,000 6% cumulative preference shares on 30 Septembers 2009 and 31 March 2010 was confirmed and a dividend @ 10% was declassed on the equity share capital of the face above of ₹ 18,00,000. The balance of profits & loss A/c is to be carried forward to next year.

You are required to prepare the profit & loss appropriation accounts.

[**Ans:** Balance profit carried forward to b/a is ₹ 2,14,500]

7. Y Ltd has a credit balance on P&L A/c of ₹ 30 lakh on 1 April 2010 and the net profit for the year 2010–11 is ₹ 3 crore. It is decided that the following decisions be carried out regarding provisions, reserves and dividend:
   (i) General reserve ₹ 35 lakh
   (ii) Investment allowance reserve ₹ 35 lakh
   (iii) Provision for taxation @ 50%
   (iv) Dividend equalization fund A/c ₹ 2 lakh
   (v) Dividend on 10% preference shares of ₹ 20 lakh
   (vi) Dividend @ 15 % on 30 lakh equity shares of ₹ 10 lakh fully paid

   You are required to prepare the P&L appropriation A/c.

   [**Ans:** Hint: Net profit as per P&L A/c: ₹ 1.5 crore. Balance carried forward to b/s: ₹ 18.5 lakh]

8. Z Ltd. had ₹ 63,00,000 profit on 31 March 2011 after making provision for depreciation and taxation ₹ 3,91,200 profit as brought forward from last year. Following recommendations were made by the directors of the company to appropriate the profits:
   (i) To transfer ₹ 18,90,000 to general reserve
   (ii) To pay ₹ 2,55,000 as ex-gratia bonus employees
   (iii) To déclassé dividend as 5% on equity shares
   (iv) To transfer ₹ 1,35,000 to staff gratuity reserve
   (v) To transfer ₹ 1,50,000 to development rebate reserve
   (vi) To transfer ₹ 2,70, 000 to deferred taxation reserve

The company's capital consisted of 3,00,000 equity shares of ₹10 each fully paid. For the year ended 31 March 2011. The directors transferred ₹1,20,000 to dividend equalization reserve and ₹90,000 to debenture redemption fund account. Prepare profit & loss appropriation account.

[**Ans:** Balance carried forward to b/s: ₹36,16,200]

9. The following is the list of balances of a public limited company as on 31 March 2011:

Particulars	₹	**Particulars**	₹
Gross Profit	4,25,250	Discounts (Cr.)	15,000
Furniture	85,000	Salaries	37,500
Rent	20,000	Sunday Expenses	35,250
P&L Appropriation A/c (Cr.) as on 31 March 2010	75,000	Dividend Paid (2009–10)	45,000
		Debtors	1,37,500
Share Capital	5,00,000	Plant	1,45,500
Creditors	87,500	General Reserve	77,500
Bank Balances	2,31,000	Bills Payable	35,000
Bills Receivable	49,000		

Prepare profit and loss appropriation account for the year ended 31 March 2011 after providing for

(i) Depreciation @ 20% on fixed assets

(ii) Provision for doubtful debts at 5%

(iii) Provide for 15% dividend

[**Ans:** Proposed dividend: ₹75,000; Dividend tax @ 10% ₹7,500; Balance carried forward to balance sheet: ₹2,52,125]

10. The accounts of Devan Ltd showed an amount of Rs. 7,00,000 on the credit of profit and loss A/c on 31 March 2011 out of which the directors decided to place ₹1,00,000 to general reserve and ₹28,0000 to debenture redemption fund. At the annual general body meeting held on 15June 2011, it was decided to place ₹48,000 to a development reserve and to pay a bonus of 3% of profit to the directors as additional remuneration. The payment of the half-yearly dividends on ₹12,00,000 6% cumulative preference shares on 30 September 2010 and 31 March 2011 was confirmed and a dividend @10% was declared on the equity share capital of the face value of ₹20,00,000.

The balance of P&L A/c is to be carried forward to next year. Prepare profit and loss appropriation account.

[**Ans**: Bonus to directors: ₹21,000; Balance of profit carried forward to balance sheet: ₹2,03,800]

11. A limited company has a paid up equity share capital of ₹4.5 crore divided into 45 lakh shares of ₹10 each and 11% preference share capital of ₹1.5 crore divided into 1,50,000 shares of ₹100 each. The balance of profit brought forward from the previous balance sheet was ₹1,40,000. The profit for the year ended on 31 March 2011 amounted to ₹1.74 crore after tax. The directors propose a dividend of 24% on equity share capital, after the following provisions:

(i) Statutory minimum transfer to general reserve

(ii) Provision of dividend on preference shares

Draw up the profit & loss appropriation A/c.

[**Ans:** Transfer to general reserve: ₹17,40,000; Corporate dividend tax: ₹12,45,000;

Balance of profit carried forward to balance sheet: ₹31,05,000]

12. Model: Preparation of P&L A/c

Figures same as in Q. No. 9.

[**Ans:** Net profit: ₹3,04,625]

[Model: Preparation of balance sheet]

13. From the following balances, prepare the balance sheet of a company in the prescribed format: (Schedule VI) Goodwill: ₹9,00,000, Investments: ₹12,00,000; Share capital: ₹30,00,000; Reserves: ₹6,60,000; Share premium: ₹90,000; Preliminary expenses: ₹60,000; Profit and loss A/c (Cr.): ₹1,50,000; Debentures: ₹15,00,000; Other fixed assets: ₹28,20,000; Stock: ₹4,80,000; Debtors: ₹3,60,000; Bank balance: ₹1,80,000; Unsecured loan ₹3,90,000; Sundry creditors: ₹2,10,00.

[**Ans:** Total: ₹60,00,000]

[Model: Balance sheet preparation]

14. Prepare a balance sheet as 31 March 2011 from the following information of public limited company as requires under the Companies Act, 1956:

	₹		₹
Term Loan	30,00,000	Sundry Debtors	36,75,00
Creditors	34,35,000	Miscellaneous	1,74,00
Advances	11,16,000	Loan from Directors	6,00,000
Cash & Bank Balance	8,25,000	Provision for Doubtful Debts	12,00,000
Staff advances	1,65,000	Stock	12,00,000
Provision for Tax	5,10,000	Fixed Assets (W.D.V)	1,54,50,000
Securities Premium	14,25,000	Finished Goods	22,50,000
Loose Tools	1,50,000	General Reserve	61,50,000
Investments	6,75,600	Capital WIP	6,00,000
Loss for the Year	9,00,000		

Further information:

1. Share capital consists of:
   (i) 90,000 equity shares of ₹ 100 each fully paid up
   (ii) 30,000 10% Preference shares of ₹ 100 each
2. Term loan is secured
3. Depreciation on assets: ₹ 15,00,000
4. Schedules need not be given

[**Ans:** Balance sheet total: ₹ 2,62,20,000]

[Model: Comprehensive]

15. From the below-mentioned trial balance of Ansul Ltd., prepare a trading and profit and loss account for the year ended 31 December 2010:

Debit Balance	₹	**Credit Balance**	₹
Opening Stock	1,80,000	Equity Share	
Rent and Taxes	36,000	Capital	
Purchases	3,65,400	6,000 Shares of	6,00,000
Wages	3,31,200	₹ 100 Each	
Discount	9,000	5% Debentures	1,50,000
Fuel	15,420	Sales	10,50,000
Building	4,20,000	Creditors	48,000
Carriage Inwards	7,050	Bank Overdraft	72,000
Debtors	1,20,000	Discount	13,200
Goodwill	1,68,00	Transfer Fee	600
Plant & Machinery	1,50,000	Returns Outwards	600
Loose Tools	36,000		
Advertisement	18,000		
General Expenses	26,400		
Bad Debts	6,180		
Debenture Interest (For 6 Months)	3,750		
Miscellaneous Expenses	18,000		
Insurance	6,000		
Cash	18,000		
	19,34,400		19,34,400

Further information:

(a) The authorized capital of the company is ₹ 12,00,000
(b) Stock on 31 December 2010 is ₹ 12,00,000
(c) Depreciate plants and machinery @ 9%
(d) Revalue tools at ₹ 24,600
(e) Allow 2.5% discount on debtors
(f) Provide 2% as bad debts reserve

[**Ans:** Gross profit: ₹ 13,51,530; Net profit ₹ 12,08,010; Balance sheet total: ₹ 20,71,760]

16. From the following balances as on 31 March 2011, of XY Ltd. prepare profit & loss A/c for the year ended and the balance sheet as on that date:

Debit Balances	₹	**Credit Balances**	₹
Stock as on 1 April 2010	1,66,900	Subscribed & Paid-up Capital	2,50,000
Discounts	33,940	Sales	7,31,340
Land	66,000	Sundry Receipts	1,000
Plants & Machinery	53,500	Creditors	1,97,660
Purchases	4,59,440	Provision for Bad Debts	26,500
Furniture	13,750		
Debtors	3,16,000	Discounts (Cr.)	29,520
P&L A/c (Dr.)	24,800	Bank Overdraft	69,115
Carriage	18,900	Customer's Deposit	2,000
Wages	45,080		
Bad Debts	9,100		
Office Expenses	51,375		
Cash on Hand	2,350		

The following adjustments have to be made:

(a) Stock on 31 March 2011: ₹ 1,77,300
(b) Depreciate plant & machinery @ 10% and furniture @ 10%
(c) Provided 10% for bad and doubtful debts
(d) Customer's deposit has been forfeited
(e) Proposed dividend @ 10%
(f) Provision for taxation: ₹ 37,500
(g) The managing director is entitled to 10% commission on net profits before charging such commission

[**Ans:** Gross profit: ₹ 2,18,320; Net profit: ₹ 89,775; Surplus carried to balances sheet: ₹ 37,475 B/s total: ₹ 6,36,925]

17. Rainbow Manufacturing Company Ltd. was registered with a nominal capital of ₹ 18,00,000 in equity shares of ₹ 100 each. The following is the list of balances extracted from its books on 31 March 2011:

Particulars	₹	Partculars	₹
Calls-in-Arrears	22,500	Salaries	43,500
Premises	9,00,000	Director's Fees	17,175
Plants & Machinery	9,90,000	Bad Debts	6,330
Interim Dividend Paid on 1 October 2010	1,12,500	Debenture Interest Paid	27,000
Stock on 1 April 2010	2,25,000	Subscribed and Fully Called-up Capital	12,00,000
Fixtures	21,600	6% Debentures	9,00,000
Sundry Debtors	2,61,000	P&L A/c (Cr.)	45,500
Goodwill	75,000	Bills Payable	1,14,000
Cash in Hand	2,250	Sundry Creditors	1,50,000
Cash in Bank	1,19,700	Sales	12,45,000
Purchases	5,55,000	General Reserve	75,000
Preliminary Expenses	15,000	Bad Debts Reserve 1 April 2010	10,500
Wages	2,54,595		
General	50,505		
Freight & Carriage	39,345		

Prepare trading and profit and loss account and the balance sheet in proper form after making the following adjustments:

(a) Depreciate plants & machinery by 10%
(b) Write off ₹ 1,500 from preliminary expenses
(c) Provide half years debentures interest due
(d) Leave bad and doubtful debts reserve at 5% on sundry debtors
(e) Closing stock: ₹ 2,85,000

[**Ans:** Gross profit: ₹ 4,56,060;
Net profit: ₹ 1,81,500;
Surplus carried to b/s ₹ 1,01,250;
Balance sheet total: ₹ 25,56,000]

18. Excellent Engineering Ltd. has an authorized capital of ₹ 1 crore. Divided into 1 lakh equity shares of ₹ 100 each. Their books show the following balances as on 31 December 2010:

Particulars	₹	Particulars	₹
Stock (1 January 2010)	13,30,000	Equity Share Capital	
Discounts & Profit	60,000	(40,000 Shares of ₹ 100 lakh	40,00,000
Carriage Inwards	1,15,000	4 % Debentures	
Patents	7,50,000	(Repayable After 10 years)	10,00,000
Rents, Taxes & Insurance	1,10,000	Bank Overdraft	13,70,000
Furniture & Fixtures	3,00,000	Sundry Creditors (For Goods)	4,81,000
Materials Purchased	24,65,000	Sales	72,34,000
Wages	26,10,000	Rent (Cr.)	60,000
Coal and Coke	1,26,000	Transfer Fees	1,34,000
Freehold Land	25,00,000	P&L A/c (Cr.)	
Plants & machinery	15,00,000		
Engineering Tools	3,00,000		
Goodwill	7,50,000		
Sundry Debtors	5,32,000		
Bills Receivable	2,69,000		
Advertisement	30,000		
Commission & Brokerage	1,35,000		
Business Expenses	1,12,000		

Bank Current A/c	40,000		
Cash in Hand	16,000		
Debenture Interest (for HaL.F.-year—30 June 2010)	20,000		
Interest (Banks)	1,82,000		
Preliminary Expenses	20,000		
Calls-in-Arrears	20,000		
	1,42,92,000		1,42,92,000

(i) The stock (value as cost or market value whichever is lower) as 31 December 2010 was ₹ 14,16,000.

(ii) Outstanding liabilities for wages: ₹ 50,000; business expenses: ₹ 50,000

(iii) Dividends declared 10% on paid-up capital

(iv) Charge depreciation: Plants & machinery @ 5%; engineering tools @ 20%; patents @ 10% and furniture & fittings @ 10%

(v) Provide 2% on debtors as doubtful debts after writing off ₹ 43,000 as bad debts

(vi) Write off preliminary expenses: ₹ 10,000 and create debenture redemption reserve ₹ 1,00,000

(vii) Provided ₹ 4,80,000 for income tax

You are required to prepare profit & loss A/c for the year ended 31 December 2010 and balance sheet as on that date.

[**Ans:** Gross profit: ₹ 19,54,000; Net profit: ₹ 5,25,220; Surplus carried to balances sheet: ₹ 1,20,420;

Balance sheet total: ₹ 80,90,220]

19. The following balances appeared in the books of Kamal & Co. Ltd. as on 31 March 2011:

Trial Balance of Kamal & Co. Ltd. as on 31 March 2011

Particulars	**Dr.** ₹	**Cr.** ₹
Stock (1 April 2010)	2,55,000	—
Purchases	40,50,000	—
Sales	—	55,50,000
Manufacturing Expenses	9,00,000	—
Salaries & Wages	1,32,000	—
General Charges	55,000	—
Interest	—	13,000
Profit & Loss A/c	—	1,50,000
Directors' Fees	2,000	—
Dividend (2009–10)	90,000	—
Buildings	5,05,000	—
Plants & Machinery	3,52,000	
Furniture	51,000	
Motor Vehicles	2,04,000	—
Stores & Spare Parts	1,50,000	
Bills Receivable	2,25,000	—
Book Debts	5,70,000	—
Investments	40,000	
Share Capital		7,20,000
Pension Fund		2,30,000
Dividend Equalization Fund		1,00,000
Taxation Provision	—	85,000
Unclaimed Dividend	—	10,000
Deposits	—	16,000
Trade Creditors	—	12,40,000
Cash at Bank	5,30,000	—
	81,14,000	81,14,000

Adjustments:

(i) Stock on 31 March 2011: ₹ 3,60,000

(ii) Outstanding expenses—Manufacturing expenses: ₹ 2,25,000; Wages: ₹ 15,000

(iii) Interest accrued on securities: ₹ 1,000

(iv) General charges pre-paid: ₹ 8,000

(v) Provide depreciation—Buildings @ 2% p.a.; furniture: 10%; plants & machinery 10%; motor vehicles: 20%

(vi) The directors propose dividends @ 20%

(vii) The taxation provisions shown in the trial balance is after payment of taxes for assessments year up to 31 March. 2010

The only liability for taxes in respect f profit for 2010–11 for which a provision of 60% on net profit is considered. Prepare trading and profit & loss A/c for the year ended 31 March 2011 and the balance sheet as on that date.

[**Ans:** Gross profit: ₹4,71,000; Net profit: ₹85,120; Surplus carried to balance sheet: NIL; Balance sheet total: ₹29,13,800]

20. The below-mentioned balances appeared in the books of a public limited company as or 31 March 2011:

	₹
Share Capital (Authorized & Issued 30,000 Shares of ₹100 Each)	30,00,000
General Reserve	12,50,000
Unclaimed Dividends	32,630
Trade Creditors	1,84,290
Buildings	5,00,000
Purchases	25,04,515
Sales	49,19,735
Manufacturing Expenses	17,95,000
Establishment	1,34,070
General Charges	1,55,390
Machinery	10,00,000
Motor Vehicle	75,000
Furniture	25,000
Stocks	8,60,290
Book Debts	11,16,900
Investments	14,44,750
Depreciation Reserve	3,55,000
Cash Balances	3,61,200
Director's Dividend	75,000
Interest (Cr.)	42,740
Profit & Loss A/c 1 April 2010 (Credit Balances)	84,240
Stock Provident fund	1,87,500

From these balances and the following information, prepare the company's balance sheet as on 31 March 2011 after preparing the trading and profit and loss for the year ended on that date:

(i) The stocks on 31 March 2011 were valued as ₹7,43,420

(ii) Provide ₹50,000 for depreciation of gross block and ₹7,500 for the company's contribution to the staff PF.

(iii) Interest accrued on investment amounted to ₹13,750

(iv) A claim of ₹12,500 for workers compensation is being disputed by the company

(v) Establishment includes ₹30,000 paid to the manager, who is entitled to remuneration at 5% of profit as per the Companies Act subject to a minimum of ₹50,000 p.a. You may make necessary adjustments.

[**Ans:** Hint: Profit before remuneration: ₹2,33,840. Gross profit: ₹5,03,330; Net profit: ₹1,83,840; Surplus carried forward to balance sheet: ₹1,85,580; Balance sheet total: ₹48,75,000]

Exercises

Part B—For Advanced Level

21. The following balances appeared in the books of Raza Ltd. as on 31 March 2011:

Particulars	**Dr.** ₹	**Cr.** ₹
Equity Shares of ₹100 Each, Fully Paid up	—	18,00,000
General Reserve	—	6,90,000
Unclaimed Dividend	—	1,578
Trade Creditors	—	1,28,574
Building (At Cost)	7,50,000	—
Purchases	15,02,709	—
Sales	—	32,51,841
Manufacturing Expenses	10,50,000	—
Establishment Charges	80,442	—
General Charges	93,234	—

Machinery (At Cost)	6,90,000	—
Furniture (At Cost)	1,05,000	—
Opening Stock	5,16,174	—
Book Debts	3,07,140	—
Investments	8,66,850	—
Provision for Depreciation on Fixed Assets	—	2,73,000
Advance Payment of Income Tax	1,50,000	—
Cash at Bank	2,16,720	—
Director's Fees	54,000	—
Interest on Investments	—	25,632
Profit & Loss A/c (1 April 2010)		50,544
Staff Provident Fund	—	1,12,500
	63,33,669	63,33,669

From the above-mentioned balances and the following information, prepare the company's balance sheet as on 31 March 2011 and its profit and loss account for the year ended on that date:

(i) The stock on 31 March 2011 was valued as ₹ 4,46,040

(ii) Provide ₹ 87,000 for depreciation on fixed assets and ₹ 24,000 for managing director's remuneration

(iii) Interest accrued on investments amounted to ₹ 8,250

(iv) Make a provision of ₹ 1,50,000 for income tax

(v) The directors propose a dividend @ 8% after transfer of ₹ 75,000 to general reserves

Also provide for dividend tax @ 10% of the proposed dividend

[C.S. (Inter). Modified]

[**Ans:** Gross profit: ₹ 6,28,998; Net profit: ₹ 2,22,804;

Balance sheet total: ₹ 31,80,000]

22. The following are the balance from the ledger of Sungam Hotels Ltd. on 31 March 2011:

	₹
Share Capital—Credit Balance on 1 April 2010	2,83,425
Preliminary Expenses	37,500
Freehold Premises	2,34,000
Furniture & Fittings	44,670
Glass & China	5,505
Linen	4,200
Cutlery & Plate	1,950
Rates, Taxes & Insurances	8,565
Salaries	12,000
Wages	21,525
Stocks on 1 April 2010:	
Wines: ₹ 6,195; Spirits: ₹ 1,890; Beer: 825	8,910
Minerals: ₹ 735; Cigars & Cigarettes: ₹ 570	1,305
Sundry Provision & Stores: ₹ 915; Coal: ₹ 750	1,665
Purchase:	
Meat: ₹ 18,135; Fish & Poultry: ₹ 19,800	37,935
Sundry Provision and Stores: ₹ 26,100	26,100
Wines: ₹ 9,405; Spirits: ₹ 10,950; Beer: ₹ 5,760	26,115
Minerals: ₹ 5,250: Cigars & Cigarettes: ₹ 1,200	6,450
Laundry	4,755
Coal and Gas	20,800
Electric Light	5,640
General Expenses	8,550
Sales:	
Wines: ₹ 29,350; Spirits: ₹ 31,675; Beer: ₹ 19,315	80,340
Minerals: ₹ 10,800; Cigars & Cigarettes: ₹ 1950	12,750
Meals	1,19,145
Rooms	46,875
Tires in Bedrooms	2,910
Washing Charges	1,095
Repairs, Renewals and Depreciation:	

Premises: ₹1,740; Furniture & Fittings: 3,300	5,040
Glass & China: ₹3,045; Linen : ₹1,950	4,995
Cutlery & Plate	1,035
Cashbook—Debit Balances:	
In Bank	40,740
In Hand	1,095
Visitors Accounts Unpaid	2,445
Sundry Creditors	16,950

Stock on 31 March 2011 were valued as follows:

Wines: ₹5,985; Spirits: ₹1,665; Beer: ₹870 Minerals: ₹1,785; Cigars & Cigarettes: ₹ 345 Sundry Provisions and Stores: ₹705; Coal: 495

The manager is entitled to a commission on 5% of the net profits after charging his commission. The authorized share capital is 5,00,000 shares of ₹10 each of which 28,5000 shares were issued, The whole of the amount being called up. The final call on 1,050 shares @ ₹1.50 per share was unpaid. the directors forfeited these shares at their meeting held on 15 March 2011.

The tax liabilities is to be provided for @ 35% and the directors propose to declare a dividend at 10%. Provision for corporate dividend tax @ 10% is also to be made.

Prepare the final accounts for presentation to the shareholders.

[C.A. (Final). Modified]

[**Ans:** Commission: ₹3,980; Net profit after tax: ₹51,740; Balance sheet total: ₹3,83,955]

23. The following is the trial balance of X Ltd. as on 31 March 2011:

Debits	₹	**Credits**	₹
Advance Tax for 2010–11	8,60,000	Shares for Feature A/c	24,000
Interims Dividend	2,00,000	Preference Share Capital	8,00,000
Dividend Tax Paid	20,000	Equity Share Capital	20,00,000
Capital Redemption A/c	8,80,000	General Reserve	8,00,000
Discount on Issue of Debenture A/c	24,000	Securities Premium A/c	80,000
Share Re-issue A/c	8,000	Profit and Loss A/c	6,00,000
Fixed Assets	40,00,000	Operating Profit for 2010–11 (Before Tax)	24,08,000
Investments	12,00,000		
Current Assets	7,60,000		
		13% Debentures	4,00,000
		Current Liabilities	8,40,000
	79,52,000		79,52,000

The following additional information is provided to you:

(i) On 31 March 2011, the issued share capital consists of 20,000 equity shares of ₹100 each fully paid up. Share re-issue account represents discounts allowed at the time of re-issue of 400 forfeited equity shares which were earlier forfeited for the non-payment of the final call.

(ii) Subsequent to the reissue of equity shares as noted above, the preference share capital was redeemed out of profits otherwise available for dividend. The directors deciding to pay a premium of 10% to the preference shareholders. The Company also issued bonus shares to equity shareholders in the ratio of 2:5 out of capital redemption reserve account. Both the redemption of preference shares and re-issue of bonus shares have not been recorded in the books except that the amount paid to the preference shareholders has been debited to the capital redemption account.

(iii) Provision for tax is required at 35%.

(iv) The Board of Directors has proposed a final dividend of 20% on equity shares after appropriating profits as per law. Provision for corporate dividend tax @ 11% of the proposed dividend is also made.

(v) The Board of Directors has decided to record the upward revaluation of fixed on issue of debenture account is yet to be written off against the profit of the current year.

You are required to prepare the profit and loss account of the company for the year ended 31 March 2011 and its balance sheet as on that date after passing journal entries for the necessary adjustments.

[**Ans:** Net profit: ₹ 15,60,000; P&L appropriation account balance: ₹ 11,62400; Balance sheet total: ₹ 78,36,000]

24. The following balances have been extracted from the books of account of Amma Ltd. as on 31 March 2011:

Debit Balance	₹	**Credit Balance**	₹
Premises	6,14,400	Equity Share Capital	8,00,000
Plant	6,60,000		
Furniture	40,000	12% Debentures	6,00,000
Stock (1 April 2010)	1,50,000	P&L A/c (1 April 2010)	61,135
Debtors	1,74,000	Bills Payable	74,000
Goodwill	10,000	Creditors	80,000
Cash at Bank	2,81,300	Sales	8,30,000
Calls-in-Arrears	15,000	General Reserve	2,50,000
Interim Dividend Paid	78,500	Provision for Bad Debts (1 April 2010)	7,000
Tax on Distributed Profits Paid	8,635		
Purchases	3,70,000		
Preliminary Expenses	10,000		
Salaries	40,450		
Wages	1,95,960		
Debenture Interest Paid	36,000		
Bad Debts	4,220		
General	13,670		
	27,02,135		27,02,135

Additional information:

(i) Depreciate plant by 15% and furniture by 10%

(ii) Write off preliminary expenses to the extent of ₹ 1,000

(iii) Half year's interest on debentures is due

(iv) Crease a provision for bad debts @ 5% on debtors

(v) Provide for income tax @ 38.%5 on book profits

(vi) Stock on 31 March 2011 was valued at ₹ 2,02,000

(vii) A claim of 5,000 for worker's compensation is being disputed by the company

(viii) Issued and subscribed capital consists of 80,000 equity shares of ₹ 10 each, fully called up

Prepare profit and loss accounts for the year ended 31 March 2011 and the balance sheet as at that date.

[B.Com (Hons) Delhi Modified]

[**Ans:** Gross profit: ₹ 3,16,040, Net profit: ₹ 49,200; Balance of P&L appropriated A/c: ₹ 23,200; B/s total: ₹ 18,79,000]

25 A manufacturing ltd. company was registered with a nominal capital of ₹ 20 crore divided into shares of ₹ 100 each, out of which 8 lakh shares had been issued and fully called.

The following is the trial balance extricated on 31 March 2011:

Partciulars	**₹ in 000's**	**₹ in 000's**
Stock 1 April 2010	37,284	—
Manufacturing Wages	21,948	—
Manufacturing Expenses	3,848	—
Purchases & Sales	1,42,642	2,33,980
Machinery Repairs	1,722	—
Carriage Inwards	982	—
Carriage Outwards	1,952	—
Advance Payments of Income Tax	2,858	
Bank Loan as 18%	—	10,000
Interests on Loan	900	—
Debtors & Creditors	32,880	18,444
P&L A/c 1 April 2010	—	1,628
Bank Current A/c	21,372	—
Cash in Hand	384	—
Leasehold Factory	32,842	—
Plant & Machinery	25,680	—

Loose Tools	2,500	—
Share Capital	—	80,000
Calls-in-Arrear	200	—
Rates & Electricity	3,522	—
(Factory: ₹2,842; Office: ₹680 bolts in thousands)		
Directors' Fees & Remuneration	2,400	—
Office Salaries & Expenses	2,600	—
Auditor's Fees	250	—
Office Furniture	1,000	—
Commission	1,620	—
Returns	2,428	1,962
Preliminary Expenses	1,200	—
	3,46,114	3,46,114

You are required to prepare trading and profit and loss account for the year ended 31 March 2011 and balance sheet at that date after taking into consideration the following adjustments:

(i) Write off one-third of preliminary expenses

(ii) Depreciation is to be provided on:
  (a) Plant furniture @ 15%
  (b) Office furniture @ 10%

(iii) Manufacturing wages ₹378 thousand and office salaries ₹240 thousand had accrued due

(iv) Provide for interest on bank loan for 6 months

(v) The stock was valued at ₹24,968 thousands for discount on debtors

(vi) Make a provision for income tax @ 40%

(vii) Provide ₹1,700 thousands on debtors for doubtful debts

(viii) The Directors recommend dividend at 15% for the year ending 31 March 2011 after transferring 5% of net profits to general reserve.

Make a provision for corporate dividend tax at 10%.

[**Ans:** Net profit: ₹16,210; Balance of profit carried to balance sheet: ₹3,958; Balance sheet total: ₹1,38,508

₹ in 000's]

26 The following balances appeared in the books of X Ltd. as on 31 March 2008:

Partciulars	₹	₹
Equity Shares of ₹10 Each Fully Paid up	—	12,00,000
General Reserve	—	4,60,000
Unclaimed Dividend	—	1,052
Trade Creditors	—	85,716
Building at Cost	3,00,000	—
Purchases and Sales	10,01,806	21,67,894
Manufacturing Expenses	7,00,000	—
Establishment Charges	53,628	—
General Charges	62,156	—
Machinery (At Cost)	4,60,000	—
Furniture (At Cost)	10,000	—
Opening Stock	3,44,116	—
Book Debts	4,64,760	—
Investments	5,77,900	—
Provision for Depreciation on Fixed Assets	—	1,82,000
Advance Payments of Income Tax	1,00,000	—
Cash as Bank	1,44,480	—
Director's Fees	3,600	—
Interest on Investments	—	17,088
Profit & Loss A/c (1 April 2007)	—	33,696
Staff Provident Fund	—	75,000
	42,22,446	42,22,446

From the above-mentioned balances and the following information, prepare company's balance sheet as at 31 March 2008 and profit and loss A/c ended on that date:

(i) Stock on 31 March 2008 was valued at ₹2,97,360

(ii) Provided ₹38,000 for depreciation on fixed assets and ₹16,000 for managing director's remuneration

(iii) Interest accrued on investments amounts to ₹3,500

(iv) Make a provision of ₹1,00,000 for income tax

(v) The directors propose a dividend of 8% after transfer of ₹70,000 to general reserve.

[B.Com (Hons) Delhi 2008]

[**Ans:** Gross profit: ₹4,19332; Net profit: ₹1,66,536; Net profit ₹17,917; B/s total: ₹20,38,000]

27. From the following trial of Bharat Braket Ltd. as at 31 March 2009, prepare profit & loss A/c for the year ended 31 March 2009 and the balance sheet as on that date:

Debits	₹	Credit	₹
Stock (1 April 2008)	60,000	Sundry Creditors	45,000
Purchases	3,20,000	Profit and Loss A/c (1 April 2008)	63,100
Wages	90,000	General Reserve	78,000
Manufacturing Expenses	50,000	Share Capital Fully Paid Equity Shares of ₹ 10 Each	5,00,000
Carriage Inward	10,000	6% Debentures (Secured Against Fixed Assets)	2,00,000
Carriage Outward	20,000	Salaries Outstanding	25,000
Salaries	60,000	Sales	7,70,000
Insurance	10,000	Interest Revived on Sinking Funds Investments	2,000
Sundry Debtors	90,000	Sinking Fund	90,000
Bank Balance	6,000		
Sinking Fund Investments (4% Govt. Securities of Rs. 1,00,000	90,000		
Debenture Interest	6,000		
Land & Building	3,00,000		
Plants & Machinery	4,50,000		
Directors' Fee	10,000		
Audit Fee	6,000		
Interim Dividend on Equity Shares	30,000		
Tax on Interim Divided	5,100		
Preliminary	20,000		
Goodwill	1,40,000		
	17,73,100		17,73,100

Additional information:

(i) Closing stock on 31 March 2009 was ₹ 58,000

(ii) Make a provision for tax ₹ 50,000

(iii) Depreciation is to be provided @ 2% on land & building and @ 10% on plant & machinery

(iv) Write off ₹ 5,000 from preliminary expenses

(v) The directors recommended that ₹ 25,000 be transferred to general reserve and final dividend @ 9% of equity shares (in addition to interim dividend) is to be provided. Assume tax on dividend (corporate) tax dividend, surcharge and education cess) @ 17%

(vi) ₹ 10,000 is to be appropriated for sinking fund

(vii) Debentures were issued 6 years ago.

[**Ans:** Gross profit: ₹ 2,98,000; Net profit:– ₹ 74,000;

Balance of profit carried forward: ₹ 1,37,100;

Total of balance sheet: ₹ 11,00,000]

28. Sonal Antriksh Ltd. has authorized share capital of ₹ 30,00,000 consisting of 3,00,000 equity shares of ₹ 10 each. The following is the trial balance of the company as at 31 March 2009:

Debits	Amounts ₹	Credits	Amounts ₹
Calls-in-Arrear	2,00,000	Sales	1,56,20,000
Purchases	87,70,000	Creditors	5,00,000
Advance Tax Paid	24,50,000	12 % Debentures	10,00,000
Salaries	20,00,000	General Reserves	5,80,000
Selling Expenses	22,00,000	Provision for Depreciation on:	
Rent	1,00,000		
Prepaid Rent	20,000		
Interest on Debentures	1,00,000	Plant	5,00,000
Plant	25,00,000	Furniture	3,00,000
Furniture	13,00,000	Securities Premium	4,50,000
Debtors	8,00,000	Profit & Loss A/c	1,20,000
		Provision for Doubtful Debts	30,000
Discount on Issue of Debenture	10,000	Commission	1,00,000

Stock	4,50,000	Equity Share Capital	20,00,000
Bad Debts	50,000		
Bank Balance	4,50,000	Provision for Tax	12,50,000
Buildings	10,50,000		
	2,24,50,000		2,24,50,000

Additional information:

(i) Rent ₹20,000 is outstanding

(ii) Plants include plant costing ₹2,50,000 purchased on 1 October 2008. Provide depreciation on plant at 20% p.a. and on furniture at 10% p.a. on written down value basis

(iii) Maintain a provision for doubtful debts at 5% on debtors

(iv) The company proposed a dividend at 10% on paid-up share capital

(v) Make a provision of 30% for income tax (including recharge and cess)

(vi) Corporate dividend tax is at 16.995% (including recharge and cess)

(vii) Closing stock is ₹20,00,000.

(iii) You are required to prepare: (i) Trading and profit & loss A/c (ii) Profit & loss appropriation A/c for the year ending 31 March 2009 (iii) Balance sheet in the prescribed form as at 31 March 2009.

[B.Com (Hons) Delhi 2010]

[**Ans:** Gross profit: ₹84,00,000; Net profit: ₹24,67,500; Balance of profit carried forward: ₹23,76,909; Total of balance sheet: ₹92,65,000]

Valuation of Goodwill and Shares 8

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Define: Goodwill.
2. Understand the nature and sources of goodwill.
3. Appreciate the need for valuing goodwill.
4. Understand the terms: future maintainable profit; normal rate of return; capital employed and average capital employed.
5. Determine average capital employed under different methods.
6. Value goodwill by average profits method; super profit method and capitalization method.
7. Appreciate the need for valuation of shares.
8. Value shares by intrinsic value method; yield method and fair value method.
9. Understand "minority" and "majority" holdings.
10. Explain the meaning of certain key terms associated with "Valuation of Goodwill and Shares".

A firm's reputation is generally assessed by goodwill. Despite its popular usage in business activities, its value is not yet properly understood in accounting language. As a student of corporate accounting, one should be able to define goodwill, and understand its nature and sources. They should also appreciate the need to value goodwill, and should be aware of the factors that affect the value of goodwill and the methods of valuing it. Similarly, the students should also know to determine the value of shares.

Questions like why the value of shares has to be ascertained, what are the factors that affect the value of shares, and what are the methods of valuation of shares are answered in detail in this chapter.

8.1 VALUATION OF GOODWILL

The term "goodwill" is most widely used in the business world. But no one will be able to explain it in crystal clear words. It is difficult to define. However, it is considered as an invaluable asset—intangible in nature. But it is not a fictitious asset. In simple words, a business firm which earns reputation over a period of time gets the credit of goodwill. It is a common notion that if a firm is a profitable one it is valued high and in turn attracts goodwill. Hence it may be said that the reputation of a firm coupled with its going

profitability represents "goodwill". But goodwill can be realizable or quantified in money's worth when the firm is disposed of. Though there are many definitions, the following are noteworthy to be quoted:

"The capacity of a business to earn profits in future is basically what is meant by the term *Goodwill*". "Goodwill is the present value of a firm's anticipated excess earnings".

8.2 NEED FOR VALUATION OF GOODWILL

Generally, goodwill may be valued and realized only at the time of disposal of the business. Such being the inherent characteristic feature of goodwill, naturally a question arises as to the necessity of valuation of goodwill. The need for valuation of goodwill depends on the form of organization. In case of sole proprietorship, it is valued at the time of disposal of the business. Goodwill cannot be sold as a separate item. In case of a partnership firm, the need for valuation of goodwill arises on some important events such as, admission of a new partner, retirement or death of a partner, change in profit sharing ratio, dissolution or sale to a company.

In case of joint stock companies, the need for valuation of goodwill arises in the following circumstances:

(i) When amalgamation of companies occur.
(ii) When one company takes over another or when the business of one company is sold to another company.
(iii) When a company wants to write off or reduce its debit balance in the profit and loss account.
(iv) When a company wants to exercise controlling interest in another company.
(v) For valuation of shares in the absence of stock exchange quotations.
(vi) Where conversion of shares from one class to another class takes place.
(vii) When the Government takes over the company's business.

8.3 FACTORS AFFECTING THE VALUE OF GOODWILL

The following are some of the factors that affect the value of goodwill:

1. The foremost factor that affects the goodwill is "Profit". The profit position over past years and profit expected to earn in future are important factors.
2. Capital employed to earn profit.
3. The yield expected by the investors.
4. The longevity of the concerns.
5. Customer association with the business concern—personal approach.
6. Market share for its products.
7. Quality of services rendered.
8. The position of a particular concern with respect to its competitors in the field.
9. Nature of after sales services.
10. Relationship between management and staff.
11. Location of the business enterprise.
12. Steps taken to popularize its brand.
13. Technical innovations.
14. Tax planning.
15. Relationship with statutory bodies and government agencies.

8.4 COMPONENTS OF GOODWILL

Now, the most important components of goodwill namely (1) profitability; (2) yield expected by the investors (normal rate of return) and (3) capital employed are to be explained in detail which will facilitate the evaluation of goodwill.

8.4.1 Profitability

According to the definition in Section 8.1, emphasis is on the future profits of a firm. It is natural that any buyer is keen to assess whether the firm will enhance the profitability in the coming years. This process of assessment whether the firm will maintain its profits in the future is otherwise called "future maintenance profit". Profits earned in the past years, naturally, forms the basis for estimating future profits. As such, the following factors are to be considered while estimating the future maintainable profits:

(i) All normal working expenses should get included, e.g., depreciation and fixed assets; interest and debentures.
(ii) Any appreciation in fixed assets has to be excluded.
(iii) However, any appreciation in current assets should get included.
(iv) Provision has to be made for taxation.
(v) Income from non-trading assets should not be taken into account.
(vi) Any transfer to general reserve should be excluded.
(vii) Preference dividend should be excluded.
(viii) Expenses which are non- recurring in nature should not be included.
(ix) Profits for past years should get averaged and average profits only need be taken into account.

8.4.2 Normal Rate of Return

It is natural that any investor is interested in getting a fair return (yield) on their investments. This is referred to as "rate of earnings". It varies from industry to industry. It depends upon various factors such as bank rate, nature of industry, risk, etc. It consists of the following elements:

1. **Return at zero risk level:** It refers to "no-risk" type forms. It refers to safe investments in firms which do not have any risk in their activities but as the same time, the rate of return may not be high but steady with normal rate of return. It may also be referred to as "pure interest". Interest is earned without facing any risk.
2. **Premium for business risk:** It refers to a risky investment. In case a firm faces more risk, then the rate of return will be high in facing risky environment. A margin is allowed to cover ordinary risk in business. Profit will vary in proportion to risk covered in the industry. The more is the risk, the higher is the rate of return.
3. **Premium for financial risk:** It refers to the risk connected with the capital structure. Here a margin is allowed to cover risks connected with the finances of business organizations. A firm or business entity having a higher debt ratio in the capital structure is considered to be more risky.

   The normal rate of return is to be ascertained by taking into account the above factors. Apart from these, the following factors that affect the normal rate of return are also should be borne in mind:

   (i) **Bank rate:** Existing bank rate is the indicator for the investor's expected rate of return.
   (ii) **Period of investment:** Period of investment is in direct proportion to the expected rate of return
   (iii) **Risk:** Risk may be due to nature of business (i.e., business risk) or due to high dependence on debt component of capital structure (i.e., finance risk)
   (iv) **Economic and political scenario:** Economic boom and political stability may enhance investor's expectation on rate of return for their investment.

8.4.3 Capital Employed

The other most important element in the valuation of goodwill is "capital employed". The quantum of profits earned with respect to the capital used is an important basis for the valuation of goodwill. Of late, capital employed represents the fixed assets *plus* net working capital. This may also be said as an aggregation of share capital, reserves and long-term loans. In other words, this term represents the equity shareholders funds along with long-term borrowings. Care should be taken to exclude non-trading assets, fictitious assets and goodwill appearing in the balance sheet.

However, this is not suitable for evaluating goodwill of individual companies. In such individual companies, the benefit accrued to the shareholders has to be assessed. For this, the amount of debentures or loans should not be included in capital.

The items to be included in the determination of capital employed are as follows:

(i) All fixed assets *LESS* depreciation written off
(ii) Trade investments
(iii) All current assets

Items to be excluded in determining capital employed are:

(i) Long-term liabilities
(ii) All current liabilities
(iii) Intangible assets including goodwill
(iv) Non-trading assets
(v) Fictitious assets

At present, "average capital" employed is used instead of capital employed. Since the profit earning is a continuous process throughout the year, it is reasonable to use average capital employed. Average capital employed is nothing but the average of the capital employed at the end of the year and employed in the beginning of the year.

If the capital employed in the beginning of the year is not given in the question, average capital employed may be determined by deducting the half the profits of the year from the capital employed at the end of the year.

All these factors can best be understood in the illustrations provided in the chapter.

8.5 METHODS OF VALUATION OF GOODWILL

The following are the methods of valuation of goodwill:

1. Average profits method
2. Super profits method
3. Capitalization method
4. Annuity method

Part A: In this part, simple problems are solved for valuation of goodwill. In the next part, i.e. Part B, advanced problems are discussed.

8.5.1 Average Profits Method

Under this method, the goodwill is valued

(i) at agreed number of "years" purchase; and
(ii) of the average profits of the past few years.

It is presumed that any new business will not be able to earn profits during the first few years. The person who purchases an already running business has to pay a sum (goodwill) which is equal to the profits that is likely to be earned in the first few years. Hence, the goodwill is to be calculated by multiplying the past average profits by the number of years during which the expected profits will accrue.

Goodwill is paid for obtaining a future advantage. After deciding the number of years for which the business will run in the market, the profits of these years expected will be paid by the buyer to the seller. For this reason, the average profit is to be multiplied by number of years.

Formula: Goodwill = Average profit × Number of years' purchase

Illustration 8.1

Model: Average profits method

The profit for the last 5 years of a company were as follows:

2006: ₹ 5,00,000

2007: ₹ 2,00,000

2008: ₹ 7,00,000

2009: ₹ 1,00,000

2010: ₹ 5,00,000

Calculate the goodwill of the company on the basis of 3 years purchase of the average profits based on the last 5 years.

Solution

Step 1: Compare the Average Profit:

(i) Formula: Average Profit $= \frac{\text{Total Profit}}{\text{Number of Years}}$

(ii) Substituting the Figures

$$= \frac{₹\,5,00,000 + ₹\,2,00,000 + ₹\,7,00,000 + ₹\,1,00,000 + ₹\,5,00,000}{5}$$

$$= \frac{₹\,20,00,000}{5} = ₹\,4,00,000$$

Step 2: Computation of Goodwill:

(i) Formula: Goodwill = Average Profits × Number of Years Purchased

(ii) Substituting the Values, We Get,

₹ 4,00,000 × 3 = 12,00,000

(Ref: Step 1) (Given)

8.5.2 Weighted Average Profit Method

This method is a modified version of average profit method. Under this method, weighted average has to be found out instead of simple average as in earlier method. For this, each year's profit is multiplied by the respective number of weights, i.e. 1, 2, 3, 4, 5, etc., to determine the value of the product and it is totalled. This is divided by the total of weights to determine the weighted average profits. Finally, the weighted average profit is multiplied by the agreed number of years purchase to ascertain the value of goodwill.

Formula:

(i) Weighted average profit = $\frac{\text{Total of Products of Profits}}{\text{Total of Weights}}$

(ii) Goodwill = Weighted Average Profits × Agreed Number of Years' Purchase.

The value obtained under this method will be better than the simple average profit method.

Illustration 8.2

Model: Weighted average method

The profits of a company for the year ended 31 March for the last 5 years were as follows:

Year	Profit
2006	1,20,00,000
2007	15,00,000
2008	9,00,000
2009	7,00,000
2010	4,00,000

Calculate the value of goodwill on the basis of 2 years' purchase of weighted average profits after weights 1, 2, 3, 4 and 5 respectively to the profits for the years 2006 to 2010.

Solution

Step 1: First, Total Value of the Product is Determined as:

Year	Profit	Weight	Product
	₹		
2006	1,20,00,000	1	1,20,00,000
2007	15,00,000	2	30,00,000
2008	9,00,000	3	27,00,000
2009	7,00,000	4	28,00,000
2010	4,00,000	5	20,00,000
Total	–	15	2,25,00,000

Step 2: Weighted Average Profit = $\frac{\text{Total of Products of Profits}}{\text{Total of Weights}}$

$= ₹\frac{2,25,00,000}{15}$

$= ₹\,15,00,000$

Step 3: Goodwill = Weighted Average Profits × Number of Years' Purchase

$= ₹\,15,00,000 \times 2$

$= ₹\,30,00,000.$

Illustration 8.3

Model: Weighted average method with adjustments

Calculate the goodwill of a company on the basis of 2 years' purchase of weighted average profits for the last 3 years. Purchase of weighted average profits for the last 3 years. 2007: ₹ 1,00,000; 2008: ₹ 70,000; 2009: ₹ 50,000. The weights assigned to each year are: 2007: 1; 2008: 2; 2009: 3.

Further information:

(a) On 1 October 2008, repair in respect of machinery was ₹ 5,000, which was charged to revenue. This is to be capitalized for goodwill calculation subject to depreciation of 10% p.a. on reducing balance method.

(b) The closing stock for the year 2007 was overvalued by ₹3,000.

(c) To cover the management cost and annual charge, ₹4,000 should be made for the purpose of goodwill valuation.

Solution

1. Adjustments:
   (i) Items to be added to the profits given in the respective year:
      (a) Capital expenditure charged to revenue
      (b) Over value of opening stock: Closing stock of the previous (last) year → Opening Stock of next year (2008)
   (ii) Items to be deducted from the given profits:
      (a) Management cost
      (b) Unprovided depreciation
      (c) Closing stock (over valued)
   (iii) Depreciation = Year 1 October 2008: Period: 3 months

$$= ₹5,000 \times \frac{10}{100} \times \frac{3}{12} = ₹125$$

Year 2009 = Period → 1 year

$$= [5,000 - 10\% \text{ of } 5,000(3 \text{ months})] \times \frac{10}{100}$$

$$= ₹4,875 \times \frac{10}{100}$$

$$= ₹487.50$$

2. Calculation of adjusted profit:

Calculation of Adjusted Profit	**2007** ₹	**2008** ₹	**2009** ₹
Base: Profits (Given)	1,00,000	70,000	50,000
Add: (i) Capital Expenditure Charged to Revenue	—	5,000	—
(ii) Over Value of Opening Stock	—	3,000	—
	1,00,000	78,000	50,000
Less: (i) Management Cost	4,000	4,000	4,000
	96,000	74,000	46,000
(ii) Overvaluation of Closing Stock	3,000		
	93,000	74,000	46,000
(iii) Unprovided Depreciation	—	125	488
Adjusted Profit	93,000	73,875	45,512

3. Calculation of weighted average profits:

Year	**Profit**	**Weight**	**Product**
2007	93,000	1	93,000
2008	73,000	2	1,47,750
2009	45,512	3	1,36,536
		6	3,77,286

Weighted average profit $= \frac{3,77,286}{6} =$ ₹ 62,881

Goodwill = ₹ 62,881 × 2 years

= ₹ 1,25,762

8.5.3 Super Profits Method

In the earlier methods, goodwill is computed on the basis of average profits. It is based on the assumption that if any new business is set up, one may not be able to earn any profits during the first few years of running the business. As such, the person who buys an existing running business has to pay an amount equal to total profits he is likely to earn in the next "few years". Hence, goodwill represents a valuation of future earnings.

The other school of thought is that the buyer's real benefit lies not in total profits but in excess profits. They do not advocate "moral" or "actual profits". This method emphasises the valuation of goodwill on the basis of excess profits.

Super profit = Average profit – Normal profit

Goodwill = Super profit × Number of years

8.5.3.1 Calculation of Goodwill Under Super Profits Method

The following are the main requirements:

(i) Normal rate of return in similar business

(ii) The fair value of capital employed

(iii) Average of the profits earned in the past few years.

Step 1: Average Profit is Calculated.

Step 2: Normal Profit on the Capital Employed on the Basis of the Normal Rate of Return is Calculated.

Step 3: Normal Profit is Deducted from Average Profit Super Profit = Average Profit – Normal Profit [Step 2 – Step 1]

Step 4: Goodwill = Super Profit × Number of Years' Purchase [Step 3 × Number of Years]

Illustration 8.4

Model: Super profits method

The books of the business showed that the capital employed on 31 March 2010, ₹ 6,00,000 and the profits for the last 5 years were:

Years	₹
2005–06:	50,000
2006–07:	60,000
2007–08:	70,000
2008–09:	80,000
2009–10:	1,40,000

You are required to calculate the value of goodwill based on 3 years' purchase of the super profits of the business, given that the normal rate of return is 10%.

Solution

Step 1: Average Profit is Calculated as:

Year	Profit (₹)
2005–06	50,000
2006–07	60,000
2007–08	70,000
2008–09	80,000
2009–10	1,40,000
Total Profit =	4,00,000

$$\text{Average Profit} = \frac{\text{Total Profit}}{\text{Number of Years}} = \frac{₹\,4,00,000}{5} = ₹\,80,000$$

Step 2: Normal Profit is Calculated:

Formula: Normal Profit = Capital Employed × Normal Rate of Return

Substituting the Values We Get,

$$= ₹\,6,00,000 \times 10\% = ₹\,6,00,000 \times \frac{10}{100}$$

$$= ₹\,60,000$$

Step 3: Super Profit = Average Profit – Normal Profit

$$= ₹\,80,000 - ₹\,60,000 = ₹\,20,000$$

Step 4: Goodwill = Super Profit × Number of Years' Purchase

$$= ₹\,20,000 \times 3 \text{ years}$$

$$= ₹\,60,000.$$

8.5.4 Annuity Method of Super Profit

Under this method, goodwill is determined by using the formula:

Goodwill = Super profit × Present value factor (PVF)

To put in other words, goodwill is determined as the present value of the future super profits.

Present value factor can be obtained either by using the formula:

$$\left[\frac{1 - \frac{1}{(1+i)^n}}{i}\right], \text{ where } i = \frac{r}{100}$$

or from annuity tables.

Goodwill is calculated as follows:

Step 1: Future Super Profits for Next 5 or 6 or 7 Years have to be Calculated.

Step 2: Rate of Return has to be Fixed.

Step 3: Present Value Factors Have to be Calculated Either by Using the Formula or From Annuity Table.

Step 4: Present Value Factors Have to be Multiplied with Future Super Profits.

Step 5: The Aggregate (Sum Total) of Product of Present Value Factors and Super Profits is the Value of Goodwill.

Illustration 8.5

Model: Annuity method of super profit

A company has made a forecast of profit for the coming 5 years as follows:

Year	I	II	III	IV	V
Profits (₹)	50,000	60,000	70,000	80,000	1,00,000

The total assets of the firm are ₹ 6,00,000 and outside liabilities are ₹ 2,00,000. The present value factor @ 10% are as follows:

Year	I	II	III	IV	V
PVF	0.9091	0.8264	0.7513	0.6830	0.6209

Calculate the value of goodwill.

Solution

Step 1: Profit on Capital Employed is Calculated as:

Capital: Assets – Liabilities (Outside)

= ₹ 6,00,000 – ₹ 2,00,000 = ₹ 4,00,000

Profit = Capital Employed × Required Rate of Return

= ₹ 4,00,000 × 10% = ₹ 40,000.

		First Year	Second Year	Third Year	Fourth Year	Fifth Year
Step 2:	Profit Forecasted: (Given in Question) (₹)	50,000	60,000	70,000	80,000	1,00,000
Step 3:	Less: Normal Profit (Step 1) (₹)	40,000	40,000	40,000	40,000	40,000
Step 4:	Super profit (Step 2 – Step 3) (₹)	10,000	20,000	30,000	40,000	60,000
Step 5:	PVF (Given)	0.9091	0.8264	0.7513	0.6830	0.6209
Step 6:	Present Value of Super Profits (Step 4 × Step 5) (₹)	9,091	16,528	22,539	27,320	62,090
Step 7:	Sum of I + II + III + IV + V Years	₹ 9,091 + ₹ 16,528 + ₹ 22,539 + ₹ 27,320 + ₹ 62.090				
Value of Goodwill =		₹ 1,37,568				

8.5.5 Capitalization Method

Under this method, goodwill may be calculated in the following two ways:

1. Capitalizing the average profits
2. Capitalizing the super profits

8.5.5.1 Capitalization of Average Profit

Under this method, the value of goodwill is determined by deducting the actual capital employed in the business from the capitalized value of the average profits on the basis of normal rate of return.

Value of goodwill is determined as follows:

Step 1: The Average Profits are Ascertained on the Basis of Past Few Years' Performance.

Step 2: The Average Profits Thus Obtained are to be Capitalized on the Basis of Normal Rate of Return, by using the

Formula: $\frac{\text{Average Profits}}{\text{Normal Rate of Return}}$

This is the Total Value of Business.

Sept 3: Actual Capital Employed (Net Assets) is Calculated by Deducting Outside Liabilities from the Total Assets (Excluding Goodwill)

Formula:

Capital Employed = Total Assets (Excluding Goodwill) – Outside Liabilities

Step 4: Goodwill is Obtained by Deducting the Actual Capital Employed (Net Assets) from the Total Value of Business (Step 2 – Step 3)

Illustration 8.6

Model: Goodwill: Capitalization of average profit

A company has earned an average profit of ₹ 60,000 during the last 5 years. The normal rate of return in a similar type of business is 10%. The total assets of the business are ₹ 7,50,000 and outside liabilities are ₹ 2,50,000. Ascertain the value of goodwill by capitalization method.

Solution

Step 1: Average Profits = ₹ 60,000 (Given)

Step 2: Capitalization of Average Profits:

$$\text{Formula} = \frac{\text{Average Profits}}{\text{Rate of Return}}$$

$$= ₹\frac{60,000}{10\%} \text{ or } \frac{60,000}{10} \times 100$$

$$= 6,00,000.$$

Step 3: Capital Employed = Total Assets – Outside Liabilities

(Net Assets)

= ₹ 7,50,000 – 2,50,000

= ₹ 5,00,000

Step 4: Goodwill = Capitalized Value – Net Assets

= ₹ 6,00,000 – ₹ 5,00,000

= ₹ 1,00,000

(Step 2 – Step 3)

8.5.5.2 Capitalization of Super Profits

Under this method, valuation of goodwill is determined as follows:

Step 1: Capital Employed is Computed

Capital Employed = Total Assets – Outside Liabilities

Step 2: Required Profit on Capital Employed is Calculated by Using the Formula:

Profit = Capital Employed × Required Rate of Return

Step 3: Average Profit for the Last Few Years is Calculated.

Step 4: Super Profits is Arrived at by Deducting Required Profits From Average Profits.

Step 5: Super Profits is Multiplied by the Required Rate of Return to Find the Value of Goodwill.

Illustration 8.7

Model: Capitalization of super profits

Compute goodwill in each of the following cases:

(i) The goodwill of a company is estimated at 3 years' purchase of the average profits of the last 5 years which are:

Years →	**2006**	**2007**	**2008**	**2009**	**2010**
Profit/Loss (₹) →	20,000	25,000	(10,000)	55,000	60,000

(ii) The capital employed is ₹ 3,00,000 and normal rate of return is 10%, the average profit for last 5 years is ₹ 50,000 and goodwill is estimated at 3 years' purchase price of super profits.

(iii) Fantastic Ltd. earn a net profit of ₹ 0,000 with a capital of ₹ 5,00,000. The normal rate of return in the business is 10%. Compute the value of goodwill by applying capitalization of super profits method.

Solution

(i)

Step 1: Total Profit ₹ 20,000 + ₹ 25,000 + ₹ 55,000 + ₹ 60,000
= ₹ 1,60,000 – ₹ 10,000 (Loss)
= ₹ 1,50,000

Step 2: Average Profit $= \frac{\text{Total Profit}}{\text{Number of Years}} = ₹\frac{1,50,000}{5} = ₹ 30,000$

Step 3: Goodwill: Average Profit × Number of Years' Purchase
= ₹ 30,000 × 3 = ₹ 90,000

(ii)

Step 1: Average Profit = ₹ 50,000

Step 2: Normal ₹ 3,00,000 × 10% or $3,00,000 \times \frac{10}{100} = ₹ 30,000$

Step 3: Super Profit = Average Profit – Normal Profit
= ₹ 50,000 – ₹ 30,000 = ₹ 20,000

Step 4: Goodwill = Super Profits × Number of Years' Purchase
= ₹ 20,000 × 3 = ₹ 60,000

(iii)

Step 1: Normal Profit = ₹ 50,000 × 10% or $5,00,000 \times \frac{10}{100}$

Step 2: Super Profit = Average Profit – Normal Profit
= ₹ 60,000 – ₹ 50,000 = ₹ 10,000

Step 3: Goodwill = Super Profit $- \frac{100}{\text{Normal Rate of Return}} = ₹ 10,000 \times \frac{10}{100} = ₹ 1,00,000$

8.6 PART B—VALUATION OF GOODWILL ADVANCED PROBLEMS

Some of the important factors that should be considered for valuation of goodwill are as follows:

1. Capital employed
2. Future maintainable profit
3. Yield expectation

8.6.1 Capital Employed

In the previous part, i.e., for the beginners in corporate accounting, the term "capital employed" was discussed in simple terms as:

Capital employed = Total assets – Outside liabilities

But in practice, in companies of large size, it is not easy to compute the value of capital employed by a simple equation. The following two different approaches are adopted to compute the value of capital employed:

1. Assets side approach;
2. Liabilities side approach

8.6.1.1 Assets Side Approach

Value of capital employed, under this approach, is calculated as follows:

Step 1:	Assets at *Market Value*	₹
	(Excluding Goodwill, All Deferred Expinditures Such as Preliminary Expenses, Discount, etc.)	—
Step 2:	Less: Liabilities to Outside Parties (Including Credits, Bills Payable, Debentures, Outstanding Bills, Taxation, Dues, etc.) at *Revised Value*	—
Step 3:	Capital Employed	xxxxxxx
Step 4:	Less: 50 % of Profit Earned During The Year	—
Step 5:	Average Capital Employed	0000

"Average capital employed" is computed because of the assumption that profits have been earned evenly over the year. Further, if fresh, additional capital is not introduced in the business, the capital employed increases due to profits.

$$\text{Average capital employed} = \frac{(\text{Capital in the Beginning of the Year}) + (\text{Capital At the End of the Year})}{5}$$

In case the capital employed in the beginning of the year is not given in the question, average capital employed can be determined by deducting 50% profit of the year from the capital employed at the end of the year as shown in Step 4 above.

8.6.1.2 Liabilities Side Approach

Capital employed may be determined as follows, under this approach:

Step 1:	Share Capital	₹
Step 2:	Add:	
	(a) Profit	—
	(b) Reserves	—
	(c) Workmen Compensation Fund	—
	(d) Gain on Revaluation of Assets and Liabilities	—
		xxxx

Step 3:	Less:	
	(a) Goodwill	—
	(b) Loss on Revaluation of Assets and Liabilities	—
	(c) All Losses	—
	(d) Preliminary Expenses	—
	(e) Investments	—
Step 4:	Capital Employed	000
Step 5:	Less: 50% (1/2) of the Profit Earned During the Year	—
Step 6:	Average Capital Employed	xxx

Illustration 8.8

Model employed and average capital employed—Computation of

You are required to calculate (a) capital employed and (b) average capital employed from the following balance sheet:

Liabilities		₹	Assets	₹
12% Preferences Share Capital		1,00,000	Goodwill	30,000
Equity Share Capital		3,00,000	Land & Buildings	90,000
Reserves (Including a Profit of ₹ 50,000 for Current Year		90,000	Plant	1,50,000
			Current Assets	4,00,000
Workmen Compensation Fund		60,000	Investments	70,000
Depreciation Fund:			Investments for Replacement of Plant	30,000
Land & Buildings	30,000		Preliminary Expenses	10,000
Plant	30,000	60,000		
Debentures		90,000		
Creditors		80,000		
		7,80,000		7,80,000

Solution

Method I: Assets Side Approach:

			₹	₹
Step 1:	Assets:			
	Add: (i)	Land & Buildings:	90,000	
	(ii)	Plant:	1,50,000	
	(iii)	Current Assets:	4,00,000	
	(iv)	Investments:	70,000	
	(v)	Investment for Replacement of Assets:	30,000	
		(i to v)		7,40,000
Step 2:	Less:			
	(i)	Debentures:	90,000	
	(ii)	Creditors:	80,000	
	(iii)	Depreciation Fund:		
		(a) Land & Buildings:	30,000	
		(b) Plant	30,000	
		(i to iii)		2,30,000

Step 3:	Capital Employed (Step 1 – Step 2):		5,10,000
Step 4:	Less: 50% of Profit (₹ 50,000/2):		25,000
Step 5:	Average Capital Employed (Step 4 – Step 5):		4,85,000

Method II: Liabilities Side Approach:

		₹	₹
Step 1:	Share Capital: Reference:	1,00,000	
	Equity:	3,00,000	4,00,000
Step 2:	Add:		
	(i) Reserves: (₹ 90,000 – Profit ₹ 50,000):	40,000	
	(ii) Profit:	50,000	
	(iii) Workman Compensation Fund:	60,000	1,50,000
			5,50,000
Step 3:	Less:		
	(i) Goodwill	30,000	
	(ii) Preliminary Expenses	10,000	40,000
Step 4:	Capital Employed ([Step 1 + Step 2] – Step 3):		5,10,000
Step 5:	Less: 50% of Profit (₹ 50,000/2):		25,000
Step 6:	Average Capital Employed (Step 4 – Step 5):		4,85,000

Note: Result will be same under both approaches; students may opt either of the two.

Illustration 8.9

Model: Capital employed—Computation of

The following is the balance sheet of Vasanth Ltd. as at 31 March 2010:

Liabilities	₹	Assets		₹
Equity shares of ₹ 10 Each Fully Paid Up	10,00,000	Goodwill		1,00,000
General Reserve		Buildings (Cost):	30,00,000	
Profit and Loss Account	3,00,000	Less: Depreciation	30,000	2,70,000
15% Debentures	2,00,000	Plant & Machinery (Cost):	6,00,000	
Creditors	2,00,000	Less: Depreciation:	1,00,000	5,00,000
Workmen's Profit Sharing Reserve	60,000	Furniture (Cost):	70,000	
Workmen's Compensation Reserve	50,000	Less: Depreciation:	20,000	50,000
	30,000	Trade Investments		
		(Cost: ₹ 2,00,000)		1,75,000
		Stock		2,80,000
		Debtors:	40,00,000	
		Less: Prov. for Bad Debts:	50,000	3,50,000
		Cash at Bank		90,000
		Preliminary Expense		25,000
	18,40,000			18,40,000

Buildings are now worth ₹5,00,000, and plant and machinery is worth ₹4,75,000.

You are required to compute the value of capital employed.

Solution

Method I: Assets side approach

Note:

- Market value is to be taken, if they are specifically shown in the problem. Here, for buildings and plant & machinery, values are given. Hence, it should be taken into account.
- For other assets, value after depreciation is to be taken

Step 1:	Assets:		₹
	Add: (i) Buildings (Market Value)		5,00,000
	(ii) Plant & Machinery (Market Value)		4,75,000
	(iii) Furniture		50,000
	(iv) Trade Investments		1,75,000
	(v) Stock		2,80,000
	(vi) Debtors		3,50,000
	(vii) Cash at Bank		90,000
			19,20,00
Step 2:	Less: Liabilities	₹	₹
	(i) 15% Debentures	2,00,000	
	(ii) Creditors	60,000	
	(iii) Workmen's Profit Sharing Reserve	50,000	3,10,000
Step 3:	Capital Employed (Step 1 – Step 2)		16,10,000
Method II:	**Liabilities Side Approach**	₹	₹
Step 1:	Share Capital		10,00,000
Step 2:	Add:		
	(i) General Reserve	3,00,000	
	(ii) P&L A/c	2,00,000	
	(iii) Workmen's Compensation	30,000	
	(iv) Appreciation in Value of Buildings	2,30,000	7,60,000
	Step 1 + Step 2		17,60,000
Step 3:	Less:	₹	₹
	(i) Goodwill	1,00,000	
	(ii) Preliminary Expense	25,000	
	(iii) Decrease in Value of Machinery	25,000	1,50,000
Step 4:	Capital employed (Step 2 – Step 3)		16,10,000

Illustration 8.10

Model: Capital employed and super profits

The following is the balance sheet of Raj Co Ltd. as on 31 March 2010:

Liabilities	₹	Assets		₹
Paid-up Capital:		Goodwill at cost		50,000
50,000 Shares of ₹ 10 Each Fully Paid	5,00,000	Land & Buildings at Cost		2,50,000
Capital Reserve	30,000	(Less Depreciation)		
Sundry Creditors	1,00,000	Plant & Machinery at Cost (Less		2,00,000
Provision for Taxation	70,000	Depreciation)		
P&L A/c	50,000	Stock at Cost		1,50,000
		Debtors:	1,00,000	
		Less: Provision		
		for Bad Debts	5,000	95,000
		Cash at Bank		5,000
	7,50,000			7,50,000

You are asked to value the goodwill of Raj Co Ltd. on the basis of 5 years' purchase of super profits, for which the following information is supplied:

(i) Adequate provisions have been made in the accounts for income tax and depreciation.
(ii) The rate of income tax may be taken at 50%.
(iii) The average rate of dividend by the company for the past 5 years was 15%.
(iv) The reasonable return on capital invested in the class of business done by the company is 12%.

[C.S. Modified]

Solutiont

(i) Computation of capital employed:
(Assets side approach is followed)

Step 1:	Add: Assets:		₹
	Land & Building		2,50,000
	Plant & Machinery		2,00,000
	Stock		1,50,000
	Debtors		95,000
	Cash at Bank		5,000
			7,00,000
Step 2:	Less: Liabilities	₹	
	Sundry Creditors	1,00,000	
	Provision for Taxation	70,000	1,70,000
Step 3:	Capital Employed		5,30,000

(ii) Profits After Providing Taxation:
Provision for Taxation is ₹ 70,000
This is at 50% of the Profit
Total Profit 100% will be ₹ 1,40,000
∴ Profit After Providing Taxation = 70,000

(iii) Computation of Normal Profit:

Reasonable Return on Capital Employed:

Capital Employed (Ref: Step 3 in (i)) = ₹ 5,30,000

Reasonable Return = 12%

∴ Normal Profit = $\frac{12}{100} \times 5,30,000$ = ₹ 63,600

(iv) Calculation of Super Profits:

Super Profits = Current Profits – Normal Profit

(ii) (iii)

= (₹ 70,000 – ₹ 63,600)

= ₹ 6,400

(v) Value of Goodwill:

Goodwill = Super Profits × Number of Years' Purchase

= ₹ 6,400 × 5

= ₹ 32,000.

Illustration 8.11

Ascertain the value of goodwill of Sudarsan Ltd. carrying on business from the following:

Balance Sheet as of 31 March 2010

Liabilities	₹	Assets	₹
Paid-up Capital:		Goodwill at Cost	2,00,000
2,00,000 Shares of ₹ 10 Each Fully Paid	20,00,000	Land & Building at Cost	9,00,000
Bank Overdraft	3,00,000	Plant & Machinery at Cost (Less Depreciation)	8,00,000
Sundry Creditors	7,00,000		
Provision for Taxation	3,75,000	Stock in Trade	12,00,000
Profit and Loss Appropriation A/c	5,00,000	Book Debts (Less Provision for Bad Debts)	7,75,000
	38,75,000		38,75,000

The Company started operations in 2005 with paid-up capital as aforementioned of ₹ 20,00,000. Profits earned before providing for taxation have been as follows:

Year Ended 31 March	₹
2006	6,00,000
2007	7,00,000
2008	8,00,000
2009	5,00,000
2010	9,00,000

Income tax @ 50% has been payable on these profits. Dividends have been distributed from the profits of first 3 years @ 10% and from those of next 2 years @ 15% of the paid-up capital.

[I.C.W.A. (Final). Modified]

Solution

(i) Calculation of capital employed (Net assets):

Step 1:	Add: Assets (Tangible)			₹
	(a) Land & Buildings			9,00,000
	(b) Plant & Machinery			8,00,000
	(c) Stock in Trade			12,00,000
	(d) Sundry Debtors			7,75,000
				36,75,000
Step 2:	Less: Liabilities:		₹	
	(a) Bank Overdraft		3,00,000	
	(b) Sundry Creditors		7,10,000	
	(c) Provision for Taxation		3,75,000	13,85,000
Step 3:	Net Assets (Capital Employed)			22,90,000

(ii) Calculation of Average Profits:

Year Ended on 31 March	₹
2006	6,00,000
2007	7,00,000
2008	8,00,000
2009	5,00,000
2010	9,00,000
Total	35,00,000

$$\text{Average Profit} = \frac{\text{Total Profit}}{\text{Number of Years}} = \frac{35,00,000}{5} = 7,00,000$$

Less: Provision for Taxation @ 50% = 3,50,000

Average Profits = 3,50,000

(iii) Computation of Goodwill:

Step 1: Average Dividend $= \dfrac{10\% \times 3 \text{ Years} + 15\% \times 2 \text{ Years}}{5 \text{ Years}}$

$= \dfrac{30 + 30}{5} = \dfrac{60}{5} = 12\%$

Fair Return of Capital = 12%

Step 2: Capitalized Value of Business:

$\dfrac{100 \times 3,50,000}{12}$ = ₹ 29,16,666.67

Step 3: Less: Net Assets = ₹ 22,90,000.00

Step 4: Value of Goodwill = ₹ 6,26,666.67

8.6.2 Future Maintainable Profit

As the purchaser pays goodwill on the firm belief that in the future good profits will be earned, proper estimation has to be made for such future profits. For evaluation of goodwill, estimation of future profits is a vital factor. The following factors should be considered for this:

1. Interest on debentures and depreciation on fixed assets should be included.
2. Provisions for liabilities should be made
3. The following items should not be taken into account:

(i) Transfer to general reserve
(ii) Redemption of liabilities
(iii) Dividend equalization fund
(iv) Non-trading assets (for capital employed)
(v) Any income derived from non-trading assets

4. Preference dividends must be deducted.
5. Results of any development that will arise in future should be taken into account

Illustration 8.12

Model: Future maintainable profit

For the year ended 31 March 2010, a public limited company reported a profit of ₹ 14,00,00,000 after paying income tax @ 30%. It was found that the year's income included ₹ 1,00,00,000 for a claim lodged in 2007–08 for which no entry had been passed then. The year 2008–09 was a normal year for trading concern. The company plans to launch a new product and the following are the estimates in respect of this

Sales	₹
Expenditure on raw material	12,00,00,000
Wages	5,00,00,000
Share of fixed expenses (including an expected increase of ₹ 1,50,00,000)	4,50,00,000

[I.C.W.A. Modified]

Solution

Step1:	Profit Before Tax for the Year Ended 31 March 2010 $= ₹\ 14,00,00,000 \times \frac{100}{70}$	20,00,00,000
Step 2:	Less: Income in Respect of 2007–08:	1,00,00,000
Step 3:	Normal Profit for 2009–10 (Step 1 – Step 2)	19,00,00,000
Step 4:	Add: Expected Profit of New Product:	₹
	(i) Sale	12,00,00,000
	(ii) Less: Expenditure on Raw Material, Additional Fixed Expenses, etc. [₹ 5,00,00,000 + ₹ 1,50,00,000]	6,50,00,000 / 5,50,00,000
Step 5:	Expected Profit Before Tax = ₹ (19,00,000 – 5,50,000) 13,50,00,000	
Step 6:	Less: Income Tax @ 30% =	4,05,00,000
Step 7:	Future Maintainable Profit = (Step 5 – Step 6)	9,45,00,000

Illustration 8.13

Model: Good will—Comprehensive

On 31 March 2010, X Ltd. proposes to purchase the business carried on by Y Ltd. Goodwill for this purpose is agreed to be valued as 3 years' purchase of the weighted average profits for the last 4 years. The appropriate weights to be used were decided as follows:

Years		Weight
2006–07	–	1
2007–08	–	2
2008–09	–	3
2009–10	–	4

The profits for these years are 2006–07: ₹ 6,20,000; 2008–09: ₹ 7,40,000; 2007–08: ₹ 5,80,000; 2009–10: ₹ 8,60,000.

On scrutinizing the accounts, the following facts are revealed:

(a) On 1 October 2008, major repairs were carried out in respect of the plant spending ₹ 2,00,000; the amount was charged to revenue. The said sum is agreed to be capitalized for the purpose of calculation of goodwill subject to the adjustment for depreciation @ 10% p.a. on reducing balance method.

(b) The closing stock for the year 2007–08 was overvalued by ₹ 90,000.

(c) To cover management cost, an annual charge of ₹ 2,00,000 is to be made while calculating goodwill. Compute the value of goodwill of the transfer or company.

Solution

Particulars		**2006–07** ₹	**2007–08** ₹	**2008–09** ₹	**2009–10** ₹
Step 1:	Profit (Given)	6,20,000	5,80,000	7,40,000	8,60,000
Step 2:	Add: Repairs Charged to Revenue: Increase in Profit on 1 October 2008	—	—	+2,00,000	—
				9,40,000	
Step 3:	Less: Due to The Above Effect, Decrease in Profit Due to Depreciation				
	(i) Depreciation on 2,00,000 for 6 months @10%	—	—	(–10,000)	
	(ii) Depreciation on 1,90,000 for 1 year @ 10%			—	(–19,000)
				9,30,000	8,41,000
Step 4:	Overvaluation of Stock on 31 March 2008	—			
	Less: Closing Stock: 2007–08		(–90,000)		
	Add: Opening Stock: 2008–09			(+90,000)	
Step 5:	Correct Profits	6,20,000	4,90,000	10,23,000	8,41,000

Step 6: Calculation of Weighted Average:

Year	**Profit** ₹	**Weight**	**Product** ₹
2006–07	6,20,000	1	6,20,000
2007–08	4,90,000	2	9,80,000
2008–09	10,23,000	3	10,69,000
2009–10	8,41,000	4	33,64,000
		10	60,33,000

Step 7:	Weighted Average: ₹ $\frac{60,33,000}{10}$ =	6,03,300
Step 8:	Less: Management Cost =	2,00,000
		4,03,000

Step 9: Goodwill = ₹ 4,03,000 × Number of Year's Purchase
= ₹ 4,03,000 × 3 = ₹ 12,09,000

Illustration 8.14

Model: Goodwill—Valuation of—Comprehensive

The following particulars are available in respect of the business of X Ltd:

(i) Profits earned for the years:

2006–07	₹ 9,00,000
2008–09	₹ 11,00,000
2009–10	₹ 10,00,000

(ii) Normal rate of return: 10 %

(iii) Capital employed: ₹ 50,00,000

(iv) Present value of an annuity of ₹ 1 for 5 years as 10% = ₹ 3.78.

(v) The profits included non-recurring profits on an average basis of ₹ 50,000 a year.

You are required to calculate the value of goodwill:

(a) As per 5 years' purchase of super profits

(b) As per capitalization of super profits method

(c) As per annuity method

Solution

Stage I: Calculation of Super Profits:

Step 1: Average Profits for the Last 3 Years:

	₹
2006–07:	9,00,000
2007–08:	11,00,000
2008–09:	10,00,000
Total	30,00,000

	₹.
Average Profit = $\frac{\text{Total Profit}}{\text{Number of Years}}$ = ₹ $\frac{30,00,000}{3}$	10,00,000
Step 2: Less: Non-Recurring Profits (Given) =	50,000
Step 3: Recurring Profits =	9,50,000
Step 4: Less: Normal Profits: Capital Employed × Normal Rate of Return = ₹ 50,000,000 × 10% =	5,00,000
Step 5: Super Profits (Average Profits – Normal Profits) = (Step 3 – Step 4)	4,50,000

Stage II: Valuation of Goodwill:

(a) As Per 5 Years' Purchase of Super Profits:

Formula = Goodwill = Super Profits × Number of Years' Purchase
= ₹ 4,50,000 × 5 = ₹ 22,50,000

(b) As Per Capitalization of Super Profits:

$$\text{Formula} = \text{Goodwill} = \frac{\text{Super Profits} \times 100}{\text{Normal Rate Return}}$$

$$= \frac{₹\,4,50,000 \times 100}{10}$$

$$= ₹\,45,00,000$$

(c) As Per Annuity Method:

Formula = Goodwill = Super Profit × Annuity Factor

= 4,50,000 × 3.78 (Given)

= ₹ 17,01,000.

Illustration 8.15

Model: Computation of expected rate of return

X Ltd's financial position is as follows:

	₹
(a) Sundry assets	40,00,000
(b) Current liabilities	4,50,000
(c) Average net profit of the last 4 years	4,82,000
(d) Average capital employed	36,00,000
(e) Managers' average annual remuneration	72,000
(f) The goodwill valued at 4 year's purchase Price of super profits	2,00,000

Compute the expected rate of return.

Solution

		₹
Step 1:	Goodwill (4 Year's Purchase Price of Super Profits:)	2,00,000
Step 2:	So, Super Profits Per Year (Average) (₹ 2,00,000/4 years)	50,000
Step 3:	Average Net Profit for the Last 4 Years (Given)	4,82,000
Step 4:	Less: Average Remuneration:	72,000
Step 5:	Net Profit (After Adjustment):	4,10,000

Step 6: Formula:

Super Profits = Adjusted Net Profit – Normal Profit

or

Normal Profits = Adjusted Net Profit – Super Profits

= ₹ 4,10,000 – ₹ 50,000

(Step 5) (Step 2)

= ₹ 3,60,000

Step 7: For An Average Capital Employed of ₹ 36,00,000, Normal Profit is ₹ 3,60,000

(Given) (Step 6)

Step 8: $\therefore$ Expected Rate of Return $= \frac{3,60,000}{36,00,000} \times 100 = 10\%$

Illustration 8.16

The summarized balance sheet of Riddhima Vasanth Ltd. as on 31 December 2010 is as follows

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	60,000
2,000, 9% Pref. Shares of ₹ 100 Each	2,00,000	Freehold Property	4,00,000
60,000 Equity Shares of ₹ 10 Each	6,00,000	Plant & Machinery LESS: Depreciation	3,00,000
Profit and Loss Account	4,00,000	Stock	3,40,000
6% Debentures (2000)	3,00,000	Debtors Net	4,50,000
Sundry Creditors	2,00,000	Bank Balance	1,50,000
	17,00,000		17,00,000

Profit after the tax for the three years 2008, 2009 and 2010 after charging debentures interest were ₹ 2,00,000; ₹ 3,00,000 and ₹ 2,25,000, respectively.

Further information:

1. The normal rate of return is 10% on the net assets.
2. Goodwill may be calculated at 3 times adjusted average super profits of the 3 years referred to above.
3. The value of freehold property is to be ascertained on the basis of 10% return. The current rental value is ₹ 60,000.
4. Rate of tax applicable is 50%.
5. 10% of profits for 2009 referred to above arose from a transaction of a non-recurring nature.
6. A provision of ₹ 10,000 on sundry debtors was made in 2010 which is no longer required; profit for the year 2010 is to be adjusted for this item.
7. A claim of ₹ 8,000 against the company is to be provided and adjusted against profit for 2010.
8. The capital employed may be taken as on 31 December 2010.

You are required to ascertain the value of goodwill of the company.

[I.C.W.A. Modified]

Solution

Stage I: Computation of capital employed as on 31 December 2010 (Net assets).

		₹	₹
Step 1:	Add: (Assets)		
	(i) Freehold Property at Market Value:		
	Current Rental Value: ₹ 60,000 (Given)		6,00,000
	Rate of Return: 10%; $60{,}000 \times \frac{100}{10}$		
	(ii) Plant & Machinery		3,00,000
	(iii) Stock		3,40,000
	(iv) Debtors Net	4,50,000	
	Add: Provision No Longer Requires:	10,000	4,60,000
	(v) Bank Balance		1,50,000
			18,50,000
Step 2:	Less: Liabilities:		
	(i) 6% Debenture – 2000:	3,00,000	

	(ii) Sundry Creditors	2,00,000	
	(iii) Outstanding Claim	8,000	5,08,000
Step 3:	Capital Employed or Net Assets} = as on 31 December 2010		13,42,000

Stage II: Computation of Future Maintainable Profit:

		₹.	₹
Step 1:	For the Year 2008–Profit:	—	2,00,000
Step 2:	For the Year 2009–Profit:	3,00,000	
	Less: Non-Recurring Profit 10% of ₹3,00,000:	30,000	2,70,000
Step 3:	For the Year 2010—Profit:	2,25,000	
	Add: Provision for Debtors no Longer Required:	10,000	
		2,35,000	
	Less: Claim Omitted	8,000	
	Less: 50% Tax on: (₹10,000 – ₹8,000)	2,27,000	
	₹2,000 × 50% = ₹1,000	1,000	2,26,000
Step 4:	Total Profit for 3 Years =		6,96,000
Step 5:	Future Maintainable Profit (Step 4 ÷ 3)		
	Average Profit: $\frac{₹6,96,000}{3}$ =		2,32,000
Stage III:	Calculation of Valuation of Goodwill:		
Step 1:	Future Maintainable Profit: Ref: Step 5 of Stage II		2,32,000
Step 2:	Less: Normal Profit 10% of Capital Employed		
	$\frac{10}{100}$ × ₹13,42,000 =		1,34,200
	(Ref: Step 3 of Stage I)		
Step 3:	Super Profit (Average Profit – Normal Profit) = Step 1 – Step 2		97,800
Step 4:	Goodwill = Super Profit × Number of Years = ₹97,800 × 3 = (Step 3) (Given)		2,93,400

8.7 VALUATION OF SHARES

Valuation of shares of a company is not an easy task. A number of factors are associated with it. All such factors may not be taken into account for ascertaining the exact value of shares. For example, if the shares of a company are not quoted on the stock exchange, their value cannot be determined precisely. Some shares, especially private company shares possess no market value as their transferability is restricted.

Notwithstanding such inherent features, the necessity to ascertain the value of these shares has become utmost important.

Valuation of shares is essential for the following purposes:

(i) When amalgamation or absorption of companies occurs.
(ii) When reconstruction scheme takes place.
(iii) When preference shares are converted into equity shares.
(iv) For assessment of tax.
(v) To meet shareholder's demands in certain contingencies.

8.8 METHODS OF VALUATION OF SHARES

The methods of valuation of shares may be categorized as follows:

8.8.1 Net Assets Method

There are so many alternative names to this method such as intrinsic value method, net worth method, equity method, asset backing method, break-up value method, real value method, asset basis method.

Under this method, value of the net assets of the company is measured against each share. Here, the emphasis is on the value of net assets. Further, the shares are valued on the basis of internal value of the assets.

Step 1: Add: All the Assets at Market Value

Step 2: Deduct: All Liabilities (Including Debentures and Preference Shares)

Step 3: Result = Net Assets

Step 4: Divide Net Assets (As Arrived at Step 3) by Number of Equity Shares. The Formula to Ascertain the Value of a Share,

Formula:

$$\text{Net Assets Value of a Share} = \frac{\text{Net Value of Assets} - \text{Liabilities} - \text{Pref. Share Holders' Claims}}{\text{Number of Equity Shares}}$$

While Evaluating the Assets, the Factors that Should be Considered are as Follows

1. **Goodwill:** Goodwill should be valued at current cost. Book value on account of purchase of goodwill should be eliminated.
2. **Inventory:** (i) Raw materials, stocks and work-in-progress should be valued at cost price.
   (ii) Finished goods should be valued as market price.
3. **Fictitious assets:** Fictitious assets should be eliminated, e.g., debit balance of P&L A/c, preliminary expenses, discount on issue of shares and debentures.
4. **Non–trading assets:** They should be valued at market price.
5. **Book debts:** Book debts should be valued after earmarking provisions for bad and doubtful debts.
6. **All other assets:** If the market value of assets are not given in the question, they should be valued at book value.

Factors that should be considered for valuation of liabilities are as follows:

1. **Share capital:** If both equity shares and preference shares are given, preference share capital should be deducted from the assets.
2. **Provisions:** Provision for taxation, provision for dividend, etc. should be included in liabilities.
3. **Outstanding expenses:** Adequate provision should be made.
4. **Contingent liabilities:** Adequate provision should be made for all contingent liabilities.

Illustration 8.17

Model: Intrinsic value—Pref. shareholders not having preference

The following is the balance sheet of VRS Ltd. as on 31 March 2010:

Liabilities	₹	Assets	₹
3,000 10% Preference Shares of ₹100 Each	3,00,000	Sundry Assets as Book Value	10,00,000
50,000 Equity Shares of ₹10 Each	5,00,000		
Bills Payable	80,000		
Creditors	1,20,000		
	10,00,000		10,00,000

The market value of 70% of the assets is estimated to be 20% more than the book value and that of the remaining 30% at 10% less than the book value. There is an unrecorded liability of ₹10,000.

Find the value of each equity share assuming that preference shares have no prior claim as to payment of dividend or as to payment of capital.

Solution

Note: Preference shareholders not having preference will not make any difference.

Step 1: Assets Should be Valued At Market Value:

		₹
(i) 70% of Assets = $\frac{70}{100} \times 10,00,000$	=	7,00,000
(ii) ₹7,00,000 Estimated as 20% More than Book Value	=	8,40,000
₹7,00,000 × $\frac{120}{100}$ = 8,40,000		
(iii) 30% of Assets = $\frac{30}{100} \times 10,00,000$	=	3,00,000
(iv) ₹3,00,000 Estimated as 10% Less than Book Value	=	2,70,000
₹3,00,000 × $\frac{90}{100}$ = ₹2,70,000		
(v) Total Assets at Market Value	=	11,10,000

Step 2: Current Liabilities Should be Deducted:

Less: Current Liabilities:	₹	₹
Bills Payable	80,000	
Creditors	1,20,000	
Unrecorded Liability	10,000	2,10,000
		9,00,000

Step 3: Less: Preference Share Capital = 3,00,000

Step 4: Net Assets Available for Equity Shareholders = 6,00,000

Step 5: Computation of Intrinsic Value Per Share:

Formula:

$$\text{Intrinsic Value Per Share} = \frac{\text{Net Assets Available for Equity Share Holders}}{\text{Number of Equity Shares}}$$

$$\text{Substituting the Values, We get} = ₹\frac{6,00,000 \text{ (Step 4)}}{50,000 \text{ (Given)}}$$

$$= ₹ 12$$

Illustration 8.18

Model: Valuation of goodwill and valuation of share—intrinsic method

The following is the balance sheet of UVR Ltd. as on 31 March 2010:

Liabilities	₹	Assets	₹
Share Capital		Goodwill	1,20,000
5,000 Equity Shares of ₹ 100 Each	5,00,000	Investments	4,80,000
Profit and Loss A/c	50,000	Stock	5,00,000
General Reserve	1,50,000	Sundry Debtors	3,00,000
10% Debentures	4,50,000	Cash at Bank	1,00,000
Sundry Creditors	1,50,000		
Workmen's Savings Bank A/c	2,00,000		
	15,00,000		15,00,000

(i) The profits for the past 5 years were:
2006: ₹ 25,000; 2007: ₹ 35,000; 2008: ₹ 50,000;
2009: ₹ 60,000; 2010: ₹ 80,000

(ii) The market value of investments was ₹ 4,00,000

(iii) Goodwill is to be valued as 3 years' purchase of average annual profits for the last 5 years

Find the intrinsic value of each share.

Solution

Step 1: First, Value of Goodwill Has to be Ascertained as:

(i) Total Profit for 5 Years = ₹ 25,000 + ₹ 35,000 + ₹ 50,000 + ₹ 60,000 + ₹ 80,000

= ₹ 2,50,000

(ii) $\text{Average Profit Per Year} = \frac{\text{Total Profit}}{\text{Number of Years}}$

$$= \frac{₹ 2,50,000}{5} = ₹ 50,000$$

(iii) Value of Goodwill = Average Profits × Number of Years' Purchase

= ₹ 50,000 × 3 = ₹ 1,50,000

Step 2: Computation of Net Assets

	₹.
(i) Assets at Market Value:	
(a) Goodwill (Step 1)	1,50,000
(b) Investments: (Given in Information)	4,00,000

	(c) Stock: (Given in b/s)		5,00,000
	(d) Sundry Debtors: (Given in b/s)		3,00,000
	(e) Cash at Bank: (Given in b/s)		1,00,000
	Total Net Assets at Market Value:		14,50,000
Step 3:	Less: Liabilities:	₹	
	(i) 10% Debentures:	4,50,000	
	(ii) Sundry Creditors:	1,50,000	
	(iii) Workmen's Savings Bank Ltd. A/c:	2,00,000	8,00,000
Step 4:	Net Assets Available		6,50,000

Step 5: Intrinsic Value of Each Share:

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

$$= \frac{₹\,6,50,000 \text{ (Step 4)}}{5,000 \text{ (Given)}} = ₹\,130$$

Illustration 8.19

Model: Rate of return; Average capital employed and Intrinsic value of share

The following is the balance sheet of VRV Ltd. as on 31 December 2009:

Liabilities	₹	Assets	₹
Share Capital:		Land & Buildings	5,00,000
1,50,000 Equity Shares of ₹ 10 Each Fully Paid	15,00,000	Plant & Machinery	3,00,000
		Stock	10,00,000
P&L A/c	2,00,000	Sundry Debtors	4,50,000
Sundry Creditors	2,50,000		
Bank Overdraft	50,000		
Provision for Taxation	1,00,000		
Dividend Equalization Fund	1,50,000		
	22,50,000		22,50,000

The net profit of the company, after deducting all working charges and providing for depreciation and taxation were:

2005: ₹ 2,00,000; 2006: ₹ 2,25,000; 2007: ₹ 2,50,000;

2008: ₹ 2,75,000; 2009: ₹ 3,00,000

On 31 December 2009, land and buildings were valued at ₹ 6,25,000 and plant and machinery at ₹ 3,75,000.

In view of the nature of business, it is considered that 10% is reasonable on capital.

You are required to calculate the value of the company's share after taking into account the revised values on fixed assets and your own valuation of goodwill based on 3 years' purchase of annual super profits.

Solution

Stage I: Ascertainment of Goodwill

Step 1:	Determination of Average Capital Employed:			₹
	Net Assets:			
	(a) Land & Buildings:			6,25,000
	(Market Value—from Information Given)			
	(b) Plant & Machinery:			3,75,000
	(Market Value—from Information Given)			
	(c) Stock (from b/s):			10,00,000
	(d) Sundry Debtors (from b/s):			4,50,000
	Total Assets at Marked Value:			24,50,000
Step 2:	LESS: Liabilities:		₹	
	Sundry Creditors		2,50,000	
	Bank Overdraft		50,000	
	Provision For Taxation		1,00,000	4,00,000
Step 3:	Net Assets (Capital Employed)	=		20,50,000
Step 4:	Less: Half of Net Profits of 2009: ₹3,00,000 × $\frac{1}{2}$ (from Information)	=		1,50,000
Step 5:	Average Capital Employed (Step 3 – Step 4)	=		19,00,000

Step 6: Computation of Normal Profit:

Formula:

Normal Profit = Average Capital Employed × Normal Rate of Return

= ₹19,00,000 × 10% (Given)

= ₹19,00,000 × $\frac{10}{100}$

= ₹1,90,000

Step 7: Computation of Average Profit:

Total Profit = ₹2,00,000 + ₹2,25,000 + ₹2,50,000 + ₹2,75,000 + ₹3,00,000

= ₹12,50,000

Average Profit = ₹$\frac{12,50,00}{5}$

= ₹2,50,000

Step 8: Calculation of Super Profit:

Formula: Super Profit = Average Profit – Normal Profit

= ₹2,50,000 – ₹1,90,000

↓ ↓

(Step 7) (Step 6)

= ₹60,000

Step 9: Determination of Goodwill:

Formula:

Goodwill = Super Profit × Number of Years' Purchase
= ₹ 60,000 × 3
(Step 8) (Given)
= ₹ 1,80,000

Stage II: Valuation of Shares:

		₹
Step 1:	Net Assets = (Ref: Step 3)	20,50,000
Step 2:	Add: Goodwill (Ref: Step 9 in Stage I) =	1,90,000
Step 3:	Net Assets Available for Equity Shareholders =	22,40,000
Step 4:	Intrinsic Value of Share:	

Formula:

$$\text{Intrinsic Value of Each Share} = \frac{\text{Net Assets Available for Equity Shareholders}}{\text{Number of Equity Shares}}$$

$$= ₹ \frac{22,40,000 \text{ (Step 3)}}{1,50,000 \text{ (Given)}}$$

$$= ₹ 14.93$$

Illustration 8.20

Model: Valuation of shares—Treatment of non-trading assets

On 31 March 2010, the balance sheet of RBS Ltd. was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	50,000
10% Preference Shares (1,000) of ₹ 100 Each Fully Paid	1,00,000	Land & Buildings	2,00,000
		Machinery	2,50,000
50,000 Equity Shares of ₹ 10 Each Fully Paid	5,00,000	Furniture	20,000
		Investment in 5% Govt. Securities at Cost (Face Value of ₹ 60,000)	75,000
General Reserve	1,00,000		
Capital Reserve	20,000	Stock	4,00,000
P&L A/c	80,000	Book Debts	80,000
6% Debentures	1,60,000	Cash at Bank	25,000
Sundry Creditors	1,00,000		
Provision for Taxation	40,000		
	11,00,000		11,00,000

The assets were revalued as follows:

	₹
Land & Building	2,80,000
Machinery	2,20,000
Furniture	30,000

The normal return on capital employed for valuation of goodwill is 10%, the basis of valuation being 4 years' purchase of super profits.

50% of investment in building is treated as non-trading asset because a sum of ₹ 12,000 is collected annually as rent from building.

You are required to calculate the value of each equity share assuming that the average annual profit after tax at 50% is ₹ 1,32,500

Solution

Stage I: Computation of value of goodwill:

			₹.	₹
Step 1:	Computation of Capital Employed:			
	(i)	Fixed Assets (Revalued at Market Price)		
		Land & Building	2,80,000	
		Machinery	2,20,000	
		Furniture	30,000	5,30,000
	(ii)	Less: Non-Trading Asset:		
		50% of ₹ 2,80,000—Buildings		1,40,000
				3,90,000
	(iii)	Add: Current Assets		
		Stock	4,00,000	
		Book Debts	80,000	
		Cash at Bank	25,000	5,05,000
				8,95,000
	(iv)	Less: Liabilities:		
		6% Debentures	1,60,000	
		Sundry Creditors	1,00,000	
		Provision for Taxation	40,000	3,00,000
	(v)	Capital Employed		5,95,000
Step 2:	Computation of Average Trading Profit:			₹
	(i)	Average Annual Profit After Tax (Given)		1,32,500
	(ii)	Less:		
		Non-Trading Income:	₹	
		Rent–50 % of ₹ 12,000:	6,000	
		Interest on Investment	1,500	
		Face Value ₹ 60,000 (Given) @ 5% = ₹ 3,000:		
		Less: Tax 50% on 3,000 = ₹ 1,500		7,500
				1,25,000
Step 3:	Calculation of Super Profit:		₹	
	(i)	Average Trading Profit:	1,25,000	
		(Step 2: (ii))		
	(ii)	Normal Profit:		
		₹ 5,95,000 × 10%	59, 500	
		(Step 1)		
	(iii)	Super Profit =	65,500	

Step 4: Calculation of Goodwill:

Formula:

Goodwill = Super Profit × Number of Years' Purchase

= ₹ 65,500 × 3 = ₹ 1,96,500

Stage II: Valuation of Share:

Step 1:	Net Assets: (At Market Value)		₹
	(i) Goodwill (Step 4)		1,96,500
	(ii) Land & Building (Revalued)		2,80,000
	(iii) Machinery (Revalued)		2,20,000
	(iv) Furniture (Revalued)		30,000
	(v) Investments (Given in b/s)		75,000
	(vi) Stock (Given in b/s)		4,00,000
	(vii) Book Debts		80,000
	(viii) Cash at Bank		25,000
			13,06,500
Step 2:	Less: Liabilities & Provisions:	₹	
	(i) 6% Debentures:	1,60,000	
	(ii) Sundry Creditors:	1,00,000	
	(iii) Provision For Taxation:	40,000	3,00,000
			10,06,500
	Less: 10% Preference Share Capital		1,00,000
Step 3:	Net Assets Available =		9,06,500

Step 4: Computation of Intrinsic Value of Share:

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

$$= ₹\frac{9,06,500}{50,000}$$

Intrinsic Value of Each Equity Share = ₹ 18.13

Illustration 8.21

Model: Valuation of fully paid and partly paid shares

Following is an extract of the balance sheet of SR Ltd. as on 31 March 2010:

Share capital:	₹
5,000, 10% Preference shares of ₹ 100 each	5,00,000
10,000 Equity shares of ₹ 10 each, ₹ 5 paid up	50,000
10,000 Equity shares of ₹ 10 each, ₹ 2.50 paid up	25,000
10,000 Equity shares of ₹ 10 each, fully paid up	1,00,000
	6,75,000
Reserves and surplus	2,00,000
P&L A/c	1,25,000
	10,00,000

On revaluation of assets, on 31 March 2010, it was found that they had appreciated by ₹ 1,00,000 over their value in the aggregate.

The Articles of Association of the Company state that in case of liquidation, the preference shareholders would have a further claim of the surplus assets, if any.

You are required to ascertain the value of each equity share assuming that liquidation of the company has to take place on 31 March 2010 and that the expenses of winding up are NIL.

Solution

Stage I: Computation of surplus assets available to equity shareholders:

		₹
Step 1:	Net Assets	
	(i) Preference Share Capital	5,00,000
	(ii) Equity Share Capital	
	(₹ 50,000 +₹ 25,000 + ₹ 1,00,000)	1,75,000
	(iii) General Reserve	2,00,000
	(iv) P&L A/c	1,25,000
	(v) Appreciation on Revaluation	1,00,000
Step 2:	Total Net Assets	11,00,000
Step 3:	Less: Preference Share Capital:	5,00,000
		6,00,000
Step 4:	Less: Equity Share Capital	1,75,000
Step 5:	Surplus Assets Available to Share Holders =	4,25,000
Step 6:	Less: Surplus to Pref. Shareholders As per Direction	
	Given in Question 10% of Surplus Assets 4,25,000:	42,500
Step 7:	Surplus Assets Available to Equity Shareholders}=	3,82,500

Stage II: Computation of Total Amount Available to Equity Shareholders:

		₹
Step 1:	Equity Share Capital (Given):	1,75,000
Step 2:	Add: Surplus Assets Available to Equity:	3,82,500
	Shareholders (Step 6)	
Step 3:	Total Amount Available:	5,52,500

Stage III: Computation of Value of Each Equity Share:

Step 1: Value of ₹ 1 of Paid-up Capital $= \frac{\text{Total Amount Available}}{\text{Paid-Up Capital}} = \frac{₹\,5,52,500 \text{(Step 3)}}{₹\,1,75,000 \text{(Step 1)}}$

$= ₹\,3.16$

Step 2: Value of Each ₹ 5 Paid-up Share:

$= ₹\,5 \times ₹\,3.16 = ₹\,15.80$

(Given) (Step 1)

Step 3: Value of Each ₹ 2.50 Paid-up Share:

$= ₹\,2.50 \times ₹\,3.16 = ₹\,7.90$

(Given) (Step 1)

Step 4: Value of Each ₹ 10 Fully Paid-up Share:

$$= \underset{\text{(Given)}}{₹10} \times \underset{\text{(Step 1)}}{₹3.16} = ₹31.60$$

Methods of Valuation of Shares—Preference Shares

Illustration 8.22

Model: Treatment of preference shares

The following is the balance sheet of RBS Ltd. as on 31 December 2008:

Liabilities	₹	Assets	₹
Share Capital:		Sundry Assets	10,00,000
2,000, 10 % Preference Shares of ₹ 100 Each Fully Paid	2,00,000	Discount on Debentures	5,000
		Preliminary Expenses	15,000
50,000 Equity Shares of ₹ 10 Each Fully Paid	5,00,000	Profit and Loss A/c	80,000
General Reserve	25,000		
Debenture Redemption Reserve	50,000		
5% Debentures	1,00,000		
Depreciation Fund	25,000		
Sundry Creditors	2,00,000		
	11,00,000		11,00,000

The debenture interest is outstanding for one year and dividends and preference shares are in arrears for 2 years.

The sundry assets are worth their book values.

You are required to ascertain the value of preference shares and equity shares in each of the following alternative cases: if,

1. Preference shares are preferential as to capital and arrears are payable
2. Preference shares are preferential as to capital but arrears are not payable
3. Preference shares do not carry priority of capital but arrears are payable
4. Neither preference shares enjoy priority of capital nor do the articles permit the payment of arrears.

Solution

First, value of net assets has to be calculated as:

Step 1:	Assets (As Market Value):		₹
	Sundry Assets (Given)		10,00,000
Step 2:	Less: Liabilities:	₹	
	(i) Depreciation Fund	25,000	
	(ii) 5% Debentures	1,00,000	
	(iii) Outstanding Debenture Interest for 1 Year (₹ 1,00,000 × 5/100)	5,000	
	(iv) Sundry Creditors:	2,00,000	3,30,000
Step 3:	Net Assets:		6,70,000

1. When preference shares are preferential as to capital and arrears are payable: (in winding up)

			₹
Step 1:	Net Assets (Step 3 Above):		6,70,000
Step 2:	Less:	₹	
	(i) Preference Share Capital:	2,00,000	
	(ii) Preference Dividend for 2 Years:		
	(₹ 2,00,000 × 10/100 × 2)	40,000	2,40,000
Step 3:	Net Assets Available to Equity Share Holders		4,30,000

Note: As Per the Directions Given in Question, Both Capital and Preference Dividend Arrears for 2 Years are Taken Into Account to Find the Net Assets Available to Equity Shareholder.

Step 4: Intrinsic Value Per Equity Share $= \dfrac{\text{Net Assets Available}}{\text{Number of Equity Shares}}$

$$= \frac{₹\,4,30,000 \text{ (Setp 3)}}{50,000 \text{ (Given)}} = ₹\,8.60$$

Step 5: Value of Preference Share = ₹ 100 (Nominal Value Users)

2. When Preference Shares are Preferential as to Capital But Not Arrears:

		₹
Step 1:	Net Assets (As Market Value)	6,70,000
Step 2:	Less: Preference Share Capital	2,00,000
Step 3:	Net Assets Available to Equity Share Holders:	4,70,000

Note: As Per the Directions Given in the Question, Only Capital is Taken Into Account.

Step 4: Intrinsic Value Per Equity Share $= \dfrac{₹\,4,70,000 \text{ (Setp 3)}}{50,000 \text{ (Given)}} = ₹\,9.20$

Step 5: Value of Presence Share = ₹ 100 (Face value)

3. When Preference Shares Do Not Carry Priority of Capital But Arrears are Payable.

		₹
Step 1:	Net Assets (As Market Value)	6,70,000
Step 2:	Less: Preference Dividend Arrears For 2 Years	40,000
Step 3:	Net Assets Available For Equity and Preference Shareholders	6,30,000

Note: As Per Direction, Only Arrears are Taken Into Account.

Step 4: Value Per Share: $\dfrac{₹\,6,30,000 \text{ (Step3)}}{(\underset{\text{Pref.}}{2,000} + \underset{\text{Equity}}{50,000})} = \dfrac{6,30,000}{52,000} = ₹\,12.11$

4. Neither Preference Shares Enjoy Priority of Capital Nor Do Arrears.

Value Per Share (Both Equity & Preference): $\dfrac{\text{Net Assets}}{\text{Number of Shares}}$

$$= \frac{₹\,6,70,000}{\underset{\text{(Equity)}}{50,000} + \underset{\text{(Pref.)}}{2,000}} = \frac{6,70,000}{52,000} = ₹\,12.88$$

Note: As Per Dividend Given in the Problem, Neither Capital Nor Arrears are Taken into Account. Only net Assets Form the Basis of Computing Value of Shares.

Illustration 8.23

Model: Fair value of shares—on the basis of majority and minority holdings

Determine the fair value of 200 shares held by Mr. Ram in Goodluck Ltd. to be transferred to Mr. Mehta on the basis of majority and minority holdings. The balance sheet of Goodluck Ltd. as on 31 March 2010 is as follows:

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	40,000
80,000 Equity Shares of ₹10 Each Fully Paid Up	8,00,000	Buildings	3,00,000
		Machinery	3,60,000
General Reserve	2,60,000	Debtors	4,00,000
P&L A/c	1,60,000	Stock	1,60,000
Sundry Creditors	80,000	Cash at Bank	20,000
		Preliminary Expenses	20,000
	13,00,000		13,00,000

Debtors are estimated to be 10% below book value and goodwill is valued at its book value. Profit and loss account shows the net profit of the year after transfer to general reserve and payment of income tax.

Dividend was paid for the last 3 years at the rate of 14%, 18% and 16%, respectively. Normal expected return is 10%.

[C.A. Modified]

Solution

Stage I: Valuation of Shares (Net Assets Method):

		₹
Step 1:	Assets (at Market Value):	
	(i) Goodwill	40,000
	(ii) Buildings	3,00,000
	(iii) Machinery	3,60,000
	(iv) Debtors (10% Below Book Value) (₹4,00,000 – 10% → 40,000)	3,60,000
	(v) Stock	1,60,000
	(vi) Cash at Bank	20,000
Step 2:	Total Net Assets	12,40,000
Step 3:	Less: Liabilities:	
	Creditors	80,000
Step 4:	Net Assets Available to Equity Shareholders:	11,60,000
Step 5:	Intrinsic Value of Each Share:	

Formula:

$$\text{Intrinsic Value of Each Share} = \frac{\text{Net Assets Available}}{\text{Number of Equity Shares}} = \frac{₹\,11,60,000}{80,000} = ₹\,14.50$$

Step 6: Intrinsic Value of 200 Shares = 200 × ₹14.50 = ₹2,900.

Stage II: Valuation of shares under yield method

Step 1: Profits of the Year After Tax and Transfer to General Reserve (Given in b/s) = ₹ 1,60,000

Step 2: Expected Rate of Return =

Formula: $\frac{\text{Profit}}{\text{Share Capital}} \times 100 = \frac{₹\,1,60,000}{₹\,8,00,000} \times 100 = 20\%$

Step 3: Yield Value Per Equity Share:

Formula:

$$\frac{\text{Expected Rate of Return}}{\text{Normal Rate of Return}} \times \text{Paid-up Value of Equity Share} = \frac{20\%\ (\text{Step 2})}{10\%\ (\text{Given})} \times ₹\,10 = ₹\,20$$

Step 4: Yield Value of 200 Shares = 200 × ₹ 20 = ₹ 4,000

Stage III: Determination of Yield Value of Minority Holding and Majority Holding:

Step 1: Average Rate of Actual Dividend = $\frac{14\% + 18\% + 16\%}{3} = \frac{48\%}{3} = 16\%$

Step 2: Value of Each Share = $\frac{16\%}{10\%} \times ₹\,10 = ₹\,16$

Step 3: Yield Value of 200 Shares: 200 × ₹ 16 = ₹ 3,200

Step 4: Fair Value of Majority Holding:

Formula:

$$= \frac{\text{Intrinsic Value} + \text{Yield Value}}{2} = \frac{₹\,2,900 + ₹\,4,000}{2} = ₹\,\frac{6,900}{2}$$

$$= ₹\,3,450$$

Step 5: Fair Value of Minority Holding:

$$= \frac{₹\,2,900 + ₹\,3,200}{2} = ₹\,\frac{6,100}{2}$$

$$= ₹\,3,050$$

8.9 DIFFERENT CATEGORIES OF EQUITY SHARES

While determining the value of shares, there will be no difficulty if only one category (class) of shares is available. In such a case,

$$\text{Value per share} = \frac{\text{Net equity}}{\text{Number of equity shares}}$$

and value per share is determined without much difficulty.

But in case there are difference categories (classes) of equity shares, the amount paid up varying for each category, the valuation of shares must be pro-rated. This is explained in the following illustration:

Illustration 8.24

Model: Different classes of shares

X Ltd. equity capital comprises:

A: 2,00,000 equity shares of ₹ 10 each fully paid

B: 2,00,000 equity shares of ₹ 10 each, ₹ 7.50 fully paid

C: 1,00,000 equity shares of ₹ 10 each, ₹ 5 fully paid

The net assets available to equity shareholders are of the value of ₹ 80,00,000. Compare the intrinsic value of the equity share of each category.

Solution

There are three categories of equity shares—A, B and C.

All the shares shall be converted into shares of one denomination. Here, it is ₹ 10 fully paid.

Step 1: A Category: **Number of Shares**

A Category Will Equal as Fully Paid = 2,00,000

(They are Fully Paid—as Given)

Step 2: B Category:

B Category are Paid ₹ 7.50 only

∵ B Category Will Equal to Number of Shares as Fully Paid: 1,50,000

$$\frac{2,00,000 \times ₹ 7.50}{10} = \frac{15,00,000}{10}$$

Step 3: C Category

C Category are Paid Only ₹ 5

∴ C Category Will Equal to As Fully Paid = 50,000

$$\frac{1,00,000 \times ₹ 5}{10} = \frac{5,00,000}{10}$$

Total (Step 1 + Step 2 + Step 3) = 4,00,000 share

Step 4: Value Per Share = $\frac{₹ 80,00,000}{4,00,000}$ = ₹ 20 Per Share

Now, Based on the Above, Each Category is to be Valued on Prorate Basis.

Step 5:

Category A: As Fully Paid:

Value of A Category Share = ₹20 Per Share

Category B: = $\frac{\text{Number of Shares Equal to Fully Paid}}{\text{Number of Category Shares}} \times ₹ 20$

$= \frac{1,50,000}{2,00,000} \times ₹ 20 = ₹ 15$ Per Share

Category: $\frac{50,000}{1,00,000} \times ₹ 20 = ₹ 10$ Per Share

8.10 METHODS OF VALUATION OF SHARES—OTHER METHODS ILLUSTRATED

8.10.1 Net Assets Method

Net assets basis or, intrinsic value: Intrinsic value of equity shares will be ascertained as follows:

Step 1: Net Assets:	₹
Add: Goodwill (As Determined) and	x x x
All Other Assets (At Market Value)	x x x
	—

Step 2:	(Deduct) Less:	
	All Liabilities &	x x x
Step 2(a):	Less: Preference Shares	x x x
		x x x
Step 3:	Net Assets Available For Equity Shareholders = (Step 1 – Step 2)	0 0 0

Step 4: Intrinsic Value Per Share = $\frac{\text{Assets Available for Equity Shareholders}}{\text{Number of Equity Shares}}$

Illustration 8.25

Model: Net assets method

The Following is the Balance Sheet of Raj Ltd. as on 31 March 2010:

Liabilities:	₹
1,00,000 Equity Shares of ₹ 10 Each, Fully Paid	10,00,000
1,00,000 Equity Shares of ₹ 10 Each, ₹ 5 Paid Up	5,00,000
80,000 14% Cumulative Pref. Shares of ₹ 10 Each, Fully Paid	8,00,000
Long-Term Secured Loan	12,00,000
Sundry Creditors	3,00,000
	38,00,000
Assets:	
Land & Buildings	20,00,000
Furniture, Fixtures & Fittings	1,00,000
Stock	5,00,000
Debtors	3,00,000
Cash at Bank	1,00,000
P&L A/c	8,00,000
	38,00,000

The current value of land and buildings is ₹ 27,00,000 and that of furniture, fixture and fittings is ₹ 60,000. Stock is valued at ₹ 7,00,000. Debtors are expected to realize only 80% of their book value. You are informed that the preference dividend has not been paid for the last 5 years. Calculate the intrinsic value of equity share by the net assets method.

Solution

Step 1: Add:	₹
(i) Current Value of Land & Buildings	27,00,000
(ii) Current Value of Furniture & Fixtures	60,000
(iii) Stock (Market Value or Current Value)	7,00,000
(iv) Debtors 80% of ₹ 3,00,000	2,40,000
(v) Cash at Bank	1,00,000
(vi) National Call on 1,00,000 Equity Shares @ ₹ 5 (₹ 10 – ₹ 5) per share	5,00,000
	43,00,000

		₹	₹
Step 2:	Less:		
	Long-Term Loan:	12,00,000	
	Sundry Creditors:	3,00,000	15,00,000
Step 3:	Net Assets =		28,00,000
Step 4:	Less: Preference Share Capital =		8,00,000
Step 5:	Intrinsic Value of 2,00,000 Equity Shares =		20,00,000

Step 6: Intrinsic Value of One Fully Paid Equity Shares $= \frac{₹\,20,00,000}{2,00,000 \text{ Shares}} = ₹\,10$

Step 7: Intrinsic Value of One Equity Share on Which ₹ 5 Has Been Paid Up

$= \underset{\text{(Step 6)}}{₹\,10} - \underset{\text{(Given)}}{₹\,5} = ₹\,5$

8.10.2 Method—Yield Basis or Market Value

Yield denotes the income that the investors get for their investments. Naturally, the price of share depends on the quantum of dividends.

Here, yield may represent (i) the entire earnings or the (ii) dividend paid by the company. The normal procedure is that dividend is taken as a basis for calculating the yield and not the entire earnings.

Valuation of shares on the basis of yield is determined as follows:

Step 1: Future Maintainable Profits are Ascertained.

Step 2: The Normal Rate of Return is Computed.

Step 3: The Multiplier or the Capitalization Factor is to Be Ascertained $= \left(\frac{100}{\text{Normal Rate of Return}}\right)$.

Step 4: Capitalized Value of Maintainable Profits is Determined by Multiplying Maintainable Profit by the Multiplier (i.e., Step 1 × Step 3)

Step 5: Finally, the Yield Value of Share is Compared by dividing the Capitalized Value of Maintainable Profits (Compared in Step 4) By the Number of Equity Shares.

$$\text{Yield} = \frac{\text{Step 4}}{\text{Number of Equity Shares}}$$

This Method is Described by the Following Illustration.

Illustration 8.26

Model: Valuation of shares-yield basis

From the following information, calculate the value of an equity share:

(i) The paid-up share capital of a company consists of 2,000 12% preference shares of ₹ 100 each and 50,000 equity shares of ₹ 10 each.

(ii) The average annual profits of the company after providing for depreciation and taxation amounted to ₹ 64,000.

(iii) The normal return expected by investors on equity shares from the type of business carried on by the company is 10%.

Solution

Step 1: Future Maintainable Profits are Ascertained:

(i)	Net Profit After Depreciation and Taxation: (Given)	₹ 64,000
(ii)	Less: Dividend to Be Paid to Pref. Share Holders: (12% on 2,000 × 100)	₹ 24,000
(iii)	Profit Available to Equity Share Holders	₹ 40,000

Step 2: Normal Rate of Return is to be Determined:
It is 10% (Given in the Question Itself)

Step 3: Capitalization Factor is Ascertained $= \frac{100}{10} = 10$

Step 4: Capitalized Value of Maintainable Profit is Calculated:
Maintainable Profits × Multiplier (Capitalization Factor)
= ₹ 40,000 × 10 = ₹ 4,00,000
(Step 1 (iii)) (Step 3)

Step 5: Yield Value of Equity Share is Determined as:

$$\text{Formula: Value of Equity Share} = \frac{\text{Capitalized Value}}{\text{Number of Equity Shares}}$$

$$= \frac{₹\,4,00,000}{\underset{\text{(Given)}}{50,000}} = ₹\,8 \text{ Per Share}$$

$$= \left(\frac{\text{Step 4}}{\text{Number of Equity Shares}}\right)$$

8.10.2.1 Dividend Basis of Yield Value

This can be calculated in another way as follows:

$$\text{Formula: Expected rate} = \frac{\text{Profit Available}}{\text{Total Paid-Up Equity Share Capital}} \times 100 = 8\%$$

$$= \frac{₹\,40,000}{₹\,5,00,000} \times 100 = 8\%$$

$$\text{Value per share} = \frac{\text{Expected Rate}}{\text{Normal Rate}} \times \text{Paid-up Value of Shares}$$

$$= \frac{8}{10} \times ₹\,10 = ₹\,8$$

8.10.2.2 Earnings per Share Basis

Earnings per share is determined by dividing the earnings with the number of equity shares.

$$\text{Earnings per Share (EPS)} = \frac{\text{Earning Available to Equity Shareholder}}{\text{Number of Equity Shares}}$$

After determining the EPS of the company, value of share on EPS is calculated by using the formula:

$$\text{Value of the share} = \frac{\text{EPS of the Company}}{\text{Average EPS}} \times \text{Paid-up value of equity share}$$

By using the same figures as in the above illustration,

(i) EPS is determined by using the formula:

$$\text{EPS} = \frac{\text{Earnings}}{\text{Number of Equity Shares}} = \frac{₹\,40,000}{50,000} = ₹\,0.80.$$

(ii) Average EPS = $\frac{₹\,0}{10}$ = ₹ 1 (paid up value is ₹ 10 and normal rate of return is 10)

Value of share on EPS basis = $\frac{\text{EPS of the Company}}{\text{Average EPS}}$ × Paid-up value of shares

= $\frac{₹\,0.80}{₹\,1}$ × ₹ 10 = ₹ 8 per share.

Thus, we can see that the yield value of shares, under various methods, is the same, i.e., ₹ 8 only.

Illustration 8.27

Model: Value of two classes of shares intrinsic method

X Ltd. started its business on 1 April 2007. On 31 March 2010, its balance sheet in a summarized form was as follows:

Liabilities	₹	Assets	₹
Share Capital: 10,000, 12% Preference		Fixed Costs (Less Depreciation)	25,00,000
Shares of ₹ 100 Each, Fully Paid	10,00,000	Current Assets	35,00,000
2,50,000 Equity Shares of ₹ 10 Each, Fully Paid	25,00,000	Preliminary Expenses	25,000
Profit Prior to Incorporation	25,000		
P&L A/c	5,00,000		
15% Debentures	4,00,000		
Sundry Creditors	14,00,000		
Provision for Income Tax	2,00,000		
	60,25,000		60,25,000

The company is yet to declare its maiden dividend. A revaluation reveals that the fixed assets as on 31 March 2010 are really worth ₹ 30,00,000. Calculate the intrinsic value of two classes of shares.

Solution

Step 1:	Add: Assets		₹
	(i) Fixed Assets (as on 31 March 2010)		30,00,000
	(ii) Current Assets		35,00,000
			65,00,000
Step 2:	Less: Liabilities & Provision	₹	
(i)	15% Debentures	4,00,000	
(ii)	Sundry Creditors	14,00,000	
(iii)	Provision for Income Tax	2,00,000	
		20,00,000	
Step 3:	Net Assets (Step 1 – Step 2)	45,00,000	
Step 4:	Preference Shares:		
	Preference Share Capital:		10,00,000
	Add: Dividend @ 12% for 3 Years:		3,60,000
			13,60,000

Value of One Preference Share:

$$\frac{\text{Pref. Share Capital + Dividend}}{\text{Number of Pref. Shares}}$$

$$\frac{₹\,13,60,000 \text{ (Ref. Step 4)}}{10,000 \text{ (Given)}} = ₹\,136$$

Step 5: Equity Shares

Net Assets After Satisfying Preference Shareholders' Claim

= Net Assets – Pref. Shareholders' Claim

= ₹ 45,00,000 – ₹ 13,60,000

(Step 3) (Step 4)

= ₹ 31,40,000

Value of One Equity Share $= \frac{₹\,31,40,000}{2,50,000} = ₹\,1256$

Illustration 8.28

Model: Fair value of equity shares

From the following particulars, calculate the fair value of an equity share assuming that out of the total assets, those amounting to ₹ 19,00,000 are fictitious.

(i) Share capital:
2,00,000 15% Preference shares of ₹ 100 each, fully paid
20,00,000 Equity shares of ₹ 10 each, fully paid

(ii) Liabilities to outsiders: ₹ 34,50,000

(iii) Reserves & Surplus: ₹ 17,50,000

(iv) The average normal profit after taxation earned every year by the company during the last 5 years: ₹ 40,00,000

(v) The normal profit earned on the market value of fully paid equity shares of similar companies is 10%

[C.S. Modified]

Solution

Stage I: Computation of Intrinsic Value of Shares.

Step 1:	Add: (Assets)		₹
	(i) Preference Share Capital (2,00,000 × ₹ 100):		2,00,00,000
	(ii) Equity Share Capital (20,00,000 × ₹ 10):		2,00,00,000
	(iii) Reserve & Surplus:		17,50,000
	(iv) Liabilities to Outsiders:		34,50,000
Step 2:	Gross Assets:		4,52,00,000
Step 3:	Less:		
	(i) Liabilities to Outsiders:	34,50,000	
	(ii) Fictious Assets:	19,50,000	54,00,000
Step 4:	Assets Available to Shareholders:		3,98,00,000
Step 5:	Less: Amount Due to Pref. Shareholders:		2,00,00,000

Step 6: Net Assets Available to Equity Shareholders: 1,98,00,000

Step 7: Intrinsic Value of Equity Shares $= \frac{\text{Net Assets Available to Equity Shareholders}}{\text{Number of Equity Shares}}$

$$= \frac{₹\,1,98,00,000}{20,00,000} = ₹\,9.90$$

Stage II: Computation of Market Value of An Equity Shares By Capitalization of Profits:

		₹
Step 1:	Average Profits: (Given):	40,00,000
Step 2:	Less: Preference Dividend (15% of ₹ 2,00,000):	30,00,000
Step 3:	Profit Available to Equity Shareholders:	10,00,000
Step 4:	Capitalization of Profit at 10%:	1,00,00,000

₹ 10,00,000 $\times \frac{100}{10}$

Step 5: Value of One Equity Share:

$$\frac{\text{Capitalized Profits}}{\text{Number of Equity Shares}} = \frac{₹\,1,00,00,000}{20,00,000} = ₹\,5.00$$

Stage III: Fair Value: $\frac{\text{Intrinsic Value + Market Value}}{2}$

$$= (₹\,9.90 \text{ (Stage I: Step 1)} + ₹\,5.00 \text{ (Stage II: Step 5)})/2$$

$$= \frac{₹\,14.90}{2} = ₹\,7.45$$

Illustration 8.29

Balance Sheet of Super Gain Ltd.
As on 31 March 2010

Liabilities:	₹
Share Capital:	5,00,000
5,000 Shares of ₹ 100 each	1,00,000
General Reserve	70,000
Profit and Loss Account	1,45,000
Sundry Creditors	35,000
Income Tax Reserve	8,50,000
Assets:	
Land & Buildings	2,00,000
Plant & Machinery	3,00,000
Patents & Trade Marks	25,000
Stocks	75,000
Debtors	2,00,000

Bank balance	35,000
Preliminary expenses	15,000
	8,50,000

The expert valuer valued the land and buildings at ₹ 2,50,000; plant and machinery at ₹ 2,80,000 and Goodwill at ₹ 2,00,000. Out of the total debtors, it is found that debtors of ₹ 20,000 are bad. The profits of the company were as follows:

		₹
2007–08	:	1,00,000
2008–09	:	1,30,000
2009–10	:	1,50,000

The Company follows the practice of transferring 25% to general reserve. Similar types of companies earn at 10% of the value of their shares.

You are required to ascertain the value of the shares of the company as follows:

1. Intrinsic value method
2. Yield value method
3. Fair value method

Solution

1. Intrinsic value method

		₹
Step 1:	Add: Assets	
	(i) Land & Buildings (Market Value)	2,50,000
	(ii) Goodwill	2,00,000
	(iii) Plant & Machinery (Market Value)	2,80,000
	(iv) Stock	75,000
	(v) Debtors (2,00,000 – Bad Debts 20,000)	1,80,000
	(vi) Patents & Trade Marks	25,000
	(vii) Bank Balance	35,000
		10,45,000
Step 2:	Less: Liabilities:	
	Sundry Creditors	1,45,000
Step 3:	Net Assets:	9,00,000

Step 4: Intrinsic Value of One Equity Share $= \frac{\text{Net assets}}{\text{Number of shares}}$

$$= ₹ \frac{9,00,000}{5,000} = ₹ 180$$

2. Yield Value Method:

		₹
Step 1:	Total Profit For Three Year:	3,80,000
	(₹ 1,00,000 + ₹ 1,30,000 + ₹ 1,50,000	
Step 2:	Less: Bad Debts (Given)	20,000
		3,60,000

Step 3: Average Profit: $\frac{₹3,60,000}{3} = ₹1,20,000$

Step 4:	Add: Decrease in Depreciation	
	On Plant & Machinery:	₹1,20,000
	Assume @ 10% on ₹20,000	₹2,000
		₹1,22,000
Step 5:	Less: Increase in Depreciation	₹5,000
	On Land & Buildings	
	Assume @ 10% on ₹50,000	
Step 6:	Average Profit =	₹1,17,000
Step 7:	Less: Transfer to Reserve	₹29,250
	@ 25% on ₹1,17,000:	
Step 8:	Profit Available For Dividend =	₹87,750

Step 9: Rate of Dividend $= \frac{\text{Profit Available from Dividend}}{\text{Total Value of Shares}} \times 100$

$= \frac{₹87,750}{₹5,00,000} \times 100$

$= 17.55\%$

Step 10: Yield Value Per Share $= \frac{\text{Date of Dividend}}{\text{Normal Rate of Return} \times \text{Paid-up Value Per Share}}$

$= \frac{17.55}{10} \times ₹100$

$= ₹175.50$

3. Fair Value Method

Fair Value of Each Share $= \frac{\text{Intrinsic Value} + \text{Yield Value}}{2}$

$= \frac{₹180 + ₹175.50}{2}$

$= ₹177.75$

Illustration 8.30

Model: Valuation of two classes of shares

From the following balance sheet, you are required to compare the value of (i) one preference share and (ii) one equity share:

Liability	₹	Assets	₹
4,000 14% Preference Shares of ₹100 Each	4,00,000	Assets at Book Value	12,00,000
60,000 Equity Shares of ₹10 Each	6,00,000		
Liabilities	2,00,000		
	12,00,000		12,00,000

The market value of 50% of the assets is considered at 10% more than the book value and that of remaining assets at 5% less than the book value. There was a liability of ₹20,000 which remain unrecorded. Assume that the preference shares have no priority as to repayment of capital or dividend.

Solution

Net assets available for equity and preference shareholders have to be calculated by using net assets method:

		₹	₹
Step 1:	Assets at Book Value (First 50%):	6,00,000	
	Add: Increase of 10%:	60,000	6,60,000
Step 2:	Assets at Book Value (Remaining 50%) :	6,00,000	
	Less: Decrease of 5%:	30,000	5,70,000
Step 3:	(Step 1 + Step 2) Assets at Market Value:	12,30,000	
Step 4:	Less: Liabilities (Book Value):	2,00,000	10,30,000
Step 5:	Less: Unrecorded Liabilities		20,000
Step 6:	Net Assets Available for Preference and Equity Shareholders:		10,10,000

Step 7: This has to be Divided in the Ratio of their Paid Capital, i.e.
40,00,000:6,00,000 4: 6 or 2:3

(i) Amount Available to Preference Shareholders:
₹ 10,10,000 × 2/5 = ₹ 2,02,000 × 2 = ₹ 4,04,000

(ii) Amount Available to Equity Shareholders:
₹ 10,10,000 × 3/5 = ₹ 2,02,000 × 3 = ₹ 6,06,000

Step 8: Value of Preference Share: $= \frac{\text{Amount Available to Preference Shareholder}}{\text{Number of Perference Shares}}$

$$= \frac{₹\,4,04,000}{4,000} = ₹\,101 \text{ Per Share}$$

Step 9: Value of Equity Shares: $= \frac{\text{Amount Available to Equity Equity Shareholders}}{\text{Number of Equity Shares}}$

$$= \frac{₹\,6,060,000}{60,000} = ₹\,10.10 \text{ Per Share}$$

8.10.3 Valuation When Only a Few Shares are to be Sold

In case shares are valued on the basis of dividend declared and expected normal rate of return,

$$\text{Value of each equity share} = \frac{\text{Weighted Average Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid-Up Value of Share}$$

8.10.4 Valuation When Majority Shares are to be Sold

In this case, shares are valued on the basis of weighted average profits of the business and expected normal earnings of similar companies in the same industry.

$$\text{Value of each equity share} = \frac{\text{Weighted Averge Rate of Earnigs(Profit)}}{\text{Normal Return}} \times \text{Paid-up Value of Each Share}$$

Illustration 8.31

Model: Value of few shares are to be sold and majority are to be sold

From the data given below, you are required to compare the value of each share when (a) only a few shares are to be sold and if (b) majority shares are to be sold:

1. Share capital: 10,000 shares of ₹ 100 each, fully paid
2. Profits after tax and dividends

Year	Profits	Dividends
	₹	
2008	3,00,000	12%
2009	4,00,000	16%
2010	5,00,000	20%

3. Normal rate of return 12%

Solution

(a) When Only a Few Shares are Sold:

Step 1: Average Rate of Dividend has to be Computed.

$$\text{Average Dividend rate} = \frac{\text{Sum of Doividend Rates}}{\text{Number of Years}}$$

$$= \frac{12\% + 16\% + 20\%}{3} = \frac{48\%}{3} = 16\%$$

Step 2: Value of Each Equity Share

$$\text{Formula: } \frac{\text{Average Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid-Up Value of Each Share}$$

Step 3: Substituting the Figures in the Formula, We Get:

$$\frac{16}{12} \times ₹\,100 = \frac{₹\,400}{3} = ₹\,133.33$$

(b) When Majority Share are Sold:

Step 1: Average Profit is to Be Calculated as

$$\text{Average Profit for 3 Years} = \frac{₹\,3,00,000 + ₹\,4,00,000 + ₹\,5,00,000}{3}$$

$$= \frac{₹\,12,00,000}{3} = ₹\,4,00,000$$

Step 2: $\text{Rate of Earning} = \frac{\text{Average Profit}}{\text{Total Value of Shares}}$

$$= \frac{₹\,4,00,000}{₹\,10,00,00} \times 100 = 40\%$$

Step 3: Value of Each Equity Share:

$$\text{Formula: } \frac{\text{Weighted Average Rate of Earning}}{\text{Normal Rate of Earning}} \times \text{Paid-Up Value of Each Share}$$

$$\frac{40\%}{12} \times ₹\,100 = \frac{4,000}{12} = ₹\,333.33$$

Illustration 8.32

Model: Market value of share—Calculations

The profit of a company, limited by shares, for the year ended 31 March 2010 was ₹ 50,00,000. After setting apart amounts for interest on borrowings, taxation and other provisions, the net surplus available capital base consisted of:

(i) 1,00,000 equity shares of ₹ 100 each, ₹ 75 per share fully paid up

(ii) 30,000 10% cumulative redeemable preference shares of ₹ 100 each, fully paid up

Enquiries in the stock market reveal that shares of companies engaged in similar business and declaring dividend of 15% on equity shares are quoted at a premium of 20%.

Based on your working on the yield method, what do you expect the market value of the company's share to be?

[C.S. (Inter). Modified]

Solution

		₹
Step 1:	Net Surplus Available to Equity Shareholders =	18,00,000
Step 2:	Less: Preference Dividend @ 10% on ₹ 30,00,000 =	3,00,000
Step 3:	Amount Available For Equity Shareholders =	15,00,000

Step 4: Rate of Equity Dividend $= \frac{\text{Amount Available for Equity Dividend}}{\text{Paid-Up Equity Capital}}$

$$= \frac{₹\,15,00,000}{₹\,75,00,000} \times 100 = 20\%$$

Step 5: Expected Market Value at 15% Dividend = ₹ 75 + Premium 20%

$$= ₹\,75 + ₹\,15 = ₹\,90$$

Step 6: Market Value At 20% Dividend $= \frac{₹\,90 \text{ (Step 5)}}{15} \times 20$

$$= \frac{1,800}{15} = ₹\,120$$

8.11 PRICE–EARNINGS RATIO—(PE RATIO)

Price–earnings ratio is the ratio of market price to earnings per share, where earnings per share (EPS) is the earnings available to equity shareholders dividend by number of shares. It may also be said that it is the multiple of earnings which an investor paid for a share. This ratio is an important yardstick to measure whether a share is over-priced or under-priced. Price–earnings ratio of comparable firms may also be used as an important tool to measure the value of share of a firm.

Formula for computing price–earnings ratio is:

$$\text{PE ratio} = \frac{\text{Market Price of Share}}{\text{Earning per Share}}$$

The same formula can be rearranged as:

$$\text{Market price of share} = \text{PE ratio} \times \text{EPS}$$

We know that the normal rate of return is the earning rate of a company, which is determined by using the formula:

$$\text{Earning rate} = \frac{\text{EPS}}{\text{Market Price per Share}} \times 100$$

Studying these two formulae, we can understand that PE ratio is the reciprocal of normal rate of return.

Hence, PE ratio may be expressed as:

$$\text{PE ratio} = \frac{1}{\text{Normal Rate of Return}}$$

As normal rate of return is expressed in percentage,

$$\text{PE ratio} = \frac{1 \times 100}{\text{Normal Rate of Return}}$$

or

$$\text{Normal rate of return} = \frac{100}{\text{PE Ratio}}$$

There is much similarly between capitalization factor and PE ratio. Even we may go to the extent that PE ratio = Capitalization factor.

Illustration 8.33

Model; PE ratio

The share of Shree Ltd. is quoted in the market at ₹ 120. Its earnings per share (EPS) is 15. Compute its normal rate of return, PE ratio and capitalization factor. If the future maintainable profits are ₹ 15,00,000 and there are 1,00,000 equity shareholders, determine the value of share on yield basis.

Solution

1. Calculation of normal rate of return:

   Formula:

   $$\text{Normal Rate of Return} = \frac{\text{Earnings}}{\text{Market Price}} \times 100$$

   $$= \frac{15 \text{ (Given)}}{120 \text{ (Given)}} \times 100 = 12.5\%$$

2. Calculation of capitalization factor:

   Formula:

   $$\text{Capitalization Factor} = \frac{100}{\text{Normal Rate of Return}}$$

   $$= \frac{100}{12.5\% \text{ (Step 1)}} = 8$$

3. Determination of PE ratio:

   Formula:

   $$\text{PE Ratio} = \frac{\text{Market Price}}{\text{Earnings per Share}}$$

   $$= \frac{120}{15} = 8$$

   PE ratio can also be determined dividend 100 by normal rate of return as:

   $$\text{PE Ratio} = \frac{100}{12.5\%} = 8$$

   Hence PE ratio = Capitalization factor

   i.e., 8 = 8

   ↓ ↓

   (Step 3) : (Step 2)

4. Determination of value of each equity share on yield basis:

(i) Calculation of capitalized value of earnings:

Formula = Future maintainable Profits × Capitalization Factor

= ₹ 15,00,00 × 8

Capitalized value of earnings = ₹ 1,20,00,000

$$\text{Value of each equity share} = \frac{\text{Capitalized Value of Earnings}}{\text{Number of Equity Shares}}$$

$$= \frac{₹\,1,20,00,000}{1,00,000} = ₹\,120$$

Illustration 8.34

Model: PE ratio–Valuation of other firm's share

'X' Ltd. has earning per share of ₹ 25 and is quoted at ₹ 225. Y Ltd., a similar firm, has earnings per share of ₹ 20. Determine the value of the share of 'Y' Ltd.

Solution

Step 1: First, Determine the Value of Share of X Ltd as:

$$\text{Formula: PE Ratio} = \frac{\text{Market Price}}{\text{EPS}} = \frac{₹\,225}{₹\,25} = 9$$

PE Ratio of 'X' Ltd. = 9

Step 2: Value of Share of 'Y' Ltd:

= EPS (of Y Ltd) × PE Ratio (of Similar Firm ×)

= ₹ 20 × 9 = ₹ 180

Illustration 8.35

Model: Value of shares—Net assets and PE ratio methods)

Dev Ltd. is a going concern and its directors who are also owners have decided to sell their business. They have approached you to make an assessment of the price per equity share a purchaser might offer. The relevant information is as follows:

Balance Sheet as on 31 March 2010

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets (Net Book Value)	
50,000 Equity Shares of ₹ 10 Each	5,00,000	Land & Buildings	14,00,000
Reserves Dividend Equalization Fund	12,00,000	Plant & Equipment	7,50,000
Secured Loan	1,50,000	Motor Vehicle	1,40,000
Staff Welfare Fund	6,00,000	Intangible Assets	10,000
Current Liabilities	50,000	Current Assets:	
Creditors	2,75,000	Stock	3,00,000
Accrued Expenses	1,25,000	Debtors	2,50,000
Proposed Dividend	75,000	Cash and Bank	50,000
		Deferred Advertisement Cost	75,000
	29,75,000		29,75,000

Net profits after tax and interest but before payment of dividends were: 2005–06: ₹1,50,000; 2006–07: ₹1,60,000; 2007–08: ₹1,20,000; 2008–09: ₹1,50,000; 2009–10: ₹1,70,000.

The fixed assets of the company have been valued by independent experts as follows:

	₹
Land & Buildings	17,40,000
Plant & Equipment	8,60,000
Motor vehicle	1,00,000

The applicable price earnings PE ratio is 10. You are required to compute the value per equity share of the company based on:

1. Net assets
2. PE ratio

[I.C.W.A. Modified]

Solution

1. Computation of value per equity share: Net assets method

Step 1:	Assets (At Market Value)		₹
	(i) Land & Buildings		17,40,000
	(ii) Plant & Equipment		8,60,000
	(iii) Motor Vehicles		1,00,000
	(iv) Stock		3,00,000
	(v) Debtors		2,50,000
	(vi) Cash & Bank		50,000
	Total Assets		33,00,000
Step 2:	Less: Liabilities:	₹	
	(i) Secured Loan	6,00,000	
	(ii) Creditors	2,75,000	
	(iii) Accrued Expenses	1,25,000	10,00,000
Step 3:	Net Assets (Step 1 – Step 2)		23,00,000

Step 4: Value Per Equity Share: (Including Dividend)

$$\text{Formula} = \frac{\text{Net Assets Available}}{\text{Number of Equity Shares}} \text{ (Including Dividend)}$$

$$= ₹\frac{23,00,000}{50,000} = ₹46$$

Value Per Equity Share (Cum Dividend) = ₹46

Step 5: Value Per Equity Share Excluding Dividend:

$$= \frac{\text{Net Assets Available Excluding Dividend}}{\text{Number of Equity Shares}}$$

= ₹23,00,000 – ₹75,000

$$= \frac{\text{(Step 3) (Given)}}{50,000} = \frac{22,25,000}{50,000} = ₹44.50$$

Value Per Equity Share (Excluding Dividend) = ₹44.50

3. Computation of Value of Each Equity Share:
   PE Ratio Method:

Step 1: Profits Before Dividend for Last 5 Years:
₹ 1,50,000 + ₹ 1,60,000 + ₹ 1,20,000 + ₹ 1,50,000 + ₹ 1,70,000 = ₹ 7,50,000
i.e.,Total Profits = ₹ 7,50,000

Step 2: Average Profit = $\frac{\text{Total Profit}}{\text{Number of Years}} = \frac{₹\,7,50,000}{5} = ₹\,1,50,000$

Step 3: Earnings Per Share:

Formula: $\frac{\text{Average Profits}}{\text{Number of Shares}} = \frac{₹\,1,50,000}{50,000} = ₹\,3$

Step 4: PE Ratio

Step 5: Value Per Equity Share = EPS × PE Ratio = ₹ 3 × 10
= ₹ 30

Note:

Assumptions:

1. Intangible assets—no market value—ignored
2. No liabilities with respect to staff welfare as it is a free reserve.
3. Deferred advertisement cost—not categorized as asset.

Summary

Goodwill is the present value of a firm's anticipated excess earnings. The need for valuation of goodwill arises under certain circumstances such as amalgamation, reconstruction, acquisition and sale of companies.

The vital components of goodwill are profitability, yield and the capital employed.

Methods of valuation of goodwill are: (i) average profits methods, (ii) super profits method, (iii) capitalization method and (iv) annuity method.

Formulae for calculating goodwill under these methods are as follows:

Average profits method

Goodwill = Average Profit × Number of Years' Purchases

and

Goodwill = Weight Average Profits × Agreed Number of Years' Purchase

Super profits method

Goodwill = Super Profit × Number of Years,

where Super Profit

= Capital Employed × Normal Rate of Reform Under Annuity Method

Goodwill = Super Profit × Present Value Factor, where present value factor is ascertained by using the formula:

$$\text{PVF} = \left[\frac{1 - \frac{1}{(1+i)^n}}{i}\right], \text{ where } i = \frac{r}{100}$$

Vector capitalization method

Goodwill is determined by capitalizing the average profits and capitalizing the super profits. Value of capital employed can be computed under two different approaches: (i) assets side approach and (ii) liabilities side approach.

Estimation of future profit—Ref: Illustration 8.12.

Valuation of shares:

1. Net assets method: Value of a share is ascertained under this method by using the formula:
   Net assets value of a share or intrinsic value of a share

$$= \frac{\text{Net Value of Assets} - \text{Liabilities} - \text{Pref. Shareholders Claims}}{\text{Number of Equity Shares}}$$

Fair value of shares is determined on the basis of majority and minority holdings. For details refer Illustration 8.23.

2. Yield basis or market value method is explained in detail in Illustration 8.26.

Earnings per Share Basis:

$$\text{EPS} = \frac{\text{Earnings Available to Equity Shareholders}}{\text{Number of Equity Shares}}$$

$$\text{Value of Share on EPS Basis} = \frac{\text{EPS of the Company}}{\text{Average EPS}} \times \text{Paid-up Value of Shares}$$

Valuation when only a few shares are to be sold and when majority shares are to be sold are explained in detail in Illustration 8.31.

Price–earnings ratio: Formula for computing PE ratio is

$$\text{PE Ratio} = \frac{\text{Market Price of Share}}{\text{Earnings per Share}}$$

Key Terms

Goodwill: The capacity of a business to earn profits in future.

Normal Rate of Return: The rate of earnings which the investors expect on their investments.

Capital Employed: Equity shareholders' funds in the company (with long-term borrowing) (or) Fixed assets + Net working capital.

Intrinsic Value of a Share: Valuation of share on the basis of internal value of the assets of a company.

Yield Value per Share: Valuation of share on the basis of yield, i.e., the effective rate of return on investment made in shares by shareholders.

Fair Value per Share: The average of the net assets value and yield value.

Average Capital Employed: Represents the closing capital employed (after deducting $\frac{1}{2}$ of the current year from it)

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. Goodwill is a tangible asset.
2. Goodwill is not recorded in the books of accounts, generally.
3. The capacity of a business to earn profit at the current accounting period is termed as goodwill.
4. When evaluating goodwill, income from non-trading assets should be excluded.
5. Profitability is one of the main factors that affect the value of goodwill. Here, profit refers to the past year's profit earned by the firm.
6. While computing capital employed, all current liabilities should be excluded.
7. Fictitious assets should be included, when capital employed is computed.
8. Provision for taxation, if it appears in the balance sheet, should be treated as a part of profit for the purpose of computing (average) capital employed.
9. The value of goodwill is directly proportionate to the amount of capital employed.
10. Weighted average method can be used to calculate future maintainable profit, if the trend is increase in profit every year.
11. Normal rate of return is the rate of profit generally earned by other similar firms in that industry.
12. By the use of capitalization of super profit method, the value of goodwill will be maximum.
13. While valuing the intrinsic value of shares, investment should be valued at their book value.
14. The value of shares of a company is affected by proportion of liabilities and the capital.
15. Provision for bad and doubtful debts should not be taken into consideration while valuing the assets in ascertaining the intrinsic value of shares.

16. In case the preference shares are participating preference shares, their claim for surplus should not be deducted from the value of the assets
17. In case of partly paid-up and fully paid-up shares, it is imperative to convert partly paid-up shares into fully paid-up shares by making a notional call.
18. Fair value of share is not connected with intrinsic value and yield value of shares.
19. When only a few shares are to be sold, profits for the past few years are to be determined, from which expected rate of return is computed.
20. Another name of intrinsic value method is asset backing method.

Answers:

1. False	2. True	3. False
4. True	5. False	6. True
7. False	8. True	9. False
10. True	11. True	12. True
13. False	14. True	15. False
16. False	17. True	18. False
19. False	20. True	

II: Fill in the blanks with apt word(s)

1. Goodwill is an _____asset.
2. Goodwill is the _____ value of a firm's anticipated excess earnings.
3. While evaluating goodwill, the buyer is keen in future_____.
4. _____refers to the rate of earnings which investors in general expect on their investment.
5. In simpler terms, Capital employed = Fixed assets + Net _____.
6. The average capital employed may be determined by either _____ or _____ approach or way.
7. Goodwill = Average profit × _____.
8. The excess of expected average profit over normal profit is referred to as_____.
9. Normal profit = Average capital employed × _____.
10. Under capitalization of super profit method, the average super profit is capitalized at a certain _____.
11. Goodwill = _____ × Annuity rate.
12. Goodwill = _____net tangible assets.
13. To ascertain the intrinsic value of shares, it is essential to determine the value of the _____of the company.
14. While determining the value of shares, goodwill should be valued at _____.
15. While calculating the value of inventories, finished goods may be value at_____.
16. Liabilities are to be valued at _____.
17. $\text{Intrinsic value per share} = \frac{\quad}{\text{Number of Equity Shares}}$
18. $\text{Yield value per share} = \frac{\text{Expected Rate of Return}}{\text{Normal Rate of Return}} \times$ _____.
19. Fair value of shares is the _____ of the net assets value and yield value of shares.
20. Market value method is also known as _____.

Answers:

1. intangible
2. present
3. maintainable profits
4. Normal rate of return
5. working capital
6. assets side or liabilities side
7. Number of year's purchase
8. super profits
9. Normal rate of return
10. rate of return
11. Average annual super profit
12. Capitalised value of business
13. net assets
14. current cost or cost price
15. cost price
16. book value
17. Net equity
18. Paid-up value per equity share
19. average
20. yield method

III: Multiple choice questions—Choose the correct answer

1. Which one of the following is not a main source for generating goodwill:
   (a) extending easy credit facilities to customers
   (b) location of the business premise
   (c) quality of goods
   (d) reputation of management
2. Which one of the following is not the main factor that affects the value of goodwill:
   (a) profitability
   (b) size of the business

(c) normal rate of return
(d) capital employed

3. While computing capital employed, which one the following items is to be excluded:
   (a) all fixed assets
   (b) all current assets
   (c) fictitious assets
   (d) trade investment
4. While computing capital employed, which one of the following items is to be included:
   (a) patents, trademarks and copyrights
   (b) discount in issue of shares and debentures
   (c) provision for bad debts
   (d) bills receivable
5. Which one the following is not a recognized method for valuation of goodwill:
   (a) average profit method
   (b) annuity method
   (c) capitalization method
   (d) none of these
6. The term "capital employed" represents the funds provided by
   (a) creditors
   (b) debenture holders
   (c) shareholders
   (d) all of these
7. The average rate of return of similar firms in the same industry is to be taken as
   (a) normal rate of return
   (b) expected rate of return
   (c) average rate of return
   (d) none of these
8. The annuity factor of ₹1 at 10% for 3 years is 2.48685 it the super profit is ₹1,00,000, value of goodwill will be
   (a) ₹1,243.685
   (b) ₹2,48,685
   (c) ₹24,686.85
   (d) ₹24,868.50
9. Which one of the following factors will not affect the value of shares:
   (a) demand and supply of shares
   (b) nature of company's business
   (c) profit-earning capacity of the company
   (d) labour force
10. The value of equity share, under the yield method, is to be calculated under the presumption that company would be
   (a) a going concern
   (b) liquidated
   (c) either (a) or (b)
   (d) none of these

Answers:

1. (a) 5. (d) 9. (d)
2. (b) 6. (c) 10. (a)
3. (c) 7. (a)
4. (d) 8. (b)

Short Answer Questions

1. Define: Goodwill
2. Give any four valid reasons for valuing goodwill.
3. Mention the important factors that affect goodwill.
4. While estimating the future maintainable profits of a firm, enumerate the important factors that need to be considered.
5. How will you determine the normal rate of return of a firm?
6. Explain "capital employed". Why does "average capital employed" attain significance in evaluating goodwill?
7. Explain the term "number of year's purchase".
8. How weightage is given for computing weighted average?
9. Mention the methods of calculating goodwill based on super profit.
10. Explain the capitalization of super profit method of calculating goodwill.
11. Explain the term "annuity factor".
12. What do you understand by "normal rate of return"?
13. Mention any four important purposes for which the shares of a company have to be valued?

14. Give any four valid factors that affect the value of shares.
15. How can "intrinsic value of a share" be calculated?
16. Enumerate the important factors that are to be considered in valuing assets while determining the value of shares.
17. How will you treat liabilities, while valuing shares?
18. How would you compute "expected rate of return"?
19. What do you mean by "fair value of shares"?
20. How will you determine value of share under "yield method"?

Essay Type Questions

1. Explain the different method of calculating "goodwill".
2. Explain with reasons the main factors affecting the value of goodwill of public limited companies.
3. Describe the different method of valuing shares.
4. Explain the following:
   (a) Treatment of partly paid-up shares
   (b) Different classes (denominations) of equity shares
   (c) Valuing minority and majority holdings
   (d) Preference shares (capital and dividend under varying conditions)
   (e) Price–earning ratio
5. "Valuation of shares is not an exact science-It is sophisticated Guess work."—Comment.

Exercises

Part A—For Undergraduate Level

1. Vasanth & Co. decided to purchase a business for ₹7,20,000. Its profits for the last 4 were 2006: ₹2,00,000; 2007: ₹1,28,000; 2008: ₹2,20,000; 2009: 2,80,000. The owner of the business was personally managing this. A manager to replace him has to be paid ₹27,000 p.a.

   You are required to calculate the value of goodwill which is valued on the basis of three year's purchase of the average net profit for the last 4 years.

   [**Ans:** Goodwill: ₹5,40,000]

   [Model: Average profit method]
2. The following particulars are available in respect of the business carried on by Sathyan Ltd:
   (a) Profit earned is 2007: ₹2,00,000; 2008: ₹1,92,000; 2009: ₹2,08,000
   (b) Profit of 2008 is reduced by ₹20,000 due to unforeseen floods and profit of 2007 included a non-recurring income of ₹12,000.
   (c) Profit of 2009 include ₹8,000 income on investment
   (d) The stock is not insured and it is thought prudent to insure the stock in future. The insurance premium is estimated at ₹2,000 p.a.
   (e) Fair remuneration to the proprietor (not taken in the calculation of profit) is ₹40,000 p.a.

   You are required to calculate the value of goodwill on the basis of 2 year's purchase of average profits for the last 3 years.

   [**Ans:** Goodwill: ₹3,16,000; future maintainable profit: ₹1,58,000]
3. Parul Ltd. proposed to purchase the business carried on by M/s Kashyap. Goodwill for this purpose is agreed to be valued at 3 year's purchase of the average profit of the past four years. The appropriate weights to be used are as follows:

   2006: 1; 2007: 2; 2008: 3; 2009: 4.

   Profit for these years were:

   2006: ₹50,000; 2007: ₹55,000;

   2008: ₹60,000; 2009: ₹75,000

   Compute the value of the goodwill of the firm.

   [**Ans:** Goodwill: ₹1,92,000]

[Model: Super profit method (years of purchase of super profit method)]

4. From the following information, calculate the value of goodwill on the basis of 3 years' purchase of the super profit:
   (a) Average capital employed in the business: ₹35,00,000
   (b) Net trading profit of the firm for the past three years:
   ₹5,38,000; ₹4,53,500 and ₹5,62,500
   (c) Rate of interest expected from capital having regard to the risk involved: 12%
   (d) Fair remuneration to the partners for their services: ₹60,000 p.a.
   (e) Sundry assets of the firm: ₹37,73,810
   (f) Sundry liabilities of the firm: ₹1,56,645
   [**Ans:** Super profit: ₹38,000; Goodwill: ₹1,14,000]
5. The following particulars are available in respect of the business carried on by Mr. Devan.
   (a) Capital invested: ₹10,00,000
   (b) Trading result:
   2006—Profit—₹2,44,000
   2007—Profit—₹3,00,000
   2008—Loss —₹40,000
   2009—Profit—₹4,20,000
   (c) Market rate of interest on investment: 8%
   (d) Rate of risk return on capital invested in business: 2%
   (e) Remuneration from alternative employment of the proprietor (if not engaged in business): ₹72,000 p.a.
   You are required to compute the value of goodwill of the business on the basis of 3 year's purchase of super profit taking average of last 4 years.
   [**Ans:** Goodwill: ₹1,77,000]
6. Govind runs an automobile repair shop from rented premises. He pays a rent of ₹45,000 per month. Apart from non-skilled workers, he employs a skilled engineer at a salary of ₹36,000 per month. Govind made a profit of ₹19,50,000 before taxes for the year 2009–10 (year ended on 31 March 2010), on which date his net asset were worth ₹90,00,000. The owner of the premises plans to acquire the business from Govind.
   The premises are worth ₹15,00,000, of which 15% were to be a reasonable return on capital employed in this line of business, how much goodwill can Govind expect on the basis of 3 years' purchase of super profits?
   [**Ans:** Goodwill: ₹27,45,000]
7. The balance sheet of ABC Ltd. on 31 March 2010 is as follows:

Liabilities	₹	**Assets**	₹
15,000 8% Preference Shares of ₹10 Each	1,50,000	Goodwill	30,000
		Fixed Assets	5,40,000
		Investment (5% Govt Loan)	60,000
30,000 Equity Shares of ₹10 Each	3,00,000	Current Assets	3,00,000
		Preliminary Expenses	30,000
Reserves (Including Provisions for Taxation ₹30,000)	3,00,000	Discount on debentures	15,000
8% Debentures	1,50,000		
Creditors	75,000		
	9,75,000		9,75,000

   The average profit of the company (after deducting interest on debentures and taxes) is ₹90,000. The market value of the machinery included in fixed assets is ₹15,000 more. Expected rate of return is 10%. Evaluate the goodwill of the company at 5 times of the super profit.
   [Ans: Goodwill: ₹1,56,750]
   [Model: Super profit method (Capitalization of super profit method)]
8. From the following information, compute the value of goodwill by capitalizing super profit:
   (a) Average capital employed: ₹10,00,000
   (b) Normal rate of profit: 10%
   (c) Profit for 2007: ₹1,55,000; 2008: ₹1,47,500; 2009: ₹1,65,000
   (d) Profit for 2008 has been arrived at after writing off abnormal loss of ₹5,000 and profit for 2009 includes a non-recurring income of ₹7,500
   [**Ans:** Goodwill: ₹5,50,000]

9. Mr. Vasudevan has invested a sum of ₹3,00,000 on his own business which is a very profitable one. The annual profit earned from his business is ₹67,500, which includes a sum of ₹15,000 received as compensation for a part of his business premises.

   As an alternative to his engagement in his business, he could have invested the money in long-term deposit with bank earning a normal rate of interest of 10% and also could engage himself in employment thereby getting an annual salary income of ₹10,800.

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

   [**Ans:** Goodwill: ₹47,500]

10 From the following information, you are required to calculate the value of goodwill as per capitalization of super profit method:

   (a) Capital employed: ₹15,00,000

   (b) Net profit for 5 years:

   2006: ₹1,44,000; 2007: ₹1,54,000; 2008: ₹1,69,000; 2009: ₹1,74,000; 2010: ₹1,79,000

   The profit included non-recurring profit on an average basis of ₹10,000, out of which it was deemed that non-recurring profit had a tendency of appearing at the rate of ₹7,000 p.a.

   (c) Normal rate of profit: 10%

   [**Ans:** Goodwill: ₹1,10,000]

   [Model:Annuity method]

11. The net profit of a company after providing for taxation for the past 5 years are ₹1,60,000; ₹1,68,000; ₹1,80,000; ₹1,84,000 and ₹1,88,000. The capital employed in the business is ₹16,00,000, on which a reasonable rate of return of 10% is expected. It is expected that the company will be able to maintain its super profit for the next 5 years. Calculate the value of goodwill of the business on the basis of an annuity of super profit, taking the present value of annuity of ₹1 for 5 years @ 10% interest at ₹3.78.

    [**Ans:** Goodwill: ₹60,480]

12. From the following particulars, compute the value of goodwill as per annuity method:

    (a) Capital employed: ₹15,00,000

    (b) Normal rate of return: 10%

    (c) Present value of ₹1 for 5 years at 10%: ₹3.78

    (d) Normal profit for 5 years:

    2005: ₹1,50,000; 2006; ₹1,60,000; 2007: ₹1,70,000; 2008: ₹1,80,000; 2009: ₹1,90,000

    Non-recurring income: ₹8,000

    Non-recurring expenses: ₹5,000

    [**Ans:** Goodwill: ₹64,260]

    [Model: Super profit method—all the three (Comprehensive)]

13. The following particular are available in respect of a business carried on by a trader:

    (a) Profit earned:

    2007: ₹2,00,000; 2008: ₹2,40,000; 2009: ₹2,20,000

    (b) Normal rate of profit: 10%

    (c) Capital employed: ₹12,00,000

    (d) Present value of an annuity of ₹1 for 5 years at 10%: ₹3.78

    (e) The profit included non-recurring profit on an average basis of ₹16,000, out of which it was deemed that non-recurring profits had a tendency of appearing at the rate of ₹4,000 p.a.

    You are required to calculate goodwill:

    (i) As per 5 year's purchase of super profit

    (ii) As per capitalization of super profit method

    (iii) As per annuity method

    [**Ans:** (i) ₹4,40,000; (ii) ₹8,80,000; (iii) ₹3,32,640]

    [Model: Capitalization method]

14. Mr. Thomas runs a textile business. His net assets as on 31 March 2010 amounted to ₹40,00,000. After paying a rent of ₹90,000 a year and a salary of ₹60,000 to the manager, he earns a profit of ₹4,20,000. His landlord, who happens to be an expert in textile business, is very much interested in purchasing the business. 8% is considered to be a reasonable return on capital employed. What can Mr. Thomas expect as payment for goodwill?

    [**Ans:** Goodwill: ₹23,75,000]

15. The balance sheet of Good Luck Co. Ltd. discloses the following financial position as on 31 March 2010:

Liabilities	₹	Assets	₹
Paid-up Capital:		Goodwill At Cost	45,000
45,000 Shares of ₹ 10 Each Fully Paid	4,50,000	Land & Building At Cost (Less Depreciation)	2,62,500
Capital Reserve	90,000	Plant & Machinery at Cost (Less Depreciation)	1,35,000
Sundry Creditors	1,06,500		
Provision for Taxation	82,500	Stock At Cost	1,72,500
P&l A/c	39000	Book Debits	
		1,47,000	
		Less: Prov. for Bad Debts 4,500	1,42,500
		Cash At Bank	10,500
	7,68,000		7,68,000

You are required to value the goodwill of the company with the additional information as following:

(a) Adequate provision has been made for income tax and depreciation
(b) Rate of income tax at 50%
(c) The average rate of dividend declared by the company for the past 5 year was 15%
(d) The reasonable rate of return on capital invested was 12%

[**Ans:** Goodwill; ₹ 1,53,500]

[Valuation of shares: Model: Net assets or intrinsic value method (Preference shares having no priority]

16. From the following balance sheet, you are required to value the equity shares:

Liabilities	₹	Assets	₹
5,000 6% Preference Shares of ₹ 100 Each	5,00,000	Assets at Book Value	15,00,000
75,000 Equity Shares of ₹ 10 Each	7,50,000		
Current Liabilities	2,50,000		
	15,00,000		15,00,000

The market value of 50% of the assets is considered at 10% more than the book values and that remaining 50% at 5% less than the book values. There was a liability of ₹ 12,500, which remained unrecorded. Assume preference shares have no priority as to the repayment of capital or dividend.

[**Ans:** Value of each equity share: ₹ 10.33]

[Model: Two classes of shares]

17. VRS Ltd. started its business on 1 April 2007. On 31 March 2010, its balance sheet in a summarized from was as follows:

Liabilities	₹	Assets	₹
Share Capital	3,00,000	Fixed Assets (Less Depreciation)	9,00,000
3,000, 10% Preference Shares of ₹ 100 Each, Fully Paid		Current Assets	12,00,000
		Preliminary Expenses	15,000
90,000 Equity Shares of ₹ 10 Each Fully Paid	9,00,000		
Capital Reserve	7,500		
P&L A/c	1,65,000		
13% Debentures	1,50,000		
Sundry Creditors	5,40,000		
Provision for Income Tax	51,500		
	21,15,000		21,15,000

The company is yet to declare its main dividend on 31 March 2010. The fixed assets are revalued at ₹ 9,60,000. You are required to calculate the value of two classes of shares.

[**Ans:** Value of one preference share: ₹ 100; Value of one equity share: ₹ 12.42]

[Model: Intrinsic value method with goodwill]

18. From the following information, you are required to compute the value of each share:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
1,00,000 Equity Shares of ₹ 10 Each	10,00,000	Goodwill	9,50,000
		Investment	15,00,000
Reserves & Surplus:	12,50,000	Current Assets; Loans & Advances	2,50,000
P&L A/c	1,50,000		
Unsecured Loans	4,00,000	Current Assets	2,50,000

Current Liabilities	1,00,000	Loans & Advances	1,50,000
		Miscellaneous Expenditure	50,000
	29,00,000		29,00,000

For the valuation of shares, goodwill shall be taken at 2 years' purchase of the average profit of the last 5 years. The profits for the last 5 years were: ₹ 3,00,000; ₹ 3,50,000; ₹ 2,00,000; ₹ 2,50,000 and ₹ 2,50,000.

[**Ans:** Goodwill: ₹ 5,40,000; Value of each share: ₹ 19.40]

[Model: Goodwill value remains the same]

19. From the following balance sheet of ABC Ltd as on 31 March 2007, calculate the value per equity share under asset backing material:

Liabilities	₹	**Assets**	₹
Share Capital:		Goodwill	3,00,000
9,000, 6% Preference Shares of ₹ 100 Each	9,00,000	Land & Buildings	1,50,000
		Plant & Machinery	3,75,000
1,50,000 Equity Shares of ₹ 1 Each	1,50,000	Furniture	1,20,000
		Investment in Govt Securities	1,50,000
Capital Reserve	30,000	Stock	1,50,000
General Reserve	75,000	Debtors	1,35,000
P&L A/c	75,000	Cash at Bank	60,000
5% Debentures	1,50,000	Preliminary Expenses	30,000
Sundry Creditors	60,000		
Provisions for Taxation	30,000		
	14,70,000		14,70,000

Preference dividend are in arrears for 3 years. There is a disputed liability of ₹ 15,000 not shown in the above balance sheet and ₹ 12,000 is likely to materialize. There is also liability of ₹ 3,000 which remains unrecorded. Goodwill is worth the same figure and 5% debtors are considered doubtful.

[**Ans:** Intrinsic value per equity share ₹ 0.775]

[Model: Yield method]

20. Mrs. Laxmi holds 20,000 equity shares in Excellent Ltd. The paid-up capital is 1,20,000 equity shares of ₹ 1 each. It is ascertained that:
    (a) The normal net profit of the company is ₹ 20,000
    (b) The normal return for the type of business carried out by the company is 8%

    Mrs. Laxmi requests you to value her shares based on the above figures.

    [**Ans:** Yield value per equity share: ₹ 2.08 Mrs. Laxmi's holding: ₹ 41,600]

21. Nirula & Co. Ltd has 10,000 equity shares of ₹ 10 each, ₹ 8 paid and 1,00,000 6% preference shares of ₹ 10 each fully paid. The company has a practice of transferring 20% of the profit to general reserve every year. If the expected profit (based on past year's performance) before tax is ₹ 2,00,000 and the rate of tax is 50%, you are required to calculate the value of equity share assuming that normal rate of dividend is 20%. [Madras University]

    [**Ans:** Value of each equity share: ₹ 10]

    [Model: Yield method—Majority and minority holdings]

22. From the following particulars, calculate the value of equity shares from the viewpoint of (i) majority holdings and (ii) minority holdings
    (a) Share capital: 1,20,000 equity shares of ₹ 10 each fully paid
    (b) Profits (after deduction of tax) for the last 3 years: ₹ 2,70,000; ₹ 3,60,000 and ₹ 3,42,000
    (c) Dividend paid for the last 3 years: 12%; 17% and 16%
    (d) Normal rate of return: 12%

    [**Ans:** Value of each equity share:
    (i) Majority holdings: ₹ 22.50
    (ii) Minority holdings: ₹ 12.50]

    [Model: Comprehensive—all methods]

23. The following particulars are available relating to a company:
    (a) Capital 9,000, 6% preference shares of ₹ 100 each fully paid; 90,000 equity shares of ₹ 10 each fully paid
    (b) External liabilities: ₹ 1,50,000
    (c) Reserves & Surplus: ₹ 70,000
    (d) The average profit (after taxation) earned every year by the company: ₹ 1,70,000
    (e) The normal profit earned on the market value of equity shares fully paid by the same type of companies; 9%

(f) 10% of the profits after tax every year is transferred to reserves

Calculate the fair value of share assuming that out of the total assets, ₹7,000 are fictitious.

[**Ans:** Intrinsic value: ₹10.70; Yield value: ₹12.22; Fair value: ₹11.46]

24. On 31 March 2010, the balance sheet of a limited company disclosed the following position:

Liabilities	₹	Assets	₹
Issued Capital in ₹10 Shares	20,00,000	Fixed Assets	25,00,000
Reserves	4,50,000	Current Assets	10,00,000
P&L A/c	1,00,000	Goodwill	2,00,000
5% Debentures	5,00,000		
Current Liabilities	6,50,000		
	37,00,000		37,00,000

On 31 March 2010, the fixed assets were independently valued at ₹17,50,000 and the goodwill at ₹2,50,000.

The net profits for the three years were ₹2,58,000; ₹2,60,000 and ₹2,58,250, of which 20% was placed to reserve, the proportion being considered reasonable in the industry in which the company is engaged and where a fair investment return may be taken at 10%.

Compute the fair value of each share.

[**Ans:**

(i) Value of share (Net assets method): ₹9.25

(ii) Value of share (Yield method): ₹10.35

(iii) Fair value of each share; ₹9.80]

25. The balance sheet of Krishan Ltd as on 31 March 2010 was as follows:

Liabilities	₹	Assets	₹
8,000 Equity Shares of ₹100 Each	8,00,000	Land & Buildings	5,00,000
		Machinery	3,00,000
General Reserve	2,00,000	Investment at Cost (Market Value ₹1,50,000)	1,80,000
P&L A/c	1,00,000		
Creditors	1,80,000		
Provision for Taxation	80,000	Debtors	2,00,000
		Stock	1,50,000
Provident Fund	70,000	Cash at Bank	1,00,000
	14,30,000		14,30,000

Additional information:

(a) Land & Buildings and Machinery are valued at ₹5,50,000 & ₹2,20,000, respectively.

(b) Of the total debtors, ₹10,000 are bad.

(c) Goodwill is to be taken at ₹1,00,000.

(d) The normal rate of dividend, declared by such type of companies, is 15% on the paid-up capital.

(e) The average rate of dividend, declared and paid by this company, is 18% on its paid-up capital.

You are required to calculate the fair value of the equity share.

[**Ans:**

(i) Intrinsic value per share; ₹141.25

(ii) Yield value per share: ₹120.00

(iii) Fair value per share: ₹130.625

Exercises

Part B—For Advanced Level

Valuation of Goodwill

26. The net profits of a company after providing for taxation for the past 5 years are 2006: ₹37 lakh; 2007: ₹42 lakh; 2008: ₹44 lakh; 2009: ₹47 lakh and 2010: ₹50 lakh.

The capital employed in the business is ₹4 crore, on which a reasonable rate of return of 10% is expected. It is expected that the company will be able to maintain its super profits for the next 5 years.

(i) Calculate the value of the goodwill of the business on the basis of an annuity of super profits, taking the present value of ₹1 for the 5 years at 10% interest as ₹3.78.

(ii) How would your answer differ if the goodwill is valued by capitalizing the excess of the annual profits over the reasonable return on capital employed on the basis of the same return of 10%?

[C.S. Modified; C.A. Modified]

[**Ans:** (i) ₹ 15,12,000; (ii) ₹ 40,00,000]

27. The following particulars are available in respect of the business carried on by Rukh & Co:

(a) Capital employed ₹ 3,00,000;

(b) Trading Results—2006: Profit ₹ 75,200; 2007: Profit ₹ 91,500; 2008: Loss ₹ 10,000; 2009: Profit ₹ 1,20,500

(c) Market rate of interest on investment 8%

(d) Remuneration from alternative employment of the proprietor (if not engaged in business): ₹ 21,600 p.a.

You are required to compute the value of goodwill on the basis of 3 years' purchase of super profits of the business calculated on the average profits of the last 4 years.

[C.A. (Inter). Modified]

[**Ans:** Goodwill: ₹ 53,100]

28. Ascertain the value of goodwill of Rainbow Ltd. carrying on business from the following:

Balance Sheet as at 31 March 2010

Liabilities	₹	Assets	₹
Paid-up Capital:		Goodwill at Cost	5,00,000
50,000 Shares of ₹ 100 Each Fully Paid	50,00,000	Land & Buildings at Cost	22,00,000
Bank Overdraft	9,60,000	Plant & Machinery at Cost (Less Depreciation)	20,00,000
Sundry Creditors	16,10,000		
Provision for Taxation	8,50,000	Stock-in-trade	30,00,000
Profit & Loss Appropriation Account	12,00,000	Book Debts (Less Provision for Bad Debts	19,20,000
	96,20,000		96,20,000

The company started operations in 2005 with a paid-up capital as aforementioned of ₹ 50,00,000. Profits earned before providing for taxation have been as follows:

Year ended 31 March	₹
2006	12,50,000
2007	13,00,000
2008	17,00,000
2009	20,00,000
2010	17,50,000

Income tax @ 50% has been payable on these profits. Dividends have been distributed from the profit of the first 3 years @ 10% and from those of next 2 years @ 15% of the paid-up capital.

[I.C.W.A. (Final)]

[**Ans:** Goodwill: ₹ 9,66,666.67]

29. The summarized balance sheet of Six Stars Ltd as on 31 December 2009:

Liabilities	₹	Assets	₹
Share Capital: (In Shares of ₹ 100 Each)		Goodwill	2,00,000
6,000, 6% Preference Shares	6,00,000	Freehold Property	15,00,000
26,000 Equity Shares	26,00,000	Plant & Machinery (Less Depreciation)	14,00,000
Profit & Loss A/c	18,00,000	Stock	14,80,000
5% Debentures—2001	12,00,000	Debtors (Net)	15,97,000
Sundry Creditors	9,57,000	Bank Balance	9,80,000
	71,57,000		71,57,000

Profits after tax for 3 years 2007, 2008 and 2009 are after charging debentures interest were ₹ 8,82,000; ₹ 12,90,000 and ₹ 9,60,000, respectively. Mr. Manu is interested in buying all the equity shares and requests you to let him know the proper price. You get the following information:

(a) The normal rate of return is 10% on the net assets attributed.

(b) Goodwill may be calculated at 3 times adjusted average super profits of the 3 years referred to above (Present value of ₹ 1 is ₹ 2.487).

(c) The value of freehold is to be ascertained on the basis of 8% return. The current rental value is ₹ 2,01,600.

(d) Rate of tax applicable is 50%.

(e) 10% of profits for 2008 referred to above arose from a transaction of non-recurring mature.

(f) A provision of ₹ 63,000 on sundry debtors was made in 2009 which is no longer required; profit for the year 2009 is to be adjusted for this item.

(g) A claim of ₹ 33,000 against the company is to be provided and against profit for 2009.

Ascertain the value of goodwill of the company by taking the capital employed as on 31 December 2009.

[I.C.W.A. Modified]

[**Ans:** Goodwill: ₹ 12,63,000]

30. From the following information supplied to you, ascertain the value of goodwill of XYZ Ltd. which is carrying on business as a retail trader, under super profits method:

Balance Sheet as on 31 March 2010

Liabilities	₹	Assets	₹
Paid-up Capital:		Goodwill	2,50,000
25,000 Shares of ₹ 100 Each, Fully Paid	25,00,000	Land & Building at Cost	11,00,000
Bank Overdraft	5,83,000	Plant & Machinery at Cost	10,00,000
Sundry Creditors	9,05,000		
Provision of Taxation	1,95,000	Stock-in-trade	15,00,000
Profit & Loss Appropriation A/c	5,66,500	Book Debts (Less Provision for Bad Debts)	9,00,000
	47,50,000		47,50,000

The company commenced operations in 1990 with a paid-up capital of ₹ 25,00,000. Profits for recent years (after taxation) have been as follows:

Year Ended 31 March	₹
2006	(2,00,000)
2007	4,40,000
2008	5,15,000
2009	5,80,000
2010	6,50,000

The loss in 2005–06 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 50% from 2010–11 onwards. Dividends were distributed at the rate of 10% on the paid-up capital in 2006–07 and 2007–08 at the rate of 15% in 2008–09 and 2009–10. The price of shares is ruling at ₹ 125 at the end of the year ended 31 March 2010. Profits till 2009–10 have been ascertained after debiting ₹ 2,00,000 as remuneration to the managing director. The government has approved a remuneration of ₹ 3,00,000 with effect from 1 April 2010. The company has been able to secure a contract for supply of materials at advantageous prices. The advantage has been valued at ₹ 2,00,000 p.a. for the next 5 years.

[C.A. Modified]

[**Ans:** Goodwill: ₹ 7,42,560]

31. The following is the balance sheet of Good Morning Ltd. as at 31 March 2010:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Equity Shares of ₹ 100 Each	20,00,000	Goodwill	2,00,000
		Machinery	10,00,000
Less: Calls in Arrears (₹ 20 on Final Call)	2,00,000	Factory Shed	11,00,000
		Vehicle	3,00,000
		Furniture	1,00,000
	18,00,000		
10% Preference Shares of ₹ 10 Each Fully Paid	8,00,000	Investments	4,00,000
		Current Assets:	
		Stock in Trade	8,00,000
Reserves & Surplus:		Sundry Debtors	14,00,000
General Reserve	8,00,000	Cash At Bank	2,00,000
Profit & Loss A/c	6,00,000	Miscellaneous Expenditure:	
Current Liabilities:			
Bank Loan	4,00,000	Preliminary Expenses	1,00,000
Sundry Creditors	12,00,000		
	56,00,000		56,00,000

Additional information:

(a) Fixed assets are worth above their book value. Depreciation on approved value of fixed assets is not to be considered for valuation of goodwill.

(b) Of the investment, 60% is non-trading and the balance is trading. All trade investments are to be valued at 25% the above cost. A uniform rate of dividend @ 15% is earned on all investments.

(c) For the purpose of valuation of shares, goodwill is to be considered on the basis of 4 years' purchase of the super profits based on average profit (after tax) of the last 3 years. Profits (after tax) are as follows:

	₹
2007–08	8,00,000
2008–09	8,60,000
2009–10	9,00,000

In a similar business, return on capital employed is 15% (after tax).

(d) In 2007–08, new machinery costing ₹ 40,000 was purchased but wrongly charged to revenue (no effect has been given yet for rectifying the same)

Depreciation on machinery is charged @ 10% on reducing balance method.

Find out the value of each fully paid and partly paid equity share on net assets basis

[C.A. Modified]

[**Ans:**

(i) Value of fully paid-up equity share: ₹ 230.74

(ii) Value of partly paid equity share; ₹ 210.74]

32. The balance sheet of Ever Fine Ltd as at 31 March 2010 is given as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets:	
18,000 Equity Shares of ₹ 100 Each Fully Paid Up	18,00,000	Buildings	4,50,000
		Machinery	6,60,000
Reserves & Surplus: Profit & Loss A/c	1,50,000	Current Assets, Loans & Advances:	
Current Liabilities & Provision:		Stock	9,00,000
		Sundry Debtors	4,80,000
		Bank	1,80,000
Bank Overdraft	30,000		
Creditors	1,80,000		
Provision for Taxation	3,30,000		
Proposed Dividend	1,80,000		
	26,70,000		26,70,000

The net profits of the company, after deducting usual working expenses but before providing for taxation, were as under:

Year	₹
2007–08	6,00,000
2008–09	7,20,000
2009–10	6,60,000

On 31 March 2010, building was revalued at ₹ 6,00,000 and machinery at ₹ 7,50,000, Sundry debtors on the same date included ₹ 30,000 as irrecoverable. Having regard to the nature of the business, a 10% return on net tangible capital invested is considered reasonable.

You are required to calculate the company's share ex-dividend. Valuation of goodwill may be based on 3 years' purchase of annual super profits. Depreciation on building is 2% and machinery 10%. The income tax rate is assumed to be at 50%. All workings should form part of your answer.

[C.A. Modified]

[**Ans:** Value per equity share (ex-dividend): ₹ 134.17]

33. Balance sheet of XY Ltd as on 31 March 2010 was as follows:

Liabilities	₹	**Assets**	₹
Equity Share Capital (₹ 10):		Buildings	8,00,000
₹ 10 Paid Up Per Share	12,00,000	Plant & Machinery	16,00,000
₹ 5 Paid Up Per Share	8,00,000	Sundry Debtors	8,40,000
9% Preference Share Capital (₹ 100)	4,00,000	Stock	10,00,000
Reserve	12,00,000	Cash at Bank	1,60,000
Sundry Creditors	8,00,000		
	44,00,000		44,00,000

Profit and dividend in last several years were as follows:

Year	Profit	Equity Dividend
	₹	%
2007–08	8,80,000	12
2008–09	10,00,000	15
2009–10	12,80,000	18

Land & Buildings are worth ₹16,00,000. Managerial remuneration is likely to go up by ₹80,000 p.a. Income tax may be provided at 50%. Equity shares of companies in the same industry with dividend rate of 10% are quoted at par. Find out the most appropriate value of an equity share assuming that: (a) Controlling interest is to be transferred and (b) only a few shares are to be transferred. Ignore goodwill value, depreciation adjustment for revaluation and the need of transfer to general reserve.

[C.A. Modified]

[**Ans**: (a) Valuation of equity shares when controlling interest is to be transferred:

(i) Capitalization of future maintainable profit—Value of fully paid-up equity shares: ₹20.14; Partly paid-up share: ₹15.14

(ii) On net assets—Value of fully paid-up share: ₹17.14; Partly paid-up share: ₹12.14.

(b) Valuation of equity shares when only a few shares are to be transferred: Value of fully paid-up equity share: ₹15]

34. The following details are available in respect of LM Ltd

	(₹ in lakhs)
PBIT for the year ended 31 December 2009	40.00
13% Secured loans as on 31 December2009	20.00
12% Preference shares of ₹100 each fully paid as on 31 December 2009	20.00
20,000 Equity shares of ₹100 each ₹80 paid-up as on 31 December 2009	16.00
80,000 Equity shares of ₹100 each fully paid as on 31 December 2009	80.00
Reserves and surplus as on 1 January 2009	20.00
Preliminary expenses as on 31 December 2009.	15.830

Other information:

(i) Corporate tax rate: 35%

(ii) Dividend distribution tax: 10%

(iii) Ignore surcharge

(iv) Transfer to general reserve: 20% of PAT

(v) Normal dividend rate in the same industry: 12.5%

(vi) Dividend declared @ 15% on paid-up equity capital

(vii) Market rate of EPS: ₹20 per share of ₹100

You are required to compute the value of different classes of equity shares on the basis of:

(a) Asset backing method

(b) Dividend yield method

(c) Earning yield method

[Working required: (i) balance of P&L A/c as on 31 December 2009 & (ii) earning percentage]

[I.C.W.A. Modified]

[**Ans:** Balance of P&L A/c: ₹0.968 lakh; Earnings percentage: 22.57%

	Value of Shares	Fully Paid Share	Partly Paid Share
		₹	₹
(a)	Asset backing method	110	90
(b)	Dividend yield method	100	80
(c)	Earning yield method	112.85	90.28

35. The balance sheet of ABC Ltd. as at 31 March 2010 was as follows:

Liabilities	Amount ₹ in lakhs	Assets	Amount ₹ in lakhs
Subscribed & Paid-up Capital		Goodwill at Cost	4.00

—50,000, 10% Cumulative Preference Shares of ₹ 10 each	5.00	Freehold Land & Building at Cost	5.00
		Plant at Cost	15.00
1,00,000 Equity Share of ₹ 10 Each	10.00	Investment at Cost (Market Value ₹ 2.5 L)	1.50
Profit & Loss A/c	7.50	Stock at Cost	6.00
Bank Overdraft	12.50	Debtors	4.00
Current Liabilities	1.50	Bank Balance	1.00
	36.50		36.50

(a) Net profit for 2008, 2009 and 2010 amounted to ₹ 1,90,000, ₹ 4,25,000 and ₹ 5,00,000, respectively after write-off goodwill each year by ₹ 50,000.

(b) Company paid dividend on preference shares each year and on equity shares at 10% in 2009 only which have been deducted in arriving at the figures stated under (a) above. Preference shares have no participating rights.

(c) Recent valuation of land and building & plant amounted to ₹ 5 lakh and ₹ 20 lakh, respectively. Depreciation per annum on buildings and plant will increase by ₹ 2,75,000 in future years.

(d) Worthless stocks, included above, which are carried forward since 2004 as it is, amounted to ₹ 4,50,000. Estimated realizable value therefore is ₹ 50,000.

What value would you place on equity share based on (i) Net assets (excluding realizable goodwill) and (ii) Capitalised value of maintainable profits which is agreed to be the weighted average net profits (weightage being 1, 2 & 3) of past three years, capitalization rate being 8½%. Confine your result on the data given.

[I.C.W.A. Modified]

[**Ans:** Gross assets excluding goodwill: ₹ 39,50,000; Net assess available to equity shares holders: ₹ 20,50,000; Value of share net assets: ₹ 20.50; Capitalized value of maintainable profit value: ₹ 45.80]

36. Company A wishes to takeover company B. The financial details of the two companies are as follows:

Particulars	**Company A** ₹	**Company B** ₹
Equity Shares (₹ 10 per Share)	5,00,000	2,50,000
Share Premium Account	—	10,000
Profit and Loss Account	1,90,000	20,000
Preference Shares	1,00,000	—
10% Debentures	75,000	25,000
	8,65,000	3,05,000
Fixed Assets	6,10,000	1,75,000
Net Current Assets	2,55,000	1,30,000
	8,65,000	33,05,000
Maintainable Annual Profit (After Tax) for Equity Shareholders	1,20,000	75,000
Market Price for Equity Share	24	27
Price/Earning Ratio	10	9

What offer do you think Company A could make to Company B in terms of exchange ratio, based on (i) net asset value; (ii) earning per share and (iii) market price per share? Which method would you prefer from Company A's point of view?

[C.S. Material]

[**Ans:** Value of share: Net asset value method:

(Company A) ₹ 13.80

Company B: ₹ 11.20.

Exchange Ratio:

(i) Based on net asset value method:

Shareholders of Company B get 0.8116 shares of Company A for every 1 share in Company B

(ii) Based on market price for equity share:

Shareholders of Company B get 1.125 share of Company A for every one share in Company B

(iii) Based on earnings per share: Shareholders of Company B get 1.25 shares of Company A for every one share in Company B

From the view point of Company A, Net assets value method is preferable.]

37. The capital structure of a company is as follows:

	₹
12% Preference shares of ₹10 each	2,50,000
Equity shares of ₹10 each	4,00,000
Reserves & Surplus	2,00,000
10% Debentures	3,00,000
11% Term loan	3,50,000
	15,00,000

The average annual profit before payment of tax and interest is ₹3,00,000. The income tax rate is 45%.

You are required to state what valuation should be put upon the equity shares of the company if the applicable price earnings ratio is 9?

[I.C.W.A. (Final). Modified]

[**Ans:** Earnings per share ₹2.43; Value of equity shares: ₹21.87 if P/E ratio is 9]

38. The following particulars relate to a company:

	₹
Total assets	37,00,000
External liabilities	5,00,000
Share capital:	
14% Preference shares of ₹10 each, fully paid	10,00,000
80,000 Equity shares of ₹10 each, fully paid	8,00,000
1,20,000 Equity shares of ₹10 each, ₹7.50 paid	9,00,000

You are required to calculate the value of each category of equity shares of the company based on a deemed liquidation.

[I.C.W.A. (Final). Modified]

[**Ans:** Value of equity share (fully paid): ₹12.50; Value of equity share (partly paid up): ₹10]

39. Following is the information of two companies for the year ended 31 March 2010:

	Company X	**Company Y**
	₹	₹
Equity shares of ₹10 each	16,00,000	20,00,000
10% Preference shares of ₹10 each	12,00,000	8,00,000
Profit after tax	6,00,000	6,00,000

Assume that the market expectation is 18% and 80% of the profits are distributed.

(i) What is the rate you would pay to the equity shares of each company
   (a) If you are buying a small lot
   (b) If you are buying controlling interested shares

(ii) If you plan to invest only in preference shares, which company's preference shares would you prefer?

[C.A. (Final). Modified]

[**Ans:**	**Company X**	**Company Y**
EPS	3.00	2.60
Dividend per share	2.40	2.08
If small lot is bought value per share	13.33	11.56
If controlling interest is bought: value	16.67	14.44
Preference dividend coverage ratio	5 times	7.5 times]

40. Shiva & Vas Co. Ltd. has an issued, subscribed and paid-up share capital comprising 20,000 equity shares of ₹100 each and 6,000 9% preference shares of ₹100 each. The following information is supplied:

Year Ended 31 March	**Average Net Worth (Excluding Investments)**	**Adjusted Taxed Profits**
	₹	₹
2008	37,20,000	3,80,000
2009	43,00,000	4,20,000
2010	43,80,000	5,00,000

As at the valuation date, the company has investments of the market value of ₹5,60,000 the yield in respect of which has been excluded in arriving at adjusted taxed profit figures.

The company sets apart 25% of taxed profits as rehabita and replacement reserve.

On the valuation date, the net worth (excluding investments) amounts to ₹45,00,000. The

expected rate of return in the market is 9%. The company has consistently maintained dividend levels of 8–10% in the past and is known for its consistency.

You are required to ascertain the value of each equity share on the basis of productivity, applying suitable weighted averages.

[I.C.W.A. (Final). Modified]

[Ans: Weighted average earning: $10\frac{2}{3}$%; Profit: ₹ 3,06,000; Capitalized value of profit: ₹ 3,96,000; Value of each equity share: ₹ 198]

[I.C.W.A. (Final). Modified]

Amalgamation, Absorption and External Reconstruction

9

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Know the various meanings of the terms "amalgamation", "absorption" and "external reconstruction".
2. Understand the difference types of "amalgamation".
3. Understand the vital factors that have significant accounting impact.
4. Know the accounting problems relating to amalgamation and external reconstruction.
5. Understand the term "consideration" as per AS-14.
6. Compute "purchase consideration" by applying any of the four methods: (i) lumpsum method; (ii) net payment method; (iii) net assets method and (iv) intrinsic value method.
7. Record transactions in the books of the purchasing and selling companies.
8. Understand the methods of accounting for amalgamation—(i) pooling of interests method and (ii) the purchase method.
9. Understand the following terms:
   (i) Amalgamation after balance sheet date
   (ii) Dissenting shareholders
   (iii) Entries at par value
   (iv) Inter-company owings
   (v) Unrealized profit in stock
   (vi) Inter-company holdings
10. Pass journal entries in the books of transferor company (selling company) and in the books of transferee company (purchasing company).
11. Know the key terms associated with amalgamation, absorption and external reconstruction.

In the globalization era, the most commonly used term in the corporate sector is "Merger, Acquisition". In simple terms, it is nothing but the joining together of companies. The underlying motive behind such combination of companies is to enhance the resources of capital, to enjoy the fruits of economies of large-scale production, to reduce competition, to increase efficiency and so on. The combination of joint stock companies may take place in the following methods:

1. *Amalgamation*
2. *Absorption*
3. (*External*) *Reconstruction*

In this chapter, each of these ways of combination of companies is explained in detail with a number of illustrations.

9.1 MEANING

There are different meanings in vogue for the terms amalgamation, absorption and external reconstruction.

9.1.1 Common Meaning

Amalgamation: When two or more companies that exist as on date combine together to form a new company, then it is called "amalgamation".

In this case, all the combining companies will get liquidated. A new company will be formed to take over their business.

To illustrate, X Ltd. and Y Ltd., the two existing companies, combine together to form Z Ltd., a new company. X Ltd. and Y Ltd. will get liquidated. A new company Z Ltd. is formed to run the business.

Absorption: When one existing company takes over the business of two or more older existing companies, it is called "absorption". The other two or more existing companies (i.e., companies whose business are taken over) will get liquidated. At the same time, no new company will be floated.

To illustrate, X Ltd., one existing company, takes over other two existing companies Y Ltd. and Z Ltd. Y Ltd. and Z Ltd. will get liquidated. X Ltd. continues to do its business and no new company will be formed. In other words, X Ltd. absorbs the other two companies Y Ltd. and Z Ltd. X Ltd. continues to do its business whereas Y Ltd. and Z Ltd. will be liquidated.

External reconstruction: When an existing company is liquidated and in its place a new company is floated but with the same shareholders, it is known as "external reconstruction". Shareholders will remain unaltered but company's name and structure will be new.

To illustrate, X Ltd. is liquidated. But the existing shareholders continue their status as shareholders and a new company Y Ltd. is formed.

9.1.2 Legal Basis

The Companies Act, 1956 remain silent on this, i.e., the term "amalgamation" has not been defined specifically. However, the Courts have interpreted the term to include amalgamation as well as absorption. In *S. Somayajulu* vs. *Hop Prudhommee and Company Ltd.,* (1963, Com. L.J61), amalgamation has been defined as "a state of things under which either two companies are joined so as to form a third entity or one is absorbed into or blended with another".

According to Halsburg's laws of England, amalgamation is a blending of two or more existing undertakings into one undertaking, the shareholders of each blending company becoming substantially the shareholders of the company which is to carry on the blended undertakings. There may be amalgamation either by transfer of two or more undertakings to a new company or by the transfer of one or more undertakings to an existing company.

Sections 390 to 396(A) of the Companies Act envisage certain provisions relating to amalgamation. Accordingly, any scheme of amalgamation necessitates the approval of the Court. The Court wields enormous powers on this matter.

Section 494 of the Companies Act facilitates amalgamation, absorption and reconstruction of a company. It provides that the liquidator of a company can accept shares, policies or other like interests in the transferee company for distribution among the members of the transferor company, provided, the following two conditions are satisfied:

(i) A special resolution is passed by the Company to the effect

(ii) The liquidator purchases the interest of any dissenting member at a price to be determined by agreement or by arbitration

9.1.3 Accounting Basis

Accounting for amalgamation: Standard AS-14, issued by the Institute of Chartered Accountants of India, deals with the accounting for amalgamation and the treatment of any resultant goodwill or reserves. This standard was issued in 1994. This is mandatory to all companies with effect from the accounting year commencing on or after 1 April 1995.

According to AS-14, amalgamation means an amalgamation pursuant to the provisions of the Companies Act 1956, or any other statute which may be applicable to companies.

The Standard uses the term "transferor company" for the company which is amalgamated into another company.

The Company selling its business is also called "vendor company".

The Company into which a transferor company is amalgamated is called "transferee company".

The Company which acquires the business is also called the "vendee company".

It is important to note that:

(i) The term amalgamation includes "absorption" also

(ii) The term amalgamation does not apply to acquisitions in the nature of controlling interest (Because in such cases, the acquired company will not be dissolved and its separate entity will continue to exist).

9.2 TYPES OF AMALGAMATION

The Standard AS-14 classifies amalgamation into two categories:

1. Amalgamation in the nature of merger
2. Amalgamation in the nature of purchase

9.2.1 Amalgamation in the Nature of Merger

Amalgamation should be considered to be an amalgamation in the nature of merger if the following conditions are satisfied:

1. All the assets and liabilities of the transferor company become the assets and liabilities of the transferee company after amalgamation.
2. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than equity shares already held therein, immediately before the amalgamation of the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of an amalgamation.
3. The consideration to the shareholders of the transferor company (willing to become equity shareholders of the transferee company) is discharged by the transferee company wholly by issue of equity shares in the transferee company except that cash may be paid in respect of any fractional shares.
4. The business of the transferee company is intended to be carried on after amalgamation by the transferee company.
5. No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

9.2.2 Amalgamation in the Nature of Purchase

The amalgamation is in the nature of purchase, if any one or more of the conditions stipulated for the merger are not satisfied.

Hence, in the amalgamation in the nature of purchase:

1. Selling company's business will not be carried on in future
2. Shareholders holding 90% of the transferor company will not become shareholders of the transferee company
3. All the assets and liabilities of the selling company will not be taken over by the transferee company
4. Consideration payable to shareholders of transferor company may be in the form of shares or cash or in any other agreed form
5. Assets and liabilities taken over by the transferee company may be shown at values other than book values at the discretion of the transferee company

Note: Transferor company is the "selling company" and transferee company is the "purchasing company".

The Accounting Standard, for the purpose of accounting, recommends the "pooling of interests method" in the case of "amalgamation in the nature of merger" and the "purchase method" for "amalgamation in the nature of purchase". These methods will be discussed in detail later.

9.3 ACCOUNTING TREATMENT AS PER AS–14

Notwithstanding the fact that amalgamation, absorption and external reconstruction differ in many aspects, all have some common accounting problems.

They are as follows:

(i) In all the cases, the transferor company and the transferee company must first agree the purchase consideration, i.e., the purchase price that should be acceptable by both parties

(ii) In all the cases, accounting entries have to be passed in the books of companies that will be liquidated in order to close the accounting books.

(iii) In all the cases, accounting entries have to be passed in the books of the transferee (purchasing) company to record the transactions pertaining to acquisition of business.

(iv) In all the cases, if the amalgamation is in the nature of merger "pooling of interest" method has to be adopted and if it is in the nature of purchase "purchase method" has to be adopted.

Before trying to solve problems relating to amalgamation, one has to understand some of the important terms associated with amalgamation, absorption and external reconstruction. They are discussed as follows:

Taking over the business: This term refers to take over of all the assets and liabilities of the business entity.

All assets: This term comprises fixed assets, current assets, goodwill, prepaid expenses, cash (in hand and at bank). But this term does not include fictitious assets shown on the assets side of the balance sheet under the heading "Miscellaneous Expenditure".

Example: Preliminary expenses, profit and loss account (debit balance), discount on the issue of shares or debentures.

Trade liabilities: Example: Creditors, bills payable—They are to be grouped under liabilities.

Liabilities: This term is used to refer all liabilities to *third* parties. First party is the company and second party is the shareholders. Liabilities include the following:

1. Creditors
2. Trade creditors
3. Bills payable
4. Bank overdraft
5. Loans

6. Outstanding expenses
7. Unclaimed dividends
8. Provision for taxation
9. Provision for gratuity
10. Pension fund
11. Provident fund
12. Superannuation fund
13. Workmen savings bank accounts (Deposit)
14. Workmen profit sharing fund
15. Workmen compensation
16. Debentures
17. Employees' deposit
18. Public deposits
19. Creditors for expenses

Provisions: Provisions for certain items may be shown separate item on the liabilities side of the balance sheet. But mostly, provisions are shown as deduction from respective assets on the assets side of the balance sheet. Both the assets and the provision on the assets are to be transferred to realization account. **Example**: Provision for depreciation, provision for doubtful debts, provision for repairs and renewals, investment fluctuation fund.

Accumulated profits and losses: Undistributed profits of both revenue and capital nature are shown on the liabilities side of the balance sheet. Accumulated losses appear on the assets side of the balance sheet.

The purchasing company (transferee company) is neither entitled to accumulated profit nor accumulated loss. They belong to the equity shareholders of the transferor company (selling or vendor company). They should be transferred to the equity shareholders. Accumulated profits would be credited and accumulated losses would be debited to that account.

Accumulated profits include the following:

1. Profit and loss A/c—credit balance
2. General reserve
3. Capital reserve
4. Capital redemption reserve
5. Dividend equalization reserve
6. Sinking fund
7. Development rebate reserve
8. Investment allowance reserve
9. Securities premium
10. Share forfeited account
11. Fund—some items only, e.g., insurance fund
12. Revaluation reserve
13. Export profit reserve
14. Project export reserve
15. Contingency reserve

Accumulated losses include the following items:

1. Profit & loss A/c (Debit balance)
2. Preliminary expenses
3. Discount on issue of shares and debentures
4. Deferred revenue expenditure
5. Underwriting commission
6. Fictitious assets

Fund: Fund items may belong to any category— assets or liabilities, depending on its nature.

1. Fully accumulated profits category:
   (i) Sinking fund
   (ii) Insurance fund
   (iii) Dividend equalization fund
   (iv) Debenture redemption fund
2. Purely liabilities category:
   (i) Employee's provident fund
   (ii) Employee's profit sharing fund
   (iii) Employee's pension fund
   (iv) Employee's superannuation fund
3. Partly profit and partly liability funds:
   (i) Employees compensation fund
   (ii) Contingency fund
   (iii) Employee insurance fund

If there is any balance in the workmen compensation fund, insurance fund and accident fund (after completely meeting out the liability), it should be transferred to equity shareholders account.

Important note:

1. In case, when some of the assets are not taken over, they are not to be included in take over even if the term "business" is given in the question.
2. In case, if any liability is not taken over, it will not form part of net assets method.

Now, we will discuss the first stage: purchase consideration.

9.3.1 Purchase Consideration

In general, "purchase consideration" means the cash and non-cash payments made to the shareholders of the transferor (vendor) company. Accounting Standard AS-14, issued by the ICA1, defines the term consideration as, "Consideration for the amalgamation means the aggregate of shares and other securities issued and the payment made in the form of cash and other assets by the transferee company to the shareholders of the transferor company".

9.3.1.1 Salient Features of "Purchase Consideration"

The following are the salient features of purchase consideration:

1. Purchase consideration is confined to payments (cash and non-cash) to the shareholders of the transferor company (Selling company).
2. This amount payable has to be made by the transferee company which is to be treated as consideration for the acquisition of business.

3. Any amount paid to debenture holders, creditors and cost of absorption should not be included in purchase consideration.
4. Non-cash elements of purchase consideration should be determined at the fair value.
5. AS-14 recognizes the consideration payable to equity as well as preference shareholders of the transferor company.

9.3.1.2 Computation of Purchase Consideration

The following are the different methods of computing purchase consideration:

1. Lumpsum method
2. Net payments method
3. Net assets method
4. Ratio of exchange method

It is to be noted that as per AS-14, purchase consideration means only payment made to shareholders, irrespective of the method applied to compute purchase consideration.

9.3.1.2.1 Lumpsum Method

At times, the purchase consideration is mentioned (as a lump sum) straightaway in the agreement. In such a case, no necessity arises to compute purchase consideration.

9.3.1.2.2 Net Payment Method

Only those agreed payments specified in the agreement have to be added to determine the purchase consideration. That means, the quantum of amount payable in cash or shares or debentures are all to be added. The aggregate of the amount is referred to as "net payment" made by the purchasing company. It has to be paid to shareholders of the selling company.

Some of the important factors to be observed while determining the purchase consideration are as follows:

1. Only the agreed amount specified in the agreement should be included in the consideration.
2. In general, purchase consideration will not include payments to debenture holders and creditors. For this, a separate adjustment has to be made: such liabilities should be transferred to the books of the transferee company and then payment of liabilities should be shown in the books of the transferee company.
3. Liquidation expenses of the transferor company are met by the transferee company. Accountants differ in the treatment of liquidation expenses. If they are payable by the purchasing company, it is to be added to purchase consideration. But some accountants exclude the liquidation expenses in determining purchase consideration.
4. Shares issued by the transferee company should be valued at market price if the "purchase method" is adopted and at par value (fully paid only) if "the pooling of interests" method is adopted.

Illustration 9.1

Model: Net payment method

X Ltd. agreed to take over the business of Y Ltd. on the following terms:

1. The shareholders of Y Ltd. are to be paid ₹ 20 in cash and the offer of five shares of ₹ 10 each in X Ltd. for every share of Y Ltd. Y Ltd. had 60,000 equity shares outstanding
2. The debenture holders holding 10,000 debentures of ₹ 100 each are to be redeemed at a premium of 20%

3. Costs of liquidation amounting to ₹ 40,000 are to be borne by X Ltd.

Compute the purchase consideration.

Solution

Note:

1. Debenture holders payment will be excluded.
2. Payment in cash and in shares have to be added.
3. Liquidation expenses are to be included, as they are to be borne by X Ltd.

Computation of Purchase Consideration (Under Net Payment Method)

		₹
Step 1:	Cash Payment 60,000 Equity Shares × ₹ 20 (Outstanding) (Given)	12,00,000
Step 2:	Payment by Shares Shares Issued 5 Shares for 1 Share ∴Total Shares = 5 × 60,000 = 3,00,000 Total Amount = 3,00,000 × ₹ 10	30,00,000
Step 3:	Cash Payment for Liquidation Expenses:	40,000
Step 4:	Purchase Consideration (Step 1 + Step 2 + Step 3):	42,40,000

9.3.1.2.3 Net Assets Method

This method will be used if the "net payment method" cannot be used. When payment made is not crystal clear for various items, this method can be used. That means, if some form of cash payment is missing in the problem, this method can be adopted.

Under this method, purchase consideration is to be determined by adding the agreed values of assets taken over and deducting the agreed value of liabilities. This can be put in the form of equation as:

Sum of value of net assets = Agreed value of assets taken over – Sum of agreed value of liabilities taken over

Some of the important factors to be observed while determining purchase consideration under this method are:

1. The term "Assets" includes cash and bank balances.
2. The term "Assets" excludes items such as preliminary expenses, profit & loss A/c (Dr.), discount on issue of shares.
3. Items shown on the assets side of balance sheet under the head "Miscellaneous Expenditure" should not be included in the category of assets.
4. Any other asset specially mentioned as "not taken over" should not be included.
5. Similarly, liabilities not taken over should not be included.
6. All credit balances should be excluded.
7. Items shown on the liabilities side of the balance sheet under the head "Reserves & Surplus" should not be included.
8. Accumulated profits are not liabilities. They should be excluded.
9. Liabilities included are amounts to third parties.
10. Any "fund"—for example, workmen's savings, profit sharing fund, PF—should be included under liabilities category.
11. "Trade creditors" comprises only creditors and bills payable. All other liabilities such as tax payable overdraft, any outstanding expenses are not a form of liability.

Illustration 9.2

Model: Net assets method

The following is the balance sheet of Maa Ltd. as on 31 March 2011:

Liabilities	₹	Assets	₹
5,000 Equity Shares of ₹ 100 Each Fully Paid	5,00,000	Fixed Assets	10,00,000
		Investments	2,00,000
General Reserve	7,00,000	Current Assets	3,00,000
Profit & Loss Account	1,50,000	Preliminary Expenses	1,80,000
Trade Creditors	2,00,000	Share Issue Expenses	1,20,000
Provision for Taxation	1,50,000		
Proposed Dividends	1,00,000		
	18,00,000		18,00,000

On the date of balance sheet, the company was taken over by Pappa Ltd. on the following terms:

(a) Fixed assets are revalued at ₹ 12,00,000

(b) Investments have a market value of ₹ 1,50,000

(c) Current assets are agreed at ₹ 3,50,000 for the purpose of absorption

(d) Pappa Ltd. has agreed to pay the tax liability, which is estimated at ₹ 1,75,000

(e) Dividends are to be paid before absorption by Maa Ltd.

Compute the purchase consideration.

Solution

		₹	₹
Step 1 :	Assets Taken Over by Pappa Ltd.:		
	(i) Fixed Assets (Ref: Terms):		12,00,000
	(ii) Investments (Ref: Terms):		1,50,000
	(iii) Current Assets:	3,50,000	
	Less: Dividend Paid:	1,00,000	2,50,000
Step 2 :	Add [(i) + (ii) + (iii)]:		16,00,000
Step 3 :	Liabilities Taken Over:		
	(i) Trade Creditors	2,00,000	
	(ii) Tax Liability	1,75,000	
Step 4 :	Add [(i) + (ii)]	3,75,000	3,75,000
Step 5 :	(Step 2 – Step 4) Purchase Consideration}:		12,25,000

Purchase Consideration payable to the Shareholders of Maa Ltd. = ₹ 12,25,000.

This amount, i.e., ₹ 12,25,000, may be paid by Pappa Ltd. either in the form of cash or shares or debentures or in the combined form of cash and securities.

Note: As dividends are to be paid before absorption, the proposed dividend has to be deducted from current assets. It may also be shown as a liability to be deducted combined with other liabilities, if it is agreed to be taken over by Pappa Ltd.

9.3.1.2.4 Share Exchange Method (or) Intrinsic Value Method

Under this method, the purchase consideration is determined on the basis of the ratio in which the shares of the transferee company are exchanged with those of the transferor company. The ratio of exchange is to be

decided on the basis of intrinsic or market value of the shares concerned. To illustrate, X Ltd. merged with Y Ltd. and allotted 7 shares for every 25 shares held by shareholders of X Ltd. If a shareholder holds 500 shares in X Ltd., he receives in exchange 140 shares in Y Ltd. $\left(\text{i.e., } \frac{500}{25} \times 7 = 140 \text{ shares}\right)$.

Intrinsic value is determined by using the formula:

$$\text{Intrinsic value} = \frac{\text{Assets Available for Equity Shareholder}}{\text{Number of Equity Shares}}$$

Then purchase consideration is determined by using the formula:

Purchase consideration = Number of shares issued to the shareholders of the transferor company × Intrinsic value of the shares of the transferee company

At this juncture, one has to understand how fractional shares will have to be treated. Take the case illustrated in the share exchange method above. One Mr. Khan holds 60 shares in X Ltd. He is entitled to have $\frac{60}{25} \times 7 = 16.8$ shares. As shares will have to be issued in whole numbers only, 16 shares can be issued to him. Mr. Khan will have to be compensated in cash for 0.8 share. It is based on market price. The transferee company sells such shares at the market price and remits the proceeds to the shareholders of the transferor company.

Illustration 9.3

Model: Intrinsic value method & treatment of fractional shares

A Ltd. takes over B Ltd. in pursuance of the scheme of amalgamation and it was agreed that the shareholders of B Ltd. must be issued shares in A Ltd. and the exchange is to be determined on the basis of intrinsic values of the shares of the two companies concerned. The capital of B Ltd. comprises 75,000 equity shares of ₹ 10 each. The intrinsic values were: A Ltd.: ₹ 80 and B Ltd.: ₹ 50. In allotment, fractional shares are aggregate to 375. The market value of A Ltd. was ₹ 90. You are required to compute the purchase consideration payable to B Ltd.

Solution

Step 1: Determine the Ratio of Exchange:

- It Is Based in Intrinsic Value of Shares as per the Direction Given in the Question.
- Intrinsic Value of Shares Ratio A:B = ₹ 80:₹ 50, i.e., 8:5
- Hence, the Ratio of Exchange Will be for Every 8 Shares of B, 5 Shares of A Ltd.

Step 2: Determine the Number of Shares to Be Issued by

A Ltd. = $\frac{75{,}000}{8} \times 5 = 46{,}875$ Shares

Step 3: Actual Number of Shares to Be Issued Is Determined by Deducting Fractional Shares, i.e., 46,875 – 375 = 46,500 Shares.

Step 4: Determination of Purchase Consideration:

(i) Number of Shares to Be Issued × Intrinsic Value		
46,500 × ₹ 80	=	₹ 37,20,000
(ii) Add: Fractional Shares 375 × ₹ 80	=	₹ 30,000
Total:		₹ 37,50,000

But, according to established accounting procedure, 375 shares representing fractional shares will have to be sold at market price. In this question, market price per share as given as ₹ 90. Then the total amount

for fractional shares will be 375 × ₹90 = ₹33,750. This amount, ₹33,750, will be remitted to individual shareholders. The shareholder will get his amount as per the fraction of the share he is entitled to. To illustrate, if one Mr. X will be getting for his fractional share, say 0.6, 0.6 × ₹90 = ₹54, and if the other one, Y for his fractional share 0.3 will be getting 0.3 × ₹90 = ₹27 and so on. However, the total amount so remitted for fractional shares will be equal to ₹33,750.

Some more illustrations on computation of purchase consideration are given in the following:

Illustration 9.4

Model: Purchase consideration—Net assets method

The balance sheet of ABC Ltd. as at 31 March 2011 is as follows:

Liabilities	₹	Assets	₹
Equity Share Capital	5,00,000	Building	2,00,000
10% Preference Share Capital	1,50,000	Plant & Machinery	3,00,000
12% Debentures	1,00,000	Furniture	70,000
Reserve Fund	40,000	Investment (MV ₹80,000)	90,000
Securities Premium	30,000	Stock	75,000
Profit & Loss A/c	10,000	Debtors	2,80,000
Workmen Compensation Fund	45,000	Bills Receivable	25,000
Bills Payable	25,000	Cash in Hand	15,000
Creditors	1,70,000	Cash at Bank	85,000
Provident Fund	80,000	Goodwill	20,000
Provision for Tax	20,000	Preliminary Expenses	10,000
	11,70,000		11,70,000

XYZ Ltd. intends to take over the business on the following terms and valuation:

(i) Building at ₹1,70,000; plant & machinery at ₹2,50,000; furniture at ₹15,000; stock at ₹1,00,000; debtors subject to a provision of 10% for doubtful debts; goodwill found to be nil

(ii) There was a liability of ₹15,000 against workmen compensation fund

(iii) Actual tax liability is ₹25,000

(iv) Realization expenses estimated at ₹10,000 to be borne by XYZ Ltd.

(v) Preference shareholders are to be paid in cash

(vi) Balance to be paid in equity shares of XYZ Ltd. of ₹10 shares

Solution

Computation of Purchase Consideration:

Step 1: Assets Taken Over (At Agreed Value)		₹	₹
(i) Building (At Agreed Value)		1,70,000	
(ii) Plant & Machinery (At Agreed Value)		2,50,000	
(iii) Furniture (At Agreed Value)		15,000	
(iv) Stock (At Agreed Value)		1,00,000	
(v) Debtors:	₹2,80,000		
Less: Provision @ 10%	₹28,000	2,52,000	

	(vi) Investments (At Market Value)	80,000	
	(vii) Bills Receivable (As in B/S)	25,000	
	(viii) Cash in Hand (As in B/S)	15,000	
	(ix) Cash at Bank (As in B/S)	85,000	
Step 2:	Add (i) to (ix)		9,92,000
Step 3:	Liabilities Taken Over:		
	(i) Creditors (As Shown in B/S)	1,70,000	
	(ii) Bills Payable (As Shown in B/S)	25,000	
	(iii) Provident Fund (As Shown in B/S)	80,000	
	(iv) Workmen Compensation Fund (Agreed Value)	15,0000	
	(v) Provision for Tax (Agreed Value)	25,000	
	(vi) 12% Debentures	1,00,000	
Step 4:	Add: Step 3 (i) to (vi)		4,15,000
Step 5:	Purchase Consideration (Step 2 – Step 4) =		5,77,000

Payment of Purchase Consideration (As per Directions Given in the Problem):

	₹
For Preference Share holders in Cash:	1,50,000
Balance in 42,700 Equity Shares (of ₹ 10 Each) 4,27,000	
(₹ 5,77,000 − ₹ 1,50,000 = 4,27,000)	
Total	5,77,000

Note:

1. Realization expenses are not included.
2. If realization expenses will be paid by the transferor company, then it will be included and the value of purchase consideration will be reduced to that extent.

Illustration 9.5

Model: Net assets method—Two companies agree to amalgamate

The following are the balance sheets of A Co. Ltd. and B. Co. Ltd. as on 31 March 2011:

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Equity Share Capital ₹ 10 per Share	2,00,000	1,00,000	Land & Building	50,000	—
			Plant & Machinery	2,30,000	80,000
10% Debentures of ₹ 10 Each	30,000	—	Stock	20,000	14,000
			Debtors	14,000	12,000
Reserve Fund	50,000	—	Cash	6,000	4,000
Dividend Equalization Fund	5,000	—			
Employees Provident Fund	10,000	—			
Trade Creditors	20,000	10,000			
Profit & Loss Account	5,000	—			
	3,20,000	1,10,000		3,20,000	1,10,000

The two companies agree to amalgamate and form a new company called C Co Ltd., which takes over the assets and liabilities of the two companies. The authorized capital of C Ltd. is ₹ 15,00,000 consisting of 1,50,000 equity shares of ₹ 10 each. The assets of A Ltd. are taken over at a reduced valuation of 20% with the exception of land and buildings and cash which are accepted at book value. Both companies are to receive 10% of the net valuation of their respective as goodwill. The entire purchase price is to be paid by C Ltd. in fully paid shares. In return for debentures of A Ltd., debentures of the same amount and denomination are to be issued by C Ltd.

You are required to compute purchase consideration.

Solution

Computation of Purchase Consideration:

			A Ltd.	**B Ltd.**
			₹	₹
Step 1:	Assets Taken Over at their Respective Book Value: (As Shown in B/S)		3,20,000	1,10,000
Step 2:	To be Adjusted as per Agreed Value, i.e., 20% Reduction in Respect of Assets Except Land & Building and Cash ₹ 3,20,000 – (50,000 + 6,000) = 20% of ₹ 2,64,000 = ₹ 52,800		52,800	—
			2,67,200	
Step 3:	Less: Liabilities Taken Over:	₹		—
	(i) Employees PF	10,000		
	(ii) Trade Creditors	20,000	…	(10,000)
	(iii) 10% Debentures	30,000	(60,000)	—
			2,07,200	1,00,000
Step 4:	Add: Goodwill: 10% of Net Valuation		20,720	10,000
Step 5:	Purchase Consideration		2,27,920	1,10,000

Illustration 9.6

Model: Net payment method or total payment method—Purchase consideration

A Ltd. is absorbed by B Ltd., the consideration being the take over of liabilities; the payment of cost of absorption as a part of purchase consideration not exceeding ₹ 30,000 (actual cost ₹ 22,000); the payment of the debentures of ₹ 1,75,000 at a premium of 10% in 12% debentures issued at par; and the payment of ₹ 15 per share in cash and allotment of 15% preference share of ₹ 10 each and 5 equity shares of ₹ 10 each fully paid for every 2 shares in A Ltd. The number of shares of the vendor company are 3,00,000 of ₹ 10 each fully paid.

You are required to calculate the purchase consideration as per Accounting Standard-14 assuming it is an absorption in the nature of purchase.

Solution

Important notes:

1. Under net payments method, payments made by the transferee (purchasing) company in any form to discharge or pay the debenture holders, creditors, contingent liabilities, expenses of realization (cost of

absorption) should not be included in the purchase consideration as per AS-14. The reason is that all such liabilities will have to be transferred by the selling (vendor) company to the purchasing company and it will have to be paid by the purchasing company after the absorption.

2. Under this method, not even a single item will be deducted while determining purchase consideration.
3. Under this method, the agreed values at which all the assets/liabilities to be transferred should be ignored.
4. The thrust is on the amount payable to the shareholders of the transferor (selling or vendor) company.
5. To sum up, the purchase consideration under the net payment (total payment) will be determined by adding up (i) payments made in the form of cash; (ii) money value of equity shares, if payments are made in the form of equity sharesand (iii) money value of the preference shares, if payments are in the form of preference shares.

These factors should be borne in mind while computing purchase consideration under net payment method.

Computation of Purchase Consideration:

(Net Payment Method in Accordance with AS-14)

		₹
Step 1:	Cash Payment: Number of Shares × Value of Share 3,00,000 × ₹ 15	45,00,000
Add:		
Step 2:	Payment in the Form of Equity Shares: 5 Equity Shares of ₹ 10 Each for Every 2 Equity Shares Held in A Ltd:	
(Add:	(3,00,000 Shares × $\frac{5}{2}$ × ₹ 10 – ₹ 75,00,000))	75,00,000
		1,20,00,000
Step 3:	Payment in the Form of Preference Shares: 15% Preference Shares of ₹ 10 Each for Every 2 Shares Held in A Ltd: $\frac{3,00,000}{2}$ × ₹ 10 = ₹ 15,00,000	15,00,000
Step 4:	Purchase Consideration:	1,35,00,000

Illustration 9.7

Model: Total payment method

The following is the balance sheet of VR Ltd. as on 31 March 2011:

Liabilities	₹	**Assets**	₹
Equity Shares of ₹ 10 Each	60,00,000	Fixed Assets	50,00,000
12% Preference Shares of ₹ 100 Each	10,00,000	Investments	2,00,000
General Reserve	2,00,000	Stock	23,00,000
15% Debentures	3,00,000	Debtors	5,00,000
Sundry Creditors	3,00,000	Bank	1,00,000
Bills Payable	2,25,000		
Provision for Tax	75,000		
	81,00,000		81,00,000

Additional information:

(i) SR Ltd. takes over VR Ltd. on 6 April 2011.

(ii) 12% Preference shareholders of VR Ltd. are discharged at a premium of 15% by issuing 13% preference shares of ₹ 100 each.

(iii) The net assets value of VR Ltd. equity share is ₹ 30 per share and that of SR Ltd. equity share is ₹ 50 per share. SR Ltd. will issue equity shares to satisfy the equity shareholders of VR Ltd. on the basis of intrinsic value. But the purchase consideration is to be based on the basis of par value only. The face value of equity share of SR Ltd. is ₹ 10.

(iv) Debentures of VR Ltd. are to be discharged at a premium of $12\frac{1}{2}$ % by issuing 15% debentures of SR Ltd.

Compute the purchase consideration.

Solution

Note:

1. Equity share value is to be determined on its face value only. All other values are to be ignored in this method.
2. Debentures of VR Ltd. are not to be included as they are to be taken over by SR Ltd. and then paid.

Computation of Purchase Consideration:

		₹
Step 1:	Payment for Preference Shareholders of VR Ltd: Discharged at a Premium of 15% of ₹ 100 Each, i.e., 11,500 Pref. shares × ₹ 100	11,50,000
Add:		3,60,00,000
Step 2:	Payment for Equity Shareholders of VR Ltd. $\left(₹\,60,00,000 \times \frac{₹\,30}{₹\,50} \times ₹\,10\right)$ (i.e., 3,60,00,000 Shares of SR Ltd. of ₹ 10 Each)	
Step 3:	Purchase Consideration	3,71,50,000

Note: To calculate number of equity shares of SR Ltd., ratio in net assets value of shares of both companies are taken as a base, i.e., $\frac{30}{50}$. However, while determining amount payable to equity shareholders, only the face value, i.e., ₹ 10, is to be taken into account.

Illustration 9.8

Model: Net assets method and net payments method

The balance sheet of PQ Ltd. as on 31 March 2011 is as follows:

(₹ in Lakhs)

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets	200
12% Preference Sh-ares of ₹ 100 Each	50	Investment	30
Equity Shares of ₹ 10 Each	100	Current Assets	20
General Reserve	60		
10% Debentures	20		
Current Liabilities	20		
	250		250

RS Ltd. signified their agreement to take over the assets and liabilities of PQ Ltd. as per the following terms & conditions:

(i) Fixed assets at 80% of book value
(ii) Investments at 20% above the par value
(iii) Current assets and liabilities at book value except that stock-in-trade at cost amounting to ₹ 10 lakh was agreed to be taken over at a discount of 25%
(iv) 10% Debentures are to be discharge at a premium of 10% by issuing 10% debentures of ₹ Ltd.
(v) Preference shareholders are to be discharged at a premium of 10% by issuing 12% preference shares of ₹ 100 each
(vi) The equity shareholders in PQ Ltd. are to be issued 6 equity shares of ₹ 10 each in RS Ltd. for every 2 shares held by them

Workout the consideration for the take over under:

(a) Net assets method and (b) Net payment method

[C.S. (Inter). Modified]

Solution

(a) **Net Assets Method:** Under this method, values of assets and liabilities are to be adjusted as per agreed terms. If no such thing is mentioned, values have to be taken as shown in the balance sheet.

Computation of Purchase Consideration:

		₹ in Lakhs
Step 1:	Value of Assets Taken Over:	
	(i) Fixed Assets: 80% of BV (As per Agreed Terms)	160.00
	(ii) Investments: 20% Above Par Value (As per Agreed Terms) Current Assets:	36.00
	(iii) Stock in Trade: Discount at 25% (As per Agreed Terms) (i.e., 75% of ₹ 10 lakh)	7.50
	(iv) Other CAs: At Par Value (BV)	10.00
Step 2:	Total Assets Taken Over (Add: Step 1 (i) to (iv))	213.50
Step 3:	Total Liabilities Taken Over:	
	(i) 10% Debentures to Be Discharged at 10% Premium	22.00
	(ii) Current Liabilities (At Par, i.e., BV)	20.00
Step 4:	Total Liabilities to Be Taken Over (Add: Step 3 (i) + (ii))	42.00
Step 5:	Purchase Consideration (Step 2 – Step 4)	171.50

(b) **Net Payment Method:** Under this method, amount payable to shareholders is to be determined as follows:

Computation of Purchase Consideration:

		₹ in Lakhs
Step 1:	Payment for Preference Shareholders (50 lakh at 10% Premium)	55.00
Add:		
Step 2:	Payment for Equity Shareholders: 6 Equity Shares for Every 2 Shares:	
	10 lakh Shares $\times \frac{6}{62} \times$ ₹ 10 = ₹ 300 lakh	300.00
Step 3:	Purchase Consideration (Step 1 + Step 2)	355.00

Illustration 9.9

Model: Intrinsic value of shares

The following are the balance sheets of AB Ltd. & CD Ltd. as on 31 March 2011:

Balance Sheet of AB Ltd.

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	14,00,000
8,000 Shares of ₹ 100 Each	8,00,000	Investments	10,00,000
General Reserve	10,00,000	Current Assets	12,00,000
Profit & Loss Account	6,00,000		
Debentures	7,00,000		
Current Liabilities	5,00,000		
	36,00,000		36,00,000

Balance Sheet of CD Ltd.

Liabilities	₹	Assets	₹
Share Capital:			
3,600 Shares of ₹ 100 Each	3,60,000	Fixed Assets	6,00,000
General Reserve	2,00,000	Current Assets	4,00,000
Profit & Loss Account	1,60,000		
Current Liabilities			
Creditors	2,00,000		
Bills Payable	80,000		
	10,00,000		10,00,000

AB Ltd. agrees to take over CD Ltd. Find out the ratio of exchange of shares on the basis of book value.

[B.Com (Hons) Modified]

Solution

Computation of Intrinsic Value of Shares

Particulars		AB Ltd. ₹	CD Ltd. ₹
Step 1:	Value of Assets (At Book value):		
	(i) Fixed Assets	14,00,000	6,00,000
	(ii) Investments	10,00,000	—
	(iii) Current Assets	12,00,000	4,00,000
Step 2:	Total Value of Assets [Add: Step 1 (i) to (iii)]	36,00,000	10,00,000
Step 3:	Value of Liabilities (At BV):		
	(i) Debentures	7,00,000	—
	(ii) Current Liabilities	5,00,000	2,80,000

Step 4:	Total Value of Liabilitie	12,00,000	2,80,000
Step 5:	Net Assets (Step 2 – Step 4)	24,00,000	7,20,000
Step 6:	Intrinsic Value of Shares	₹ 24,00,000 ÷ 8,000 Shares	₹ 7,20,000 ÷ 3,600 Shares
		₹ 300	₹ 200

Ratio of exchange:

LCM (Lowest Common Multiple) of Intrinsic Values of Shares of 2 Companies = ₹ 600

Ratio = AB Ltd.:CD Ltd.

$$\frac{600}{300} : \frac{600}{200}$$

2:3

∴ 2 Shares of AB Ltd. = ₹ 600

3 Shares of CD Ltd. = ₹ 600

Illustration 9.10

Model: Intrinsic worth method

JK Ltd. is absorbed by LM Ltd. Following are the balance sheets of these two companies as on 31 March 2011:

Liabilities	**JK Ltd.** ₹	**LM Ltd.** ₹	**Assets**	**JK Ltd.** ₹	**LM Ltd.** ₹
Share Capital:			Sundry Assets	10,15,000	49,05,000
Paid-up Share Capital 5.000 Equity Shares of ₹ 100 each, ₹ 70 Paid up	3,50,000		Cash in Hand	10,000	1,35,000
50,000 Equity Shares of ₹ 100 Each, ₹ 75 Paid up		37,50,000			
Reserve Fund	4,25,000	11,00,000			
Profit & Loss Account	1,50,000	1,00,000			
Sundry Creditors	1,00,000	90,000			
	10,25,000	50,40,000		10,25,000	50,40,000

It was decided that the holder of every 3 shares in JK Ltd. was to receive 5 shares in LM Ltd. plus as much cash as in necessary to adjust the rights of shareholders of both the companies in accordance with the intrinsic value of shares as per respective balance sheets.

Calculate purchase consideration.

Solution

Stage I: Computation of Intrinsic Value of Shares

Particulars		JK Ltd. ₹	LM Ltd. ₹
Step 1:	Value of Assets (At BV)		
	(i) Sundry Assets	10,15,000	49,05,000
	(ii) Cash	10,000	1,35,000
Step 2:	Value of Total Assets [Step 1 (i) + (ii)]	10,25,000	50,40,000
Step 3:	Value of Liabilities (At BV): Creditors	1,00,000	90,000
Step 4:	Value of Net Assets (Step 2 – Step 3)	9,25,000	49,50,000
Step 5:	Number of Equity Shares	5,000 Shares	50,000 Shares
Step 6:	Intrinsic Value of Shares (Step 4 ÷ Step 5)	₹ 185	₹ 99

Stage II: Difference Payable—Computation of:

			₹
Step 1:	Intrinsic Value of 3 Shares in JK Ltd: 3× ₹ 185 (Step 6)	=	555
Step 2:	Intrinsic Value of 5 Shares in LM Ltd: 5 × ₹ 99 (Step 6)	=	495
Step 3:	Difference Payable in Cash (Step 1 – Step 2)}	=	60

Stage III: Computation of Purchase Consideration Under Net Payments Method:

		₹
Step 1:	Payment for Equity Shareholders: (In Shares) Number of Shares to Be Allotted = $5{,}000 \times \frac{5}{3}$ = 8,333,333 Value of Payment for 8,333 Shares: 8,333 × ₹ 99	8,24,967
Add:		
Step 2:	Payment in Cash:	
	(i) For Fractional Shares: 0.333 × ₹ 99 = ₹ 32.967}	33
	(ii) Difference Payable in Cash: $\frac{5{,}000 \text{ Shares}}{3} \times$ ₹ 60 (Stage II: Step 3)	1,00,000
Step 3:	Purchase Consideration (Step 1 + Step 2 (i) & (ii)]	9,25,000

Stage IV: Calculation of Shares Allotted to Shareholders of JK Ltd:

			₹
(i)	Paid-up Value = 8,333 Shares × ₹ 75	=	6,24,975
(ii)	Value of Premium: (₹ 99 – ₹ 75) ₹ 24		
	: 8,333 Shares × ₹ 24	=	1,99,992
	Total		8,24,967

9.3.2 Accounting Procedure

9.3.2.1 Accounting Treatment in the Books of Transferor (Selling or Vendor) Company

Important note: The accounting procedure is SAME for all types of amalgamation, whether it is in the nature of "merger" or "purchase", in the books of the transferor (vendor) company.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Step 1: Transfer of Assets:			
	Realization A/c Dr.		…	
	To Assets (Individually) Account			…
	[Important Hints for transfer of assets:			
	(i) All assets, *whether taken over or not* must be transferred to realization a/c at *book value*.			
	(ii) Provisions should not be deducted, but to be shown separately by crediting realization a/c.			
	(iii) Agreed values should be ignored.			
	(iv) Each and every asset has to be transferred *individually*.			
	(v) Fictitious assets are to be ignored. (They should not be transferred to realization a/c)			
	(vi) When amalgamation is in the nature of purchase, cash in hand and cash at bank are to be transferred to realization a/c *if* they are taken over by the transferee company.			
	When amalgamation is in the nature of merger, these accounts *MUST* be transferred to realization a/c.			
	(vii) All intangible accounts such as goodwill, patent copyrights are to be transferred to realization a/c. In case, they are mentioned as worthless, then they have to be transferred to shareholders A/c as "loss".]			
	Step 2: Transfer of Liabilities:			
	Liabilities (Individually) A/c Dr.		…	
	To Realization A/c			…
	[Important Hints for Transfer of Liabilities:			
	(i) Liabilities not taken over and liabilities to be settled by immediate payment are not to be transferred to realization a/c.			
	(ii) Liabilities should be transferred as their respective book values.			
	(iii) All the items shown under the heads "Secured Loans" and "Unsecured Loans" are to be transferred whether they are taken over or not by the transferee (purchasing) company. This also includes "Debentures", irrespective of the method of calculating purchase consideration.			
	(iv) Any amount in the nature of reserve should not be transferred to realization a/c.			
	Example: Accumulated profits (P&L A/c credit balance), sinking fund, dividend equalization fund, debenture redemption fund, i.e., all funds in the nature of profits.			
	(v) Funds which are not reserves are to be transferred to realization A/c. **Example**: Pension fund, PF., superannuation fund.			
	(vi) Funds which are partly profit and partly liability—only liability part is to be transferred to realization A/c and the other part is to be transferred to shareholders A/c.			

	Step 3: Purchase Consideration—DUE:			
	(Purchasing) Transferee Co's A/c Dr.		…	
	To Realization A/c			…
	Step 4: Realization Expenses :			
	(a) If (a) If Liquidation Expenses Are Paid and Borne by the Transferor Company (Selling/Vendor)			
	Realization A/c Dr.		…	
	To Bank A/c			…
	(b) If the Transferor Pays and Later Gets Reimbursed by Transferee Company:			
	(i) Transferee Company's A/c Dr.		…	
	To Bank A/c			
	(ii) Bank A/c Dr.			…
	To Transferee Company's A/c			
	Note: At times, actual expenses paid and the reimbursement amount may vary. In such cases, the difference will be adjusted with realization A/c.			
	(c) If Liquidation Expenses Are Paid and Borne by the Purchasing (Transferee) Company, then No Need to Enter in the Books of the Vendor (Transferor) Company.			
	(However, the Liquidation Expenses Reimbursable Are Not at All to Be Included in the Purchase Consideration According to AS-14)			
	Step 5: Realization of Assets Not Taken Over by the Purchasing Company (Recorded or Not Recorded):			
	Bank A/c [Amount Realized] Dr		…	
	To Realization A/c			…
	Step 6: Payment of Liabilities Not Taken Over:			
	Realization A/c Dr.		…	
	To Bank A/c			…
	[***Note:*** In the settlement of iability, if there is premium, realization A/c is to be debited or credited in case of discount.]			
	Step 7: Discharge of Preference Share Capital:			
	(a) When Payable at Premium:			
	Preference Share Capital A/c [Face Value] Dr.		…	
	Realization A/c (Premium) Dr.		…	
	To Preference Shareholders A/c [Total]			…
	(b) When Payable at Discount:			
	Preference Share Capital A/c (Face Value) Dr.		…	
	To Preference Shareholders A/c (Net Amount Payable)			…
	To Realization A/c (Amount of Discount)			…
	(c) When Payable at Par:			
	Preference Share Capital A/c (Face Value) Dr.		…	
	To Preference Shareholders A/c (Face Value)			…
	[***Note:*** At times, on amalgamation, may be paid as premium or discount. In such cases, they have to be adjusted in realization A/c first and only then their profit/loss is to be determined.]			

	Step 8: Profit/Loss on Realization:			
	(a) When There Is Profit on Realization:			
	Realization A/c [With Profit Amount] Dr.		…	
	To Equity Shareholders A/c			…
	(b) When There is Loss on Realization:			
	Equity Shareholders A/c (With Loss Amount) Dr.		…	
	To Realization A/c			
	Step 9: On Receipt of Purchase Consideration:			
	Bank A/c (In the Form of Cash) Dr.		…	
	Preference Shares in Transferee Company's A/c			…
	(In the Form of Equity Shares) Dr.		…	
	Equity Shares in Transferee Company's A/c Dr.		…	
	(In the Form of Equity Share)			
	To Transferee Company's A/c (Total)			
	[Purchasing Company's A/c Will Be Closed with This Entry]			
	Step 10: Transfer of Equity Share Capital, Accumulated Profits & Reserves:			
	Equity Shares Capital A/c Dr.		…	
	Capital/Revenue A/c Dr.		…	
	General Reserve A/c Dr.		…	
	Any Other Reserve A/c Dr.		…	
	Profit & Loss A/c Dr.		…	
	To Equity Shareholders A/c			…
	Step 11: Transfer of Accumulated Losses and Fictitious Assets:			
	Equity Shareholders A/c Dr.		…	
	To Preliminary Expenses A/c			…
	To Underwriting Commission A/c			…
	To Discount on Issue of Shares/Debentures A/c			…
	To Profit & Loss A/c			…
	Step 12: Final Settlement of Claims to Preference Shareholders.			
	Preference Shareholders A/c (Amount Due) Dr.		…	
	To Bank A/c (Cash Paid)			…
	To Preference Share in Transferee Company A/c			…
	(Paid in the Form of Pref. Shares)			…
	Step 13: Final Payment to Equity Shareholders:			
	Equity Shareholders A/c (Amount Due) Dr.		…	
	To Bank A/c (Cash Paid)			…
	To Equity Share in Transferee Company A/c			…
	(Paid in the Form of Equity Shares)			
	[***Note:*** Vendor company's account will get closed after payment is made to equity shareholders.]			

Illustration 9.11

Model: Accounting in the books of transferor company

The balance sheets of X Ltd. and Y Ltd. were as follows on 31 March 2011:

(₹ in 000's)

	X Ltd. ₹	Y Ltd. ₹
Assets:		
Goodwill	—	350
Patents	1,000	—
Land & Buildings	3,000	—
Plant & Machinery	7,750	—
Motor Vehicles	—	200
Furniture	—	125
Investments	0,575	—
Stocks	1,750	1,195
Debtors	400	310
Cash at Bank	225	85
	14,700	2,265
Liabilities:		
Share Capital: 25,000 Pref. Shares of ₹ 100 Each	2,500	—
7,50,000 Equity Shares of ₹ 10 Each	7,500	—
2,00,000 Equity Shares of ₹ 10 Each	—	2,000
	10,000	2,000
General Reserve	4,000	—
Profit and Loss A/c	450	160
Creditors	250	105
	14,700	2,265

A new company Z Ltd. was formed to acquire the assets and liabilities of X Ltd. and Y Ltd. The terms of acquisition of business were as follows:

(i) Z Ltd. to have an authorized capital of ₹ 1,75,00,000 divided into 25,000 12% preference shares of ₹ 100 each and 15,00,000 lakh equity shares of ₹ 10 each

(ii) Business of X Ltd. valued at ₹ 1,50,00,000; settlement being ₹ 30,00,000 cash and balance by issue of fully paid equity shares of ₹ 12 each

(iii) Business of Y Ltd. valued at ₹ 24,00,000 to be settled by issue of fully paid equity shares of ₹ 12 each

(iv) Preference shares of X Ltd. were redeemed

You are required to make journal entries in the books of X Ltd. and Y Ltd. to close their books of account and also show the necessary ledger Accounts.

[C.S. (Inter). Modified]

Solution

Books of X Ltd.
Journal

(₹ in 000's)

Date	Particulars	L.F.	Dr. ₹	Dr. ₹
	Step 1: For Assets Taken Over by Z Ltd.			
	Realization A/c Dr.		14,700	
	To Patents			1,000
	To Land & Buildings			3,000
	To Plant & Machinery			7,750
	To Investment			575
	To Stock			1,750
	To Debtors			400
	To Bank			225
	(Transfer of All Assets Taken Over by Z Ltd.)			
	Step 2: For Liabilities Taken Over:			
	Creditors A/c Dr.		250	
	To Realization A/c			250
	(Transfer of Creditors to Realization A/c)			
	Step 3: Purchase Consideration Due (Given)			
	Z Ltd. A/c Dr.		15,000	
	To Realization A/c			15,000
	(Purchase Consideration Due from Z Ltd.)			
	Step 4: Profit on Realization (Ref: Realization A/c—Ledger)			
	Realization A/c Dr.		550	
	To Equity Shareholders A/c			550
	(Profit on Realization Transferred to Shareholders A/c)			
	Step 5: On Receipt of Purchase Consideration:			
	Equity Shares in Z Ltd. Dr.		12,000	
	Bank A/c Dr.		3,000	
	To Z Ltd. A/c			15,000
	(Purchase Consideration Received in Shares and Cash)			
	Step 6: Amount Due to Preference Shareholders:			
	Preference Share Capital A/c Dr.		2,500	
	To Preference Shareholders A/c			2,500
	(Amount Due to Preference Shareholders)			
	Step 7: Settlement of Claim to Pref. Shareholders			
	Preference Shareholders A/c Dr.		2,500	
	To Bank A/c			2,500
	(Payment Made to Pref. Shareholders)			

	Step 8: Amount Due to Equity shareholders				
	Equity Share Capital A/c	Dr.		7,500	
	General Reserve A/c	Dr.		4,000	
	Profit & Loss A/c	Dr.		450	
	To Equity Shareholders A/c				11,950
	(Amount Due to Equity Shareholders)				
	Step 9: Settlement of Claims to Equity Shareholders:				
	Equity Shareholders A/c	Dr.		12,500	
	To Equity Shares in Z Ltd.				12,000
	To Bank A/c				500
	(Payment Made to Equity Shareholders in Cash & Shares)				

1. Realization A/c

(₹ in 000's)

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Sundry Assets:			By Sundry Creditors	250
	Patents	1,000		By Z Ltd.	15,000
	Land & Buildings	3,000			
	Plant & Machinery	7,750			
	Investments	575			
	Stock	1,750			
	Debtors	400			
	Bank	225			
	*[1]To Equity Shareholders A/c (Profit Bal. Fig)	550			
		15,250			15,250

2. Preference Shareholders A/c

Particulars	₹	Particulars	₹
To Bank A/c	2,500	By Pref. Shareholders A/c	2,500
	2,500		2,500

3. Equity Shareholders A/c

Particulars	₹	Particulars	₹
To Equity Shares in Z Ltd.	12,000	By Equity Share Capital A/c	7,500
To Bank A/c	500	By General Reserve	4,000
		By Profit and Loss A/c	450
		By Realization A/c	550
	12,500		12,500

4. Equity Shares in Z Ltd.

Particulars	₹	Particulars	₹
To Z Ltd.	12,000	By Equity Shareholders A/c	12,000
	12,000		12,000

5. Z Ltd. A/c

Particulars	₹	Particulars	₹
To Realization A/c	15,000	By Bank A/c	3,000
		By Share in Z Ltd.	12,000
	15,000		15,000

6. Bank A/c

Particulars	₹	Particulars	₹
To Z Ltd.	3,000	By Equity Shareholders A/c	500
		By Pref. Shareholders A/c	2,500
	3,000		3,000

Books of Y Ltd.

Journal

(₹ in 000's)

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Step 1: Assets Taken Over:			
	Realization A/c Dr.		2,265	
	To Goodwill			350
	To Motor Vehicles			200
	To Furniture			125
	To Stocks			1,195
	To Debtors			310
	To Bank			85
	(Transfer of All Assets Taken Over by Z Ltd.)			
	Step 2: Liabilities Taken Over:			
	Sundry Creditors A/c Dr.		105	
	To Realization A/c			105
	(Transfer of Liabilities Taken Over)			
	Step 3: Purchase Consideration Due (Given):			
	Z Ltd. A/c Dr.		2,400	
	To Realization A/c			2,400
	(Purchase Consideration Due)			

	Step 4: Realization Profit (Ref : Realization A/c):				
	Realization A/c	Dr.		240	
	To Equity Shareholders A/c				240
	+'(Realization Profit Transferred to Equity Shareholders A/c)				
	Step 5: Amount Due to Equity Shareholders:				
	Equity Shares Capital A/c	Dr.		2,000	2,160
	Profit and Loss A/c	Dr.		160	
	To Equity Shareholders A/c				
	(Amount Due to Equity Shareholders)				
	Step 6: On Receipt of Purchase Consideration:				
	Equity Shares in Z Ltd.	Dr.		2,400	
	To Z Ltd. A/c				2,400
	(Purchase Consideration Received)				
	Step 7: Settlements to Equity Shareholders:				
	Equity Shareholders A/c	Dr.		2,400	
	To Shares in Z Ltd.				2,400
	(Amount Paid to Equity Shareholders in the Form of Shares)				

Ledger Accounts

1. Realization A/c

(₹ in 000's)

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
To Sundry Assets:		By Sundry Creditors	105
Goodwill	350		
Motor Vehicles	200	By Z Ltd.	2,400
Furniture	125		
Stocks	1,195		
Debtors	310		
Bank	85		
+'To Equity Shareholders A/c	240		
(Profit Bal. Fig)			
	2,505		2,505

2. Equity Shareholders A/c

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
To Equity Shares in Z Ltd.	2,400	By Equity Share Capital	2,000
		By Profit and Loss	160
		By Realization A/c	240
	2,400		2,400

3. Equity Shares in Z Ltd.

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Z Ltd.	2,400	By Equity Shareholders A/c	2,400
	2,400		2,400

4. Z Ltd. A/c

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Realization A/c	2,400	By Equity Shares in Z Ltd. A/c	2,400
	2,400		2,400

9.3.2.2 Accounting Treatment in the Books of Transferee (Purchasing) Company

Accounting treatment in the books of purchasing company is based on the nature of amalgamation. Accounting Standard AS-14 stipulates two methods of accounting for amalgamation:

1. Pooling of interest methods
2. Purchase method

When the amalgamation is in the nature of merger, the transferee company has to apply "pooling of interests method". When the amalgamation is in the nature of purchase, the transferee company has to apply "purchase method".

9.3.2.2.1 Pooling of Interests Method

Pooling of assets, liabilities, capital, reserves and business of both companies takes place in this method:

1. The assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (i.e., book values). That means no adjustment is made in the book values of assets and liabilities of the transferor company. Further, fictitious assets are not assets and hence should not be incorporated in the books of transferee company.
2. The effects on the financial statements of any changes in accounting policies are to be reported as per AS-5.
3. The purchase consideration under this method is to be valued at par value of shares issued.
4. The balance in the profit and loss account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve.
5. The difference between the amount recorded as share capital issued + additional consideration in form of cash or other assets and the amount of share capital is to be adjusted in reserves in financial statements of the transferee company.

   The Expert Advisory Committee of ICAI Recommends:

   (a) The difference between the issued share capital of the transferee company and share capital of transferor company should be treated as CAPITAL RESERVE.

   (b) Reserve created on amalgamation is not available for dividend and/or bonus shares issued.

Journal Entries in the Books of Transferee Company
(Pooling of Interest Method)

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Step 1: Purchase of Business:			
	Business Purchase A/c Dr.		…	
	(With the Amount of Purchase Consideration.)			
	To Liquidators of Transferor Company			…
	Step 2: Take Over of the Assets, Liabilities and Reserves of the Transferor Company:			
	Sundry Assets A/c (Individually) Dr.		…	
	To Sundry Liabilities A/c (Individually)			…
	To Profit and Loss A/c			…
	To Reserves A/c (Individually)			…
	To Business Purchase A/c			…
	[***Note:*** All assets and liabilities are to be recorded at their book values separately. But at times, book value gets adjusted according to the accounting policy of purchasing company.]			
	Step 3: Settlement of Purchase Consideration:			
	(i) When Shares Are Issued at Par:			
	Liquidators of Transferor Company A/c Dr.		…	
	To Equity Share Capital A/c			…
	To Preference Share Capital. A/c			…
	To Bank A/c			…
	(ii) When Shares Are Issued at Premium:			
	Liquidators of Transferor Company A/c Dr.		…	
	To Equity Share Capital A/c			…
	To Preference Share Capital A/c			…
	To Securities Premium A/c			…
	To Bank A/c			….
	(iii) When Shares Are Issued at Discount:			
	Liquidators of Transferor Company A/c Dr.		….	
	Discount on Issue of Shares A/c Dr.		….	
	To Equity Share Capital A/c			….
	To Preference Share Capital A/c			…..
	To Bank A/c			…..
	Step 4: Discharge of Liabilities:			
	(i) When Debentures Are Issued at Par:			
	Debentures of Transferor Company A/c Dr.		…	
	To Debentures (of Transferee Company) A/c			…

	(ii) When Debentures Are Issued at Premium:			
	Debentures of Transferor Company A/c Dr.		…	
	To Debentures (of Transferee Company) A/c			….
	To Securities Premium A/c			
	(iii) When Debentures Are Issued as Discount:			
	Debentures of Transferor Company A/c Dr.		….	
	Discount on Issue of Debentures A/c Dr.		….	
	To Debentures (of Transferor Company) A/c			….
	Step 5: Liquidation Expenses:			
	(i) Liquidation Expenses A/c Dr.		…	
	To Bank A/c			…
	(ii) General Reserve/P&L A/c Dr.		…	
	To Liquidation Expenses A/c			…
	Step 6: Formation Expenses:			
	Preliminary Expenses A/c Dr.		…	
	To Bank A/c			…
	[***Note:*** At times, preliminary expenses are not written off against general reserve or P&L A/c. In such cases, it will be shown on the assets side of B/S under "Miscellaneous Expenditure".]			

9.3.2.2.2 Purchase Method

Accounting for amalgamation: When amalgamation is in nature of purchase, "purchase method" will have to be applied, in accordance with AS-14.

Accounting Entries in the Books of Transferee Company
(Purchase Method)

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Step 1: Business Purchase: (Purchase of Business)			
	Business Purchase A/c Dr.			
	To Liquidators of Transferor Company A/c			
	Step 2: Taken Over of Assets of Liabilities:			
	All Assets A/c (Individually) Dr.		…	
	at Agreed Values			
	To Liabilities A/c (Individually) at Agreed Values			….
	To Debentures in Vendor's Company A/c			…
	To Business Purchase A/c			…
	[***Important Hints & Notes*:**			
	Case 1: If total amount of credit accounts is greater than the total amount of debit accounts, the difference is to be treated as a capital loss and is to be debited to goodwill A/c. Then entry will be:			

	Goodwill A/c (Balancing Figure)	Dr.		….	
	Assets A/c (Individually)	Dr.		…	
	To Liabilities A/c (Individually)				…
	To Business Purchase A/c				…
	Case 2: On the other hand, if total amount of debit accounts is greater than the total amount of credit accounts, then the difference is to be treated as a capital profit and is to be credited to capital reserve A/c. Then entry will be:				
	Assets A/c (Individually)	Dr.		…	
	(Excluding Goodwill A/c)				
	To Liabilities A/c (Individually)				…
	To Business Purchase A/c				…
	To Capital Reserve A/c (Balancing Figure)				…
	Case 3: If there are both goodwill & capital reserve, then only net amount has to be shown in the B/S].				
	Step 3: Payment of Purchase Consideration:				
	(i) When Securities Are Issued at Par:				
	Liquidators of Transferor Company A/c	Dr.		…	
	To Bank A/c				…
	To Equity Share Capital A/c				…
	To Preference Share Capital A/c				…
	To Debentures A/c				…
	(ii) When Securities Are Issued at Premium:				
	Liquidators of Transferor Company A/c	Dr.		…	
	To Bank A/c				…
	To Equity Share Capital A/c				…
	To Preference Share Capital A/c				…
	To Debentures A/c				…
	To Securities Premium A/c				…
	(iii) When Securities Are Issued at Discount:				
	Liquidator of Transferor Company A/c	Dr.		…	
	Discount on Issue of Shares A/c	Dr.		…	
	Discount on Issue of Debentures A/c	Dr.		…	
	To Bank A/c				…
	To Equity Share Capital A/c				…
	To Preference Share Capital A/c				…
	To Debentures A/c				…
	Step 4: Statutory Reserves:				
	Amalgamation Adjustment A/c	Dr.		…	
	(Total Amount of Statutory Reserves)				
	To Particular Statutory Reserve A/c (Individually)				…

	Step 5: Discharge of Debentures:			
	Debentures in Transferor Company A/c Dr.		…	
	To Debentures in Transferee Company A/c			…
	To Securities Premium A/c			…
	To Bank A/c			…
	To Equity Share Capital A/c			…
	To Pref. Share Capital A/c			…
	Step 6: Liquidation Expenses (Paid and Borne by Transferee Company:			
	Goodwill A/c Dr.		…	
	To Bank A/c			…
	Step 7: Formation Expenses (In Case of a New Company)			
	Preliminary Expenses A/c Dr.		…	
	To Bank A/c			…
	[***Note:*** If both goodwill A/c and capital reserve appear in the books of transferee company, then goodwill A/c should be set off against the capital reserve A/c. The entry will be:			
	Capital Reserve A/c Dr.		…	
	To Goodwill A/c]			…

The following table shows the differences between "pooling of interests method" and "purchase method":

Basis of Distinction	Pooling of Interests Method	Purchase Method
1. Applicability	Applicable to amalgamation in the nature of merger.	This is applicable to amalgamation in the nature of purchase.
2. Recording of assets & liabilities	All assets and liabilities are incorporated as their book values.	They are to be recorded as agreed or fair or market values.
3. Treatment of reserves	All reserves are to be taken over by the purchasing company along with assets & liabilities.	Reserves are ignored. except statutory reserves.
4. Status of shareholders	At least 90% of equity shareholders of transferor company will become shareholders of transferee company.	Shareholders of transferor company may or may not become shareholders of transferee company.
5. Difference between consideration and sharecapital of vendor company	Such difference is to be adjusted in capital reserve, revenue reserve or P&L A/c.	The difference is to be adjusted in goodwill or capital reserve.
6. Writing off goodwill	It does not arise in this method.	It should be written off within 5 years.
7. Liquidation expenses	Liquidation expenses are written off to general reserve or P&L A/c of the purchasing company.	Liquidation expenses are to be debited to goodwill A/c.
8. Amalgamation adjustment A/c	No necessicity of such account in this method.	Statutory reserves of selling company should be debited to "amalgamation adjustment A/c". It is to be shown on assets side of B/S.

Illustration 9.12

Model: Journal entries in the books of transferee company—amalgamation in the nature of merger

On 31 March 2011, the balance sheet of AX Ltd stood as follows:

Liabilities	₹	Assets	₹
Share Capital:		Plant & Machinery	8,05,000
75,000 Equity Shares of ₹10 Fully Paid	7,50,000	Furniture & Fixtures	97,200
Securities Premium	75,000	Stock	3,52,750
General Reserve	3,12,750	Debtors	99,220
Profit & Loss A/c	92,650	Cash at Bank	56,600
Creditors	1,80,370		
	14,10,770		14,10,770

On this date AX Ltd. took over the business of BY Ltd. for ₹3,30,000 payable in the form of its fully paid equity shares of ₹10 each at par. Shareholders of BY Ltd. get 110 shares of AX Ltd. for every 100 shares held in BY Ltd. The scheme of amalgamation also provided that 1,500 12% debentures of BY Ltd. would be converted into equal number of 14% debentures of AX Ltd. of ₹100 each. The balance sheet of BY Ltd. on the date of amalgamation was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Machinery	2,75,000
30,000 Equity Shares of ₹10 Each Fully Paid	3,00,000	Furniture	67,600
		Stock	1,57,900
Capital Reserve	6,500	Debtors	64,650
Foreign Projects Reserve	4,850	Cash at Bank	37,180
General Reserve	37,675		
Profit & Loss A/c	12,065		
1,500 12% Debentures of ₹100 Each	1,50,000		
Creditors	91,240		
	6,02,330		6,02,330

You are required to pass journal entries in the books of AX Ltd. assuming that the amalgamation is in the nature of merger.

[C.S. (Inter). Modified]

Solution

Working Notes:

Treatment of Reserve:

Method 1:General Reserve (Given in B/S of BY Ltd.)	=	₹37,675
Less:Difference Between Purchase Consideration and Share Capital of Vendor Company: ₹3,30,000 — ₹3,00,000 (Purchase Consideration Given) (Share Capital Face Value of Shares of BY Ltd.)	=	₹30,000
∴General Reserve of BY Ltd. to Be Shown in AX Ltd. Books	=	₹7,675

Method 2:

First, the Difference ₹ 30,000 May Be Adjusted Against P&L A/c = ₹ 30,000 – ₹ 12,065
= ₹ 17,935

Next, This ₹ 17,935 May Be Adjusted from General Reserve = ₹ 37,675 – ₹ 17,935
= ₹ 19,740

∴ General Reserve balance = ₹ 19,740

P&L A/c Balance (Entire Amount Adjusted) = NIL

Books of AX Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Step 1: Business Purchase:			
	Business Purchase A/c Dr.		3,30,000	
	To Liquidator of BY Ltd.			3,30,000
	(Purchase Price of Business Payable)			
	Step 2: Assets & Liabilities Taken Over:			
	(Reserve Adjusted)			
	Machinery A/c Dr.		2,75,000	
	Furniture A/c Dr.		67,600	
	Stock A/c Dr.		1,57,900	
	Debtors A/c Dr.		64,650	
	Cash at Bank A/c Dr.		37,180	
	To 12% Debentures (BY Ltd.) A/c			1,50,000
	To Creditors			91,240
	To Capital Reserve			6,500
	To Foreign Projects Reserve			4,850
	To General Reserve (Ref: Working Notes Method I)			7,675
	To Profit and Loss A/c			12,065
	To Business Purchase A/c			3,30,000
	[Assets & Liabilities Taken Over and Reserves of BY Ltd. After Adjusted (as Shown in Working Notes)]			
	Step 3: Discharge of Purchase Consideration:			
	Liquidator of BY Ltd. A/c Dr.		3,30,000	
	To Equity Share Capital A/c			3,30,000
	(Purchase Consideration Paid in the Form of Shares)			
	Step 4: Discharge of Debentures:			
	12% Debentures (BY Ltd.) A/c Dr.		1,50,000	
	To 14% Debentures (AX Ltd.) A/c			1,50,000
	(Issue of Debentures to Settle Debenture Holders of BY Ltd.)			

Illustration 9.13

Model: Accounting entries in the books of transferee company—Amalgamation in the nature of purchase

The balance sheets of P Ltd. and Q Ltd. as at 31 March 2011 is as follows:

Liabilities	P Ltd. ₹	Q Ltd. ₹	Assets	P Ltd. ₹	Q Ltd. ₹
Equity Shares of ₹ 10 Each	8,40,000	6,00,000	Goodwill	60,000	—
10%Redeemable Pref.			Land	—	1,20,000
Shares of ₹ 100 Each	3,60,000	—	Building	—	3,00,000
Security Premium			Plant	12,00,000	5,40,000
Capital Redemption	42,000	—	Fixtures	20,000	60,000
Reserve	2,40,000	—	Vehicles	40,000	60,000
General Reserve			Stocks	4,80,000	3,00,000
9% Debentures	1,98,000	3,00,000	Debtors	3,20,000	2,00,000
Creditors	2,40,000	3,60,000	Advances	2,00,000	1,40,000
	4,80,000	5,40,000	Cash and Bank	80,000	80,000
	24,00,000	18,00,000		24,00,000	18,00,000

On 1 April 2011, R Ltd. was formed by amalgamation P Ltd. and Q Ltd. on the following terms:

1. R Ltd. to issue 2,400 14% debentures of ₹ 100 each to debenture holders of P Ltd.
2. The debentures of Q Ltd. insisted that they should be allotted equity shares in R Ltd. Accordingly, they were allotted 30,000 equity shares of ₹ 10 each and as ₹ 12 per share.
3. Preference shareholders of P Ltd. insisted for allotment 3,600 12% redeemable preference shares of ₹ 100 each.
4. The equity shareholders of P Ltd. are to be allotted 10 equity shares at par for 7 equity shares held by them. The shares of P Ltd. are of ₹ 10 each
5. The assets of P Ltd. are taken over at book value.
6. The assets & liabilities of Q Ltd. are valued as follows:

	₹
Goodwill	1,20,000
Land	6,00,000
Building	1,80,000
Plant	4,80,000
Other Fixed Assets	60,000
All Current Assets	6,00,000
All Current Liabilities	6,00,000

The balance of consideration is to be paid by allotment of equity shares at par to Q Ltd.

You are required to show:

(i) Purchase consideration payable to P Ltd. and Q Ltd.

(ii) Opening entries in the books of R Ltd.

Assume that R Ltd. does not intend to carry on the same business of P Ltd.

Solution

Computation of Purchase Consideration:

I: To P Ltd: Net Payment Method:			₹
(i) 3,600 12% Preference Shares of ₹ 100 Each			3,60,000
Add:			
(ii) 1,00,000 Equity Shares ($84,000 \times \frac{10}{7}$) of ₹ 10 each			12,00,000
			15,60,000
II: To Q Ltd: Net Assets Method:	₹		
(i) Assets (After Revaluation)			20,40,000
Less:			
(i) Current Liabilities	6,00,000		
(ii) 9% Debentures	3,60,000		9,60,000
			10,80,000

This Purchase Consideration Is to Be Discharged
by Issue of 1,08,000 Equity Shares of ₹ 10 Each = ₹ 10,80,000

In the Books of R Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Business Purchase A/c	Dr.		26,40,000	
	To Liquidators of P Ltd.				15,60,000
	To Liquidators of Q Ltd.				10,80,000
	(Purchase Consideration to Be Paid to Liquidators of P Ltd. & Q Ltd. Ref: Computation of Purchase Consideration for Figures)				
	Goodwill A/c (Bal. Fig)	Dr.		60,000	
	Land	Dr.		6,00,000	
	Building	Dr.		1,80,000	
	Plant	Dr.		16,80,000	
	Other Fixed Assets	Dr.		1,20,000	
	Current Assets	Dr.		16,80,000	
	To Current Liabilities				10,80,000
	To 9% Debentures of P Ltd.				2,40,000
	To 9% Debentures of Q Ltd.				3,60,000
	To Business Purchase A/c				26,40,000
	(Assets and Liabilities of P Ltd. & Q Ltd. are Taken Over; goodwill – Balancing Figure)				

	Liquidators of P Ltd.	Dr.		15,60,000	
	Liquidators of Q Ltd.	Dr.		10,80,000	
	To 12% Preference Share Capital A/c				3,60,000
	To Equity Share Capital A/c				22,80,000
	(Payment Made to Liquidators)				
	9% Debentures of P Ltd.	Dr.		2,40,000	
	To 14% Debentures A/c				2,40,000
	(Issue of 14% Debentures to 9% Debenture Holders of P Ltd.)				
	9% Debentures of Q Ltd.	Dr.		3,60,000	
	To Equity Share Capital A/c				3,00,000
	To Securities Premium A/c				60,000
	(Issue of Equity Shares at Premium)				

Illustration 9.14

Model: Amalgamation in the nature of merger and purchase—Preparation of balance sheet

The following are the abridged balance sheets of C Ltd. and D Ltd. as on 31 March 2011:

Liabilities	**C Ltd.** ₹	**D Ltd.** ₹	**Assets**	**C Ltd.** ₹	**D Ltd.** ₹
Equity Share Capital of ₹100 Each	40,000	15,000	Fixed Assets	55,000	23,650
12% Preference Shares of ₹100 Each	—	5,000	Current Assets	20,000	9,850
General Reserve	23,050	4,900			
Statutory Reserve	1,950	625			
Profit & Loss A/c	2,815	1,775			
14% Debentures	—	1,250			
Current Liabilities	7,185	4,950			
	75,000	33,500		75,000	33,500

On 1 April 2011, C Ltd. takes over D Ltd. on the following terms:

(i) C Ltd. will issue 1,75,000 equity shares of ₹100 each at par to equity shareholders of D Ltd.

(ii) C Ltd. will issue 55,000 12% preference shares of ₹100 each at par to the preference shareholders of D Ltd.

(iii) The debentures of D Ltd. will be converted into an equal number of 15% debentures of the same denomination. You are informed that the statutory reserves of D Ltd. are to be maintained for two more years.

You are required to show the balance sheet of C Ltd. immediately after the above-mentioned scheme of amalgamation has been implemented assuming that:

(a) The amalgamation is in the nature of merger

(b) The amalgamation is in the nature of purchase

[C.S. (Inter). Modified]

Solution

(a) When the amalgamation is in the nature of merger:

Stage I: Computation of General Reserve:		₹
Step 1:	C Ltd.'s General Reserve:	2,30,50,000
Add:		
Step 2:	D Ltd.'s General Reserve:	49,00,000
		2,79,50,000
Less:		
Step 3:	Difference Between Purchase Consideration and Share Capital of D Ltd. = ₹ 2,30,00,000 – ₹ 2,00,00,000	30,00,000
Step 4:	General Reserve (To Be Shown in B/S	2,49,50,000

Stage II: Balance Sheet of C Ltd. as on 1 April 2011:

(₹ in '000s)

Liabilities	₹	**Assets**	₹
Equity Share Capital:		Fixed Assets	
1,75,000 Shares + 4,00,000 Shares		(₹ 55,000 + ₹ 23,650)	78,650
5,75,000 Shares of ₹ 100 Each	57,500	↓ ↓	
Pref. Share Capital:		C Ltd. D Ltd. (Given)	
55,000 12% Preference Shares of ₹ 100 Each (see: Terms)	5,500	Current Assets	
General Reserve:	24,950	(₹ 20,000 + ₹ 9,850)	29,850
(Ref: Stage I Step 4)		↓ ↓	
Statutory Reserve (₹ 1,950 + ₹ 625)	2,575	C Ltd. D Ltd. (Given)	
Profit & Loss A/c (₹ 2,815 + ₹ 1,775)	4,590		
15% Debentures	1,250		
Current Liabilities (₹ 7,185 + ₹ 4,950)	12,135		
	1,08,500		1,08,500

(b) When amalgamation is in the nature of purchase:

Stage I: Computation of Capital Reserve/Goodwill:			(₹ in 000's)
Step 1:	Assets of D Ltd. Taken Over by C Ltd.		33,500
Less:			
Step 2:	Debentures of D Ltd.		1,250
			32,250
Less:			
Step 3:	Current Liabilities of D Ltd.		4,950
			27,300
Less:			
Step 4:	Contribution Payable to:	₹	
	Equity Shareholders	17,500	
	Pref. Shareholders	5,500	23,000
Step 5:	Capital Reserve to Be Shown in B/S =		4,300

Stage II:

Balance Sheet of C Ltd.
as on 1 April 2011

(₹ in 000's)

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	78,650
(1,75,000 Shares + 4,00,000 Shares 5,75,000 Shares of ₹ 100	57,500	(₹ 55,000 + ₹ 23,650)	
		Current Assets	29,850
Pref. Share Capital:		(₹ 20,000 + ₹ 9,850)	
55,000, 12% Pref. Shares of ₹ 100 Fully Paid	5,500	Amalgamation Adjustment Account (See : Note Below)	625
Capital Reserve (Ref: Stage I Step 5)	4,300		
General Reserve	23,050		
Statutory Reserve (₹ 1,950 + ₹ 625)	2,575		
Profit & Loss A/c	2,815		
15% Debentures	1,250		
Current Liabilities (₹ 7,185 + ₹ 4,950)	12,135		
	1,09,125		1,09,125

Note: As per the direction of the question, statutory reserves are to be maintained for two more years.

Hence, an equal amount is to be shown under the head "Amalgamation Adjustment A/c" on the assets side of the balance sheet.

When the conditional period is over, both can be eliminated from the balance sheet.

Illustration 9.15

Model: Preparation of balance sheet—Amalgamationby "pooling of interest" method

V Ltd. and R Ltd. were amalgamated on and from 1 April 2011. A new company S Ltd. was formed to take over the business of existing companies. The balance sheets of V Ltd. and R Ltd. as on 31 March 2011 are given in the following:

(₹ in Lakhs)

Liabilities	V Ltd. ₹	R Ltd. ₹	Assets	V Ltd. ₹	R Ltd. ₹
Share Capital:			Fixed Assets	6,000	5,000
Equity Shares of ₹ 100 Each	5,000	4,000	Current Assets Loans & Advances	4,400	2,825
10% Pref. Shares of ₹ 100 Each	2,000	1,500			
Reserve & Surplus:	500	400			
Revaluation Reserve					
General Reserve	1,000	750			
P&L A/c	400	300			

Secured Loan:					
12% Debentures of ₹ 100 Each	480	400			
Current Liabilities and Provisions	1,020	475			
	10,400	7,825		10,400	7,825

Other information:

(i) 12% Debenture holders of V Ltd. and R Ltd. are discharged by S Ltd. by issuing adequate number of 16% debentures of ₹ 100 each to ensure that they continue to receive the same amount of interest.

(ii) Preference shareholders of V Ltd. and R Ltd. have received the same number of 10% preference shares of ₹ 100 each of S Ltd.

(iii) S Ltd. has issued 7.5 lakh equity shares for each equity share of V Ltd. and 5 lakh equity shares for each share of R Ltd. The face value of shares issued by S Ltd. is ₹ 100 each.

Prepare the balance sheet of S Ltd. as on 1 April 2011, after the amalgamation has been carried out using the "pooling of interest method".

[C.A. Modified]

Solution

Basic Calculations:

Stage I: Amalgamation Is in the Nature of Merger. First, Purchase Consideration Has to Be Determined as Follows:

Computation of Purchase Consideration: (₹ in Lakhs)

	V Ltd. ₹	R Ltd. ₹	Total ₹
Step 1: Amount to Be Paid to Equity Shareholders	7,500	4,000	11,500
Step 2: Amount to Be Paid to Preference Shareholders	2,000	1,500	3,500
Step 3: Purchase Consideration (Step 1 + Step 2)	9,500	5,500	15,000
Stage II: Determination of Difference Between Purchase Consideration and Share Capital:			
Amount of Sharecapital:	7,000	5,500	12,500
Difference (Stage I – Stage II):	2,500	Nil	2,500
Stage III: Assessment of Difference With Amount of Debenture Holders:			
Amount of Debentures Issued:	360 $\left(\frac{12\%}{16\%} \times 480\right)$	300 $\left(\frac{12\%}{16\%} \times 400\right)$	660
Amount of Debentures of Transferor Companies	480	400	880
Difference =	(120)	(100)	(220)

Stage IV: Total Difference = (₹ 2,500 lakh – ₹ 220 lakh)
(Stage II) (Stage III)
= ₹ 2,280 lakh.

Stage V: Adjustment of Difference Against Reserve:

	Combined Amount	Adjusted Amount	B/S Amount
General Reserve	1,750	1,750	NIL
Profit & Loss A/c	700	530	170
	2,450	2,280	170

Stage VI: Preparation of Balance Sheet:

Balance Sheet of S Ltd.
as at 1 April 2011

(₹ in Lakhs)

Liabilities	₹	Assets	₹
Equity Shares of ₹ 100 Each (1.5 × 5,000 + 1 × 4,000)	11,500	Fixed Assets (₹ 6,000 + ₹ 5,000)	11,000
10% Preference Shares (₹ 2,000 + ₹ 1,500)	3,500	↓ ↓ V Ltd. R Ltd.	
Revaluation Reserve (₹ 500 + ₹ 400)	900	Current Assets, Loans and Advances (₹ 4,400 + ₹ 2,825)	7,225
General Reserve (Ref: Basic Calculation Stage V)	Nil		
Profit & Loss A/c (Ref: Stage V)	170		
16% Debentures of ₹ 100 Each (Ref: stage V)	660		
Current Liabilities and Provisions (₹ 1,020 + ₹ 475)	1,495		
	18,225		18,225

Illustration 9.16

Model: Preparation of balance sheet—Amalgamation in the nature of merger

X Ltd. and Y Ltd. were amalgamated on and from 1 April 2011. A new company Z Ltd. was formed to take over the business of existing companies. The balance sheets of X Ltd. and Y Ltd. as on 31 March 2011 are shown in the following:

(₹ in 000's)

Liabilities	X Ltd. ₹	Y Ltd. ₹	Assets	X Ltd. ₹	Y Ltd. ₹
Share Capital:			Fixed Assets:	3,600	2,400
Equity Shares of ₹ 100 Each	1,800	1,200	Less: Depreciation	600	450
10% Pref. Shares of ₹ 100 Each	900	600		3,000	1,950
			Investments	1,200	450

Reserve & Surplus:			Currents Assets:		
Capital Reserve	650	400	Stock	900	450
General Reserve	900	450	Debtors	1,200	600
Profit & Loss A/c	300	150	Cash & Bank Balance	900	450
Secured Loans	1,200	600			
Trade Creditors	900	300			
Tax Provision	600	150			
	7,200	3,900		7,200	3,900

Other information:

(i) Preference shareholders of the two companies are issued equipment number of 12% preference shares of Z Ltd .

(ii) Z Ltd. will issue one equity share of ₹ 100 each for every share of X Ltd. and Y Ltd.

You are required to prepare the balance sheet of Z Ltd. on the assumption that the amalgamation is in the nature of merger.

Solution

Stage I: Computation of Purchase Consideration:

(₹ in 000's)

Particulars		**X Ltd.** ₹	**Y Ltd.** ₹
Step 1:	Payment to Preference Shareholders:		
	9,000 Shares of ₹ 100 Each—X Ltd.	900	—
	6,000 Shares of ₹ 100 Each—Y Ltd.	—	600
Add:			
Step 2:	Payment to Equity Shareholders:		
	18,000 Shares of ₹ 100 Each—X Ltd.	1,800	—
	12,000 Shares of ₹ 100 Each—Y Ltd.	—	1,200
Step 3:	Purchase Consideration (Step 1 + Step 2)	2,700	1,800

Stage II: Ascertainment of Difference Between Purchase Consideration and Share Capital:

(i) Pref. Share Capital + Equity Share Capital	2,700	1,800
(ii) Purchase Consideration (Ref: Stage I Step 3)	2,700	1,800
(iii) Difference [(i) – (ii)]	Nil	Nil

Hence, no amount is to be adjusted against reserves, since the difference between purchase consideration and share capital is NIL.

∴ Capital reserve and general reserve are to be shown in the balance sheet of Z Ltd. at their original values shown in the balance sheets of P Ltd. and Q Ltd. with out any adjustments.

Stage III: Preparation of Balance Sheet:

Balance Sheet of Z Ltd.
as on 1 April 2011

(₹ in 000's)

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
(9,000 + 6,000) 15,000 Preference Shares of ₹ 100 Each	1,500	₹ 3,600 + ₹ 2,400 = ₹ 6,000	
(18,000 + 12,000) 30,000 Equity Shares of ₹ 100 Each	3,000	Less: Depreciation:	
Reserve & Surplus:		₹ 600 + ₹ 450 = ₹ 1,050	4,950
Capital Reserve (₹ 600 + ₹ 450)	1,050	Investments	1,650
General Reserve	1,350	(₹ 1,200 + ₹ 450)	
(₹ 900 + ₹ 450)		Current Assets:	
Profit & Loss A/c (₹ 300 + ₹ 150)	450	Stock (₹ 900 + ₹ 450)	1,350
Secured Loan (₹ 1,200 + ₹ 600)	1,800	Debtors (₹ 1,200 + ₹ 600)	1,800
Trade Creditors (₹ 900 + ₹ 300)	1,200	Cash & Bank Balances (₹ 900 + ₹ 450)	1,350
Tax Provision (₹ 600 + ₹ 150)	750		
	11,100		11,100

Illustration 9.17

Model: Preparation of balance sheet—Amalgamation in the nature of purchase

Given below are the balance sheets of Strong Ltd. and Weak Ltd. as on 31 March 2011. Weak Ltd. was merged with Strong Ltd. on 1 April 2011.

Balance Sheets
as on 31 March 2011

(₹ in 000's)

Liabilities	Strong Ltd. ₹	Weak Ltd. ₹	Assets	Strong Ltd.	Weak Ltd.
Share Capital:			Fixed Assets	3,000	2,000
Equity Share of ₹ 100 Each	2,500	1,500	Non-trade Investments	750	500
General Reserve			Current Assets:		
Profit & Loss A/c	1,000	500	Stocks	1,000	750
Export Profit Reserve	500	375	Debtors	1,000	500
10% Debentures	400	200	Bank Balance	750	300
Trade Creditors	600	625	Preliminary Expenses	100	—
Tax Provision	500	300			
Proposed Dividend	500	250			
	600	300			
	6,600	4,050		6,600	4,050

Other information:

(i) Strong Ltd. would issue sufficient number of debentures at par to the debenture holders of Weak Ltd.

(ii) For every share of Weak Ltd, Strong Ltd. would issue one share at a premum of ₹ 20 per share.

You are required to prepare the balance sheet of Strong Ltd. after merger assuming it to be in the nature of purchase.

Solution

Note: As per AS-14, payments made to debenture holders are not to be considered while determining the purchase consideration.

Stage I: Computation of Purchase Consideration: (₹ in 000's)

	Payments to Equity Shareholders		
	(15,000 Shares × ₹ 100 + ₹ 20	=	₹ 1,800 thousand
∴	Purchase Consideration	=	₹ 1,800 thousand

Stage II: Computation of Goodwill/Capital Reserve

			(₹ in 000's)
Step 1:	Assets Acquired (Total as Shown in Problem)	=	4,050
Less:			
Step 2:	Liabilities:	₹	(₹ in 000's)
	(i) 10% Debentures	625	
	(ii) Trade Creditors	300	
	(iii) Tax Provision	250	
	(iv) Proposed Dividend	300	
			1,475
Step 3:	Net Assets (Step 1 – Step 2) =		2,575
Step 4:	Less: Purchase Consideration (Stage 1)		1,800
Step 5:	Capital Reserve		775

[As net assets value is greater than purchase consideration, this results in capital reserve.]

Stage III: Preparation of Balance Sheet:

Balance Sheet of Strong Ltd.
as on 1 April 2011

(₹ in 000's)

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets (₹ 3,000 + ₹ 2,000)	5,000
40,000 Shares of ₹ 100 Each	4,000	Investments (₹ 750 + ₹ 500)	1,250
Reserve & Surplus:		Stock (₹ 1,000 + ₹ 750)	1,750
General Reserve	1,000	Debtors (₹ 1,000 + ₹ 500)	1,500
P&L A/c	500	Bank Balances (₹ 750 + ₹ 300)	1,050
Securities Premium	300	Preliminary Expenses	100
Export Profit Reserve (₹ 400 + ₹ 200)	600	Amalgamation Adjustment Account	200

Capital Reserve (Ref: Stage II)	775		
Secured Loans:			
10% Debentures (₹ 625 + ₹ 600)	1,225		
Trade Creditors (₹ 500 + ₹ 300)	800		
Tax Provision (₹ 500 + ₹ 250)	750		
Proposed Dividend (₹ 600 + ₹ 300)	900		
	10,850		10,850

9.4 ABSORPTION

9.4.1 Meaning

If an existing company takes over the business of another existing company or companies, it is termed as absorption. Merger is also absorption. To illustrate, when the business an existing company—say P Ltd.—is taken over by another existing company—Q Ltd.—it is absorption. In this case of absorption, P Ltd. will be liquidated and Q Ltd. will retain its identity.

9.4.2 Mean Features of Absorption

The following are the main features of absorption:

1. No new company will be formed.
2. At least one merged (absorbed) company will get liquidated. That means, more than one existing company can be merged with an existing company. The existing company is called the purchasing company (vendee company) and the merged company is called the vendor company (transferor company or absorbed company or liquidated company).

9.4.3 Accounting Treatment

1. Accounting entries in the books of vendor (transferor) Company:
   The procedure is same as that of adopted in the case of amalgamation.
2. Accounting entries in the books of purchasing (Transferee) Company:
   The procedure is same as explained in amalgamation. However, here it is immaterial whether the absorption is in the nature of merger or purchase. For both types, procedure is common in absorption unlike amalgamation.

9.4.4 Specific Problems (Issues) in Absorption

9.4.4.1 Intercompany Owings

It is natural to note that transferee company and transferor company are debtors and creditors of each other while absorption occurs. The reason is due to any of the following transactions:

(i) Purchase of goods
(ii) Sale of goods
(iii) Loans
(iv) Advances
(v) Bills of exchange given by one company to another company

After absorption, both the companies, i.e., the absorbing company as well as the absorbed company, become one single enterprise. The result being that the amounts involved in the above-mentioned

transactions are neither receivable nor payable. Then, how can these be dealt with? One such account has to be set off against the other. To illustrate, sundry debtors account have to be set off against sundry creditors. For such inter-company owings, the following journal entries are to be recorded in the books of the purchasing company (transferee or absorbing):

(i) Cancellation of Inter-company Debtors and Creditors

Sundry Creditors A/c (Amount Payable)	Dr.	….	
To Sundry Debtors A/c (Amount Receivable)			….

(ii) Cancellation of Inter-company Loans:

Loans Payable A/c (Amount Payable)	Dr.	…	
To Loans Receivable A/c (Amount Receivable)			…

(iii) Cancellation of Inter-company Bills:

Bills Payable A/c	Dr.	….	
To Bills Receivable A/c			….

Note:

1. Bills payable to third parties cannot be cancelled.
2. No special treatment is needed for transactions with respect to inter-company owings. Such accounts are to be transferred to realization A/c.

9.4.4.2 Inter-company Stock (Unrealized Profit

Case 1: Goods Sold by Transferor Company (Vendor):

It is found that some goods sold by the vendor company to the purchasing company may form a part of stock of the purchasing company when absorption takes place. Such goods are generally at sale price of the vendor company. They include the profit element. As stock is to be shown at cost, the profit part must be cancelled. For this, the following entries should be passed:

(a) When Absorption (Amalgamation) Is in the "Nature of Merger":

Profit and Loss A/c	Dr.	...	
(With the Amount of Unrealized Profit)			
Or General Reserve A/c	Dr	...	
To Stock A/c			...

(b) When Absorption Is in the "Nature of Purchase":

Goodwill A/c	Dr.	….	
(With the Amount of Unrealized Profit)			
To Stock A/c			….

Case 2: Goods Sold by the Purchasing Company:

The stock of goods of the transferor company may include some goods sold by transferee company to it. In such a situation, at the time of absorption, vendors stock will become the stock of purchasing company and the value of such stock will be as sale price. This includes the unrealized profit also.

Treatment: At times of absorption, the purchasing company will have to record such stock at its cost price.

9.4.4.3 Payment of Dividend Before Absorption

- When the company (transferor or transferee) pays dividend to its shareholders, the entry to be passed will be:

Profit & Loss Appropriation A/c Dr. ….
[Amount with the Dividend]
(Or) General Reserve A/c Dr. ….
To Bank A/c ….

- When the proposed dividend A/c appears in the balance sheet, the entry to be passed will be:

Proposed Dividend A/c Dr. ….
To Bank A/c …

Case 1: When the dividend is paid by the transferor company, then it is to be treated as dividend paid *before absorption*. In that case, reduced cash balance (dividend paid is to be deducted) is *transferred to realization A/c.* Similarly, the reduced balance of P&L appropriation A/c is transferred to equity shareholders account of the transferor company.

Case 2: When the dividend is paid by the purchasing company, the P&L appropriation A/c balance and cash (Bank) balances are reduced by the amount of dividend paid but *after absorption*, to be made in *balance sheet*.

9.4.4.4 Sale of Shares Received Towards Purhase Consideration

At times, the shareholders of the transferor company may seek the assistance of shareholders to sell some of the shares received as part of purchase consideration. The journal entries will be:

Case 1: Sale of Share in the Purchasing Company:

Bank A/c (With the Sale Value) Dr. ….
To Shares in Purchasing Company ….

Case 2: Profit on Sale of Shares:

Shares in Purchasing Company A/c Dr. …..
(With Profit)
To Equity Shareholders A/c ….

Case 3: Loss on Sale of Shares:

Equity Shareholders A/c (Loss) Dr. ….
To Shares in Purchasing Company ….

9.4.4.5 Distribution of Balance Shares

The remaining shares (after purchase consideration is discharged) will be distributed among the equity shareholders. They will get the balance in the form of cash. The entry will be:

Equity Shareholders A/c Dr. …
To Shares in Purchasing Company
To Bank A/c

Illustration 9.18

Model: Absorption—by way of merger

The following were the balance sheets of X Ltd. and Y Ltd. as on 31 March 2011:

Liabilities	X Ltd. ₹	Y Ltd. ₹	Assets	X Ltd. ₹	Y Ltd. ₹
2,25,000 10% Preference Shares of ₹ 100 Each	22,500	—	Goodwill	—	750
			Freehold Premises	36,000	—

90,00,000 Equity Shares of ₹ 10 Each	90,000	—	Machinery	1,03,530	—
			Furniture & Fittings	3,360	2,250
15,00,000 Equity Shares of ₹ 10 Each	—	15,000	Trademarks	300	—
			Stock	38,400	15,030
Capital Reserve	28,800	—	Debtors	13,020	3,510
General Reserve	37,200	4,350	Bills Receivable	—	300
Profit & Loss A/c	3,450	660	Bank	6,690	660
10% Debentures	15,000	—			
Creditors	4,350	2,490			
	2,01,300	22,500		2,01,300	22,500

On the above-mentioned date, X Ltd. merged with Y Ltd. The absorption by way of merger took place on the following conditions:

(i) Y Ltd. allotted to X Ltd. 2,25,000 15% fully paid preference shares of ₹ 100 each and 84,00,000 equity shares of ₹ 10 each to satisfy the claims of X Ltd's preference shareholders and equity shareholders respectively. Y Ltd. also agreed to convert 10% debentures of X Ltd. into 12% debentures at a discount of 10%.

(ii) Expenses of liquidation of X Ltd.—₹ 45,000—were borne by Y Ltd.

You are required to:

(a) Prepare necessary ledger accounts with respect to X Ltd.

(b) Pass journal entries in the books of Y Ltd.

(c) Prepare a post-absorption balance sheet in the books of Y Ltd.

Solution

Stage I: Calculation of Purchase Consideration:

		(₹ in 000's)
Step 1:	Payment to Pref. Shareholders:	
	2,25,000 Pref. Shares of ₹ 100 each:	22,500
Add		
Step 2:	Payment to Equity Shareholders:	
	84,00,000 Equity Shares of ₹ 10 Each	84,000
Step 3:	Purchase Consideration:	1,06,500

Stage II: Preparation of Ledger Accounts:

In the Books of X Ltd.

1. Realization Account

Dr. **Cr.**

Particulars	₹ in 000's	Particulars	₹ in 000's
Freehold Premises	36,000	10 % Debentures	15,000
Machinery	1,03,530	Creditors	4,350
Furniture & Fittings	3,360	Y Ltd. (Purchase Consideration	1,06,500
Trademarks	300	(Ref: Stage I)	
Stock	38,400	Equity Shareholders A/c	75,450

Debtors	13,020		
Cash at Bank	6,690		
	2,01,300		2,01,300

2. Y Ltd.'s A/c

Particulars	₹ in 000's	Particulars	₹ in 000's
Realization A/c	1,06,500	15% Pref. Shares in Y Ltd.	22,500
		Equity Shares in Y Ltd.	84,000
	1,06,500		1,06,500

3. Equity Shareholder's A/c

Particulars	₹ in 000's	Particulars	₹ in 000's
Realization A/c	75,450	Equity Share Capital A/c	90,000
Equity Shares in Y Ltd.	84,000	Capital Reserve A/c	28,800
		General Reserve A/c	37,200
		Profit & Loss A/c	3,450
	1,59,450		1,59,450

In the Books of Y Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Step 1: Purchase Consideration:				
	Business Purchase A/c	Dr.		1,06,500	
	To Liquidator of X Ltd.				1,06,500
	(Purchase Consideration Payable)				
	Step 2: Taken Over of Assets, Liabilities and Reserves of X Ltd.:				
	Freehold Premises A/c	Dr.		36,000	
	Machinery A/c	Dr.		1,03,530	
	Furniture & Fixtures A/c	Dr.		3,360	
	Trademarks A/c	Dr.		300	
	Stock A/c	Dr.		38,400	
	Debtors A/c	Dr.		13,020	
	Cash at Bank A/c	Dr.		6,690	
	To 10% Debentures A/c				15,000
	To Creditors A/c				4,350
	To General Reserve A/c				37,200
	To Profit & Loss A/c				3,450
	To Business Purchase A/c				1,06,500
	To Capital Reserve A/c (Balancing Figure)				34,800
	(Assets, Liabilities and Reserves of X Ltd. Taken Over by Y Ltd. and the Difference Is Transferred to Capital Reserve A/c)				

	Step 3: Allotment of Shares for Business Purchase:			
	Liquidators of X Ltd. Dr.		1,06,500	
	To 15% Preference Share Capital A/c			22,500
	To Equity Share Capital A/c			84,000
	(Allotment of Pref. Shares and Equity Shares for Take Over of Business)			
	Step 4: Allotment of Debentures:			
	10% Debentures A/c Dr.		15,000	
	To 12% Debentures A/c			13,500
	To Capital Reserve A/c (Discount Amount)			1,500
	(Allotment to Debenture Holders at 10% Discount)			
	Step 5: Expenses on Liquidation			
	Profit & Loss A/c Dr.		45	
	To Bank A/c			45
	(Liquidation Expenses)			
	Step 6: Goodwill Written off:			
	Capital Reserve A/c Dr.		750	
	To Goodwill A/c			750
	(Goodwill A/c Written off to Capital Reserve)			

Stage III: Preparation of Balance Sheet:

Working Notes:

1. Calculation of Amount to Be Adjusted in Reserve: Share Capital Taken Over

	(₹ in 000's)
Share Capital Taken Over	1,12,500
Less: Share Capital Issued	1,06,500
Surplus on Taken Over of Share Capital =	6,000

This has to be adjusted with capital reserve.

Balance Sheet of Y Ltd.
as on 1 April 2011

Liabilities	**₹ in 000's**	**Assets**	**₹ in 000's**
Share Capital:		Fixed Assets:	
Issued & Subscribed:	22,500	Freehold Premises	36,000
2,25,000 10% Pref Shares of ₹ 100		Machinery	1,03,530
99,00,000 Equity Shares of ₹ 10	99,000	Furniture & Fittings	
(This Includes All the Pref. Shares and 84,00,000 Equity Shares Issued for Consideration Other than Cash)		(₹ 3,360 + ₹ 2,250)	5,610
		Trademarks	300
		Current Assets:	
Capital Reserve (₹ 36,300 – ₹ 750)	35,550	Stock (₹ 38,400 + ₹ 15,030)	53,430
General Reserve (₹ 37,200 + ₹ 4,350)	41,550	Debtors (₹ 13,020 + ₹ 3,510)	

Profit & Loss A/c (₹ 3,450 + ₹ 660): ₹ 4,110 – ₹ 45 = ₹ 4,065	4,065	Cash at Bank (₹ 6,690 + ₹ 660 – ₹ 45)	16,530
Secured Loans:		Loans & Advances:	7,305
12% Debentures (₹ 15,000 – ₹ 1,500)	13,500	Bills Receivable	300
Current Liabilities:			
Creditors (₹ 4,350 + ₹ 2,490)	6,840		
	2,23,005		2,23,005

Illustration: 9.19

Model: Absorption—Nature of purchase: Net payment method

The following is the balance sheet of P Ltd. as on 31 March 2011:

Liabilities	₹	Assets	₹
Share Capital:		Land & Buildings	5,00,000
1,00,000 Shares of ₹ 10 Each	10,00,000	Plant & Machinery	7,50,000
General Reserve	1,25,000	Furniture	12,500
Dividend Equalization Reserve	1,00,000	Stock	3,00,000
Profit & Loss A/c	25,500	Work-in-Progress	1,50,000
12% Debentures	5,00,000	Sundry Debtors	1,25,000
Sundry Creditors	1,50,000	Cash at Bank	63,000
	19,00,500		19,00,500

The company was absorbed by Q Ltd. on the above date. The consideration for absorption is the discharge of the debentures at a premium of 5%, taking over the liability in respect of sundry creditors and a payment of ₹ 7 in cash and one share of ₹ 5 in Q Ltd. at the market value of ₹ 8 per share for every share in P Ltd. The cost of liquidation is to be met by the purchasing company amounts to ₹ 7,500.

You are required to close the books of P Ltd. and pass the journal entries in the books of Q Ltd.

[Madras University Modified]

Solution

I. Computation of Purchase Consideration:	₹
(i) Payment by Cash 1,00,000 Shares × ₹ 7 :	7,00,000
Add	
(ii) Payment in Shares : 1,00,000 shares × 1 × ₹ 8 :	8,00,000
∴ Purchase Consideration	15,00,000

Important notes:

1. Purchase price includes payment to shareholder's only in accordance with AS-14.
2. Debentures are to be taken over by Q Ltd. and then settled.
3. Cost of liquidation met by the purchasing company is to be shown as reimbursement.

II: **Book of P Ltd.**

Journal:

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2011	Realization A/c	Dr.		19,00,500	
	To Sundry Assets A/c				19,00,500
	(Transfer of all Assets to Realization A/c)				
31 March 2011	Sundry Creditors A/c	Dr.		1,50,000	
	12% Debentures A/c	Dr.		5,00,000	
	To Realization A/c				6,50,000
	(Transfer of Liabilities to Realization A/c)				
31 March 2011	Q Ltd. A/c	Dr.		15,00,000	
	To Realization A/c				15,00,000
	(Purchase Price Receivable)				
31 March 2011	Bank A/c	Dr.		7,00,000	
	Shares in Q Ltd. A/c	Dr.		8,00,000	
	To Q Ltd. A/c				15,00,000
	(Purchase Consideration Received in Cash & Shares)				
31 March 2011	Q Ltd. A/c	Dr.		7,500	
	To Bank A/c				7,500
	(Liquidation Expenses Paid)				
31 March 2011	Bank A/c	Dr.		7,500	
	To Q Ltd. A/c				7,500
	(Liquidation Expenses Reimbursed by Q Ltd.)				
31 March 2011	Share Capital A/c	Dr.		10,00,000	
	General Reserve A/c	Dr.		1,25,000	
	Dividend Equalization Reserve A/c	Dr.		1,00,000	
	Profit & Loss A/c	Dr.		25,500	
	To Shareholders A/c				12,50,500
	(Transfer for Share Capital & Accumulated Profits to Shareholders)				
31 March 2011	Realization A/c	Dr.		2,49,500	
	To Shareholders A/c				2,49,500
	(Profit on Realization)				

31 March 2011	Shareholders A/c Dr.		15,00,000	
	To Bank A/c			7,00,000
	To Shares in Q Ltd. A/c			8,00,000
	(Final Settlement by Payment of Cash and Shares)			

Ledger Accounts

1. Realization A/c

Particulars	₹	Particulars	₹
To Sundry Assets	19,00,000	By Sundry Creditors	1,50,000
To Shareholders A/c	2,49,500	By 12% Debentures	5,00,000
		By Q Ltd.	15,00,000
	21,50,000		21,50,000

2. Q Ltd.'s A/c

Particulars	₹	Particulars	₹
To Realization	15,00,000	By Bank A/c	7,00,000
		By Shares in Q Ltd.	8,00,000
	15,00,000		15,00,000

3. Shares in Q Ltd. A/c

Particulars	₹	Particulars	₹
To Q Ltd.	8,00,000	By Shareholders A/c	8,00,000
	8,00,000		8,00,000

4. Bank A/c

Particulars	₹	Particulars	₹
To Balance b/d	63,000	By Realization A/c Transfer	63,000
To Q Ltd.	7,00,000	By Shareholders A/c	7,00,000
To Q Ltd.	7,500	By Q Ltd.	7,500
	7,07,500		7,07,500

5. Shareholders A/c

Particulars	₹	Particulars	₹
To Bank A/c	7,00,000	By Share Capital A/c	10,00,000
To Share in Q Ltd.	8,00,000	By General Reserve	1,25,000
		By Dividend Equalization Reserve	1,00,000
		By Profit & Loss A/c	25,500
		By Realization A/c	2,49,500
	15,00,000		15,00,000

Books of Q Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2010	Business Purchase A/c	Dr.		15,00,000	
	To Liquidator of P Ltd. A/c				15,00,000
	(Purchase Consideration Payable)				
31 March 2010	Land & Building A/c	Dr.		5,00,000	
	Plant & Machinery A/c	Dr.		7,50,000	
	Furniture A/c	Dr.		12,500	
	Stock A/c	Dr.		3,00,000	
	Work-in-Progress A/c	Dr.		1,50,000	
	Sundry Debtors A/c	Dr.		1,25,000	
	Bank A/c			63,000	
	Goodwill A/c (Bal. Fig.)	Dr.		2,74,500	
	To Sundry Creditors A/c				1,50,000
	To 12% Debentures of P Ltd.				5,00,000
	To Premium on Redemption of Debentures				25,000
	To Business Purchase				15,00,000
	(Assets & Liabilities Taken Over)				
31 March 2010	Goodwill A/c	Dr.		7,500	
	To Bank A/c				7,500
	(Liquidation Expenses Paid)				
31 March 2010	12% Debentures of P Ltd.	Dr.		5,00,000	
	Premium on Redemption of Debenture	Dr.		25,000	
	To Debentures A/c				5,25,000
	(Transfer of Debentures)				
31 March 2010	Debenture Holders A/c	Dr.		5,25,000	
	To Bank A/c				5,25,000
	(Debenture Claim Discharged)				
31 March 2010	Liquidator of P Ltd.	Dr.		15,00,000	
	To Share Capital A/c (1,00,000 × ₹ 5)				5,00,000
	To Share Premium A/c (1,00,000 × ₹ 3)				3,00,000
	To Bank A/c				7,00,000
	(Purchase Consideration Paid in Cash and Shares)				

Illustration 9.20

Model: Absorption—Pooling of interests; Method—Net payment method

B Ltd. agreed to acquire the assets of C Ltd. except its investments as on 31 December 2010. Balance sheet of C Ltd. as on that date is given in the following:

Liabilities	₹	Assets	₹
Share Capital (₹ 10 Each)	8,00,000	Goodwill	2,50,000
Reserves	2,15,000	Land & Buildings	4,00,000
8% Debentures	3,00,000	Plant	4,00,000
Provision for Taxation	1,00,000	Investments	1,50,000
Creditors	1,85,000	Stock	2,00,000
		Debtors	1,00,000
		Bank	1,00,000
	16,00,000		16,00,000

B Ltd. Nil:

(i) Discharge the debentures at 8% premium by issue of 7% debentures in B Ltd. at 10% discount

(ii) Issue of 3 shares of B Ltd. at a valuation of ₹ 11 for every 2 shares in C Ltd.

(iii) Pay ₹ 2 in cash for each share of C Ltd.

(iv) Pay absorption expenses of ₹ 15,000

C Ltd. sells its investments for ₹ 1,60,000. One-third of the shares received from B Ltd. are sold at ₹ 10.50 each. Tax liability was determined at ₹ 1,20,000. Before the absorption, C Ltd, declares and pays 10% dividend to its shareholders.

You are required to given the required journal entries and the ledger accounts in the books of the vendor company.

Solution

Stage I: Computation of Purchase Consideration:

Step 1:	Payment to Shareholders in Cash:	₹
	(80,000 × ₹ 2) :	1,60,000

Add:

Step 2:	Payment by Shares in B Ltd.:	
	$(\frac{3}{2}\times$ 80,000 Shares) × ₹ 11 :	13,20,000
∴	Purchase Consideration =	14,80,000

Books of C Ltd.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 December 2010	Realization A/c Dr.		15,20,000	
	To Goodwill A/c			2,50,000
	To Land & Buildings A/c			4,00,000

	To Plant A/c				4,00,000
	To Investments A/c				1,50,000
	To Stock A/c				2,00,000
	To Debtors A/c				1,00,000
	To Bank A/c				20,000
	(Transfer of Assets to Realization A/c)				
	[***Note:*** Dividend Paid @ 10%, i.e. ₹ 80,000, Adjusted out of Revenue Profits and Bank A/c is Shown by Way of Deducting This, i.e., ₹ 1,00,000 – ₹ 80,000]				
31 December 2010	8% Debentures A/c	Dr.		3,00,000	
	To Realization A/c				3,00,000
	(Transfer of Debentures—Liability)				
31 December 2010	B Ltd. A/c	Dr.		14,80,000	
	To Realization A/c				14,80,000
	(Purchase Consideration Receivable) [Ref: Stage I]				
31 December 2010	Bank A/c	Dr.		1,60,000	
	Shares in B Ltd. A/c	Dr.		13,20,000	
	To B Ltd. A/c				14,80,000
	(Purchase Consideration Received in Cash and Shares)				
31 December 2010	Bank A/c	Dr.		1,60,000	
	To Realization A/c				1,60,000
	(Investments Not Taken Over Realized)				
31 December 2010	Provision for Taxation A/c	Dr.		1,00,000	
	Realization A/c	Dr.		20,000	
	To Tax Liability A/c				1,20,000
	(Tax Liability & Excess Loss Due to It)				
31 December 2010	Tax Liability A/c	Dr.		1,20,000	
	Creditors A/c	Dr.		1,85,000	
	To Bank A/c				3,05,000
	(Liabilities Not Taken Over Discharges)				
31 December 2010	B Ltd. A/c	Dr.		15,000	
	To Bank A/c				15,000
	(Expenses of Absorption Paid on Behalf of B Ltd.)				

31 December 2010	Bank A/c Dr.		15,000	
	To B Ltd. A/c			15,000
	(Reimbursement of Expenses)			
31 December 2010	Bank A/c Dr.		4,20,000	
	Realization A/c		20,000	
	To Shares in B Ltd.			4,40,000
	(Sale of $\frac{1}{3}$ of 1,20,000 = 40,000 Shares Received From B Ltd. @ ₹ 10.50 & Loss Thereon)			
31 December 2010	Dividend A/c Dr.		80,000	
	To Bank A/c			80,000
	(Dividend Paid to Shareholders @ 10%)			
31 December 2010	Reserves A/c Dr.		80,000	
	To Dividend A/c			80,000
	(Dividend Paid Adjusted Out of Profits)			
31 December 2010	Share Capital A/c Dr.		8,00,000	
	Reserves A/c (₹ 2,15,000 – ₹ 80,000) Dr.		1,35,000	
	To Shareholders A/c			9,35,000
	(Capital & Reserves Transferred to Shareholders A/c)			
31 December 2010	Realization A/c Dr.		3,80,000	
	To Shareholders A/c			3,80,000
	(Realization Profit)			
31 December 2010	Shareholders A/c Dr.		13,15,000	
	To Bank A/c			4,35,000
	To Shares in B Ltd. A/c			8,80,000
	(Final Settlement to Shareholders in Cash and Shares)			

Ledger Accounts

1. Realization A/c

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Sundry Assets	15,20,000	By Bank A/c (Investments)	1,60,000
To Tax Liability	20,000	By B Ltd.	14,80,000
(₹ 1,20,000 – ₹ 1,00,000)		By 8% Debentures	3,00,000
To Shares in B Ltd. (Loss)	20,000		
To Shareholders A/c (Profit)	3,80,000		
	19,40,000		19,40,000

2. Shares in B Ltd. A/c

Particulars	₹	Particulars	₹
To B Ltd.	13,20,000	By Bank A/c (Sale)	4,20,000
		By Realization (Loss)	20,000
		By Shareholders A/c	8,80,000
	13,20,000		13,20,000

3. B Ltd. A/c

Particulars	₹	Particulars	₹
To Realization A/c	14,80,000	By Bank A/c	1,60,000
To Bank (Absorption Exp.)	15,000	By Shares in B Ltd	13,20,000
		By Bank (Absorption Exp.)	15,000
	14,95,000		14,95,000

4. Bank A/c

Particulars	₹	Particulars	₹
To Balance b/d	1,00,000	By Dividend A/c	80,000
		By Realization A/c	20,000
	1,00,000		1,00,000
To B Ltd.	1,60,000	By B Ltd.	15,000
To Realization A/c	1,60,000	By Tax liability	1,20,000
To Shares in B Ltd.	4,20,000	By Creditors	1,85,000
To B Ltd.	15,000	By Shareholders	4,35,000
	7,55,000		7,55,000

5. Shareholders A/c

Particulars	₹	Particulars	₹
To Bank A/c	4,35,000	By Shareholders A/c	8,00,000
To Shares in B Ltd.	8,80,000	By Reserves (₹ 2,15,000 – ₹ 80,000)	1,35,000
		By Realization A/c	3,80,000
	13,15,000		13,15,000

Illustration 9.21

Model: Absorption—Net assets method

The financial position of two companies R Ltd. and S Ltd. as on 31 March 2011 was as follows:

(₹ in 000's)

Liabilities	R Ltd. ₹	S Ltd. ₹	Assets	R Ltd. ₹	S Ltd. ₹
Equity Shares of ₹ 10 Each	5,000	1,500	Goodwill	250	125
9% Pref. Shares of ₹ 100			Building	1,500	500
Each	500	—	Machinery	2,500	750
10% Pref. Shares of			Stock	1,250	875
₹ 100 Each	—	500	Debtors	1,000	500
General Reserve			Cash at Bank	250	100
	500	400	Preliminary Expenses	150	50

Retirement Gravity Fund	250	100			
Sundry Creditors	650	400			
	6,900	2,900		6,900	2,900

R Ltd. absorbs S Ltd. on the following terms:

(i) 10% Preference shareholders are to be paid at 10% premium by issue of 9% preference shares of R Ltd.

(ii) Goodwill of S Ltd. is valued at ₹ 250 thousand, buildings are valued at ₹ 750 thousand and machinery at ₹ 800 thousand

(iii) Stock to be taken over at 10% less value; and reserve for bad and doubtful debts to be created at 7.5%

(iv) Equity shareholders of S Ltd. will be issued equity shares @ 5% premium

You are required to:

(a) Prepare necessary ledger accounts to close the books of S Ltd.

(b) Show the acquisition entries in the books of R Ltd.

(c) Construct the balance sheet after absorption as at 31 March 2011

Solution

Stage I: Computation of Purchase Consideration:

(All Values at Agreed Terms)

			(₹ in' 000)
Step 1:	Add: (All Assets:)		
	Goodwill		250
	Building		750
	Machinery		800
	Stock (10% Less)		787.5
	Debtors (creation of 7.5% DD)		462.5
	Cash at Bank		100
			3,150.0
Step 2:	Less: Liabilities:		
	Gratuity	100	
	Creditors	400	500
Step 3:	Net Assets (Purchase Consideration):		2,650

Stage II: Discharge of Purchase Consideration:

		(₹ in 000's)
Step 1:	Payment to 10% Preference Shareholders of S Ltd.	500
Add:	Premium @ 10% (As per Direction in Question)	50
		550
Step 2:	Payment to 9% Pref. Shares of S Ltd. 5,500 Shares × ₹ 100:	550
Step 3:	Payment to Equity Shareholders of S Ltd. by Issuing 2 lakh Equity Shares of S Ltd. at 5% Premium (2 lakh × ₹ 10.50):	2,100
Step 4:	Pref. + Equity Shareholders Total =	2,650

Stage III: Ledger Accounts in the Books of S Ltd

1. Realization Account

(₹ in 000's)

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Sundry Assets (₹ 2,900 – ₹ 50)	2,850	By Gratuity Fund	100
To Pref. Shareholders (Premium on Redemption)	50	By Sundry Creditors	400
		By R Ltd. (Ref: Stage I Step 3)	2,650
To Equity Shareholders (Profit on Realization)	250		
	3150		3150

2. Equity Shareholders A/c

Particulars	₹in 000's	Particulars	₹in 000's
To Preliminary Expenses	50	By Share Capital	1,500
To Equity Shares of R Ltd.	2,100	By General Reserve	400
		By Realization A/c (Profit on realization)	250
	2,150		2,150

3. Preference Shareholders A/c

Particulars	₹in 000's	Particulars	₹in 000's
To 9% PZref. Shares of R Ltd.	550	By Pref. Share Capital	500
		By Realization A/c (Premium on Redemption)	50
	550		550

4. R Ltd. A/c

Particulars	₹in 000's	Particulars	₹in 000's
To Realization A/c	2,650	By 9% Preference Shares	550
		By Equity Shares	2,100
	2,650		2,650

Stage IV: Journal Entries (in the Books of R Ltd.)

(₹ in 000's)

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2011	Goodwill A/c	Dr.		250	
	Building A/c	Dr.		750	
	Machinery A/c	Dr.		800	
	Stock A/c	Dr.		787.5	
	Debtors A/c	Dr.		500	
	Bank A/c	Dr.		100	

	To Gratuity Fund A/c			100
	To Sundry Creditors A/c			400
	To Provision for Doubtful Debts A/c			37.5
	To Liquidators of S Ltd. A/c			2,650
	(Assets & Liabilities are Taken Over)			
31 March 2011	Liquidators of S Ltd. A/c Dr.		2,650	
	To 9% Preference Share Capital A/c			550
	To Equity Share Capital A/c			2,000
	To Securities Premium A/c			100
	(Purchase Consideration Discharged in the Form of Pref. Shares and Equity @ 5% Premium			

STAGE V:

Balance Sheet of R Ltd.
(After Absorption)
as at 31 March 2011

(₹ in 000's)

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets:		
10,500 9% Preference Shares of ₹ 100 Each	1,050	Goodwill		500
		Building		2,250
7,00,000 Equity Shares of ₹ 10	7,000	Machinery		3,300
(5,500 Pref Shares & 2,00,000 Equity Shares Were Issued in Consideration Other than Cash)		Current Assets:		
		Stock:		2,037.5
			₹ in 000's	
Reserve & Surplus:		Debtors	1,500	
Securities Premium	100	Less: Provision	37.5	1,462.5
General Reserve	500	Cash at Bank		350
Current Liabilities:		Miscellaneous Expenses to the Extent Not Written off:		
Gratuity Fund	350			
Sundry Creditors	1,050	Preliminary Expenses		150
	10,050			10,050

Illustration 9.22

Model: Absorption—Purchase and merger

The following are the balance sheets of A Ltd. and B Ltd. as on 31 March 2011:

(₹ in 000's)

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Equity Share Capital of ₹ 10 Each	3,000	1,800	Land & Buildings	1,500	930

14% Pref. Share Capital of ₹ 100 Each	1,320	1,020	Plants & Machinery	1,950	1,020
General Reserve	300	150	Furniture & Fittings	345	210
Export Profit Reserve	180	120	Investments	750	570
Investment Allowance Reserve	—	60	Stock	540	618
Profit & Loss A/c	450	300	Debtors	435	312
13% Debentures (₹ 100 Each	300	210	Cash & Bank	420	300
Current Liabilities)	390	300			
	5,940	3,960		5,940	3,960

A Ltd. takes over B Ltd. on 1 April 2011. A Ltd. discharges the purchase consideration as follows:

(i) Issued 2,10,000 equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.

(ii) Issued 15% preference shares of ₹ 100 each to discharge the preference shareholders of B Ltd. at 10% premium

(iii) The debentures of B Ltd. will be converted into equivalent number of debentures of A Ltd.

(iv) The statutory reserves of B Ltd. (Export profit reserve and investment allowance reserve) are to be maintained for three more years

You are required to prepare the balance sheet of A Ltd. assuming that:

(a) The amalgamation is in the nature of merger

(b) The amalgamation is in the nature of purchase

[B.Com (Hons) Delhi Modified]

Solution

Computation of Purchase Consideration:

(₹ in 000's)

Step 1:	Payment to Preference Shareholders:	
	(11,220 Preference Shares × ₹ 100) + Including Premium at 10%	1,122
Add:		
Step 2:	Payment to Equity Shareholders:	
	2,10,000 lakh equity Shares × ₹ 10	2,100
Step 3:	Purchase Consideration =	3,222

(a) Amalgamation in the "nature of merger":

Balance Sheet of A Ltd.
as at 31 March 2011

(₹ in 000's)

Liabilities	₹	**Assets**	₹
Equity Share Capital:			
5,10,000 Shares of ₹ 10 Each	5,100	Land & Buildings (₹ 1,500 + ₹ 930)	2,430

Preference Share Capital: 15% Pref. Shares (11,220) of ₹ 100	1,222	Plant & Machinery (₹ 1,950 + ₹ 1,020)	2,970
14% Pref. Shares (13,200) of ₹ 100 (These Include 2,10,000 Equity Shares of ₹ 10 Each and 11,220 15% Pref. Shares of ₹ 100 Each, Which Are Allotted to Vendors for Consideration Other than Cash)	1,320	Furniture & Fittings (₹ 345 + ₹ 210)	555
General Reserve	300	Investments (₹ 750 + ₹ 570)	1,320
Export Profit Reserve	300	Stock (₹ 540 + ₹ 618)	1,158
Investment Allowance Reserve	60	Debtors (₹ 435 + ₹ 312)	747
Profit & Loss A/c	498	Cash at Bank	720
13% Debentures	510		
Current Liabilities	690		
	9,900		9,900

Profit and Loss A/c may also determined and verified by means of journal entry as follows:

(₹ in 000's)

Particulars		**Dr.** ₹	**Cr.** ₹
Land & Buildings A/c	Dr.	930	
Plant & Machinery A/c	Dr.	1,020	
Furniture & Fittings A/c	Dr.	210	
Investments A/c	Dr.	570	
Stock A/c	Dr.	618	
Debtors A/c	Dr.	312	
Cash & Bank A/c	Dr.	300	
To 13% Debentures A/c			210
To Current Liabilities A/c			300
To Export Profit Reserve A/c			120
To Investment Allowance Reserve			60
To Profit & Loss A/c (₹ 300 – ₹ 252)			48
To Liquidators of B Ltd.			3,222
		3,960	3,960

Computation of Capital Reserve:

			₹
Step 1:	Total Assets of B Ltd. Taken Over		3,960
Step 2:	Less: 13% Debentures:	210	
	Current Liabilities:	300	510
Step 3:	Net Assets Taken Over		3,450
Step 4:	Less: Purchase Consideration		3,222
Step 5:	∴ Capital Reserve		228

(b) Amalgamation in the "nature of purchase":

Balance Sheet of A Ltd
as at 31 March 2011

(₹ in 000's)

Liabilities	₹	**Assets**	₹
Equity Share Capital:		Land & Buildings	2,430
5,10,000 Shares of ₹ 10 Each	5,100	Plant & Machinery	2,970
Preference Share Capital:		Furniture & Fittings	555
15% 11,220 Pref. Shares of ₹ 100 Each	1,122	Investments	1,320
14% 13,200 Pref. Shares of ₹ 100 Each	1,320	Stock	1,158
(These Include 2,10,000 Equity Shares of		Debtors	747
₹ 10 Each and 11,220 15% Pref. Shares of		Cash at Bank	720
₹ 100 Each That are Allotted to Vendors		Amalgamation Adjustment A/c	180
for Consideration Other Than Cash)			
General Reserve			
Capital Reserve	300		
Profit & Loss A/c	228		
Export Profit Reserve A/c	450		
Investment Allowance Reserve	300		
13% Debentures	60		
Current Liabilities	510		
	690		
	10,080		10,080

*Capital Reserve may be determined and even verified through the entry as follows:

(₹ in 000's)

Particulars		**Dr.**	**Cr.**
Land & Buildings A/c	Dr.	930	
Plant & Machinery A/c	Dr.	1,020	
Furniture & Fittings A/c	Dr.	210	
Investments A/c	Dr.	570	
Stock A/c	Dr.	618	
Debtors A/c	Dr.	312	
Cash & Bank A/c	Dr.	300	
To 13% Debentures A/c			210
To Current liabilities A/c			300
To Liquidators of B Ltd. A/c			3,222
To Capital Reserve A/c (Bal. Fig)			228
		3,960	3,960

Illustration 9.23

Model: Absorption in the nature of purchase

The summarized balance sheet of Veer Ltd. on 30 June 2010 was as follows:

Liabilities	₹	Assets	₹
Share Capital:			
Shares of ₹ 10 Fully Paid	18,00,000	Goodwill	3,00,000
General Reserve	5,10,000	Land, Building & Plans	19,20,000
Profit & Loss Account	3,30,000	Stock	5,04,000
12% Debentures	3,00,000	Debtors	1,08,000
Creditors	60,000	Cash	1,68,000
	30,00,000		30,00,000

Karat Ltd. agreed to absorb the business of Veer Ltd. with effect from 1 July 2010. The purchase consideration payable by Karat Ltd. was agreed as follows:

(i) A cash payment equivalent to ₹ 2.50 for every ₹ 10 share in Veer Ltd.

(ii) The issue of 2,70,000 equity shares of ₹ 10 each fully paid in Karat Ltd. having an agreed value of ₹ 15 per share

(iii) The issue of such an amount of fully paid 14% debentures in Karat Ltd. at 96% is sufficient to discharge 12% debentures in Veer Ltd. at a premium of 20%

(iv) When computing purchase consideration, Karat Ltd. valued land, Building and plans at ₹ 36,00,000; stock at ₹ 4,26,000 and debtors at their face value subject to a reserve of 5% for doubtful debts.

You are required to:

(a) Close the books of Veer Ltd. by preparing realization A/c, Karat Ltd. A/c, shareholders' A/c and debentures A/c

(b) Pass journal entries in the books of Karat Ltd. regarding acquisition of business

[C.A. (Inter). Modified]

Solution

Computation of Purchase Consideration:

		₹
Step 1:	Cash Payment of Shareholders: 1,80,000 × ₹ 2.50	4,50,000
Add:		
Step 2:	Payment to Equity Shareholders: 2,70,000 × ₹ 15	40,50,000
Step 3:	Purchase Consideration	45,00,000

In the Books of Veer Ltd.

Realization A/c

Dr. **Cr.**

Particulars	₹	Particulars	₹
Goodwill A/c	3,00,000	Creditors A/c	60,000
Land, Building & Plant	19,20,000	Karat Ltd. A/c	45,00,000
Stock A/c	5,04,000	12% Debentures A/c	3,00,000

Debtors A/c	1,08,000		
Cash A/c	1,53,00		
Cash A/c (Expenses)	15,000		
Shareholders A/c (Profit)	18,60,000		
	48,60,000		48,60,000

Karat Ltd. A/c

Particulars	₹	Particulars	₹
Realization A/c	45,00,000	Bank A/c	4,50,000
		Equity Shares in Karat Ltd.	40,50,000
	45,00,000		45,00,000

Shareholders' A/c

Particulars	₹	Particulars	₹
Bank A/c	4,50,000	Share Capital A/c	18,00,000
Equity Shares in Karat Ltd.	40,50,000	General Reserve A/c	5,10,000
		Profit & Loss A/c	3,30,000
		Realization A/c	18,60,000
	45,00,000		45,00,000

12% Debentures A/c

Particulars	₹	Particulars	₹
Realization A/c	3,00,000	Balance c/d	3,00,000
	3,00,000		3,00,000

Bank A/c

Particulars	₹	Particulars	₹
Cash A/c	1,68,000	Realization A/c (Transfer)	1,53,000
Karat Ltd.	4,50,000	Realization A/c (Expenses)	15,000
		Shareholders' A/c	4,50,000
	6,18,000		6,18,000

Working Notes:

1. As per AS-14, the purchase consideration means payment for shareholders.
   Shareholders of Veer Ltd. will get ₹ 45,00,000.
2. For expenses on liquidation, the existing cash is utilized.
3. Value of 10% debentures is determined as:
   Amount Payable = ₹ 3,60,000
   Issue Price = ₹ 96

$$\therefore \text{Number of Debentures} = \frac{₹,\ 3,60,000}{₹\ 96} = 3,750$$

Face Value of Debentures		
3,750 × ₹ 100	=	₹ 3,75,000
Less: Discount @ 4%	=	₹ 15,000
	=	₹ 3,60,000

In the Books of Karat Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 July 2010	Business Purchase A/c	Dr.		45,00,000	
	To Liquidators of Veer Ltd.				45,00,000
	(Purchase Consideration)				
	Goodwill A/c (Bal. Fig)	Dr.		6,38,400	
	Land, Building and Plant A/c	Dr.		36,00,000	
	Stock A/c	Dr.		4,26,000	
	Debtors A/c	Dr.		1,08,000	
	Cash A/c	Dr.		1,53,000	
	To Creditors A/c				60,000
	To 12% Debentures in Veer Ltd. A/c				3,60,000
	To Provision for Doubtful Debts A/c				5,400
	To Business Purchase A/c				45,00,000
	(Business Taken Over, Goodwill → Bal. Fig)				
	Liquidators of Veer Ltd.	Dr.		45,00,000	
	To Equity Share Capital A/c				27,00,000
	To Securities Premium A/c				13,50,000
	To Bank A/c				4,50,000
	(Purchase Consideration Discharged)				
	12% Debentures in Veer Ltd.	Dr.		3,60,000	
	Discount on Issue of Debentures A/c	Dr.		15,000	
	To 14% Debentures A/c				3,75,000
	(Issue of 14% Debentures to Debenture Holders of Veer Ltd. at a Discount of 4%)				

Illustration 9.24

Model: Absorption—Intrinsic value method

The balance sheets of 'L' Ltd. and 'M' Ltd. as on 31 March 2011 were as follows:

Liabilities	L Ltd. ₹	M Ltd. ₹	Assets	L Ltd. ₹	M Ltd. ₹
Share Capital: (Equity)					
₹100 Each	15,00,000	—	Goodwill	1,20,000	—
₹10 Each	—	12,00,000	Fixed Assets	12,00,000	24,00,000
Capital Reserve	3,00,000	—	Cash at Bank	—	3,00,000
General Reserve	1,05,000	12,00,000	Other Current Assets	13,50,000	9,90,000
Secured Loan	—	7,50,000			
Unsecured Loan	3,00,000	—			
Sundry Creditors	4,65,000	5,40,000			
	26,70,000	36,90,000		26,70,000	36,90,000

It was proposed that L Ltd. should be taken over by M Ltd. The following terms were agreed upon by both the companies:

(i) Goodwill of L Ltd. is considered worthless.

(ii) Arrears of depreciation in L Ltd. amounted to ₹60,000.

(iii) The holder of every 2 shares in L Ltd. was to receive:

(a) As fully paid, at par, 10 shares in M Ltd.

(b) So much cash as is necessary to adjust the rights of shareholders of both the companies in accordance with the intrinsic values of the values of the shares as per their balance sheets after the adjustments mentioned above.

You are required to:

1. Determine the purchase consideration
2. Show the balance sheet of M Ltd. after the absorption, if the amalgamation is in the nature of purchase.

Solution

Stage I: Computation of Intrinsic Value of Shares:

(A) L Ltd. =		₹	₹
Step 1:	Fixed Assets:	12,00,000	
Step 2:	Less: Arrears in Depreciation	60,000	11,40,000
Step 3:	Add: Other Current Assets:		13,50,000
Step 4:	Gross Assets		24,90,000
Step 5:	Less: (i) Unsecured Loan:	3,00,000	
	(ii) Sundry Creditors:	4,65,000	7,65,000
Step 6:	Net Assets Available to Shareholders:		17,25,000

Step 7: Number of Equity Shares = $\frac{15,00,000}{₹100}$ = 15,000 Shares

Step 8: Intrinsic Value per Share = (Step 6 ÷ Step 7) = ₹ $\frac{17,25,000}{15,000}$ = ₹115

(B) M Ltd:

			₹
Step 1:	Fixed Assets		24,00,000
		₹	
Step 2:	Add:(i) Cash at Bank	3,00,000	
	(ii) Other Current Assets	9,90,000	12,90,000
Step 3:	Gross Assets =		36,90,000
Step 4:	Less: (i) Secured Loan	7,50,000	
	(ii) Sundry Creditors	5,40,000	12,90,000
Step 5:	Net Assets Available to Shareholders		24,00,000

Step 6: Number of Equity Shares = $\frac{12,00,000}{₹10}$ = 1,20,000 Shares

Step 7: Intrinsic Value per Share = $\frac{24,00,000}{1,20,000}$ = ₹ 20

Stage II: Ascertainment of Cash to Be Paid as Part of Purchase Price:

			₹
Step 1:	Intrinsic Value of 2 Shares in L Ltd: ₹ 115 × 2	=	230
	Less:		
Step 2:	Intrinsic Value of 10 Shares in M Ltd. = ₹ 20 × 10	=	200
Step 3:	Cash to Be Paid for Every 2 Shares	=	30
Step 4:	Cash to Be Paid per Share in L Ltd. (₹ 30 ÷ 2)	=	15

Stage III: Computation of Purchase Consideration:

		₹
Step 1:	Payment in Cash: 15,000 Shares × ₹ 15 :	2,25,000
	Add:	
Step 2:	Payment by Shares: 15,000 Shars × ₹ 20 × $\frac{10}{2}$	15,00,000
Step 3:	Purchase Consideration:	17,25,000

Stage IV: Balance Sheet of M Ltd. as at 31 March 2011:

Liabilities	₹	Assets	₹
Share Capital:			
1,95,000 Shares of ₹ 10 Each Fully Paid	19,50,000	Fixed Assets	35,40,000
		(₹ 11,40,000 + ₹ 24,00,000)	
(This Includes 75,000 Shares that Were		Cash at Bank	75,000
Issued for Consideration Other than		(₹ 3,00,000 – ₹ 2,25,000)	
Cash)			
Securities Premium	7,50,000	Other Current Assets	23,40,000
General Reserve	12,00,000	(₹ 13,50,000 + ₹ 9,90,000)	
Secured Loan	7,50,000		
Unsecured Loan	3,00,000		
Sundry Creditors	10,05,000		
(₹ 4,65,000 + ₹ 5,40,000)			
	59,55,000		59,55,000

Note:

(i) Face value of shares issued: $15,000 \times \frac{10}{2} \times 10 =$ ₹ 7,50,000

(ii) Premium on the share issued: $15,000 \times \frac{10}{2} \times 10 =$ ₹ 7,50,000

₹ 15,00,000

Illustration 9.25

Model: Absorption—Fraction of shares

The following are the balance sheets of X Ltd. and Y Ltd. as on 31 March 2011:

Liabilities	X Ltd. ₹	Y Ltd. ₹	Assets	X Ltd. ₹	Y Ltd. ₹
Share Capital:					
Share of ₹ 10 Each	8,00,000	16,00,000	Fixed Assets	9,60,000	20,00,000
General Reserve	3,20,000	4,80,000	Debtors	1,60,000	80,000
Profit and Loss A/c	80,000	—	Stock	2,40,000	3,20,000
Sundry Creditors	2,40,000	4,00,000	Cash	80,000	80,000
	14,40,000	24,80,000		14,40,000	24,80,000

Y Ltd. agreed to absorb X Ltd. on the following terms:

(i) Y Ltd. to give one share of ₹ 10 each as an agreed value of ₹ 30 per share for every three shares in X Ltd. The shares of Y Ltd. are quoted in the market at ₹ 45 per share.

(ii) The trade liability is to be taken over.

You are required to prepare:

(a) Journal entries in the books of Y Ltd.

(b) Balance sheet of Y Ltd. after absorption assuming the amalgamation is in nature of purchase

Solution

Stage I: Computation of Purchase Consideration:

Step 1: Calculation of Number of Shares to Be Received from Y Ltd:

Number of Shares in X Ltd. $\frac{8,00,000}{10}$: 80,000 Shares

Number of Shares to Be Received from Y Ltd. = 80,000 ÷ 3 = $26,666\frac{2}{3}$ Shares

	₹
Step 2: Payment to Shareholders as:	
Agreed Value = 26,666 Shares × 30 =	7,99,980
Step 3: Cash for Fractional Value of Shares = $\frac{2}{3} \times$ ₹ 45 = 30	
Step 4: Purchase Consideration:	8,00,010

Note: As fractions of shares with respect to individual shareholders are not given, it is ignored. Always fractions are to be valued at market price.

Stage II:

Books of Y Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2011	Business Purchase A/c	Dr.		8,00,010	
	To Liquidator of X Ltd.				8,00,010
	(Purchase Consideration Payable)				
	Fixed Assets A/c	Dr.		9,60,000	
	Debtors A/c	Dr.		1,60,000	
	Stock A/c	Dr.		2,40,000	
	Cash A/c	Dr.		80,000	
	To Creditors A/c				2,40,000
	To Business Purchase				8,00,010
	To Capital Reserve (Bal. Fig)				3,99,990
	(Assets & Liabilities Taken Over and the Capital Reserve Being the Bal. Fig)				
	Liquidator of X Ltd.	Dr.		8,00,010	
	To Cash A/c				30
	To Share Capital A/c (26,666 × ₹ 10)				2,66,660
	To Securities Premium A/c (26,666 × ₹ 20)				5,33,320
	(Discharge of Purchase Consideration)				

Stage III:

Balance Sheet of Y Ltd. (After Absorption)

as at 31 March 2011

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	
1,86,600 Share of ₹ 10	18,66,660	(₹ 9,60,000 + ₹ 20,00,000)	29,60,000
Reserves & Surplus:		Current Assets:	
Securities Premium	5,33,320	Debtors (₹ 1,60,000 + ₹ 80,000)	2,40,000
General Reserve	4,80,000	Stock (₹ 2,40,000 + ₹ 3,20,000)	5,60,000
Capital Reserve	3,99,990	Cash (₹ 80,000 + ₹ 80,000 – ₹ 30)	1,59,970
Creditors	6,40,000		
	39,19,970		39,19,970

Illustration 9.26

Model: Absorption—inter-company owings

A Ltd. agreed to acquire the business of D Ltd. as on 31 March 2011. The balance sheet of D Ltd. as on that date was as follows:

Liabilities	₹	Assets	₹
Paid-up Capital:		Fixed Assets:	
40,000 – 12% Preference Shares of ₹ 10 Each	4,00,000	Land & Building	8,00,000
80,000 Equity Share of ₹ 10 Each	8,00,000	Machineries	4,00,000
Reserves	80,000	Current Assets:	
Profits & Loss A/c	1,20,000	Stock	8,00,000
12% Debentures	4,00,000	Debtors	2,00,000
Sundry Creditors	6,00,000	Cash & Bank Balances	1,40,000
		Miscellaneous Expenditures:	
		Preliminary Expenses	40,000
		Debenture Discount	20,000
	24,00,000		24,00,000

The consideration payable by A Ltd. was agreed as follows:

(i) The preference shareholders of D Ltd. were to be allotted 14% preference shares of ₹ 4,40,000

(ii) Equity shareholders to be allotted six equity shares of ₹ 10 each issued at a premium of 10% and ₹ 3 cash against every five shares held

(iii) 12% of D Ltd. to be paid @ 8% premium by issue of 14% debentures at 10% discount

While arriving at the agreed consideration, the directors of A Ltd. valued land & building at ₹ 10,00,000; stock at ₹ 8,80,000; debtors at their book value subject to an allowance of 5% to cover doubtful debts. Debtors of D Ltd. included ₹ 40,000 due from A Ltd. The machineries were valued at book value. It was agreed that before acquisition, D Ltd. will pay dividend at 10% on equity shares. Liquidation expenses are ₹ 20,000.

You are required to draft journal entries necessary to close the books of D Ltd. and to record acquisition in the book of A Ltd.

[C.A. (Inter). Modified]

Solution

Computation of Purchase Consideration:

			₹
Step 1:	14% Preferences Shares (At Agreed Value):		4,40,000
Step 2:	Equity Shares:		
	Number of Shares: $\frac{80,000}{5} \times 6$	= 96,000	
	(Allotment of 6 Shares to Every 5 Shares)		
	Value: 96,000 Shares × ₹ 10	: 9,60,000	
	Add: Premium @ 10%	: 96,000	10,56,000
Step 3 :	Cash @ ₹ 3 : $\frac{80,000}{5}$ Shares × ₹ 3 =		48,000
Step 4 :	Purchase Consideration:		15,44,000

Stage II:

In the Books of D Ltd.
Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2011	Profit and Loss A/c	Dr.		80,000	
	To Bank A/c				80,000
	(Equity Dividend Paid @ 10%)				
31 March 2011	Realization A/c	Dr.		22,40,000	
	To Land & Building A/c				8,00,000
	To Machineries A/c				4,00,000
	To Stock A/c				8,00,000
	To Debtors A/c				2,00,000
	To Cash at Bank A/c				40,000
	(All Assets Are Transferred to Realization A/c)				
31 March 2011	12% Debentures A/c	Dr.		4,00,000	
	Sundry Creditors A/c	Dr.		6,00,000	
	To Realization A/c				1,00,000
	(All Liabilities Transferred)				
31 March 2011	A Ltd. A/c	Dr.		15,44,000	
	To Realization A/c				15,44,000
	(Purchase Consideration Due)				
31 March 2011	Realization A/c	Dr.		20,000	
	To Bank A/c				20,000
	(Realization Expenses Paid)				
31 March 2011	Realization A/c	Dr.		40,000	
	To Preference Shareholders A/c				40,000
	(Premium to Pref. Shareholders)				
31 March 2011	14% Preference Shares Is A Ltd. A/c	Dr.		4,40,000	
	Equity Shares in A Ltd. A/c	Dr.		10,56,000	
	Bank A/c	Dr.		48,000	
	To A Ltd. A/c				15,44,000
	(Purchase Consideration Received)				

31 March 2011	Realization A/c	Dr.		2,44,000	
	To Equity Shareholders A/c				2,44,000
	(Profit on Realization)				
31 March 2011	12% Preference Shares Capital A/c	Dr.		4,00,000	
	To Preference Shareholders A/c				4,00,000
	(Pref. Shareholder's A/c Recorded)				
31 March 2011	Preference Shareholders A/c	Dr.		4,40,000	
	To 14% Preference Shares in A Ltd.				4,40,000
	(As per Agreement, Allotment of Pref. Shares)				
31 March 2011	Equity Share Capital A/c	Dr.		8,00,000	
	Reserves A/c	Dr.		80,000	
	Profit & Loss A/c	Dr.		40,000	
	To Equity Shareholders A/c				9,20,000
	(Payment Due to Shareholders)				
31 March 2011	Equity Shareholders A/c	Dr.		60,000	
	To Preliminary Expenses A/c				40,000
	To Debentures Discount A/c				20,000
	(Fictitious Assets Transferred)				
31 March 2011	Equity Shareholders A/c	Dr.		11,04,000	
	To Equity Share in A Ltd. A/c				10,56,000
	To Bank A/c				48,000
	(Payment to Equity Shareholders)				

Stage III:

In the Books of A Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Business Purchase A/c	Dr.		15,44,000	
	To Liquidators of D Ltd. A/c				15,44,000
	(Purchase Consideration Due)				
31 March 2011	Goodwill A/c (Bal. Fig)	Dr.		64,000	
	Land & Buildings A/c (As Agreed Value)	Dr.		10,00,000	
	Machineries A/c (As Agreed Value)	Dr.		4,00,000	

	Stock A/c (As Agreed Value)	Dr.		8,80,000	
	Sundry Debtors A/c	Dr.		2,00,000	
	Cash at Bank A/c	Dr.		40,000	
	To Sundry Creditors A/c				6,00,000
	To 12% Debentures in D Ltd.				4,32,000
	To Provision for Bad Debts A/c				8,000
	To Business Purchase A/c				15,44,000
	(Assets & Liabilities Taken Over as an Agreed Terms, Balance Being Goodwill)				
31 March 2011	Liquidators of D Ltd. A/c	Dr.		15,44,000	
	To 14% Preference Share Capital A/c				4,40,000
	To Equity Share Capital A/c				9,60,000
	To Share Premium A/c				96,000
	To Bank A/c				48,000
	(Discharge of Purchase Consideration)				
31 March 2011	12% Debentures in D Ltd. A/c	Dr.		4,32,000	
	Discount on Issue of Debentures A/c	Dr.		48,000	
	To 14% Debentures A/c				4,80,000
	(Issue of Debentures)				
31 March 2011	A Ltd's Creditors A/c	Dr.		40,000	
	To D Ltd.'s Debtors A/c				40,000
	(Cancellation of Inter-company's Debts)				

Illustration 9.27

Model: Absorption—Issue of bonus shares

ABC Ltd. want to acquire the business of XYZ Ltd. as on 31 December 2010. The balance sheets of two companies as that date are given below:

Liabilities	**ABC Ltd.** ₹	**XYZ Ltd.** ₹	**Assets**	**ABC Ltd.** ₹	**XYZ Ltd.** ₹
Share Capital:			Sundry Assets	37,50,000	5,00,000
25,000 Equity Shares of ₹100 each	25,00,000	—	Balances	5,00,000	2,50,000
10,000 Equity Shares of ₹50 Each	—	5,00,000			
Reserve & Surplus	15,00,000	1,25,000			

Sundry Creditors	2,50,000	1,25,000			
	42,50,000	7,50,000		42,50,000	7,50,000

The shares of both companies are quoted on the Stock Exchange. Such values on 31 December 2010 are:

ABC Ltd.—₹ 160 per share

XYZ Ltd.—₹ 45 per share

The terms of absorption are as follows:

(i) ABC Ltd. to take over all the sundry assets and liabilities of XYZ Ltd. except cash and bank balances.

(ii) The values of sundry assets of XYZ Ltd. to be fixed at 90% of their book values.

(iii) The purchase consideration is to be met by ABC Ltd. by the allotment of one equity share at the market value for every five equity share held in XYZ Ltd. and the balance, if any, to be met by cash payment.

(iv) On acquisition of the business by ABC Ltd., the directors of ABC Ltd. decide to capitalize the reserve by allotting bonus shares in the preparation of one share for every two shares held.

(v) The authorized capital of ABC Ltd. is increased to ₹ 50,00,000 in 100 shares.

(vi) The balance of unissued shares has now been issued at a premium of ₹ 40 per share. All the allottees have fully met their obligations.

(vii) Out of the moneys received, the sundry creditors are paid off in full.

You are required to draw up the balance sheet of ABC Ltd. as it would stand after making due adjustments for carrying out the above scheme under purchase method.

Solution

Stage I: Computation of Purchase Consideration:

	₹
(i) Sundry Assets (At Agreed, i.e. 90% of Book Value)	4,50,000
(ii) Less: Liabilities:	1,25,000
(iii) Net Assets Available for Shareholders:	3,25,000

Stage II: Discharge of Purchase Consideration:

(i) By Issue of Shares: $10,000 \times \frac{1}{5} \times$ ₹ 160 :	3,20,000
(ii) Balance (₹ 3,25,000 – ₹ 3,20,000) ₹ 5,000 in Cash:	5,000
	3,25,000

Stage III: Treatment of Shares:

(i) Existing Number of Shares:	25,000	Shares
Add		
(ii) Issued to Vendor Company:	2,000	Shares
(iii) Total Number of Shares:	27,000	Shares
(iv) Out of 27,000 Shares, Issued on Bonus Shares:		
27,000 ÷ 2 (One Share for Every 2 Shares):	13,500	Shares
(v) Shares Issued for Cash		
(50,000 Shares – (i to iv)		
40,500 Shares = 9,500):	9,500	shares
(vi) Total Number of Shares:	50,000	shares

Stage IV: Calculation of Cash and Bank Balances:		₹
(i) Balances as per B/S:		5,00,000
Add:		
(ii) By Issue of 9,500 Shares at ₹ 140 per Shares:		13,30,000
		18,30,000
Less: Paid to Vendor Company:	5,000	
Paid to Sundry Creditors:	3,75,000	3,80,000
		14,50,000

Stage V: Calculation of Securities Premium:	
(i) On Issue of Shares to Vendor Company 2,000 × ₹ 60 :	1,20,000
(ii) On Issue of Shares for Cash 9,500 × ₹ 40:	3,80,000
	5,00,000

Stage VI:

Balance Sheet of ABC Ltd
as on 31 December 2010

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets:	
Issued & Subscribed:		Sundry Assets (₹ 37,50,000 + ₹ 4,50,000)	42,00,000
50,000 Equity Shares of ₹ 100 Each Fully Paid	50,00,000		
(This Includes 2,000 Shares That Have Been Allotted to Vendors for Consideration Other than Cash & 13,500 Shares Bonus Shares)		Current Assets: Cash & Bank Balances	14,50,000
Securities Premium	5,00,000		
General Reserve (₹ 15,00,000 – ₹ 13,50,000)	1,50,000		
	56,50,000		56,50,000

Illustration 9.28

Model: Absorption—Dissenting shareholders

AB Ltd. agrees to absorb CD Ltd. on the [img] basis of the following balance sheet as on 31 March 2011:

(₹ in 000's)

Liabilities	₹	**Assets**	₹
Share Capital:		Land & Buildings	2,000
Authorized: 2,00,000 Shares of ₹ 50 Each	10,000	Machinery	400

Issued and Subscribed:		Stock		2,400
1,60,000 Shares of ₹ 50 Each	8,000			
Called-up & Paid-up Capital:				
1,60,000 Shares of ₹ 50 Each ₹ 30 Called & Paid	4,800	Sundry Debtors:	1,840	
		Less: Provision for Bad Debts:	80	1,760
Reserves	1,000	Cash at Bank		240
Profit & Loss A/c	480			
Creditors	600			
	6,880			6,880

AB Ltd. took over all the assets and liabilities of CD Ltd. subject to the retention of ₹ 120 thousand cash to provide for costs of liquidation, and to satisfy the dissenting shareholders.

The consideration for the sale is the allotment of one share of ₹ 100 (₹ 50 paid up) in AB Ltd. for every two shares in CD Ltd. The market value of the ₹ 50 paid-up share of AB Ltd. on that date was ₹ 70 per share.

The liquidator of CD Ltd. has paid out of ₹ 120 thousand retained, the cost of liquidation of ₹ 60 thousand and dissenting shareholders of 800 shares at ₹ 32.50 per share totaling ₹ 26,000.

You are required to prepare ledger accounts in the books of CD Ltd. and give journal entries in the books of AB Ltd.

Solution

Books of CD Ltd.
Ledger Accounts
Realization A/c

(₹ in 000's)

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
To Land & Buildings	2,000	By Provision for Bad Debts	80
To Machinery	400		
To Stock	2,400	By Creditors	600
To Investments	80		
To Sundry Debtors	1,840	By AB Ltd.	3,980
To Cash at Bank (₹ 240 – ₹ 120)	120	₹ 1,60,000 – ₹ 800:	
To Bank (Expenses)	80	$\frac{1,59,200}{2} \times$ ₹ 50	
To Dissenting Shareholder (Excess)	2	By Shareholders A/c (Loss)	2,262
	6,922		6,922

AB Ltd. A/c

(₹ in 000's)

Particulars	₹	Particulars	₹
To Realization A/c	3,980	Shares in AB Ltd.	3,980
	3,980		3,980

Shareholders A/c

(₹ in 000's)

Particulars	₹	Particulars	₹
To Realization A/c	2,262	By Share Capital A/c (1,59,200 × ₹ 30)	4,776
To Share in AB Ltd.	3,980	By Reserves	1,000
To Bank	14	By P&L A/c	480
	6,256		6,256

Dissenting Shareholders A/c

(₹ in 000's)

Particulars	₹	Particulars	₹
To Bank A/c	26	By Share Capital A/c	24
		By Realization A/c (Excess)	2
	26		26

Bank A/c

(₹ in 000's)

Particulars	₹	Particulars	₹
To Balance b/d	240	By Realization (Transfer)	120
			120
	240		240
To Balance b/d	120	By Balance c/d (Retained)	80
		By Realization (expenses)	
		By Dissenting Shareholders	26
		By Shareholders (Bal Fig.)	14
	120		120

Books of AB Ltd.

Journal

(₹ in 000's)

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2011	Business Purchase A/c Dr.		3,980	
	To Liquidator of CD Ltd.			3,980
	(Purchase Consideration Due)			

	Land & Building A/c	Dr.		2,000	
	Machinery A/c	Dr.		400	
	Stock A/c	Dr.		2,400	
	Investments A/c	Dr.		80	
	Sundry Debtors A/c	Dr.		1,840	
	Cash at Bank A/c	Dr.		120	
	To Creditors A/c				600
	To Provision for Bad Debts A/c				80
	To Business Purchase A/c				3,980
	To Capital Reserve A/c				2,180
	(Assets & Liabilities Taken Over; Bal. Fig Being Capital Reserve) (Bal. Fig)				
	Liquidator of CD Ltd.	Dr.		3,980	
	To Share Capital A/c				3,980
	(Purchase Consideration Discharged)				

Illustration 9.29

Model: Purchase consideration—NIL

The following are the balance sheets of G Ltd. and H Ltd. as on 31 March 2011:

(₹ in Lakhs)

Liabilities	G Ltd. ₹	H Ltd. ₹	Assets	G Ltd. ₹	H Ltd. ₹
Share Capital:			Fixed Assets	3,000	25
Authorized	2,500	125	Less: Depreciation	2,500	20
				500	5
Issued Share Capital:	500	50	Investments:	100	—
(i) For Cash Fully Paid: Equity Shares of ₹ 10			(i) 12.5 lakh Shares of H Ltd. Fully Paid at Cost		
(ii) For Consideration Other than Cash: As Bonus Shares Fully Paid Equity Shares of ₹ 10 Each out of General Reserve	2,000	75	(ii) 5 lakh Unsecured Debentures of H Ltd. of ₹ 100 Each Fully Paid at Cost	490	—
Reserves & Surplus: Capital Reserve			(iii) 5 lakh Fully Paid Equity Shares of ₹ 10 Each of Vas Ltd. at Cost (Market Value 150 lakh)	—	50
	500	25			

Revenue Reserve	9,500	350	Current Assets	10,500	750
Unsecured Loans:			Loans & Advances	15,000	500
Debentures	2,500	500	Miscellaneous	—	20
Current Liabilities	7,500	250	Expenditure Not Written		
Provisions	4,090	75	off		
	26,590	1,325		26,590	1,325

On that day, G Ltd. absorbed H Ltd. taking over all the assets and liabilities. The consideration was NIL. You are required to

(i) Pass journal entries in the books of G Ltd.

(ii) Prepare the balance sheet of G Ltd. after absorption under purchase method

Solution

(i) On the Books of B Ltd.
Journal Entries

(₹ in Lakhs)

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2011.	Fixed Assets A/c	Dr.		5	
	(At Book Values)				
	Investments A/c (At Book Values)	Dr.		50	
	Current Assets A/c	Dr.		1,250	
	(At Book Values) (₹ 750 + ₹ 500)				
	To Investments in Share of G Ltd.				100
	To Current Liabilities A/c (₹ 250 + ₹ 75)				325
	To Investments in Debentures of H Ltd.				490
	*1 To Capital Reserve (Bal. Fig.)				390
	(Assets & Liabilities of H Ltd. Are Taken Over at Their Book Value by G Ltd.)				

(ii)

Balance Sheet of G Ltd.
as on 31 March 2011

(₹ in Lakhs)

Liabilities	₹	Assets		₹
Share Capital:		*Fixed Assets:*	3,005	
Authorized	2,500	Less: Depreciation	2,500	505
Issued & Paid up:		*Investments:*		
250 lakh Equity Shares of ₹ 10 Each (This Includes 200 lakh Shares Issued as Bonus Shares)	2,500	5 lakh Fully Paid Equity Shares of ₹ 10 Each in Vas Ltd. (Market Value ₹ 150 lakh)		50

Reserves & Surplus:		*Current Assets:*	
*1 Capital Reserves (₹ 500 + ₹ 390)	890	(₹ 10,500 + ₹ 750)	11,250
Revenue Reserves	9,500		
Unsecured Loans		*Loans & Advances:*	
Debentures	2,500	(₹ 15,000 + ₹ 500)	15,500
Current Liabilities (₹ 7,500 + ₹ 250)	7,750		
Provisions (₹ 4,090 + ₹ 75)	4,165		
	27,305		27,305

9.5 EXTERNAL RECONSTRUCTION

9.5.1 Meaning of Reconstruction

Generally "reconstruction" means the reorganization of financial (Capital) structure of the existing company. Such reorganization may be carried out by winding up or not winding up the existing company.

9.5.2 Types of Reconstruction

Reconstruction may broadly be categorized into:

1. External reconstruction
2. Internal reconstruction

Internal reconstruction is discussed in Chapter 11.

9.5.3 External Reconstruction

9.5.3.1 Meaning

When reorganization of a company's financial structure involves winding up of a company and a floatation of a new company (with the same assets and shareholders), then it is referred to as "external reconstruction".

External reconstruction is more or less like "amalgamation in the nature of purchase".

External reconstruction necessitates:

1. Winding up of an existing company
2. Formation of new company

That means, the old company is restructured to form a new company.

In external reconstruction, the new company takes over the assets and liabilities of the old company at its true values. The share capital issued also will reveal the true value of net assets.

Under external reconstruction, the company acquires the status of new legal entity. All the shareholders of the old company need not be the shareholders of the new company. The old company is called the transferor or vendor company and the new company is termed "transferee company" or purchasing company.

9.5.3.2 Accounting Treatment

As per AS-14, under external reconstruction, the assets and liabilities of the old company are taken over by the new company at their true or revised values and not at their book values.

Accounting entries in the books of account of vendor company (old company):

The accounting entries are made to close the books of vendor company in the same method as discussed in the amalgamation process.

Accounting entries in the books of account of the new company or purchasing company:

The same accounting procedure explained in the case of "amalgamation in the nature of purchase" is to be followed here.

Some Special Items:

1. **Payment to creditors of the old company:** Creditors should be transferred to Realization A/c. After that, they should be paid off by the new company after take over.
2. **Contingent liability:** Contingent liability need not be transferred to Realization A/c. They should be recorded in the books of the purchasing company as taken over and paid off by the new company.

The following table shows the difference between amalgamation and external reconstruction:

Basis of Distinction	External Reconstruction	Amalgamation
1. Number of companies	In external reconstruction, only one is involved	In amalgamation, two or more companies are involved
2. Formation	New Company is a restructured old company	Two or more companies are merged or taken over by a new company
3. Types for accounting purposes	It is like amalgamation in the nature of purchase.	Here two types: (i) Amalgamation in the nature of merger and (2) amalgamation in the nature of purchase are followed

Illustration 9.30

Model: External reconstruction—Net payment method

The books of Hari Ltd. contained the following balances as on 30 November 2010:

(₹ in 000's)

Particulars	Debit ₹	Credit ₹
Equity Share Capital (₹ 10 Each)	—	4,800
Creditors	—	5,600
Patents & Trademarks	4,800	—
Plant & Machinery	1,600	—
Stock	1,200	—
Debtors	2,000	—
Cash	50	—
Preliminary Expenses	290	—
Profit & Loss A/c	460	—
	10,400	10,400

The patents & trademarks are considerably overvalued The company is also not in a position to raise any further capital.

The following scheme of reconstruction has therefore been framed:

(i) The company will go into voluntary liquidation. A new company Gopal Ltd. will be formed with an authorized capital of ₹ 80 lakh to take over the assets.

(ii) Liability will be discharged by the new company to the creditors by payment of 25 paise in a rupee in cash and 50 paise in a rupee by issue of 9% debentures.

(iii) 4.8 lakh shares of ₹ 10 each (₹ 5 per share paid) will be issued to shareholders of Hari Ltd.; the balance ₹ 5 per share be paid on allotment.

(iv) Expenses of liquidation amounting to ₹ 70,000 will be paid by Gopal Ltd.

The scheme was approved by all concerned. You are required to:

(a) Close the ledger of Hari Ltd.

(b) Pass journal entries to open the books of Gopal Ltd.

(c) Show the Balance Sheet of Hari Ltd.

[Madras University Modified]

Solution

I: Books of Hari Ltd.

Ledger Accounts

Realization A/c

(₹ in 000's)

Particulars	₹	Particulars	₹
To Patents & Trademarks	4,800	By Gopal Ltd. (4.8 lakh Shares × ₹ 5)	2,400
To Plant & Machinery	1,600	By Creditors (Given)	5,600
To Stock	1,200	By Shareholders (Loss) (Bal. Fig)	1,650
To Debtors	2000		
To Cash	50		
	9,650		9,650

Creditors A/c

(₹ in 000's)

Particulars	₹	Particulars	₹
To Realization A/c	5,600	By Balance b/d	5,600
	5,600		5,600

Gopal Ltd. A/c

(₹ in 000's)

Particulars	₹	Particulars	₹
To Gopal Ltd.	2,400	By Gopal Ltd. A/c (Expenses)	2,400
	2,400		2,400

Bank A/c

(₹ in 000's)

Particulars	₹	Particulars	₹
To Gopal Ltd.	70	By Gopal Ltd. A/c (Expenses)	70
	70		70

Shareholders A/c

(₹ in 000's)

Particulars	₹	Particulars	₹
To Preliminary Expenses	290	By Share Capital A/c	4,800
To Profit & Loss A/c	460		
To Realization A/c	1,650		
To Shares in Gopal Ltd.	2,400		
	4,800		4,800

Shares in Gopal Ltd

(₹ in 000's)

Particulars	₹	Particulars	₹
To Gopal Ltd. A/c	2,400	By Shareholders A/c	2,400
	2,400		2,400

II: In the Books of Gopal Ltd.

Journal Entries

(₹ in 000's)

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
30 November 2010	Business Purchase A/c Dr.		2,400	
	To Liquidator of Hari Ltd.			2,400
	(Purchase Price Payable)			
30 November 2010	Patents & Trademarks A/c Dr.		4,800	
	Machinery A/c Dr.		1,600	
	Stock A/c Dr.		1,200	
	Debtors A/c Dr.		2,000	
	Cash A/c Dr.		50	
	To Business Purchase A/c			2,400
	To Creditors A/c (75% of 5,600)			4,200
	To Capital Reserve A/c (Bal. Fig)			3,050
	(Assets & Liabilities are Taken Over, Capital Reserve Being the Balancing Figure)			

30 November 2010	Capital Reserve A/c Dr.		3,050	
	To Bank (Exp)			70
	To Patents & Trademarks (Bal. Fig)			2,980
	(Capital Profit Utilized to Write off Patents and Trademarks & Expenses)			
30 November 2010	Liquidator of Gopal Ltd. Dr.		2,400	
	To Equity Share Capital A/c (₹ 5)			2,400
	(Purchase Price in Equity Share Paid)			
30 November 2010	Bank A/c Dr.		2,400	
	To Equity Share Capital A/c			2,400
	(Receipt of ₹ 5 per Share)			
30 November 2010	Creditors A/c Dr.		4,200	
	To Bank A/c			1,400
	To 9% Debentures A/c			2,800
	(Payment Made to Creditors)			

III: Computation of Purchase Consideration Shares in Gopal Ltd: 4,80,000 Shares × ₹ 5 = 24,00,000 = ₹ 2,400 thousand

IV:

Balance Sheet of Gopal Ltd.
as on 30 November 2010

(₹ in 000's)

Liabilities	₹	Assets	₹
Share Capital:		Patents & Trademarks	1,820
Authorized: 8 lakh Shares of ₹ 10 Each	8,000	(₹ 4,800 – ₹ 2,980)	
		Plant & Machinery	1,600
Issued & Paid-up Capital:		Stock	1,200
4.8 lakh Shares of ₹ 10 Each Fully Paid	4,800	Debtors	2,000
9% Debentures	2,800	Cash	50
		Bank (₹ 2,400 – ₹ 1,470)	930
	7,600		7,600

Illustration 9.31

Model: External reconstruction—Dissenting shareholders

The abridged balance sheet of H Ltd. as at 31 December 2010 is as follows:

Liabilities	₹	Assets	₹
20,000 Equity Shares of ₹ 100 Each Fully Paid	20,00,000	Patents	2,80,000
		Freehold Premises	10,00,000

8,000, 10% Preference Shares of ₹100 Each Fully Paid	8,00,000	Machinery	5,40,000
		Stock	8,00,000
15% Debentures	8,00,000	Debtors	7,20,000
Unsecured Loan	4,00,000	Bank	2,00,000
Creditors	6,00,000	Profit	11,80,000
Accrued Interest on Debentures	1,20,000		
	47,20,000		47,20,000

The following scheme of reconstruction was approved by the Court:

(i) A new company L Ltd. is to be formed to take over the entire business of H Ltd.

(ii) L Ltd. to issue one equity share of ₹100, ₹60 to be paid up in exchange of every two shares in H Ltd. to the shareholders who agree with the scheme; shareholders who do not agree with the scheme are to be paid @ ₹20 per share in cash. Such shareholders hold 1,600 equity shares.

(iii) Preference shareholders to get 15, 11% preference shares of ₹10 each in exchange of two preference shares of H Ltd.

(iv) Liability in respect of 15% debentures and interest accrued thereon to be taken over and discharged directly by L Ltd. by issue of equity shares of ₹100 each fully paid up.

(v) The creditors of H Ltd. will get from L Ltd. 50% of their dues in cash and 25% in equity shares of ₹100 each and the balance to be forgone by them.

(vi) The freehold premises to be revalued at 20% more. The value of machinery to be reduced by $33\frac{1}{3}$ and to ₹6,40,000. Patents to have no value.

(vii) The preliminary expenses amounted to ₹20,000.

You are required to:

(a) Open realization account in the books of H Ltd.

(b) Pass journal entries in the books of L Ltd.

[B.Com (Hons) Delhi Modified]

Solution

Stage I: Computation of Purchase Consideration:

	₹
Step 1: Payment to Equity Shareholders $\frac{18,400}{2} \times$ ₹60 (2 Shares for Every 1 Shares)	5,52,000
Step 2: Payment of Cash for Dissenting Shareholders: 1,600 × ₹20	32,000
Step 3: For Preference Shareholders $\frac{8,000 \text{ Shares}}{2} \times 15 \times$ ₹10 (15 Shares for Every 2 Shares)	6,00,000
Step 4: Purchase Consideration (Add: Step 1 + Step 2 + Step 3)	11,84,000

Note:

1. Equity shareholders are satisfied by issue of shares
2. Dissenting shareholders are satisfied by payment in cash.

Stage II:

Books of H Ltd.

Realization A/c

Particulars	₹	Particulars	₹
Patents A/c	2,80,000	15% Debentures A/c	8,00,000
Freehold Premises A/c	10,00,000	Unsecured Loan A/c	4,00,000
Machinery A/c	5,40,000	Creditors A/c	6,00,000
Stock A/c	8,00,000	Accrued Interest A/c	1,20,000
Debtors A/c	7,20,000	L Ltd. A/c	11,84,000
Bank A/c	2,00,000	10% Preference Shareholders A/c	2,00,000
		Equity Shareholders (Dissenting) A/c	1,28,000
		Equity Shareholders (Agreeing) – (Loss) A/c	1,08,000
	35,40,000		35,40,000

Stage III:

Books of L Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 December 2010	Business Purchase A/c	Dr.		11,84,000	
	To Liquidators of H Ltd.				11,84,000
	(Purchase Consideration Payable)				
31 December 2010	Freeholder Premises A/c	Dr.		12,00,000	
	Machinery A/c	Dr.		3,60,000	
	Stock A/c	Dr.		6,40,000	
	Debtors A/c	Dr.		6,48,000	
	Bank A/c	Dr.		2,00,000	
	To 15% Debentures A/c				8,00,000
	To Accrued Interest A/c				1,20,000
	To Unsecured Loan A/c				4,00,000
	To Creditors A/c				4,50,000
	To Business Purchase A/c				11,84,000
	To Capital Reserve A/c (Bal. Fig)				94,000
	(Assets & Liabilities are Taken Over at Approved Terms, the Balancing Figure Being Capital Reserve)				

31 December 2010	15% Debentures A/c	Dr.		8,00,000	
	Accrued Interest A/c	Dr.		1,20,000	
	To Equity Share Capital A/c				9,20,000
	(Discharge of Debenture with Interest Accrued by Issue of Equity Shares)				
31 December 2010	Creditors A/c	Dr.		6,00,000	
	To Equity Share Capital A/c				3,00,000
	To Bank A/c				1,50,000
	(Creditors are Paid in Shares and Cash and the Balance Forgone)				
31 December 2010	Liquidators of H Ltd.	Dr.		11,84,000	
	To Equity Share Capital A/c				5,52,000
	To 11% Preference Share Capital A/c				6,00,000
	To Bank A/c				32,000
	(Purchase Consideration Discharged in the Form of Equity Share, Preference Share and Cash)				
31 December 2010	Preliminary Expenses A/c	Dr.		20,000	
	To Bank A/c				20,000
	(Payment of Preliminary Expenses)				
31 December 2010	Capital Reserve A/c	Dr.		20,000	
	To Preliminary Expenses A/c				20,000
	(Preliminary Expenses Paid—Adjusted)				

For Advanced Level (B.Com (Hons); M.Com; C.S.; C.A.; I.C.W.A.; M.B.A.)

9.5.3.3 Inter-company Holdings

Sometimes, companies in the scheme of combination (merger or acquisition or absorption) have financial interest in other companies. Companies' moneys would have interlocked in shares and debentures of other companies. In such cases, the accounting treatment is a tricky affair. For the convenience of accounting, they may be divided into three broad categories as follows:

1. When purchasing company holds shares in vendor company (absorbed company)
2. When the vendor (absorbed) company holds shares in the purchasing company
3. When both the companies hold shares in each other

Let us discuss one by one.

9.5.3.3.1 When Purchasing Company Holds Shares in Vendor Company

In this case, the purchasing company is also a shareholder of the vendor company. Legally, it has rights to have a proportionate amount in the net assets. Hence, the problem arises in the treatment of amount due to shareholders. Because for the amount due to combination, it cannot receive its own shares. The absorbing

company, in this case, can buy only the net assets belonging to outside shareholders. Then what can be done with respect to absorbing company for its part of securities in the vendor company. This problem of accounting can be resolved as follows:

Books of Vendor (Absorbed) Company:

Step 1: Purchase consideration should be computed for the entire business concern. This may be under net assets or payments method, depending on the case

Step 2: Debit the purchasing company with the full price.

Step 3: Credit with the amount that is received relating to outsiders.

Step 4: There will be a debit balance. This represents the amount to be received from purchasing company as the part of purchase consideration.

Step 5: Similarly, in the shareholders' A/c there will be a credit balance. This amount represents the quantum payable to purchasing company. This is neither paid by the vendor company nor received by it in the capacity as a shareholder.

Step 6: These two accounts are to be closed by the set-off entry as:

Shareholders' A/c Dr. ……..

Purchasing Company's A/c ……..

Books of Purchasing Company:

The same problem is tackled by passing the following entry in the books of the purchasing company as:

Liquidator of Vendor Company Dr.

(With Full Purchase Price)

To Share Capital/Debenture/Bank

(With Amount Payable to Outsiders)

To Shares in the Vendor Company

(With Amount Due to Purchasing Company)

Note: Any difference in shares in the vendor company A/c is to be transferred to goodwill or capital reserve depending on the case.

Illustration 9.32

Model: Inter-company holdings—when purchasing company holds shares in vendor company

The following are the balance sheets of A Ltd. and B Ltd. as on 31 March 2011:

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Share Capital ₹ 100 Each	30,00,000	7,50,000	Land & Buildings	22,50,000	3,00,000
Profit & Loss A/c	22,50,000	3,75,000	Investments	3,75,000	—
Current Liabilities	22,50,000	2,25,000	Current Assets	48,75,000	10,50,000
	75,00,000	13,50,000		75,00,000	13,50,000

A Ltd. agrees to absorb B Ltd. on the following terms:

1. It is assessed that net assets of B Ltd. may be taken at ₹ 10,87,500 which is to be satisfied by the issue of fully paid shares of ₹ 100 each by A Ltd. at par.

2. A Ltd's Investments include 20% of the shares in B Ltd. at a cost of ₹ 1,80,000.

Close the books of B Ltd. and give journal and balance sheet in the books of A Ltd.

[C.S. (Inter). Modified]

Solution

Books of B Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2011	Realization A/c	Dr.		13,50,000	
	To Land & Buildings A/c				3,00,000
	To Current Assets				10,50,000
	(Assets Transferred)				
31 March 2011	Current Liabilities A/c	Dr.		2,25,000	
	To Realization A/c				2,25,000
	(Liabilities Transferred)				
31 March 2011	A Ltd. A/c	Dr.		10,87,500	
	To Realization A/c				10,87,500
	(Purchase Consideration—Net Assets Recorded)				
31 March 2011	Shares in A Ltd. A/c	Dr.		8,70,000	
	To A Ltd. A/c				8,70,000
	(₹ 10,87,500 – ₹ 2,17,500 = ₹ 8,70,000) (Purchase Consideration Received After Set off)				
31 March 2011	Shareholders A/c	Dr.		2,17,500	
	To A Ltd. A/c				2,17,500
	(Set off of 20% Shares on ₹ 10,87,500)				
31 March 2011	Share Capital A/c	Dr.		7,50,000	
	P&L A/c	Dr.		3,75,000	
	To Shareholders A/c				11,25,000
	(Transfer of Capital & Reserves to Shareholders)				
31 March 2011	Shareholders A/c	Dr.		8,70,000	
	To Shares in A Ltd.				8,70,000
	(Final Payment to Shareholders)				

Realization A/c

Particulars	₹	Particulars	₹
To Land & Buildings	3,00,000	By Current Liabilities	2,25,000
To Current Assets	10,50,000	By A Ltd.	10,87,500

		By Shareholders A/c (Loss)	37,500
	13,50,000		13,50,000

Shareholders A/c

Particulars	₹	Particulars	₹
To Realization A/c	37,500	By Share Capital	7,50,000
To A Ltd. A/c (Set off)	2,17,500	By P&L A/c	3,75,000
To Shares in Ltd. (Final Payment)	8,70,000		
	11,25,000		11,25,000

A Ltd. A/c

Particulars	₹	Particulars	₹
To Realization A/c	10,87,500	By Shares in A Ltd	8,70,000
		By Shareholders A/c (20% Set off)	2,17,500
	10,87,500		10,87,500

Shares in A Ltd. A/c

Particulars	₹	Particulars	₹
To A Ltd. A/c	8,70,000	By Shareholders A/c	8,70,000
	8,70,000		8,70,000

Books of A Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2011	Business Purchase A/c	Dr.		10,87,500	
	To Liquidator of B Ltd. A/c				10,87,500
	(Purchase Price Payable)				
31 March 2011	Land & Buildings A/c	Dr.		3,00,000	
	Current Assets A/c	Dr.		10,50,000	
	To Current Liabilities A/c				2,25,000
`	To Business Purchase A/c				10,87,500
	To Capital Reserve A/c				37,500
	(Assets & Liabilities Taken Over)				
31 March 2011	Liquidator & B Ltd. A/c	Dr.		10,87,500	
	To Share Capital A/c				8,70,000
	To Investments A/c				2,17,500
	(Discharge of Purchase Price & Adjustment of Investment)				

31 March 2011	Investment A/c Dr. To Capital Reserve A/c (Profit on Cancellation of Investment in Shares of B Ltd.)		37,500	 37,500

Next, investment A/c is to be prepared to arrive at the figure to be transferred to balance sheet.

Investments A/c

Particulars	₹	Particulars	₹
To Balance b/d (Given)	3,75,000	By Liquidator of B Ltd. (Cancellation—Adjustment of Investment in Shares)	2,17,500
To Capital Reserve A/c (Profit on Cancellation of Investment)	37,500	*1 By Balance c/d	1,95,000
	4,12,500		4,12,500

Balance Sheet of A Ltd.
as on 31 March 2011

Liabilities	₹	Assets	₹
Share Capital:		Land & Buildings	25,50,000
38,700 Shares of ₹ 100 Each	38,70,000	(₹ 22,50,000 + ₹ 3,00,000)	
(This Includes 8,700 Shares That Were Issued for Consideration Other than Cash)		*1 Investments (Ref: Investment A/c)	1,95,000
Reserves & Surplus:		Current Assets	59,25,000
Capital Reserve (₹ 37,500 + ₹ 37,500)	75,000	(₹ 48,75,000 + ₹ 10,50,000)	
P&L Account	22,50,000		
Current Liabilities (₹ 22,50,000 + ₹ 2,25,000)	24,75,000		
	86,70,000		86,70,000

9.5.3.3.2 When Vendor (Transferor/Selling) Company Having (Holds) Shares in Purchasing (Transferee) Company

Net Payment Method:

- Under this method, the number of shares already held by the vendor company should be deducted from the shares agreed to be issued.
- The investment of the vendor company in shares of the purchasing company should not be taken over by the purchasing company. That means investments in purchasing company are not to be transferred to realizsation A/c.
- This method is explained in the following illustration:

Illustration 9.33

Model: When the vendor company holds shares in purchasing company—Net payment method X Ltd. absorbs Y Ltd. by payment of 5 shares of ₹ 10 each at a premium of 10% for every 4 shares in Y Ltd. The balance sheet of Y Ltd. as on the date of absorption is shown in the following:

Liabilities	₹	Assets	₹
Share Capital ₹ 10 Each	4,00,000	Fixed Assets	3,60,000
General Reserve	40,000	8,000 Shares in X Ltd.	80,000
Creditors	1,20,000	Current Assets	1,20,000
	5,60,000		5,60,000

You are required to:

(i) Prepare necessary ledger accounts in the books of Y Ltd.

(ii) Give acquisition entries in the books of X Ltd.

Solution

I: Computation of Purchase Consideration:

Step 1: Number of Shares to Be Issued by X Ltd. $= \frac{4,00,000}{10} \times \frac{5}{4}$

$= 50,000$ Shares

Step 2: Number of Shares Already in Y Ltd. (Given) $= \underline{8,000}$ Shares

Step 3: Total Number of Shares to be Issued by X Ltd. $= \underline{42,000}$ Shares

(Step 1 – Step 2)

Step 4: Purchase Consideration $= 42,000$ Shares × (₹ 10 + 1)

$=$ ₹ 4,62,000

II: Some Important Notes: To Be Observed While Preparing the Ledger Accounts:

1. While preparing realization A/c, shares in X Ltd. should not be transferred to realization A/c
2. While preparing shareholders' A/c, profit on revaluation is to be determined as:

(i) Value of 8,000 shares already held = ₹ 80,000

(ii) Revalued at the price with premium = ₹ 88,000

(iii) Difference in profit = ₹ 8,000

(iv) This profit on revaluation, i.e., ₹ 8,000, has to be transferred to shareholders' A/c

III: Preparation of Ledger Accounts:

Realization A/c

Particulars	₹	Particulars	₹
To Fixed Assets	3,60,000	By Sundry Creditors	1,20,000
To Current Assets	1,20,000	By X Ltd. (Purchase Consideration Ref: I (Step 4)	4,62,000
To Shareholder's A/c (Profit—Bal Fig.)	1,02,000		
	5,82,000		5,82,000

Shareholders' A/c

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Shares in X Ltd.	5,50,000	By Share Capital	4,00,000
		By General Reserve	40,000
		By Realization A/c	1,02,000
		By Shares in X Ltd. (Ref: Note II 2)	8,000
	5,50,000		5,50,000

Share in X Ltd. A/c

Particulars	₹	Particulars	₹
To Balance b/d (8,000 Shares)	80,000	By Shareholder A/c (Number of Shares 50,000)	5,50,000
To Shareholders' A/c	8,000		
To X Ltd. (42,000 Shares)	4,62,000		
	5,50,000		5,50,000

In the Books of X Ltd.

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Business Purchase A/c	Dr.		4,62,000	
	To the Liquidator of Y Ltd.				4,62,000
	(Purchase Consideration)				
	Goodwill A/c (Bal. Fig.)	Dr.		1,02,000	
	Fixed Assets A/c	Dr.		3,60,000	
	Current Assets A/c	Dr.		1,20,000	
	To Sundry Creditors A/c				1,20,000
	To Business Purchase A/c				4,62,000
	(Assets & Liabilities Taken Over—Bal. Fig Being Goodwill)				
	Liquidator of Y Ltd.	Dr.		4,62,000	
	To Share Capital A/c				4,20,000
	To Share Premium A/c				42,000
	(Discharge of Purchase Price)				

II: Net Assets Method:

- Under this method, the assets in the form of "investment in shares of the purchasing company" should not be taken into account for computing the purchase consideration.
- This method is explained in the following illustration:

Illustration 9.34

Model: When the vendor company holds shares in purchasing company—Net assets method

Basu Ltd. and Vasu Ltd. had the following financial position as on 31 March 2011:

(₹ in 000's)

Liabilities	Basu Ltd. ₹	Vasu Ltd. ₹	Assets	Basu Ltd.	Vasu Ltd.
Share Capital:			Goodwill	2,000	400
Equity Shares of ₹100 Each Fully Paid	3,200	2,400	Fixed Assets	1,600	2,800
General Reserve	1,200	800	Investments at Cost	1,200	800
Investment Allowance Reserve	—	1,200	Current Assets	1,200	1,000
Liabilities	1,600	600			
	6,000	5,000		6,000	5,000

It was decided that on that date, Basu Ltd. will take over the business of Vasu Ltd. on the basis of the respective share value, adjusting, wherever necessary, the book values of assets and liabilities on the strength of the information given below:

1. Investment of Vasu Ltd. included 4,000 shares in Basu Ltd., acquired at a cost of ₹150 per share. The other investment of Vasu Ltd. have a market value of ₹1,00,000.
2. Investment allowance reserve was in respect of additions made to fixed assets by Vasu Ltd. during the year 2009–10, on which income tax relief has been obtained. In terms of Income Tax Act, the company has to carry forward till 2014, reserve of ₹6,00,000 for utilization.
3. Goodwill of Basu Ltd. and Vasu Ltd. are to be taken at ₹1,600 thousand and ₹800 thousand, respectively.
4. The market value of investment of Basu Ltd. was ₹800 thousand.
5. Current assets of Basu Ltd. included ₹320 thousand of stock in trade obtained from Vasu Ltd., which normally sold goods at a profit of 25% over cost.
6. Fixed assets of Basu Ltd. & Vasu Ltd. are valued at ₹2,000 thousand and ₹3,000 thousand, respectively.

Suggest the scheme of absorption and show the journal entries in the books of Basu Ltd. Also prepare the balance sheet of that company after take over of the business of Vasu Ltd.

[C.A. (Inter) Modified]

Solution

Stage I: Computation of Net Assets:

	Basu Ltd. (₹ in 000's)	Vasu Ltd. (₹ in 000's)
(i) Goodwill	1,600	800
(ii) Fixed Assets	2,000	3,000
(iii) Investments at Market Value	800	100
		500
(iv) Current Assets	1,200	1,000

A: Gross Assets [Add: (i) to (iv)]	5,600	5,400
B: Liabilities	1,600	600
C: Net Assets [A – B]	4,000	4,800

Stage II: Determination of Value of Shares:

D: Number of Shares:	32,000	24,000
E:Value of Equity Share (C ÷ D):	₹ 125	₹ 200

Stage III: Ratio of Exchange: 125:200

5:8

That means that for every 5 shares in Vasu Ltd., 8 shares of Basu Ltd. will be exchanged.

∴ Market Value of 5 Shares of Vasu Ltd. = 5 × ₹ 200 = ₹ 1,000

Market Value of 8 Shares of Basu Ltd. = 8 × ₹ 125 = 1,000

Stage IV: Computation of Purchase Consideration:

Step 1: Number of Shares to Be Issued = $24,000 \times \frac{8}{5}$ = 38,400 Shares
(for Every 5 Shares in Vasu Ltd. 8 Shares in Basu Ltd.)

Step 2: Shares Already Held by Vasu Ltd.: 4,000 Shares

Step 3: Actual Shares to Be Issued (Step 1 – Step 2): 34,400

Step 4: Purchase Consideration 34,400 Shares × ₹ 125 per Share (Ref: Stage III)
Or ₹ 4,300 Thousand

Stage V:

Books of Basu Ltd.
Journal Entries

(₹ in 000's)

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
31 March 2011	Goodwill A/c	Dr.		800	
	Fixed Assets A/c	Dr.		3,000	
	Investment A/c	Dr.		100	
	Current Assets A/c	Dr.		1,000	
	To Sundry Liabilities A/c				600
	To Liquidator of Vasu Ltd				4,300
	(Assets and Liabilities are Taken Over)				
31 March 2011	Amalgamation Adjustment A/c	Dr.		600	
	To Investment Allowance Reserve A/c				600
	(Statutory Reserve of Vasu Ltd. Incorporated)				

31 March 2011	Goodwill A/c Dr. To Current Assets A/c (Stock Purchased from Vasu Ltd, Cost Reduced by One-fifth of ₹ 320 Thousand)		64	 64
31 March 2011	Liquidator of Vasu Ltd. Dr. To Equity Share Capital A/c To Share Premium A/c (34,400 Shares of ₹ 100 Each Issued to the Liquidator, ₹ 25 Credited to Share Premium A/c)		4,300	 3,440 860

Note: Market value of 4,000 shares in Basu Ltd. is to be valued at ₹ 125 per share—Ref: Stage II]

Stage VI:

Basu Ltd. Balance Sheet (After Absorption) as on 31 March 2011

(₹ in 000's)

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets:		4,000
Issued & Subscribed				
66,400 Equity Shares of ₹ 100 Each Fully Paid (Includes 34,400 Shares Issued for Consideration Other Than Cash)	6,640	Goodwill	2,000	
		Add:	1,464	3,464
		Investments :	1,200	
		Add:	100	1,300
Reserves & Surplus:				
General Reserve	1,200	Current Assets		
Share Premium	860	(₹ 1,200 + ₹ 1,000 – ₹ 64)		2,136
Investments Allowance Reserve	600	Amalgamation Adjustment		600
Current Liabilities & Provisions:				
Sundry Creditors	2,200			
	11,500			11,500

9.5.3.3.3 When Shares are Held by the Companies in Each Other

(i) Net Payment Method:

Under this method, the purchase consideration is to be computed under the following steps:

Step 1: The Number of Shares to Be Issued to Outside Shareholders in the Absorbed Company = …

Step 2: Number of Shares Due to Purchasing Company as Shareholder in the Vendor Company = …

Step 3: Total Number of Shares (Step 1 + Step 2) = …

Step 4: Less: Number of Shares Already Held by the Absorbed Company = …

Step 5: Purchase Consideration (Number of Share as per Step 4 × Issue Price per Share) = ₹ …

Illustration 9.35

Model: When shares are held by both the companies in each other—Net payment method

X Ltd. is to absorb Y Ltd. by issuing 5 shares of ₹ 10 each at a premium of 10% for every 4 shares held in Y Ltd. On the date of absorption, the balance sheets were as follows:

Liabilities	X Ltd. ₹	Y Ltd. ₹	Assets	X Ltd. ₹	Y Ltd ₹
Share Capital			Fixed Assets	24,00,00	12,00,000
(Shares of ₹ 10 Each)	30,00,000	18,00,000	Investments:		
			36,000 Shares in Y Ltd.	4,80,000	—
General Reserve	3,00,000	2,40,000	30,000 Shares in X Ltd.	—	3,60,000
Creditors	6,00,000	3,60,000	Current Assets	10,20,000	8,40,000
	39,00,000	24,00,000		39,00,000	24,00,000

You are required to show (i) the important ledger accounts in the books of Y Ltd. and (ii) the acquisition entries in the books of X Ltd.

Solution

Stage I: Computer of Purchase Consideration:

			No. of Shares
			No. of Shares
Step 1:	No of Shares to Be Issued to Outside Shareholders of Y Ltd.: $1,44,000 \times \frac{5}{4} = 1,80,000$	=	1,80,000
Step 2:	Shares to X Ltd. (Due): $36,000 \times \frac{5}{4}$: 45,000	=	45,000
Step 3:	Total Number of Shares (Step 1 + Step 2)		2,25,000
Less:			
Step 4:	Shares Already Held by Y Ltd.		30,000
Step 5:	Actual Number of Shares	=	1,95,000
Step 6:	Purchase Consideration (Number of Shares × Issue Price 1,95,000 × ₹ 11 (Step 5) (10 + 1 Premium)	=	₹ 21,45,000

Stage II: Preparation of Ledger Accounts:

In the Books of Y Ltd.

Realization A/c

Particulars	₹	Particulars	₹
To Fixed Assets A/c	12,00,000	By Sundry Creditors	3,60,000
To Current Assets	8,40,000	By X: Ltd. (Purchase Consideration)	21,45,000
To Shareholders' A/c (Profit)	4,65,000		
	25,05,000		25,05,000

X Ltd. A/c

Particulars	₹	Particulars	₹
To Balance b/d	21,45,000	By Shares in X Ltd.	16,50,000
		By Shareholders' A/c (Set off)	4,95,000
	21,45,000		21,45,000

Shares in X Ltd.

Particulars	₹	Particulars	₹
To Balance b/d	3,60,000	By Shareholders' A/c (Loss on Revaluation)	30,000
To X Ltd. Shares	16,50,000	By Shareholders' A/c	19,80,000
	20,10,000		20,10,000

Shareholders' A/c

Particulars	₹	Particulars	₹
To X Ltd. (Set off)	4,95,000	By Share Capital A/c	18,00,000
To Shares in X Ltd.	30,000	By General Reserve	2,40,000
To Shares in X Ltd.	19,80,000	By Realization A/c	4,65,000
	25,05,000		25,05,000

Stage III:

In the Books of X Ltd.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Business Purchase A/c Dr.		21,45,000	
	To The Liquidator of Y Ltd.			21,45,000
	(Being the Purchase Price of Business)			
	Goodwill A/c (Bal. Fig) Dr.		4,65,000	
	Fixed Assets A/c Dr.		12,00,000	
	Current Assets A/c Dr.		8,40,000	
	To Sundry Creditors A/c			3,60,000
	To Business Purchase A/c			21,45,000
	(Assets & Liabilities are Taken Over, Balancing Figure Representing Goodwill)			
	Liquidator of Y Ltd. A/c Dr.		21,45,000	
	To Shares Capital A/c			15,00,000
	To Share Premium A/c			1,50,000
	To Shares in Y Ltd. A/c			4,95,000
	(Discharge of Purchase Consideration—X Ltd. Will Issue Only 1,50,000 Shares. Of the 1,95,000 Shares, 45,000 Shares are Due to 'X' and Hence They Will Not Be Issued)			

	Shares in Y Ltd. A/c Dr. To Goodwill A/c (Shares Value in the Books of X Ltd. is ₹ 4,80,000; Surrendered to Liquidator at ₹ 4,95,000; Difference ₹ 15,000 Is Used to Reduce the Goodwill Value)		15,000	 15,000

(ii) Net Assts Method:

Net Assets of a Company Should Be Ascertained by Using Simultaneous Equations.

		₹
Step 1:	Total Value of Assets of Each Company (Applying Algebraic Equation):	…
Less:		
Step 2:	Proportionate Value of Assets (Shares):	…
Less:		
Step 3:	Shares of the Purchasing Company Held by Vendor Company:	…
		…

Illustration 9.36

Model: When shares are held by both the companies in each other—Net assets method

Following are the balance sheets of C Ltd. and D Ltd.:

Liabilities	**C Ltd.** ₹	**D Ltd.** ₹	**Assets**	**C Ltd.** ₹	**D Ltd.** ₹
Shares of ₹ 10 Each Fully Paid-up	3,00,000	1,50,000	Sundry Assets	12,00,000	6,00,000
Reserves	9,36,000	4,80,000	3,000 Shares in D Ltd.	36,000	—
			3,000 Shares in C Ltd	—	30,000
	12,36,000	6,30,000		12,36,000	6,30,000

It was decided that C Ltd. will absorb D Ltd. You are required to compute the purchase consideration.

Solution

Step 1: Computation of Total Assets of Each Company:

(i) Assumption: Let the Total Assets of C Ltd. be C; Let the Total Assets of D Ltd. be d.

(ii) $\therefore C = 12,00,000 + \frac{1}{5} \times d$ (1)

$d = 6,00,000 + \frac{1}{10} \times C$ (2)

*(iii) Substitute the Value of d in equation (1), We Get:

$$C = 12,00,000 + \frac{1}{5}\left(6,00,000 + \frac{1}{10} \times C\right) = C = ₹\,13,46,938$$

(iv) Value of Each Share of C Ltd. $= ₹\,\frac{13,46,938}{30,000} = ₹\,44.897$ or 44.90

(v) Substitute the Value of C in equation (2), We Get:

$$\text{Value of Each Share of D Ltd.} = \left(6,00,00 + \frac{1}{10} + 13,46,938\right)$$
$$= ₹\,6,00,000 + ₹\,13,469$$
$$= ₹\,6,13,469$$

(vi) Total Value of Assets of the Absorbed Company = ₹ 6,13,469.

Step 2: Computation of Purchase Consideration:

	₹
(i) Total Value of Assets in D Ltd:	6,13,469
(ii) Less: Already belonging to C Ltd. $\left(\frac{1}{5}\text{ of } ₹\,6,13,469\right)$:	1,22,694
	4,90,765
This Will Be Further Reduced by:	
For Making Payment of ₹ 44.90 C Ltd. Issues =	1 Share
∴ For Making Payment of ₹ 4,90,765 $\left(\frac{4,90,765}{44.90}\right)$ C Ltd. Issues =	10,930.178 Shares
Shares to Be Issued by C Ltd. =	10,930.178 Share
Less: Already Held by D Ltd. =	3,000 Shares
New Shares to Be Issued =	7,930.178 Shares

∴ Purchase Consideration Is to Be Paid by

(a) Issuing 7,930 Shares of ₹ 10 Each	=	₹ 79,300
(b) Fraction Share 0.178 × ₹ 44.90	=	₹ 7.99
Purchase Consideration	=	₹ 79,307.99

***Step 1** (iii) is explained below:

$$C = 12,00,000 + \frac{1}{5}\left(6,00,000 + \frac{1}{10}C\right)$$
$$C = 12,00,000 + \frac{1}{5}\left(6,00,000 + \frac{1}{5} \times \frac{1}{10}C\right)$$
$$= 12,00,000 + 1,20,000 + \frac{1}{50}C$$
$$C - \frac{1}{50}C = 13,20,000$$
$$\frac{50C - 1C}{50} = 13,20,000$$
$$\frac{49C}{50} = 13,20,000$$
$$49C = 13,20,000 \times 50$$
$$C = \frac{13,20,000 \times 50}{49}$$
$$= ₹\,13,46,938.775$$

Summary

Amalgamation: When two or more existing companies combine to form a new company, it is amalgamation.

Absorption: When one existing company takes over the business of one or more existing companies, it is absorption.

External reconstruction: When one existing company is wound up and a new company is floated with the same shareholders, it is external reconstruction.

Legally, amalgamation includes absorption. AS-14 deals with accounting for amalgamation.

Reorganization of a company without winding up (liquidating) the company is internal reconstruction. On the other hand, if it involves the liquidation of the existing company, it is external reconstruction.

Types of amalgamation: (i) Amalgamation in the nature of merger and (ii) Amalgamation in the nature of purchase.

Purchase consideration: It refers to the total amount payable to the shareholders of transferor company.

Methods of computation of purchase consideration: (i) Lump sum method (ii) Net payment method (iii) Net assets method and (iv) Intrinsic value method. Each method is explained with a sufficient number of illustrations (Ref: The text).

Items that are to be treated as liabilities, trade liabilities, provisions, accumulated profits and accumulated losses are explained clearly. (Ref: the text for detail)

Methods of accounting for amalgamation: (i) The pooling of interest method and (ii) Purchase method.

Accounting treatment: Whatever may be the form of combination (i.e., amalgamation, absorption or external reconstruction), the books of the transferor (selling, vendor) company have to be closed. This has to be made by passing necessary entries in the books of journal and preparing the relevant ledger accounts. At the same time, journal entries have to be passed in the books of purchasing company (transferee).

These are all explained by way of illustrations (Ref: text).

Some of the following factors should be taken into account while accounting for amalgamation, absorption and external reconstruction is carried out:

(i) Amalgamation adjustment A/c
(ii) Amalgamation after balance sheet date
(iii) Dissenting shareholders
(iv) Inter-company owings
(v) Unrealized profit in stock

Accounting treatment for Inter-company holdings:

(i) When shares are held by the transferee company in the transferor company
(ii) When shares are held by the transferor company in the transferee company
(iii) When shares are held by both the companies in each other (cross holdings)

Each type is explained with illustrations (Ref: text)

Key Terms

Amalgamation: A form of business combination in which two or more companies combine together to form a new company.

Absorption: A form of business combination in which one existing company takes over the business of one or more existing companies.

External Reconstruction: A form of reorganization in which an existing company is liquidated and a new company floated with the same shareholders.

Purchase Consideration: It refers to the total amount payable to the shareholders of the transferor company by the purchasing company.

Amalgamation Adjustment A/c: An account to which any statutory reserve (of the selling company that is to be continued for a few years) should be debited to and to be shown as asset in the balance sheet. Applicable only when purchase method is adopted.

Dissenting Shareholders: Shareholders of the transferor company who have not given their asset to the proposed scheme of amalgamation (or any reorganization scheme).

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. In absorption, no new company is formed.
2. A new company is floated with new shareholders in "external reconstruction".
3. As per Sections 390 & 396 (A) of the Companies Act, any scheme of amalgamation requires the approval of a court.
4. As per AS-14, amalgamation differs from absorption.
5. Internal reconstruction requires the winding up of an existing company.
6. External reconstruction is more or less same as that of "amalgamation in the nature of purchase".
7. In the case of amalgamation in the nature of merger, all the assets and liabilities of the selling company will become the assets and liabilities of the purchasing company.
8. Adjustment has to be made in the book values of the assets and liabilities of the transferor company when they are transferred to the financial statements of the purchasing company, when amalgamation is in the nature of merger.
9. Under amalgamation in the nature of merger, purchase consideration should be discharged to the shareholders only in the form of cash.
10. When amalgamation is in the nature of purchase, less than 90% of the selling company's shareholders may become shareholders in the purchasing company.
11. When amalgamation is in the nature of purchase, assets and liabilities taken over by the purchasing company should be shown only at their book values.
12. While computing the purchase consideration, amount agreed to be paid to debenture holders and creditors should be taken into consideration.
13. Liquidation expenses can be treated as reimbursement while ascertaining purchase price.
14. The aggregate of agreed payments represents the "net payment method".
15. Under "net assets" method, assets taken over should not include cash and bank balances.
16. Under net assets method, accumulated profits should not form part of liabilities.
17. Under "shares exchange method", the exchange ratio is determined on the basis of "intrinsic value of shares" of the respective companies' shares.
18. When the amalgamation is in the nature of merger, purchase consideration should be made in the form of "cash" only.
19. While recording transactions in the books of the companies, provisions should be transferred to realization account and losses should be transferred to the shareholders' account.
20. "Amalgamation adjustment account" is to be shown on the liabilities side of the balance sheet.
21. If the purchase consideration agreed to be paid is greater than the net assets taken over, the difference should be treated as "capital reserve".
22. "Pooling of interests method" is confirmed to amalgamations in the nature of merger.
23. Under pooling of interests method, goodwill account should be written off within a period of 5 years.
24. In the books of the transferor company, for unrealized profit in stock, no adjustment is needed.
25. If the amalgamation is in the nature of purchase, the amount of unrealized profit is to be debited to goodwill/capital reserve A/c.

Answers:

1. True	2. False	3. True
4. False	5. False	6. True
7. True	8. False	9. False
10. True	11. False	12. False
13. True	14. True	15. False
16. True	17. True	18. False
19. True	20. False	21. False
22. True	23. False	24. True
25. True		

II: Fill in the blanks with apt word(s)

1. When two or more companies combine together to form a new company, it is called _____.

2. When one existing company takes over the business of one or more existing companies, it is known as _____.
3. When an existing company is liquidated and a new company is formed (with the same shareholders mostly), it is termed _____.
4. In the eyes of law, amalgamation includes _____ also.
5. The Accounting Standard _____, issued by the ICAI, specifies the procedure of accounting for amalgamations.
6. If the reorganization is carried out without liquidating the company, it is _____.
7. In a reorganization, if a company gets liquidated and a new company is floated with the same shareholders, it is called _____.
8. Amalgamations may broadly be divided into two categories: (i) _____ and (ii) _____.
9. When amalgamation is in the nature of merger, _____ assets and liabilities are to be taken over by the purchasing company.
10. When amalgamation is in the nature of merger, assets and liabilities taken over should be shown at their _____ values.
11. When amalgamation is in the nature of purchase, all assets and liabilities _____ over by the purchasing company.
12. When amalgamation is in the nature of purchase, assets and liabilities taken over may be shown at values _____.
13. As per AS-14, purchase consideration means the total amount payable to the _____ of the transferor company.
14. In the purchase price, amount paid to _____ and _____ should not be included.
15. The total of the agreed payments represents _____ made by the purchasing company to the shareholders of transferor (selling) company.
16. "Net assets" taken over by the purchasing company represent the _____ under "net assets" method.
17. Agreed value of "assets" taken over – Agreed value of liabilities taken over = _____.
18. $\frac{\text{Assets Available for Equity Shareholder}}{\text{Number of Equity Share}}$ = ____.
19. One method of accounting for amalgamation is "the pooling of interests method"; and the other one is _____.
20. When amalgamation is in the nature of merger, _____ method of accounting is used.
21. The pooling of interests method has no specific effect on the books of the _____ company.
22. _____ method of accounting is used when amalgamation is in the nature of purchase.
23. When the purchase price agreed to be paid exceed the net assets taken over, such excess amount should be debited to _____ A/c.
24. When the purchase consideration is less than the amount of net assets taken over, such difference should be credited to _____ A/c.
25. In purchase method, "statutory reserves" of the transferor company should be _____.
26. All statutory reserves should be debited to _____ A/c if they are continued for some more years.
27. Shareholders of transferor company who have not given their assent for amalgamation are called _____.
28. Amalgamation effected after the balance sheet date should be in accordance with the standard _____.
29. Inter-company owings, due to purchase and or sale of goods, will create a problem of _____.
30. If the amalgamation is in the nature of merger, the amount of unrealized profit is to be debited to _____.

Answers:

1. Amalgamation
2. Absorption
3. External reconstruction
4. Absorption
5. AS-14
6. Internal reconstruction
7. External reconstruction
8. Amalgamation in the nature of merger
9. Amalgamation in the nature of purchase
10. All
11. Book values
12. May not be taken
13. Other than book values
14. Shareholders
15. Debenture holders; creditors
16. Net payment
17. Purchase consideration
18. Intrinsic value
19. The purchase method

20. The pooling of interests
21. Transferor/selling
22. The purchase
23. Goodwill
24. Capital reserve
25. Continued
26. Amalgamation adjustment
27. Dissenting shareholders
28. AS-14
29. Unrealized profit in stock
30. General reserve
30. P&L A/c

III: Multiple choice questions—Choose the correct answer

1. In which of the following are all the combining companies liquidated:
   (a) amalgamation
   (b) absorption
   (c) external reconstruction
   (d) internal reconstruction
2. When an existing company is liquidated and a new company is formed with the same shareholder to run the business, it is referred to as
   (a) amalgamation
   (b) external reconstruction
   (c) absorption
   (d) internal reconstruction
3. Assets and liabilities taken over should be shown in purchasing company at their (amalgamation in the nature of merger)
   (a) sales value (b) market value
   (c) book value (d) costs
4. In amalgamations in the nature of purchase, consideration payable to shareholders of the transferor company may be in the form of
   (a) shares (b) cash
   (c) any agreed form (d) all of these
5. Intrinsic value of shares means
   (a) dividing the assets available by number of equity shares
   (b) face value
   (c) market value
   (d) none of these
6. While recording transactions in the books of companies for reorganization, "underwriting commission" is treated as
   (a) trade liabilities
   (b) accumulated losses
   (c) accumulated profits
   (d) provisions
7. "Investment fluctuation fund" is treated as
   (a) trade liabilities
   (b) accumulated profits
   (c) provision
   (d) accumulated losses
8. "Workmen's compensation fund" is treated as
   (a) liabilities
   (b) provisions
   (c) accumulated losses
   (d) accumulated profit
9. Pooling of interests method is used
   (a) when amalgamation is in the nature of merger
   (b) when amalgamation is in the nature of purchase
   (c) for internal reconstruction scheme only
   (d) none of these
10. In purchase method, excess of purchase consideration over the net assets taken over is treated as
   (a) capital reserve (b) revenue reserve
   (c) statutory reserve (d) goodwill

Answers:

1. (a) 2. (b) 3. (c) 4. (d)
5. (a) 6. (b) 7. (c) 8. (d)
9. (a) 10. (d)

Short Answer Questions

1. What do you mean by "amalgamation"?
2. Explain the term "absorption".
3. What is "external reconstruction"?
4. What is the main difference between external reconstruction and internal reconstruction?
5. What is the legal meaning of amalgamation?

6. Explain the term "amalgamation" as per AS-14.
7. "External construction is like old wine in new bottle"—Comment.
8. Name the two types of amalgamation.
9. Mention the important features in amalgamation in the nature of merger.
10. What are the salient features in amalgamation in the nature of purchase?
11. Explain "purchase consideration".
12. Mention the methods of computing purchase consideration.
13. What does AS-14 stipulate with respect to "consideration"?
14. What do you mean by net payment method?
15. How would you determine "net assets"?
16. How will the "intrinsic value" of shares be determined?
17. What is the main difference between "provision" and "loss" while recording transactions in the books of companies?
18. How will you treat "accumulated profits"?
19. Name the items that are included in "trade liabilities".
20. Name the methods of accounting for amalgamation.
21. What method is used in merger type of amalgamation?
22. Name the method that is used in purchase type of amalgamation.
23. What is AS-14 concerned with?
24. Explain "dissenting shareholders".
25. Write short notes on "amalgamation adjustment account".
26. How does goodwill arise? How will it be treated?
27. What is "capital reserve"? How would you treat it?
28. What is "unrealized profit in stock"?
29. What do you mean by "inter-company owings"? Why does it arise?
30. Mention the possible situations that may arise in "inter-company holdings"?

Essay Type Questions

1. Explain the different types of meaning for: (a) amalgamation (b) absorption and (c) external reconstruction.
2. How do amalgamation, absorption and external reconstruction differ from each other? Illustrate your answer.
3. Explain the salient features of AS-14.
4. What are the types of amalgamation? Elucidate the salient features of each such type. How do they differ from each other?
5. Define "purchase consideration". Name the methods of computation of purchase consideration. Explain "net payment method" with an example of your own.
6. Explain "net assets method". Explain the relevant factors to be considered while determining purchase consideration.
7. What is meant by intrinsic value method? Explain with suitable illustration.
8. Discuss the various factors that are to be taken into account while recording transactions in the books of both transferor and transferee companies.
9. What are the methods of accounting for amalgamations? Discuss the salient features of each method. How do they differ from each other?
10. What do you mean by "inter-company holdings"? How will you treat:
    (a) If shares are held by the transferee company in the vendor company
    (b) If shares are held by the vendor company in the purchasing company
    (c) If shares are held by both the companies in each other
11. Write short notes on:
    (a) Amalgamation adjustment A/c
    (b) Amalgamation after balance sheet date
    (c) Dissenting shareholders
    (d) Inter-company owings
    (e) Unrealized profit in stock

Exercises

Part A—For Undergraduate Level

[Model: Computation of purchase consideration]

1. Vivek Ltd. is absorbed by Abhishek Ltd., the consideration being:
   (i) The taking over of trade liabilities of ₹1,20,000
   (ii) The payment of cost of absorption ₹45,000
   (iii) The payment of 'Y' Debentures of Vivek Ltd. of ₹6,00,000 at par
   (iv) The discharge of 'X' debentures of ₹9,00,000 in the vendor company at a premium of 10% by the issue of 8% debentures in Abhishek Ltd. at par
   (v) A payment of ₹20 per share in cash and the exchange of 4 fully paid ₹10 shares in Abhishek Ltd. at a market price of ₹15 per share for every ₹50 share in Vivek Ltd. which were 1,20,000 in number

   You are required to find out the purchase consideration

   [B.Com Osmania University Modified]

   [**Ans:** Purchase consideration: ₹96,00,000]

[Model: Amalgamation in the nature of merger]

2. A Ltd. and B Ltd. have agreed to amalgamate. A new company C Ltd. has been formed to take over the combined concern as on 31 December 2010. After negotiations, the assets of two companies have been agreed upon as shown in the following:

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Share Capital:			Land & Buildings	10,00,000	6,00,000
Shares of ₹10 Each	20,00,000	10,00,000	Plant & Machinery	4,00,000	5,00,000
Reserve Fund	—	1,00,000	Goodwill	—	1,00,000
P&L A/c	1,00,000	1,00,000	Furniture	2,20,000	—
Creditors	1,60,000	1,00,000	Stock	3,00,000	40,000
			Debtors	2,40,000	40,000
			Bank	1,00,000	20,000
	22,60,000	13,00,000		22,60,000	13,00,000

Prepare the balance sheet of C Ltd. assuming:

(a) The entire purchase price is paid off in the form of equity shares of ₹100 each in C Ltd.

(b) The amalgamation is in the nature of merger

[B.Com Madras University Modified]

[**Ans:** Purchase price: A Ltd.—₹21,00,000, B Ltd.—₹12,00,000; Excess of purchase consideration adjusted against reserves: ₹3,00,000; Balance sheet total: ₹35,60,000]

[Model: Amalgamation in the nature of merger]

3. The following are the balance sheets of X Ltd. and Y Ltd. as on 31 March 2011:

Liabilities	X Ltd. ₹	Y Ltd. ₹	Assets	X Ltd. ₹	Y Ltd. ₹
Share Capital of ₹10 Each	45,00,000	18,00,000	Fixed Assets	48,10,500	13,48,500
Securities Premium	4,50,000	45,000	Current Assets	27,86,790	11,11,800
P&L A/c	5,68,080	—	Miscellaneous Expenditure	30,000	—
General Reserve	14,10,000	—	P&L A/c	—	2,89,590
8% Debentures	—	6,00,000			
Creditors	6,99,210	3,04,890			
	76,27,290	27,49,890		76,27,290	27,49,890

Z Ltd. was formed to take over the business of X Ltd. and Y Ltd. for the agreed purchase consideration of ₹58,50,000 and ₹13,40,000, respectively, which is payable in the form of ₹100 per shares at par. Y Ltd's debentures are to be converted into 10% debentures of Z Ltd.

Amalgamation expenses of ₹45,000 are to be borme by the transferee company.

[Model: Amalgamation in the nature of purchase]

Close the books of the transferor companies and give journal entries and balance sheet in the transferee company's books.

[**Ans:** Realization loss: X Ltd.—₹13,48,080, Y Ltd.—₹1,15,41; Balance sheet total: ₹1,00,42,590]

4. P Ltd. and Q Ltd. agree to amalgamate as from 31 December 2010 on which date their respective balance sheets were as follows:

Liabilities	P Ltd. ₹	Q Ltd. ₹	Assets	P Ltd. ₹	Q Ltd. ₹
Share Capital:			Cash in Hand	500	250
Shares of ₹ 10 Each	4,00,000	1,25,000	Cash at Bank	17,000	2,250
Sundry Creditors	15,000	5,000	Sundry Debtors	1,12,500	30,000
Reserves	37,500	20,000	Plant	60,000	22,500
Profit & Loss A/c	12,500	5,000	Stock	75,000	35,000
			Premises	1,50,000	50,000
			Patents	50,000	15,000
	4,65,000	1,55,000		4,65,000	1,55,000

Draw up the balance sheet of the new company PQ Ltd., which was incorporated to take over the amalgamated concerns, and state the number of shares in the new company, which will be allotted to the shareholders of the old companies. (Assume the same face value)

[**Ans:** Number of shares to allotted in PQ Ltd: 45,000 shares to be allotted to P Ltd. and 15,000 shares to be allotted to Q Ltd. shareholders; Balance sheet total: ₹7,20,000]

5. R Ltd. and S Ltd. are two companies carrying on business in the same lines of activity. Their balance sheets as on 31 March 2011 are as follows:

Liabilities	R Ltd. ₹	S Ltd. ₹	Assets	R Ltd. ₹	S Ltd. ₹
Fully Paid Equity Shares of	24,00,000	8,00,000	Land & Buildings	4,00,000	—
₹10 Each			Plant & Machinery	28,00,000	12,00,000
General Reserve	16,00,000	8,00,000	Investments	4,00,000	—
Secured Loan	24,00,000	4,00,000	Stock	36,00,000	16,00,000
Current Liabilities	24,00,000	16,00,000	Debtors	12,00,000	4,00,000
			Cash at Bank	4,00,000	4,00,000
	88,00,000	36,00,000		88,00,000	36,00,000

The two companies decided to amalgamate into T Ltd. The following further information is as follows:

(i) All assets and liabilities of the two companies are taken over

(ii) Each share in S Ltd. is valued at ₹25 for the purpose of amalgamation

(iii) Shareholders of S Ltd. and R Ltd. are paid off by issue of sufficient number of equity shares of ₹10 each in T Ltd. as fully paid at par

(iv) Each share in R Ltd. is valued at ₹15 for the purpose of amalgamation

Show the journal entries to close the books of both the companies.

[**Ans:** Realization loss to R Ltd.: ₹4,00,000; Realization profit to S Ltd.: ₹4,00,000; Purchase

consideration R Ltd.: ₹36,00,000; Purchase consideration S Ltd.: ₹20,00,000]

6. M Ltd. and N Ltd. propose to amalgamate. Their balance sheets as on 31 December 2010 were as follows:

Liabilities	M Ltd. ₹	N Ltd. ₹	Assets	M Ltd. ₹	N Ltd. ₹
Equity Share Capital	16,00,000	6,00,000	Fixed Assets	13,20,000	4,00,000
General Reserve	7,20,000	60,000	Investments	2,88,000	—
Profit & Loss A/c	2,40,000	92,000	(Face Value ₹3,20,000)		
Creditors	4,18,000	98,000	Stock	6,40,000	1,62,000
			Debtors	3,74,000	2,00,000
			Cash	3,56,000	88,000
	29,78,000	8,50,000		29,78,000	8,50,000

Profit After Tax Year	M Ltd. ₹	N Ltd. ₹
2010	4,92,000	1,66,000
2009	4,38,000	1,25,600
2008	3,96,000	1,08,000

Goodwill may be taken at 4 years purchase of average super profits of 3 years from trading on the basis of 10% normal trading profit on closing capital invested.

Q Ltd. is formed for the purpose of amalgamation of both companies.

Prepare balance sheet of Q Ltd. as on 31 December 2010.

[**Ans:** Purchase consideration: M Ltd. = ₹33,04,000; N Ltd. = ₹9,84,00; Total of balance sheet: ₹48,04,000]

7. X Ltd. and Y Ltd. agree to amalgamate as from 31 December 2010 on which date their balance sheets were as follows:

Liabilities	X Ltd. ₹	Y Ltd. ₹	Assets	X Ltd. ₹	Y Ltd. ₹
Share Capital (₹1 Each)	25,000	10,000	Fixed Assets	26,000	8,750
Creditors	2,500	1,000	Current Assets	20,500	6,750
Reserves	4,000	3,000			
12% Debentures	15,000	1,500			
	46,500	15,500		46,500	15,500

Z Ltd. was formed to take over the concerns of both X Ltd. and Y Ltd. Purchase price is to be discharged as follows:

For shareholders of X Ltd., 30,000 shares of ₹1 each in Z Ltd.

For shareholders of Y Ltd., 12,500 shares of ₹1 each in Z Ltd.

Debenture holders are to be settled by issue of 15% debentures in Z Ltd.

You are required to close the books of X Ltd. and Y Ltd. and give journal entries and balance sheet in the books of Z Ltd. assuming the amalgamation is in the nature of purchase.

[**Ans:** Realization Profit in X Ltd.: ₹1,000; Realization Loss in Y Ltd.: ₹500; Balance sheet total of Z Ltd.: ₹62,500]

[Model: Absorption]

8. Akash Ltd. having a capital of ₹70,00,000 divided into 70,000 shares of ₹100 each (₹75 paid up) and a reserve fund of ₹17,50,000 was absorbed by Rishi Ltd. having a capital of ₹2,80,00,000 divided into 2,80,000 shares of ₹100 each (₹6 paid up) and a reserve fund of ₹1,12,00,000 on the terms that for every four shares in Akash Ltd., Rishi Ltd. was to give five shares partly paid as its original ones.

Prepare ledger accounts to close the books of Akash Ltd.

[**Ans:** Purchase consideration: ₹ 52,50,000; Loss on realization: ₹ 17,50,000; Payment to shareholders (value of shares): ₹ 52,50,000]

9. The following is the balance sheet of Bhama Ltd. on 31 March 2011:

Liabilities	₹	**Assets**	₹
12,000 Shares of ₹ 100 Each	12,00,000	Land & Buildings	6,00,000
Debentures	6,00,000	Plant & Machinery	9,00,000
Sundry Creditors	1,80,000	Work-in-Progress	1,80,000
Reserve Fund		Stock	3,60,000
Dividend Equalization Fund	1,50,000	Furniture & Fittings	15,000
Profit and Loss Appropriation A/c	1,20,000	Sundry Debtors	1,50,000
	30,600	Cash at Bank	75,000
		Cash in Hand	600
	22,80,600		22,80,600

The Company is absorbed by Rita Ltd. on the above date. The consideration for the absorption is the discharge of debentures at a premium of 5% taking over the liability in respect of the sundry creditors and payment of ₹ 70 in cash and one share of ₹ 50 in Rita Ltd. at the market value of ₹ 80 per share in exchange for one share in Bhama Ltd. The cost of liquidation of ₹ 30,000 is to be met by the purchasing company.

Pass journal entries in the books of both the companies. Show how the purchase price is arrived at.

[**Ans:** Purchase price: ₹ 2,99,400; Payment to shareholders: Cash—₹ 6,84,000, Shares—₹ 9,60,000]

10. The balance sheet of AB Ltd. as on 31 December 2010 was as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets	18,00,000
2,00,000 Shares of ₹ 10 Each	20,00,000	Current Assets	2,00,000
Sundry Liabilities	4,00,000	P&L A/c	4,00,000
	24,00,000		24,00,000

CD Ltd. absorbed the AB Ltd. and took over all the assets for ₹ 14,40,000 payable ₹ 10,00,000 in shares of ₹ 10 each and ₹ 4,40,000 in cash (in order to enable AB Ltd. to pay off its liabilities and cost of winding up).

Show realization A/c, shareholders A/c and cash A/c in the books of AB Ltd.

[**Ans:** Realization loss: ₹ 6,00,000; Purchase price: ₹ 10,00,000; Payment to share holders: ₹ 10,00,000]

11. A Co Ltd. agreed to acquire the assets excluding cash as on 31 December 2010 of B Co Ltd.

The balance sheet of B Co Ltd. as on that day was as follows:

Liabilities	₹	**Assets**	₹
Equity Capital:		Goodwill	3,60,000
Shares of ₹ 10	18,00,000	Land & Buildings	7,20,000
Each	4,80,000	Plant &	12,00,000
General Reserve	3,00,000	Machinery	4,80,000
Debentures	60,000	Stock	1,80,000
Creditors	3,60,000	Debtors	60,000
Profit & Loss A/c		Cash	
	30,00,000		30,00,000

The consideration was as follows:

(i) A cash payment of ₹ 4 for every share of B Co Ltd.

(ii) The issue of one share of ₹ 10 each at market value of ₹ 12.50 in the A Co Ltd. for every share in B Co Ltd.

(iii) The issue of 6,600 debentures of ₹ 50 each in A Co Ltd. to enable B Co Ltd. to discharge its debentures at 10% premium

(iv) The expenses of liquidation of B Co Ltd. amounting to ₹ 24,000 were to be met by themselves

Give the journal entries in the books of both the companies.

[**Ans:** Purchase consideration: ₹ 29,70,000; Realization profit: ₹ 3,06,000; Payment to shareholders: Cash—₹ 6,96,000, Shares—₹ 22,50,000]

Note: Cash is not taken over, it is utilized to pay creditors.

12. The position of two companies L and R is as follows:

(₹ in 000's)

Liabilities	L Ltd. ₹	R Ltd. ₹	Assets	L Ltd. ₹	R Ltd. ₹
Nominal Capital:			Fixed Assets	3,600	6,000
Shares of ₹ 10 Each	6,000	12,000	Debtors & Stock	4,200	1,000
Issued and Paid up Capital:			Cash at Bank	—	1,200
Shares of ₹ 10 Each Fully Called & Paid	6,000	8,400	Goodwill	1,200	4,200
			Profit & Loss	1,800	—
5% Debentures	1,200	—			
Creditors	3,600	2,400			
Profit & Loss A/c	—	1,800			
	10,800	12,600		10,800	12,600

R Ltd. agreed to absorb L Ltd. upon the following terms:

(i) The shares in L Ltd. are to be considered as worth ₹ 6 each. The shareholders of L Ltd. are to be paid one quarter in cash and the balance in shares of R Ltd. at ₹ 12.50 each.

(ii) The debenture holders in L Ltd. agreed to take ₹ 95 of 7% debentures in R Ltd. for every ₹ 100 of 5% debentures held in L Ltd.

(iii) L Ltd. is to be wound up.

Show the journal entries to record the above in both companies and draw the balance sheet showing the position of R Ltd. after the absorption.

[**Ans:** Purchase consideration: ₹ 36,00,000; Realization loss: ₹ 6,00,000; B/S total: ₹ 2,00,40,000]

13. The following is the balance sheet of Weak Ltd. as on 30 June 2010:

Liabilities	₹	Assets	₹
16,000 Equity Shares of ₹ 10 Each	16,00,000	Buildings	6,80,000
		Plans & Machinery	16,00,000
General Reserve	2,00,000	Investments	2,02,400
Profit and Loss A/c	22,400	Debtors	5,62,000
		Stock	3,22,800
5% Debentures	10,00,000	Cash at Bank	66,000
Creditors	5,14,800		
Dividend Equalization Fund	96,000		
	34,33,200		34,33,200

Weak Ltd. was absorbed by Strong Ltd. on the above date on the following terms:

(i) Assume all liabilities and to acquire all assets except investments which were sold by Weak Ltd. for ₹ 1,80,000

(ii) Discharge the debenture at a discount of 5% by issue of 7% debentures in Strong Ltd.

(iii) Issue two shares of ₹ 60 each in Strong Ltd. at ₹ 65 per share and also pay ₹ 2 in cash to the shareholders of Weak Ltd. in exchange for one share in Weak Ltd.

(iv) Pay the cost of absorption of ₹ 6,000

With the consent of the shareholders, the liquidator of Weak Ltd. sold off in open market one-fourth of the shares received from Strong Ltd. at an average price of ₹ 63 per share.

You are required to prepare:

(a) Statement of surchase consideration

(b) Important ledger accounts in the books of Weak Ltd.

[B.Com Bombay University Modified]

[**Ans:** Purchase consideration: ₹ 21,12,0000; Realization profit: ₹ 3,57,600; Payment to shareholders: Cash—₹ 7,16,000, S h a r e s — ₹ 15,60,000]

14. A Ltd. agreed to acquire the business of B Ltd. as on 31 December 2010. The balance sheet of B Ltd. on that date was as follows:

Liabilities	₹	Assets	₹
Share Capital of ₹ 10 Each	30,00,000	Goodwill	5,00,000
		Land and Buildings	32,00,000
General Reserve	8,50,000		
Profit & Loss A/c	5,50,000	Stock in Trade	8,40,000

6% Debentures	5,00,000	Debtors	1,80,000
Creditors	1,00,000	Cash	2,80,000
	50,00,000		50,00,000

The consideration payable by A Ltd. was agreed upon as follows:

(i) A cash payment equivalent to ₹2.50 for every ₹10 share in B Ltd.

(ii) The issue of 4,50,000 ₹10 shares fully paid in A Ltd. having an agreed value of ₹15 per share.

(iii) The issue of such an amount of fully paid 5% debentures of A Ltd. at 96% is sufficient to discharge the 6% debentures of B Ltd. at a premium of 20%. While computing the consideration, the directors of A Ltd. valued land & buildings at ₹60,00,000, the stock at ₹7,10,000 and the debtors at their face value subject to an allowance of 5% to cover doubtful debts. The cost of liquidation of B Ltd. came to ₹25,000 which is to be paid by A Ltd.

Close the books of B Ltd. and give journal entries in the books of A Ltd.

[Madras University Modified]

[**Ans:** Purchase consideration: ₹75,00,000; Profit on realization: ₹31,00,000; Payment to shareholders: Cash—₹7,50,000, Shares—₹67,50,000]

[Model: Intrinsic value (Absorption)]

15. Balance Sheet of X Ltd. as on 31 March 2011 is as follows:

(₹ in Lakhs)

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets	415
2.5 lakh Shares of	250	Current Assets	345
₹10 Each		Investments	85
Capital Reserve	50	Goodwill	10
General Reserve	180		
Unsecured Loans	110		
Sundry Creditors	210		
Provision for Taxation	55		
	855		855

X Ltd. is amalgamated with Y Ltd. as on 31 March 2011, on which date the balance sheet of Y Ltd. is as follows:

Liabilities	₹ (Lakh)	**Assets**	₹ (Lakh)
Share Capital:		Fixed Assets	800
40 lakh Shares	400	Current Assets	840
of ₹10 Each			
General Reserve	500		
Secured Loans	200		
Sundry Credtors	230		
Provision for Tax	260		
Provision for Dividend	50		
	1,640		1,640

For the purpose of amalgamation, the goodwill of X Ltd. is considered to be of no value. There are also arrears of depreciation in X Ltd. amounting to ₹20 lakh. The shareholders in X Ltd. are allotted in full satisfaction of their claims, shares in Y Ltd. in the same proportion that the respective intrinsic values of the shares of the companies bear to each other.

Pass journal entries in the books of both companies to give effect to the above.

[**Ans:** Intrinsic value of the shares of X Ltd.: ₹180; Intrinsic value of the shares of Y Ltd.: ₹22.50; Purchase consideration: ₹450 lakh]

[Model: Fractions]

16. Vincent Ltd. acquired the business of Stephen Ltd. on 31 March 2011, whose balance sheet as on that date was as given in the following:

Liabilities	₹	**Assets**	₹
Capital:		Fixed Assets	15,00,000
2,00,000 Shares	20,00,000	Stock	4,00,000
of ₹10 Each		Debtors	2,50,000
Profit & Loss Account	3,00,000	Cash at Bank	3,50,000
Creditors	2,00,000		
	25,00,000		25,00,000

All the assets except the bank balances were taken over along with the trade liability. The purchase consideration was agreed at the exchange of five shares of ₹10 each in Vincent Ltd. at an agreed price of ₹12 per share for every 6 shares held.

Vincent Ltd's share was quoted in the market at ₹15.

In addition, the expenses of liquidation of ₹50,000 were agreed to be paid by Vincent Ltd.

You are required to give:

(i) Realization A/c & shareholders' A/c in the vendor company

(ii) Journal entries to record the acquisition in the purchasing company

[**Ans:** Purchase consideration: ₹20,00,005; ₹25 cash for fractions & shares: ₹19,99,980; Profit on realization: ₹50,005; Goodwill in Vincent Ltd.: ₹1,00,005]

[Model: Dissenting shareholders (Absorption)]

17. R Ltd. agreed to absorb the business of V Ltd. on the basis of the following balance sheet as on 31 December 2010:

Liabilities	₹	**Assets**	₹
Share Capital:		Land & Buildings	15,00,000
Authorized:		Machinery	3,00,000
1,50,000 Shares of ₹50 Each	75,00,000	Stock	18,00,000
Issued & Subscribed:		Investments ₹	60,000
1,20,000 Shares of ₹50 Each	60,00,000	Sundry Debtors 13,80,000	
Called up & Paid-up Capital:		Less: Provision for Bad Debt: 60,000	13,20,000
1,20,000 Shares of ₹50 Each ₹30 Called and Paid	36,00,000		1,80,000
Reserves	7,50,000	Cash at Bank	
Profit & Loss A/c	3,60,000		
Creditors	4,50,000		
	51,60,000		51,60,000

R Ltd. took over all the assets and liabilities of V Ltd. subject to the retention of ₹90,000 cash to provide for costs of liquidation, and to satisfy any dissenting shareholders.

The consideration for the sale is the allotment of one share of ₹100 (₹50 paid up) in R Ltd. for every two shares in V Ltd. The market value of the ₹50 paid-up share of R Ltd. on that date was ₹70 per share.

The liquidator of V Ltd. has paid, out of ₹90,000 retained, the cost of liquidation of ₹60,000 and dissenting shareholders of 600 shares at ₹32.50 per share, totalling ₹19,500.

Prepare ledger accounts in the books of V Ltd. and give journal entries in the books of R Ltd.

[**Ans:** Purchase consideration: ₹29,85,000; Realization loss: ₹16,96,500]

[Model: External reconstruction]

18. The creditors and shareholders having agreed upon a scheme of reconstruction, A Ltd. went into voluntary liquidation. The balance sheet as at that date of reconstruction stood as follows:

Liabilities	₹	**Assets**	₹
Share Capital		Building	3,80,000
1,00,000 Equity Shares of ₹10 Each	10,00,000	Machinery	4,20,000
		Stock	2,00,000
		Debtors	2,40,000
5% Debentures	4,00,000	Cash at Bank	8,000
Trade Creditors	1,60,000	Profit & Loss A/c	3,12,000
	15,60,000		15,60,000

The scheme of reconstruction provided as under:

(i) A new company called A New Ltd. to be formed with a share capital of ₹20,00,000 in 2,00,000 shares of ₹10 each to take over from the above company, stock and debtors at 20% less than the book value and building and machinery at ₹3,08,000 and ₹4,00,000, respectively.

(ii) The shareholders agreed to receive 1,00,000 equity shares of ₹10 each credited with ₹5 per share paid up, with a call of ₹2.50 per share to be made forthwith.

(iii) The debenture holders were to be satisfied by the issue of 6% mortgage debentures of ₹6,00,000 in the new company in exchange for old debentures.

(iv) The trade creditors agreed to receive ₹1,40,000 from the new company in full settlement of their claims.

(v) The bank balance was utilized in payment of reconstruction expenses.

Give the journal entries in the books of A Ltd. and A New Ltd.

[B.Com Osmania University Modified]

[**Ans:** Purchase consideration: ₹5,00,000; Loss on realization: ₹1,88,000]

19. Leela Co Ltd. decided to reconstruct and went into liquidation with the following assets and liabilities:

Liabilities	₹	Assets	₹
Reference Share Capital of ₹10 Each	4,00,000	Fixed Assets	9,98,400
		Stock	1,47,000
		Debtors	2,62,000
Equity Share Capital of ₹10 Each	16,00,000	Cash	800
		Profit & Loss A/c	8,25,400
General Reserve	24,200		
Bank Loan	37,200		
Creditors	1,72,200		
	22,33,600		22,33,600

A new company called Mala Co Ltd. was formed to acquire the fixed assets and stock of Leela Co Ltd. at ₹6,80,000 and ₹1,20,000, respectively. The purchase price is to be paid by issue of 10% preference shares and equity shares of ₹10 each for equal amounts.

Debtors realized ₹2,45,500 and creditors were paid ₹1,62,680 in full satisfaction. Bank loan was paid in full. The expenses of liquidation came to ₹21,420.

Close the books of Leela Co Ltd. and give the balance sheet of Mala Co Ltd.

[**Ans:** Purchase price: ₹8,00,000; Loss on realization: ₹3,73,800 Payment to equity shareholders: Cash—₹25,000 and Equity shares in Mala Ltd.—₹4,00,000; Balance sheet of Mala Ltd. total: ₹8,00,000]

20. The balance sheet of Govind Ltd. as on 31 December 2010 is given as follows:

Liabilities	₹	Assets	₹
Share Capital:		Land	3,25,000
5,000 Shares of ₹100 Each Fully Paid up	5,00,000	Machinery	1,10,000
		Furniture	15,000
		Stock	1,25,000
8% Debentures	2,00,000	Debtors	75,000
Creditors	30,000	Cash	20,000
		Profit & Loss A/c	60,000
	7,30,000		7,30,000

Khan Company Ltd. was formed to take over the business of Govind Ltd. With a nominal capital of ₹5,00,000 divided into 2,500 9% preference shares of ₹100 each and 2,500 equity shares of ₹100 each on the following basis:

(i) The debenture holders in Govind Ltd. are to accept 1,750 preference shares

(ii) The shareholders in Govind Ltd. are to receive one equity share in Khan Ltd. for every two shares held by them

(iii) Cost of liquidation met by Khan Ltd. was ₹3,000

(iv) The balance of preference shares has been issued which are taken up by the public

Give important ledger accounts to close the books of Govind Ltd. and journal entries in the books of Khan Ltd.

[**Ans:** Purchase consideration: ₹2,50,000; Realization loss: ₹1,90,000; Capital reserve in Khan Ltd. (after paying expenses): ₹2,12,000]

[Model: External reconstruction]

21. On 31 March 2011, the following was the balance sheet of Coral Ltd

Liabilities	₹	Assets	₹
60,000 Equity Shares of ₹10 Each	6,00,000	Plant & Machinery	4,50,000
		Furniture & Fixtures	75,000
Capital Reserve	10,000		
Loan	1,80,000	Stock	2,00,000
Sundry Creditors	1,50,000	Sundry Debtors	1,10,000
		Cash at Bank	50,000
		Profit & Loss A/c	55,000
	9,40,000		9,40,000

A new company Ruby Ltd. was incorporated which took over fixed assets and stock of Coral Ltd. for ₹6,30,000 payable as to ₹4,50,000 in the form of 90,000 equity share of ₹5 each and ₹1,80,000 in the form of 1,800 12% mortgage debentures of ₹100 each. Loan creditors accepted the debentures of Ruby Ltd. in discharge of the loan. Sundry Debtors realized ₹1,02,500. Expenses of liquidation amounted to ₹4,000 and were met by Coral Ltd. The available cash was distributed among sundry creditors in full satisfaction of their claim.

Close the book of Coral Ltd. and draw initial balance sheet of Ruby Ltd.

[**Ans:** Realization A/c loss: ₹1,05,000; Capital reserve: ₹95,000; B/S total: ₹7,25,000]

22. Express Ltd. has just recovered from a great financial difficulty. Its balance sheet as on 31 December 2010 is as follows:

Liabilities	₹	Assets	₹
Equity Share Capital	3,00,000	Buildings	2,00,000
		Plants &	1,00,000
5% Preference Share Capital	2,00,000	Machinery	1,00,000
		Current Assets	1,75,000
Liabilities	75,000	Profit & Loss A/c	
	5,75,000		5,75,000

Express (2011) Ltd. is formed to take over buildings at ₹1,50,000; plant & machinery at ₹70,000 and Stock at 30,000.

Purchase consideration is to be satisfied by 7% preference shares (₹100) and equity shares (₹10) of Express (2011) Ltd. in the ration of 3:2. Preference shareholders are to be settled in full by allotment of the new preference shares.

Sundry debtors realized ₹75,000, and ₹55,000 was paid to creditors in full settlement. There is no other current asset except stock and debtors. Cost of winding up amounted to ₹5,000.

Show ledger accounts in the books of Express Ltd. and journal entries in the books of Express (2011) Ltd. Also draft the balance sheet of Express (2011) Ltd.

Assume that the value of assets taken over is exclusively paid to equity shareholders.

[B.Com Mysore University Modified]

[**Ans:** Purchase price: ₹4,50,000; Realization profit: ₹1,40,000]

[Model: External reconstruction share fraction]

23. Lal Co. Ltd. went into liquidation on 31 December 2010 and its whole undertaking was sold to Gupta co Ltd., the terms agreed to by the parties being:
    (a) The discharge of debentures outstanding by the issue of ₹95 of 9% debentures stock in Gupta Ltd. for each ₹100 Lal Ltd. debentures
    (b) The assumption by the transfer of all other liabilities of the transferor
    (c) The exchange of five ₹1 fully paid shares in Gupta Ltd. at an agreed value of ₹1.25 a share, for every eight shares in Lal Ltd.
    (d) Gupta Ltd. also undertook to pay the liquidator of Lal Ltd. a sum of money, on the basis of ₹1 per share, to enable him to deal with fraction of shares; the number of shares represented by the addition of the fraction was 470.

Balance Sheet of Lal Ltd.
as on 31 December 2010

Liabilities	₹	Assets	₹
Share Capital:		Freehold Properties	3,00,000
4,00,000 Shares of ₹1 Each Fully Paid	4,00,000	Plant & Machinery	1,00,000
9% Debentures	50,000	Investment on Accident Compensation Fund	2,500
Creditors	7,500		
Employees' Profit Sharing Fund	12,500		
Fatal Accident Compensation Fund	2,500	Stock & Debtors	75,000
		Balance at Bank	5,000
Profit & Loss A/c	10,000		
	4,82,500		4,82,500

Five days after the day of transfer, one of the discounted bills for ₹500 fell due and was dishonored.

Show journal entries to close the book of Lal Ltd. Ignore the costs of liquidation:

[**Ans:** Hint: Agreed value of shares in Gupta Ltd. after deducting shares for fraction 3,11,912.50. Purchase consideration: ₹3,12,382.50]

[Model: Ratio of exchange of shares]

24. The following are the balance sheets of Verma Ltd. and Sharma Ltd. as on 31 March 2011:

Balance Sheet of Verma Ltd
as on 31 March 2011

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	10,50,000
6,000 Shares of ₹100 Each	6,00,000	Investments	7,50,000
		Current Assets	
General Reserve	7,50,000		9,00,000
Profit & Loss A/c			
Debentures	4,50,000		
Current Liabilities	5,25,000		
	3,75,000		
	27,00,000		27,00,000

Balance Sheet of Sharma Ltd.
as on 31 March 2011

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	4,50,000
2,700 Shares of ₹100 Each	2,70,000	Current Assets	3,00,000

General Reserve	1,50,000		
Profit & Loss A/c	1,20,000		
Current Liabilities:			
Creditors	1,50,000		
Bills Payable	60,000		
	7,50,000		7,50,000

Verma Ltd. agrees to take over Sharma Ltd.

Find out the ration of exchange of shares on the basis of book values.

[**Ans:** Ration of exchange is 1,800 shares of Verma Ltd. for 2,700 shares of Sharma Ltd. 2:3; Two shares of Verma Ltd. for every 3 shares of Sharma Ltd.]

[Model: Inter-company owings and unrealized profit in stock]

25. The following are the balance sheets of Big Ltd. & Small Ltd. as on 31 December 2010:

Liabilities	**Big Ltd.** ₹	**Small Ltd.** ₹	**Assets**	**Big Ltd.** ₹	**Small Ltd.** ₹
Share Capital:			Sundry Fixed		
Equity Shares of ₹ 10 Each	12,00,000	6,00,000	Assets	15,00,000	9,00,000
Reserves	4,80,000	4,80,000	Stock	2,40,000	1,20,000
Creditors	1,80,000	1,50,000	Trade Debtors	90,000	1,50,000
			Bank	30,000	60,000
	18,60,000	12,30,000		18,60,000	12,30,000

Big Ltd. agreed to absorb the business of Small Ltd. for an agreed price of ₹ 15,00,000 payable in fully paid equity shares of ₹ 10 each of Big Ltd. as a premium of ₹ 10 per share.

Trade debtors of Small Ltd. include ₹ 60,000 payable by Big Ltd. Stock of Big Ltd. includes ₹ 60,000 purchased from Small Ltd. which was supplied as a profit of 25% on sale price. Stock of Small Ltd. also includes goods supplied by Big Ltd. as profit of 20% on the sale price of ₹ 30,000.

Give journal entries and balance sheet in the books of Big Ltd, assuming that the amalgamation is in the nature of purchase.

[**Ans:** Hint: Stock: ₹ 1,14,000; Unrealized profit: ₹ 15,000. Purchase price: ₹ 15,00,000; Balance sheet total: ₹ 34,50,000]

Exercises

Part B—For Advanced Level

26. Two companies A Ltd. and B Ltd. amalgamate and form a new company C Ltd. The position of two companies is as follows:

A Ltd.

Liabilities	₹	**Assets**	₹
Paid-up Capital:		Goodwill	2,10,000
90,000 Equity Shares of ₹ 10 Each	9,00,000	Stock	5,40,000
		Debtors	6,00,000
Profit and Loss A/c	1,50,000		
5% Debentures	2,10,000		
Sundry Creditors	90,000		
	13,50,000		13,50,000

B Ltd.

Liabilities	₹	**Assets**	₹
Paid-up Capital:		Goodwill	2,40,000
60,000 Equity Shares of ₹ 10 Each	6,00,000	Debtors	6,60,000
Profit & Loss A/c	1,26,000		
Sundry Creditors	1,74,000		
	9,00,000		9,00,000

The average profits of A Ltd. and B Ltd. have been ₹ 90,000 and ₹ 60,000, respectively. C Ltd. agrees to take over both the concerns for a sum

of ₹ 18,00,000 and in addition to discharge all liabilities; ₹ 3,00,000 to be paid in cash and the balance in shares at face value.

It is agreed that before being taken over by C Ltd., the debtors of A Ltd. and B Ltd. will be written off to the extent of 10% of their respective book figures.

The profit on conversion is to be divided between the shareholders of A Ltd. and B Ltd. in the same proportion as to the profits previously earned by them.

Draw up the purchases A/c on the completion of the transfer in the book of C Ltd. Also show how the share capital Accounts in A Ltd. and B Ltd. should be closed.

[C.A. (Inter). Modified]

[**Ans:** Purchase consideration: A Ltd.—₹ 10,80,000, B Ltd.—₹ 7,20,000; Realization A/c: A Ltd. (Profit)—₹ 30,000, B. Ltd. (Loss)—₹ 6,000; Profit on takeover: ₹ 1,50,000; Share of A Ltd.: 90,000; Share of B Ltd.—₹ 60,000]

[Model: Absorption]

27. The balance sheets of C Ltd. and D Ltd. as on 31 March 2011 are as follows:

(₹ in Lakhs)

Liabilities	**C Ltd.** ₹	**D Ltd.** ₹	**Assets**	**C Ltd.** ₹	**D Ltd.** ₹
Equity Shares of ₹ 10 Each	200	400	Fixed Assets	880	400
Reserves	1,048	234	Investments	130	200
12% Debentures	88	44	Current Assets	322	26
Creditors	64	22	Miscellaneous Expenditure	68	74
	1,400	700		1,400	700

Investments of C Ltd. represent 10,00,000 shares of D Ltd. Investments of D Ltd. are considered worth ₹ 270 lakh.

D Ltd. is taken over by C Ltd. on the basis of the intrinsic value of shares in their respective books of account.

Prepare a statement showing the number of shares to be allotted by C Ltd. to D Ltd. and the balance sheet of C Ltd. after absorption of D Ltd.

[C.A. (Final). Modified]

[**Ans:** Purchase consideration: ₹ 450 lakh; Outside shareholders balance sheets of C Ltd. total: ₹ 1,936 lakh]

[Model: Absorption (Net assets method)]

28. The following are the balance sheets of Emerald Ltd. & Diamond Ltd. as at 31 March 2011:

Liabilities	**Emerald Ltd.** ₹	**Diamond Ltd.** ₹	**Assets**	**Emerald Ltd.** ₹	**Diamond Ltd.** ₹
Share Capital:			Fixed Assets:		
Share of the Face Value of ₹ 10 Each	7,50,000	6,00,000	Cost Less Depreciation	7,00,000	3,75,000
			Current Assets:		
Reserves	4,75,000	50,000	Stock	2,10,000	2,35,000
10% Debenture	—	1,00,000	Trade Debtors	1,50,000	2,50,000
Current Liabilities: Trade Creditors	2,35,000	1,60,000	Balance at Bank	4,00,000	50,000
	14,60,000	9,10,000		14,60,000	9,10,000

Emerald Ltd. agreed to absorb Diamond Ltd. as on 31 March 2011 on the following terms:

(a) Emerald Ltd. agreed to repay 10% debentures of Diamond Ltd.

(b) Emerald Ltd. revalue its fixed assets at ₹ 9,75,000 to be incorporated in the books

(c) Share of both the companies to be valued on net assets basis, after considering

₹2,50,000 towards the value of goodwill of Diamond Ltd.

(d) The cost of absorption of ₹15,000 are met by Emerald Ltd.

You are required to prepare:

(i) Ratio of exchange of shares

(ii) Journal entries in the books of Emerald Ltd.

(iii) Bank A/c to arrive at the balance sheet on absorption

[I.C.W.A. (Final). Modified]

[**Ans:** Ration of exchange: For every 4 shares in Diamond Ltd. 3 shares in Emerald Ltd.; Intrinsic values ₹20 & ₹15; Purchase consideration:₹9,00,000]

[Model: Pooling of interests method]

29. The following were the balance sheets of P Ltd. and Q Ltd. as at 31 December 2010:

Liabilities	**P Ltd.** ₹	**Q Ltd.** ₹	**Assets**	**P Ltd.** ₹	**R Ltd.** ₹
Equity Share Capital			Land & Buildings	18,000	NIL
Fully Paid Share of ₹10 Each	45,000	18,000	Plant & Machinery	42,000	15,000
Securities Premium			Furniture & Fixture	6,912	5,100
Foreign Project Reserve	9,000	—	Stock	23,586	12,123
General Reserve	—	930	Debtors	6,360	3,060
Profit & Loss A/c	28,500	9,600	Cash at Bank	3,342	1,827
12% Debentures	8,610	2,475	Bills Receivable	—	240
Bills Payable	—	3,000	Cost of Issue of Debentures	—	150
Sundry Creditors	360	—			
Sundry Provisions	3,240	1,389			
	5,490	2,106			
	1,00,200	37,500		1,00,200	37,500

All the bills receivable held by Q Ltd. were P Ltd's acceptances.

On 1 January 2011, P Ltd. took over Q Ltd. in an amalgamature in the nature of merger. It was agreed that in discharge of consideration for the business, P Ltd. would allot three fully paid equity shares of ₹10 each at par for every two shares held in Q Ltd. It was agreed that 12% debentures in Q Ltd. would be converted into 13% debentures in P Ltd. of the same amount and denomination.

Expenses of amalgamation amounting to ₹3 lakh were borne by P Ltd.

You are required to prepare:

(i) Journal entries in the book of P Ltd.

(ii) P Ltd.'s balance sheet immediately after the merger

[C.A. (Inter). Modified]

[**Ans:** Purchase consideration: ₹27,000 lakh; Balance sheet total: ₹1,37,307 lakh]

30. The following is the balance sheet of ABC Ltd. on 31 December 2010:

Liabilities	₹	**Assets**	₹
Capital:		Land & Buildings	4,80,000
80,000 Share of ₹10 Each	8,00,000	Plant & Machinery	6,00,000
Debentures	4,00,000	Work-in-Progress	1,20,000
Sundry Creditors	1,20,000	Stock	2,40,000
Reserve Fund	1,00,000	Furniture & Fittings	10,000
Workmen's Compensation Fund	40,000	Sundry Debtors	1,00,000
		Cash at Bank	50,000
Dividend Equalization Fund	40,000	Cash in Hand	400
P&L Appropriation A/c	20,400		
Depreciation Provision:			
Land & Buildings	80,000		
	16,00,400		16,00,400

The Company is absorbed by XYZ Ltd. on the above date. The consideration for the absorption is the discharge of the debentures at a premium of 5%, taking over the trade liability and a payment of ₹ 7 in cash and one share of ₹ 5 in XYZ Ltd. at the market value of ₹ 8 per share in exchange for one share in ABC Ltd. The cost of liquidation of ₹ 2,000 is to be met by the purchasing company.

Pass journal entries in the books of both the companies show how the purchase price is arrived at.

[C.S. (Inter). Modified]

[**Ans:** Profit on realization: ₹ 1,99,600; Purchase consideration: ₹ 12,00,000]

31. ABC Ltd. decided to absorb XYZ Ltd. as on 30 September 2010. The summarized balance sheet of XYZ Ltd. was as follows:

Liabilities	**(₹ 000)**	**Assets**	**(₹ 000)**
Share Capital:		Fixed Assets:	
30,000 Equity Shares of ₹ 100 Each	3,000	Land & Buildings	1,800
		Furniture	150
		Plant & Machinery	3,330
General Reserve	1,500		
Profit and Loss A/c	720	Current Assets:	420
		Stock	210
5% Debentures	600	Sundry Debtors	60
Sundry Creditors	180	Cash at Bank	30
		Cash in hand	
	6,000		6,000

ABC Ltd. agreed to take over all the assets and liabilities including debentures of XYZ Ltd. The current assets were to be taken over at their book value but the fixed assets were revalued as follows:

	(₹ in 000's)
Land & Buildings	2,100
Furniture	90
Plant and Machinery	3,600
Goodwill to Be Valued at	300

The purchase consideration was paid at ₹ 1,530 thousand in cash and the balance in fully paid equity shares of ABC Ltd.

The absorption was duly carried out on 1 October 2010 and the expenses of absorption amounted to ₹ 30,000 paid by XYZ Ltd.

You are required to show the journal entries in the books of XYZ Ltd.

[**Ans:** Purchase consideration: ₹ 60,30,000; Profit on realization: ₹ 7,80,000]

32. The following are the balance sheets of A Ltd. and B Ltd. as on 31 December 2010:

Liabilities	**A Ltd.**	**B Ltd.**	**Assets**	**A Ltd.**	**B Ltd.**
Share Capital			Fixed Assets	1,400	500
Equity Share of ₹ 10 Each	1,200	600	Investment:		
10% Pref. Shares of ₹ 100 Each	400	200	12,000 Shares of B Ltd.	160	—
			10,000 Shares of A Ltd.	—	
Reserves & Surplus	600	400	Current Assets:		160
Secured Loans:			Stock	480	640
12% Debentures	400	300	Debtors	720	380
Current Liabilities:			Bills Receivable	120	40
Sundry Creditors	440	250	Cash at Bank	220	80
Bills Payable	60	50			
	3,100	1,800		3,100	1,800

Fixed assets of both the companies are to be revalued at 15% above book value. Stock in trade and debtors are taken over at 15% lesser than their book value. Both the companies are to pay 10% equity dividend; preference dividend having been already paid.

After the above transactions are given effect to, A Ltd. will absorb B Ltd. on the following terms:

(i) 8 Equity shares of ₹ 10 each will be issued by A Ltd. at par against 6 shares of B Ltd.

(ii) 10% Preference shareholders of B Ltd. will be paid at 10% discount by issue of 10% preference shares of ₹ 100 each at par in A Ltd.

(iii) 12% Debenture holders of B Ltd. are to be paid at 8% premium by 12% debenture in A Ltd. issued at a discount of 10%.

(iv) ₹60,000 is to be paid for liquidation expenses by A Ltd. Sundry Creditors of B Ltd. include ₹20,000 due to A Ltd.

Prepare (a) Absorption entries in the books of A Ltd. and (b) Statement of consideration payable by A Ltd.

[C.A. (Final). 2002 Modified]

[**Ans:** Purchase consideration: ₹7,20,000; Consideration payable by A Ltd:

	₹
(i) For Equity Shares Held by Outsiders: 54,000 Shares × ₹10	= 5,40,000
(ii) For Pref. Shares to be Paid at 10% Discount	= 1,80,000
Total Consideration Amount	= 7,20,000]

[Model: Dissentient shareholders]

33. With a view to effect economy in working, Modern Mills Ltd. agreed to take over the business of the Ancient Mills Ltd. from 1 November 2010. The following is the balance sheet/S of the Modern Mills Ltd. as on that date:

Liabilities	₹	**Assets**	₹
Paid-up Capital:		Land & Buildings	5,40,000
36,000 Shares of ₹50 Each	18,00,000	Plans & Machinery	3,75,000
Reserve Fund	3,60,000	Stock	7,50,000
Reserve for Doubtful Debts	30,000	Debtors	8,70,000
		Cash at Bank	75,000
Creditors	2,25,000		
Profit and Loss A/c	1,95,000		
	26,10,000		26,10,000

The purchasers took over all the assets and liabilities of the vendor company except a sum of ₹30,000 to provide for cost of liquidation and payment to any dissent shareholders. The purchase price was to be discharged by the allotment to the shareholders of the vendor company of the share of ₹100 (₹90 paid up) of the modern Mills Ltd. for every two shares in Ancient Mills Ltd. The expenses of liquidation amount to ₹9,000. Dissentient shareholders of 300 shares are paid out at ₹70 per share, i.e. ₹21,000.

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

[**Ans:** Purchase consideration: ₹16,06,500 (Before payment of ₹6,000 to dissentient shareholders) Loss on realization: ₹7,27,500; Capital reserve ₹7,18,500]

[Model: Absorption—Vendor company holding shares in vendee company]

34. A Ltd. absorbs B Ltd. by issue of 6 shares of ₹10 each at a premium of 10% for every 5 shares of B Ltd. For the purpose of absorption, it was agreed that trade investment held by B Ltd. will realize their book value and goodwill of B Ltd. will be ₹1,00,000.

The balance sheets of the two companies were as follows:

Liabilities	**A Ltd.** ₹	**B Ltd.** ₹	**Assets**	**A Ltd.** ₹	**B Ltd.** ₹
Share Capital:			Investments:		
Equity Shares of ₹10 Each	20,00,000	15,00,000	Trade	1,50,000	1,00,000
Reserves	12,00,000	7,50,000	Share at A Ltd. at Cost	—	3,00,000
Trade Creditors	2,00,000	1,50,000	Other Assets	32,50,000	20,00,000
	34,00,000	24,00,000		34,00,000	24,00,000

Prepare the balance sheet of A Ltd. after absorption of B Ltd.

[C.A. (Inter). Modified]

[**Ans:** Purchase consideration: ₹19,80,000; B/S total: ₹55,30,000]

[Model: Absorption—Purchasing company holding shares in vendor company]

35. X Ltd. presents the following summarized balance sheet as on 31 December 2010:

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets	51,00,000
Share of ₹10 Each	48,00,000	Current Assets	30,60,000

5% Debentures	30,00,000	Profits & Loss A/c	15,00,000
Accrued Interest	1,50,000		
Creditors	17,10,000		
	96,60,000		96,60,000

The Company is absorbed by Y Ltd. who holds 25% of share capital (Purchased by their for 11,10,000 and all debentures issued (at par) by X Ltd.

The purchase consideration being taking over all assets and liabilities as book value, subject to fixed assets revalued at ₹ 42,00,000.

The payments to other shareholders to be made on the basis of such share being worth ₹ 15 per share and shares in X Ltd. being worth ₹ 5 per share.

Show the entries in the books of X Ltd. after determining purchase consideration.

[I.C.W.A. (Final). Modified]

[**Ans:** Loss on realization: ₹ 3,00,000; Number of shares issued by Y Ltd.: 1,20,000]

[Model: Absorption—Cross holdings]

36. S Ltd. and T Ltd. have the following balance sheets on 31 March 2011:

(₹ in Lakhs)

Liabilities	**S Ltd.** ₹	**T Ltd.** ₹	**Assets**	**S Ltd.** ₹	**T Ltd.** ₹
Share Capital	216	108	Fixed Assets	90	27
Reserve & Surplus	54	27	3,60,000 Shares of T Ltd.	72	—
			4,32,000 Shares of S Ltd.	—	90
			Current Assets	108	18
	270	135		270	135

If S Ltd. is to acquire the business of T Ltd. and if the fixed and current assets are expected to realize twice the values at which they stand in the balance sheet.

Workout the purchase consideration and the number of shares of S Ltd. to be issued to meet the consideration if the face value of shares of both companies is ₹ 10 each.

[I.C.W.A. (Final). Modified]

[**Ans:** S Ltd. has to issue 1,39,950 shares to external share holders of T Ltd.; Value of shares of S Ltd.: ₹ 21.131; T Ltd.: ₹ 16.786]

[Model: Amalgamation: Cross holdings]

37. The following are the abridged balance sheets of C Ltd. and D Ltd. as at 31 December 2010:

Liabilities	**C Ltd.** ₹	**D Ltd.** ₹	**Assets**	**C Ltd.** ₹	**D Ltd.** ₹
Share Capital	16,00,000	6,00,000	Sundry Assets	22,40,000	8,00,000
Profit & Loss A/c	3,00,000	—	Goodwill	1,60,000	2,00,000
Creditors	5,00,000	5,00,000	Profit & Loss A/c	—	1,00,000
	24,00,000	11,00,000		24,00,000	11,00,000

C Ltd. holds 4,000 shares in D Ltd. at cost of ₹ 1,00,000 and D Ltd. holds 200 shares in C Ltd. at cost of ₹ 2,80,000 in each case included in the sundry assets. The shares of C Ltd. are ₹ 100 each fully paid; the shares of D Ltd. are ₹ 50 each ₹ 30 paid. The two companies agree to amalgamate and form a new company CD Ltd. on the basis that:

(i) The shares which each company holds in the other are to be valued at book value having regard to the goodwill valuation given in (ii)

(ii) The goodwill values are C Ltd.: ₹ 6,00,000; D Ltd.: ₹ 1,00,000

(iii) The new shares are to be of a nominal value of ₹ 50 each, credited as ₹ 25 paid.

You are required to prepare:

(a) A balance sheet resulting from merger

(b) A statement showing shareholdings in the new company attributable to the members of merged companies

[C.A. (Final). Modified]

[**Ans:** Book values of assets of C Ltd.: ₹23,20,852; D Ltd.: ₹4,10,256; Balance sheet total: ₹33,60,000]

[Model: Inter-company owings]

38. The balance sheets of X Ltd. and A Ltd. as on 31 December 2010 are given as follows:

Liabilities	X Ltd. ₹	A Ltd. ₹	Assets	X Ltd. ₹	A Ltd. ₹
Share Capital of ₹10 Each	10,00,000	20,00,000	Sundry Assets	15,50,000	30,00,000
Reserves	2,00,000	5,00,000	Loan to 'A' Ltd.	1,50,000	—
9% Debentures of ₹100 each	5,00,000	—	Investments: 25,000 Shares in X Ltd.	2,50,000	—
Loan from X Ltd.	—	1,50,000			
Creditors	2,50,000	3,50,000			
	19,50,000	30,00,000		19,50,000	30,00,000

A Ltd. proposes to takeover X Ltd. on the following terms:

(i) A Ltd. will issue sufficient number of its shares of ₹11 each and pay ₹0.50 each per share held by the members of X Ltd.

(ii) 9% Debentures of X Ltd. are to be paid at 8% premium by issue of sufficient number of ₹100 10% debentures of A Ltd. at ₹90 each

Show journal entries in the ledger accounts in the books of the companies and draft the balance sheet in the books of A Ltd.

[M.Com Madras University Modified]

[**Ans:** Purchase consideration: ₹11,50,000; Realization loss ₹50,000; Balance sheet total ₹48,10,000]

[Model: Inter-company holdings]

39. X Ltd. absorbs Y Ltd. by payment of 5 shares of ₹10 each at a premium of 10% for every 4 shares held in Y Ltd. The balance sheet of Y Ltd. as on the date of absorption is given below:

Liabilities	₹	Assets	₹
Share Capital (₹10)	8,00,000	Fixed Assets	7,20,000
General Reserve	80,000	Current Assets	2,40,000
Creditors	2,40,000	16,000 Shares in X Ltd.	1,60,000
	11,20,000		11,20,000

Show the important ledger accounts in the books of Y Ltd. and the acquisition entries in the books of X Ltd.

[M.Com Madras University Modified]

[Model: Inter-company holdings]

40. The following are the summarized balance sheets of P Ltd. and Q Ltd. as on 31 March 2011:

Liabilities	P Ltd. ₹	Q Ltd. ₹	Assets	P Ltd. ₹	Q Ltd. ₹
Share Capital (₹100 Each)	36,00,000	32,00,000	Sundry Assets	38,40,000	42,40,000
Reserves	12,00,000	24,00,000	12,000 Shares in P Ltd	—	13,60,000
			8,000 Shares in Q Ltd	9,60,000	—
	48,00,000	56,00,000		48,00,000	56,00,000

You are required to ascertain:

(a) The intrinsic value of shares of both companies individually as their respective net worth

(b) Purchase consideration if P Ltd. acquires the business of Q Ltd.

(c) Purchase consideration if Q Ltd. acquires the business of P Ltd.

(d) Purchase consideration if a new company R Ltd. acquires the amalgamated concerns of P Ltd. and Q Ltd.

[**Ans:** (a) P: ₹148.48; Q: ₹188.18; Net worth: P Ltd—₹53,45,452, Q Ltd.— ₹60,21,816

(b) Purchase price: ₹45,16,320

(c) Purchase price: ₹35,63,636

(d) Purchase prices: ₹35,63,636 to P Ltd.; Outsiders: ₹45,16,328]

41. The following is the balance sheet of X Ltd. as on 31 March 2011:

Liabilities	₹	Assets	₹
Equity Shares of ₹100 Each	30,00,000	Land & Building	20,00,000
		Plant & Machinery	18,00,000
14% Preference Shares of ₹100 Each	10,00,000	Furniture	4,20,000
		Investments	2,00,000
General Reserve	5,00,000	Stock	9,20,000
12% Debentures	16,00,000	Debtors	9,60,000
Sundry Creditors	8,00,000	Bank	6,00,000
	69,00,000		69,00,000

Other information:

(i) Y Ltd. takes over X Ltd. on 1 April 2011. Debenture holders of X Ltd. are discharged by Y Ltd. by issuing 15% debentures at a premium of ₹60 each (Nominal value of debentures: ₹100).

(ii) 14% Preference shares of X Ltd. are to be discharged at a premium of 20% by issuing necessary number of 15% pref. shares of Y Ltd.

(iii) Intrinsic value per share of X Ltd. is ₹150 and that of Y Ltd. ₹300. Y Ltd.

will issue equity shares to satisfy the equity shareholders of X Ltd. on the basis of intrinsic value. However, entry should be made at par value only. The nominal value of each equity share of Y Ltd. is ₹100.

(iv) Y Ltd. revalues stock of X Ltd. at ₹9,00,000.

You are required to:

(a) Close the books of X Ltd.

(b) Give opening entries in the books of Y Ltd.

[B.Com (Hons) Delhi 2007 Modified]

[**Ans:** Purchase consideration: ₹27,00,000; Books of Y Ltd.—Capital Reserve A/c: ₹17,80,000]

42. The following is the balance sheet of Unfortunate Ltd. as at 31 March 2011:

Liabilities	₹	Assets	₹
4,00,000 Equity Shares of ₹10 Each	40,00,000	Patents	4,00,000
		Freehold Premises	19,20,000
2,40,000 10% Preference Shares of ₹10 Each	24,00,000	Stock in Trade	20,00,000
		Debtors	15,20,000
		Furniture	2,40,000
		Investment	6,00,000
12% Debentures	16,00,000	Bank	80,000
Unsecured Loan	2,88,000	Profit & Loss A/c	28,40,000
Creditors	11,20,000		
Accrued Interest on Debentures	1,92,000		
	96,00,000		96,00,000

The following scheme of external reconstruction was approved:

(i) A new company by the name of Unfortunate (2011) Ltd. to be formed to take over the entire business of Unfortunate Ltd.

(ii) One equity share of ₹10 ₹6 paid up is to be given in exchange of every two equity shares of Unfortunate Ltd.

(iii) One 11% pref. share of ₹100 each is to be given in exchange for 15 pref. shares of Unfortunate Ltd.

(iv) The claims of 12% debenture holders of Unfortunate Ltd. would be discharged by the issue of equity shares of ₹10 each fully paid.

(v) The creditors will receive 60% of their dues in cash and 25% in equity shares of ₹10 each and the balance to be foregone.

(vi) The party paid equity shares are to be made fully paid by receiving cash from the shareholders.

(vii) Furniture is subject to depreciation by 25%.

(viii) The freehold premises were revalued at 20% more while the stock was revalued at ₹12,80,000. The investments are to be brought upto market value of ₹7,20,000 and debtors reduced by 10%. Preliminary expenses amounted to ₹40,000.

You are required to:

(a) Close the accounts in the books of Unfortunate Ltd.

(b) Opening entries in the books of Unfortunate (2011) Ltd.

[B.Com (Hons) Delhi 2008 Modified]

[**Ans:** Purchase consideration: ₹28,00,000; Profit on realization: ₹40,000; Capital reserve A/c: ₹ 5,00,000]

43. M/S XYZ Ltd. agreed to acquire the business except cash of M/S KLM Ltd. as on 31 March 2011. The summarized balance sheet of M/S KLM Ltd. as on that date was as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Goodwill	1,50,000
90,000 Shares of ₹10 Each	9,00,000	Land & Building	3,00,000
General Reserve	3,00,000	Plants & Machinery	6,60,000
Profit and Loss Account	1,20,000	Stock-in-Trade	2,40,000
12% Debentures	1,50,000	Sundry Debtors	90,000
Creditors	60,000	Cash at Bank	90,000
	15,30,000		15,30,000

The consideration payable by M/S XYZ Ltd. was agreed as follows:

(i) A cash payment of ₹5 for each share of ₹10 in M/S KLM Ltd.

(ii) The issue of 1,80,000 shares of ₹10 each was fully paid at an agreed value of ₹15 per share.

(iii) The issue of such as amount of 14% debentures of M/S XYZ Ltd. at 4% discount is sufficient to discharge 12% debentures of M/S KLM Ltd. at a premium of 20%. While computing the agreed consideration the management of M/S XYZ Ltd. valued land and building at ₹9,00,000; plant & machinery at ₹10,50,000; stock in trade at ₹2,10,000 and debtors at their face value subject to an allowance of 4% to cover doubtful debts.

Prepare realization account and equity shareholders account in the books of M/S KLM Ltd. and pass acquisition entries in the books of M/S XYZ Ltd.

[B.Com (Hons) Delhi 2009 Modified]

[**Ans:** Purchase consideration: ₹31,50,000; Profit on realization: ₹19,20,000; Equity Shareholders A/c (Total): ₹32,40,000; Goodwill A/c ₹11,43,600 (XYZ Ltd. Books)]

44. Jindal Usha Ltd. agreed to acquire the business of Ankur Ltd. The balance sheet of Ankur Ltd. is as follows:

Liabilities	₹	**Assets**	₹
1,50,000, 15% Preference Shares of ₹10 Each	15,00,000	Land	30,00,000
		Plant	15,00,000
		Stock	30,00,000
3,00,000 Equity Share of ₹10 Each	30,00,000	Cash at Bank	7,50,000
		Debtors	5,25,000
		Preliminary Expenses	1,70,000
Reserves	7,50,000		
10% Debentures	15,00,000	Discount on Issue of Debentures	55,000
Creditors	22,50,000		
	90,00,000		90,00,000

The consideration payable was agreed as follows:

(i) The preference shareholders of Ankur Ltd. are to be discharged at a premium of 10% by issue of 15% preference shares in Jindal Usha Ltd.

(ii) Equity shareholders are to be allotted six equity shares of ₹10 each at a premium of 10% and are to be paid ₹3 in cash against every five shares held.

(iii) Debenture holders of Ankur Ltd. are to be discharged by Jindal Usha Ltd. at 8% premium by issue of 10% debentures at 10% discount.

While arriving at agreed consideration, the directors of Jindal Usha Ltd. valued land at ₹37,50,000, stock at ₹33,00,000 and debtors at book value subject to an allowance of 5% for doubtful debts. Debtors of Ankur Ltd. include ₹20,000 due from Jindal Usha Ltd. It was agreed that before acquisition, Ankur Ltd. will pay dividend at 20% on equity shares. The preference dividends had already been paid before acquisition. Prepare necessary ledger accounts in the books of Ankur Ltd. and draft journal entries in the books of Jindal Usha Ltd.

[B.Com (Hons) Delhi 2010 Modified]

[**Ans:** Purchase consideration: ₹57,90,000; Realization account profit: ₹12,15,000; Goodwill A/c: ₹4,61,250]

[Model: External reconstruction—Dissenting share holders balance sheet in vertical form]

45. The balance sheet of F Ltd. as on 31 December 2010 was as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets:	
10,000 Equity Shares of ₹100 Each Fully Paid	10,00,000	Land & Building	5,20,000
		Plants & Machinery	3,00,000
Sundry Creditors	4,40,000	Current Assets:	
Preferential Creditors	60,000	Stock	2,00,000
		Debtors	2,28,000
		Cash	4,000
		Preliminary Expenses	22,000
		Profit & Loss A/c	2,26,000
	15,00,000		15,00,000

The shareholders of the company resolved to take the company into voluntary liquidation and to form G Ltd., a new company with an authorized capital of ₹40 lakh to take over the business on the following terms:

(a) Preferential creditors of ₹60,000 are to be paid in full.

(b) Unsecured creditors to receive ₹0.50 in a rupee in full settlement of their claims or par value of their claim in 7% debentures of G Ltd.

(c) 10,000 Equity shares of ₹100 each ₹60 paid to be distributed pro rata to existing shareholders.

Five shareholders holding 800 shares dissented and their interest was purchased at ₹50 per share by an assenting shareholder to whom the shares were transferred.

Half the unsecured creditors opted to be paid in cash, and funds for this purpose were procured by calling up the balance of ₹40 per share. Cost of liquidation amounting to ₹14,000 paid by G Ltd. as part of purchase consideration.

Journalize the above transactions in the books of G Ltd. and prepare the balance sheet in Vertical form thereafter assuming that plants & machinery, stock and debtors were acquired at their book values and land & building is to be taken at ₹2,72,000.

[**Ans:** Hint: After preparing B/S in vertical form, schedules forming past of balance sheet should be shown. Purchase consideration: ₹6,00,000; Capital reserve: ₹14,000; Balance sheet total: ₹12,34,000]

Liquidation of Companies 10

LEARNING OBJECTIVES

After studying this chapter you should be able to understand:

1. The meaning and salient features of liquidation.
2. The legal provisions with respect to different modes of winding up, viz,-compulsory winding up, voluntary winding up and winding up subject to the supervision of the court.
3. The term "contributories" and "adjustment of rights of contributories".
4. The order of payments to be followed by the liquidator in making the payments out of realization.
5. The term "preferential payments".
6. The procedure for preparation of statement of affairs and deficiency/surplus account.
7. The procedure for preparation of liquidators' final statement of account.
8. The key terms associated with "liquidation of companies".

We have seen that companies can be incorporated (formed) in accordance with the provisions of the Companies Act, 1956. Likewise, Companies can be wound up or liquidated as per the provisions of the Companies Act. Liquidation is a process by which the life of a company is brought to an end. In the process of winding up, a company's assets are realized and applied in payment of debts. After all debts are discharged, the balance if any, will have to be paid to the shareholders in proportion to their contributions to the share capital. Modes of winding up, various steps involved in the process of liquidation, order of payment, preparation of Statement of Affairs, preparation of Deficiency or Surplus Account, Liquidator's final statement of account are discussed in detail and accounting treatment is explained in various illustrations in this chapter.

10.1 MEANING AND SALIENT FEATURES OF LIQUIDATION

Liquidation or winding up is a process by which a company is dissolved. As a student of corporate accounting, you are aware that a company is an artificial person and is created in accordance with the provisions of the Companies Act. Similarly, a company can be wound up, i.e. liquidated, in compliance with the legal provisions. Liquidation is a legal process by which the corporate life of a company is brought to an end.

Liquidation is a lengthy procedure in which the dissolution of a company is carried out by realizing its assets and paying its debts (out of the proceeds of realized assets) and distributing the balance, if any, to the members in proportion to their contribution. By liquidation, the life of a company will be brought to an end.

10.1.1 Salient Features

The following are the salient features of liquidation:

(i) Any company can be liquidated legally. It is immaterial whether the company is solvent or insolvent. This means that even solvent companies may be liquidated.

(ii) Once the liquidation takes place, that company will be closed down forever.

(iii) During the process of liquidation, assets of the company are realized. Out of realized assets, claims of creditors are discharged. The balance, if any, is distributed to the members of the company in proportion to their contributions.

(iv) In the liquidation procedure, the role of a person—the liquidator—is important. The person with whom the job of liquidation is entrusted with is known as liquidator. The job of liquidator is to realize the assets and settle the claims of creditors and other liabilities.

(v) **Modes of liquidation**: The process of liquidation may take place in any one of the following ways:

(a) Compulsory winding up—By the Court

(b) **Voluntary winding up**: (i) Members' voluntary winding up and (ii) Creditors' voluntary winding up

(c) Winding up subject to supervision of Court

(a) **Compulsory winding up:** (Section. 433) (Winding up by a court):

This mode of liquidation takes place when

1. The company passes a special resolution (or)
2. It makes default in delivering the statutory report to the Registrar, or in holding the statutory meeting (or)
3. It does not commence business within a year from its incorporation or suspends its business for the whole year (or)
4. It is unable to pay its debt (or)
5. Its membership reduces below 7 in a public company (below 2 in a private company) (or)
6. It is just and equitable in the Court's opinion that it should be wound up

(b) **Voluntary winding up** (Section 484-521):

When a company is wound up at the instance of either the members or creditors, such winding up is known as voluntary winding up. These are two kinds:

(i) **Members' voluntary winding up:** When the members of the company decide to wind up despite its sound financial condition, the winding is termed as members' voluntary winding up.' This mode of liquidation takes place when a declaration of company's solvency, verified by an affidavit, is delivered to the registrar, by its directors.

(ii) **Creditors' voluntary winding up:** When the declaration of solvency is not made while the delivery was made to the registrar, then it is called "creditors' voluntary winding up". In this case also, a copy of resolution passed by the creditors, presided over by one of its directors, has to be sent to the registrar.

(c) **Winding up subject to supervision of the Court:** Section 522-527. When a company passes a resolution for "voluntary winding up", and the Court, upon an application made by a creditor, pass an order to that effect. Such an order is passed by the Court if the situation warrants. The whole procedure of winding up is carried out under the supervision of the Court, by appointing its own official liquidator.

(vi) **When winding up is carried out, the shareholders are called "contributories":** Section 428 defines a contributory as, "every person liable to contribute to the assets of a company in the event of its being wound up and includes any holder of shares which are fully paid-up."

This term includes the holder of fully paid shares. It also means any person liable to contribute to the assets of company. It includes all present and all past shareholders who have ceased to be members with in 1 year immediately preceding the commencement of the process of liquidation. The contributories are categorized into two lists:

- List A—includes the present shareholders
- List B—includes the past shareholders

The liability of the contributory is subject to the following:

(a) A contributory is not liable to pay more than the unpaid value of shares held by him.

(b) A past member is not liable to contribute unless the present members have been called upon to contribute to the fullest extent to which they can so be asked.

(c) A past member who has ceased to be a member for at least one year before the commencement of liquidation is not liable to contribute.

(d) A past member is not liable in respect of any liability or debt of the company incurred after he ceased to be a member.

(e) A shareholder (contributory) cannot set off any debt due to him from the Company against calls made on him for paying unpaid capital. He must first pay the calls. His claim is to be considered at par with other members and not with creditors.

(vii) Adjustment of rights of contributories: In the event of winding up, the liquidator should adjust the rights and interest of contributories in the following manner:

(a) When some of the shares are fully paid-up and others are only partly paid-up, the liquidator may make a call on those shareholders whose shares are already paid-up so that the amount finally contributed by shareholders of any one class become equal as among themselves.

(b) The distribution of surplus, if any, among contributories should be in accordance with the rights provided in the Articles of Association.

(c) After returning payments on capital, if any surplus remains, it has to be distributed only to equity shareholders unless it has been specifically mentioned that preference shares are participating shares.

10.2 ORDER OF PAYMENTS

The company's debts and liabilities should be discharged out of realized assets in the following order:

1. Secured creditors: The name itself reveals that these type of creditors hold some security for debt due to them from the company such as pledge, mortgage, charge or lien. Their rights are discussed in Section 529 (A).
2. Income tax and sales tax dues.
3. Preferential payments: These are discussed in Sections 529 (4) and 530.
4. Cost of liquidation (Cost of winding up, liquidators remuneration, legal charges, etc.)
5. Debenture holders having a floating charge on the assets of the company.
6. Unsecured creditors: After preferential creditors, unsecured creditors attain priority. In case the amount is insufficient, these will be paid proportionately from the balance.
7. Preference shareholders.
8. Equity shareholders.

In case any surplus remains after making payments as mentioned above, it will be distributed among the equity shareholders unless specifically mentioned that preference shares are participating shares.

If the preference shares are participating, they are entitled to have a right to participate in such surplus.

10.2.1 Overriding Preferential Payments

Companies Amendment Act, 1985 has introduced the factor "overriding preferential payments".

As per Section 529 (1), the security of every creditor is deemed to be subject to "Pari Paasu" charge in favour of the workmen to the extent of workmen's portion.

Section 529 (A) reads as follows:

1. Notwithstanding anything contained in any other provision of this Act or any other law for the time being in force, in the winding up of a company-(a) workmen's dues; and (b) debts due to secured creditors to the extent such debts rank under clause (c) of the proviso to the sub-section (1) of Section 529 PARI PAASU with such dues, shall be paid in priority to all other debts.
2. The debts payable under clause (a) and clause of sub-section (1) shall be paid in full unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

Illustration 10.1

Model: Overriding preferential payments

The value of the security of a secured creditor of a company is ₹ 5,00,000 and the amount owing to him is ₹ 15,00,000. Dues to the workers remaining unpaid amount to ₹ 5,00,000. State how the security will be shared by the secured creditor and workmen.

Solution

Step 1:	Ratio of Dues Between Secured Creditors and Workmen	=	5,00,000:15,00,000
Step 2:	Ratio of the Security and Workmen to Be Shared	=	5:15 (or) 1:3
Step 3:	Workers Claim for Security	=	1/4 × ₹ 5,00,000
		=	₹ 1,25,000

As per Section 529(1), the security of every creditor is subject to Pari Paasu in favour of the workmen to the extent of workmen's portion therein.

Step 4:	Hence, Workmen Dues that Constitute Overriding Preferential Treatment	=	₹ 5,00,000 – ₹ 1,25,000
		=	₹ 3,75,000
Step 5:	Overriding Preferential Treatment for Secured Creditor (As per Pari Paasu Clause)	=	(₹ 15,00,000 – ₹ 3,75,000) or ₹ 1,25,000
		=	₹ 11,25,000 or ₹ 1,25,000
		=	₹ 1,25,000

Step 6: *Note*: Least of ₹ 11,25,000 and ₹ 1,25,000 is ₹ 1,25,000.

Illustration 10.2

Model: Overriding preferential payments (Pari Paasu clause)

Determine the mode of sharing the security and the extent to which the balance of amounts rank "Pari Paasu" as overriding preferential payments in each of the following alternative cases:

		₹
(I)	Workmen's Dues	50,000

	Secured Creditors	1,50,000
	Value of Security	20,000
(II)	Workmen's Dues	50,000
	Secured Creditors	2,00,000
	Value of Security	2,25,000

Solution

Case I

Step 1:	Ratio of Dues Between Secured Creditors and Workmen	=	₹ 50,000: ₹ 1,50,000
Step 2:	Ratio of Security and Workmen to be Shared	=	50:150 (or) 1:3
Step 3:	Workmen's Share	=	1/4 × ₹ 80,000 = ₹ 20,000
Step 4:	Secured Creditors' Share	=	3/4 × ₹ 80,000 = ₹ 60,000
Step 5:	Overriding Preferential Payment for Workers	=	Dues – Share
		=	₹ 50,000 – ₹ 20,000
			↓ ↓
			(Given) (Step 3)
		=	₹ 30,000
Step 6:	Overriding Preferential Payment for Creditors	=	₹ 20,000 only

Explanation Note:

The balance not satisfied for creditors	=	₹ 1,50,000 – ₹ 60,000
	=	₹ 90,000
But the share of workmen is	=	₹ 20,000

This is less than ₹ 90,000.

Hence, only ₹ 20,000 will rank overriding, preferential payment for the creditors. It will rank Pari Paasu along with similar payment due to the creditors.

Case II

Step 1:	Ratio of Dues Between Secured Creditors and Workmen	=	₹ 50,000:₹ 2,00,000
Step 2:	Ratio to be Shared	=	50:200 (or) 1:4
Step 3:	Workmen's Share	=	1/5 × ₹ 2,25,000
		=	₹ 45,000
Step 4:	Secured Creditors Share	=	4/5 × ₹ 2,25,000
		=	₹ 1,82,000
Step 5:	Overriding Preferential Payment for Workers	=	₹ 50,000 – ₹ 45,000
			↓ ↓
			(Given) (Step 3)
		=	₹ 5,000
Step 6:	Overriding Preferential Payments for Creditors	=	₹ 2,00,000 (Given) – ₹ 1,80,000 (Step 4) = ₹ 20,000

Explanatory note:

For creditors, unsatisfied amount is ₹ 20,000. This amount is less than ₹ 45,000—share of workers due in security.

Hence ₹ 20,000 will rank as overriding preferential, payment for the creditors and will rank Pari Paasu along with similar payment due to creditors, although workers will obtain ₹ 45,000 and ₹ 5,000 which will rank as overriding preferential payment.

***Note*:** Overriding preferential payments must be paid before the payment of preferential creditors.

10.2.2 Preferential Payments (or) Preferential Creditors

These payments have to be made before the payments of unsecured creditors except the cost of liquidation and the remuneration payable to the liquidator.

Some preferential creditors or payments are as follows:

(i) All revenues, taxes, cess and rates due to the central or state government or to a local authority payable within 12 months next before the commencement of winding up.

(ii) All wages or salaries or commission to an employee due for period not exceeding 4 months, within 12 months, prior to relevant date. This amount is limited to ₹ 20,000.

(iii) All accrued holiday remuneration payable to an employee.

(iv) All amount payable to an employee under ESIC (Employees Stare Insurance Corporation) during 12 months prior to relevant date, unless the company is wound up voluntarily for reconstruction and amalgamation purposes.

(v) All amounts payable to an employee (other than workmen) under the Workmen's Compensation Act unless the company is wound up for reconstruction and amalgamation.

(vi) All sums due to an employee from the Provident Fund Pension, Fund, Gratuity or any other fund maintained by the company for the welfare of the employees.

(vii) The expenses for any investigation held in pursuance of Section 235 or Section 237 in so far as they are payable by the company.

The above-mentioned debts rank equally among themselves.

The relevant date refers to the date of passing of resolution or date of the appointment of a provisional liquidator in case of compulsory winding up.

10.3 STATEMENT OF AFFAIRS

When the Court has passed a winding up order or appointed the official liquidator as provisional liquidator, the officers and directors of the company must submit a statement as to the affairs of the company in the prescribed form verified by an affidavit. This statement is known as statement of affairs.

The statement of affairs must be submitted to the liquidator within 21 days from the date of winding up order (or within such extended time not exceeding 3 months as the liquidator or the Court permits).

10.3.1 Contents of the Statement of Affairs

The statement of affairs contains the following particulars:

(i) The assets of the company, stating separately the cash in hand and cash at bank and the negotiable securities

(ii) The debts and liabilities of the company

(iii) The names and addresses of its creditors, stating separately the amount of secured and unsecured debts

(iv) In the case of secured debts, particulars of the securities held by the creditors, their value and the debts on which they are given

(v) The debts due to the company and names and addresses of the persons from whom they are due and the amount likely to be realized

(vi) Such other information as may be required by the official liquidator of the central government

The statement of affairs is open to inspection by any person stating in writing to be a creditor or contributory. This statement must always be verified by an affidavit. This should be prepared in the prescribed form, as set out by the Supreme Court.

The following is the specimen format:

FORM NO. 57
(SEE RULE 127)

In the High Court at……..(or) in the District Court at……..Original Jurisdiction…….. In the matter of Companies Act, 1956.

In the matter of……..Ltd.

Companies petition No. …….. of 20……..

Statement of Affairs under Section 454

Statement of affairs of the above named Company as on the ..... day of .....20..., the date of winding-up order (or the order appointing Provisional Liquidator or the date directed by the Official Liquidator).

I/We.....of.....do solemnly affirm and say that the statement made overleaf and the several lists here unto annexed marked "A" to "I" are to the best of my/our knowledge and belief a full, true and complete statement as to the affairs of the above-named company, on the.....day of.....20..... the date of winding-up order (or the order appointing Provisional Liquidator on the date directed by the Official Liquidator), and that the said Company carries/carried on the following business:

(Here set out nature of company's business)

Solemnly affirmed at ..... before me..... Signature(s) this..... day of .....20 .....

The Commissioner is particularly requested, before swearing the affidavit, to ascertain that the full name, address and description of the deponent are stated, and to initial any crossing out or other alterations in the printed form. A deficiency in the affidavit in any one of the above respects will entail its refusal by the Court, and will necessitate its being re-sworn.

Note: The several lists annexed are not exhibits to the affidavit.

10.3.2 Statement of Affairs and Lists to Be Annexed

Statement as to the affairs of……..Ltd., on the……..day of……..20……., being the date of the winding up order (or order appointing Provisional Liquidator of the date directed by the official Liquidator as the case may be) showing assets at estimated realizable values and liabilities expected to rank:

Assets Not Specifically Pledged (As per List A)				
	Estimated Realishable Values (₹)			
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. Investments Other than Marketable Securities Livestock Other Property viz., …… ……				
Assets Specifically Pledged (As per List B) …….. ……	(a) Estimated Realizable Values ₹	(b) Due to Secured Creditors ₹	(c) Deficiency Ranking as Un-secured Creditors ₹	(d) Surplus Carried to Last Column (₹)
₹	…	…	…	…
Estimated Surplus from Assets Specifically 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 Specifically Pledged	…
	Other Assets	….
	Gross Assets	…

(e)	Liabilities	
Gross 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 Specifically Pledged (Item (a) or (b), whichever is less) (Insert in "Gross Liabilities" column only)	
…	Preferential Creditors (As per List C)	
	Estimated Balance of Assets Available for Debenture Holders 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 Clams of Creditors Partly Secured on Specified Assets, Brought from Preceding Page (c)	…
…	Trade Accounts	…
…	Bills Payable	…
…	Outstanding Expenses	…
…	Contingent Liabilities (State Nature) Estimated Surplus (Deficiency) as Regards Creditors (being the Difference Between Gross Assets Brought from Preceding Page (d) and Gross Liabilities as per Column (e))	…
	Issued and Called-up Capital:	…
	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]	…

One can grasp the following two vital factors from the statement of affairs:

1. Estimated surplus/deficiency as regards creditors
2. Estimated surplus/deficiency as regards members

Preparation of statement of affairs involves the preparation of following lists:

1. List A : This list includes all assets which are not specifically pledged. It reflects only the values realizable.
2. List B : This includes all assets which are specifically pledged.
   With the help of these two lists—List A and List B—a summary of gross assets is shown.
3. List C : This is a list of preferential creditors and the amounts due.
4. List D : This is a list of debenture holders having a floating charge on the assets of the company.
5. List E : This list contains names of unsecured creditors and the amounts due.
6. List F : This gives the amount due to preference shareholders.
7. List G : This is a list of equity shareholders including called-up equity capital.
8. List H : This is a separate statement showing how surplus or deficiency in the statement of affairs arose (format shown separately).

Important points to be noted in the preparation of statement of affairs:

1. **Calls-in-arrears**: The amount recoverable on calls-in-arrears is shown in List A. The amount that cannot be recoverable is to be shown as deduction from called-up capital.
2. **Debentures**: In the absence of any specific information, debentures are treated as having a floating charge.
3. **Uncalled capital**: This is to be shown as a Note at the end of statement of affairs.
4. **Unclaimed dividend**: It is included in List E.
5. **Contingent liabilities**: The portion, which is expected to materialize, has to be added to unsecured creditors.

10.4 STATEMENT OF DEFICIENCY OR SURPLUS (LIST H)

This statement is prepared to explain how the company did incur loss. The net result, i.e., surplus/deficiency, is shown in a nutshell. It is divided into two parts. The first part contains the items that increase deficiency. The second part includes all profits.

When the total of the first part is greater than the second part, it results in deficiency. On the other hand, when the total of the second part exceeds the first part, it results in surplus.

The deficiency shown in this account should agree with the one shown in the statement of affairs.

The period covered by this account should commence on a date not less than 3 years before the date of winding-up order (or the order appointing provisional liquidator, or the date directed by the official liquidator) or, if the company has not been incorporated for the whole of that period, the date of formation of the company, unless the official liquidator otherwise agrees.

10.4.1 Presented Form of Deficiency/Surplus Account

10.4.1.1 List H—Deficiency or Surplus Account

The following are the items contributing to Deficiencyor reducing surplus

	₹
1. Excess (if any) capital and liabilities over assets on the……..20……..as shown by the balance sheet (copy annexed)	...
2. Net dividends and bonus declared during the period, from……..20……..to the date of settlement.	...
3. Net trading losses (after charging items shown in note to below) for the same period.	...
4. Losses other than trading losses written off or for which provision has been made in the books during the same period (give particulars or annexe schedule).	...
5. Estimated losses now written off or for which provision has been made for the purpose of preparing the statement (give particulars or annexe schedule).	...
6. Other items contributing to deficiency or reducing surplus.	...
The following are the items reducing deficiency or contributing to surplus:	
1. Excess (if any) of assets over capital and liabilities or the…….20…….as shown in the balance sheet (Copy annexed).	...
2. Net trading profits (after charging items shown in note below) for the period from…….20…….to the date of settlement.	...
3. Profits and income other than trading profits during the same period (give particulars or annexe schedule)	...
4. Other items reducing deficiency or contributing to surplus.	...
Deficiency/Surplus (As shown in statement of affairs):	xxx

10.4.2 Note as to Net Trading Profit and Losses

Particulars are to be inserted here (so far as applicable) of the items mentioned below, which are to be taken into account in arriving at the amount of net trading profits or losses shown in this account.

Provision for depreciation, renewals, diminution, in value of fixed assets.

Charges for Indian income tax and other Indian taxation on profits.

	₹	
Interest on debentures and other fixed loans, payments to directors made by the company and required by law to be disclosed in the accounts		…
Exceptional or Non-recurring Expenditure:	…	
Less : Exceptional or Non-recurring Receipts Balance,		
Being Other Trading Profits or Losses)	…	
Surplus Account Above.	…	…

Signature:

Dated …… 20……....

Illustration 10.3

Model: Statement of affairs preparation

The Sunset Ltd. is to be liquidated. Their summarized balance sheet as at 30 September 2010 appears as follows:

Liabilities	₹	Assets	₹
1,25,000 Equity Shares of ₹ 10 Each	12,50,000	Land & Buildings	2,50,000
Secured Debentures (on Land and Buildings)	5,00,000	Other Fixed Assets	10,00,000
Unsecured Loans	10,00,000	Current Assets	22,50,000
Trade Creditors	17,50,000	Profits & Loss A/c	10,00,000
	45,00,000		45,00,000

Contingent liabilities are as follows:

For Bills Discounted ₹ 50,000

For Excise Duty Demands ₹ 75,000

On investigation, it is found that the contingent liabilities are certain to devolve and the assets are likely to be realized as follows:

	₹
Land & Building	5,50,000
Other Fixed Assets	9,00,000
Current Assets	17,50,000

Taking the above into account, prepare the statement of affairs.

Solution

Statement of Affairs of Sunset Ltd.
as on 30 September 2010

Assets	Estimated Realizable Value (₹)
Assets Not Specifically Pledged (As per List A):	
Other Fixed Assets	9,00,000
Current Assets	17,50,000
	26,50,000

Assets Specifically Pledged (As per List B):					
	Estimated Realizable Value	**Due to Secured Creditors**	**Deficiency Ranking as Unsecured**	**Surplus Carried to Last Column**	
	₹	₹	₹	₹	
Land & Building	5,50,000	5,00,000	—	50,000	50,000
Estimated Total Assets Available for Preferential Creditors, Debenture Holders Having a Floating Charge and Unsecured Creditors					27,00,000

Summary of Gross Assets:		₹	
Gross Realizable Value of Assets Specifically Pledged		5,50,000	
Other Assets		26,50,000	
Gross Assets		32,00,000	
	Liabilities		
Gross	To be Deducted from Surplus or Added to Deficiency Liabilities		
5,00,000	Secured Creditors (As per List B) to the Extent to Which Claims are Estimated to Be Covered by the Assets Specifically Pledged		
75,000	Preferential Creditors (As per List C)		75,000
	Unsecured Creditors (As per List E)		26,25,000
10,00,000	Unsecured Loans	10,00,000	
17,50,000	Trade Creditors	17,50,000	
50,000	Contingent Liability on Bills Discounted	50,000	28,00,000
33,75,000			
	Estimated Deficiency as Regards Creditors (₹ 33,75,000 – ₹ 32,00,000)		1,75,000
	Preference Share Capital (As per List F)		—
	Equity Share Capital (As per List G) (1,25,000 Equity Shares of ₹ 10 Each)		12,50,000
	Estimated Deficiency as Regards Contributors (As per List H)		14,25,000

Illustration 10.4

Model: Statement of affairs

The following information is extracted from the books of X Ltd. on 30 June 2010 on which date or winding-up order was made:

	₹.
Equity Share Capital 40,000 Shares of ₹ 10 Each	4,00,000
10% Preference Share Capital 6,000 Shares of ₹ 100 Each	6,00,000
Calls-in-arrears on Equity Shares (Estimated to Produce ₹ 4,000)	8,000

9% First Mortgage Debentures, Secured by a Floating Charge on the Whole of the Assets of X Ltd.		4,00,000
Creditors Fully Secured (value of Shares in AB Ltd. ₹ 80,000)		70,000
Creditors Partly Secured (Value of Shares in CD Ltd. ₹ 40,000)		80,000
Preferential Creditors		15,000
Bank Overdraft, Secured by a Second Charge on the Whole Assets of the Company		40,000
Unsecured Creditors		5,20,000
Estimated Liability on Bills Discounted		20,000
Cash in Hand		4,050
Book Debts	Good	75,000
	Doubtful (Estimated to Produce 40%)	15,000
	Bad	9,000
Stock in Trade (Estimated to Produce ₹ 1,19,350)		1,44,000
Freehold Land and Buildings (Estimated to Produce ₹ 3,91,000)		3,30,000
Plant & Machinery (Estimated to Produce ₹ 1,06,000)		1,50,000
Fixtures & Fittings (Estimated to Produce ₹ 15,000)		25,000

Prepare a statement of affairs
(a) As regards creditors
(b) As regards contributories

Solution

Statement of Affairs of X Ltd. as on 30 June 2010

Assets	Estimated Realizable Value (₹)
Assets Not Specifically Pledged (As per List A)	
Cash in Hand	
Trade Debtors (₹ 75,000 + 40% or ₹ 15,000)	4,050
Calls-in-Arrears	81,000
Stock in Trade	4,000
Freehold Land & Buildings	1,19,350
Plant & Machinery	3,91,000
Fixtures & Fittings	1,06,000
Assets Specifically Pledged (As per List B)	15,000
	*[1]7,20,400

	Estimated Realizable Value ₹	Due to Secured Creditors ₹	Deficiency Ranking as Unsecured ₹	Surplus Carried to Last Column ₹	
Shares in AB Ltd.:	80,000	70,000	—	10,000	
Shares in CD Ltd.:	40,000	80,000	40,000	—	
	[*2]1,20,000	1,50,000	40,000	10,000	10,000

Estimated total assets available for preferential creditors, debenture holders secured by a floating charge, bank overdraft secured by a second floating charge and unsecured creditors.

Summary of Gross Assets

Gross Realizable Value of Assets:		₹
Specifically Pledged		[*2]1,20,000
[*1]Others		7,20,400
		8,40,400

Gross Liabilities (₹)	Liabilities		
	To Be Deducted from Surplus or Added to Deficiency as the Case May Be:		
1,00,000	Secured Creditors (As per List B) to the Extent to Which Claims are Estimated to be Covered by Assets Specifically Pledged		—
15,000	Preferential Creditors (as per List C)		15,000
	Estimated Balance of Assets Available for Debenture Holders Secured by a Floating Charge Bank Overdraft by a Second Floating Charge and Unsecured Creditors		7,15,400
4,00,000	Debenture Holders Secured by a Floating Charge (as per List D)		4,00,000
			3,15,400
40,000	Bank Overdraft Secured by a Second Floating Charge (as per List D)		40,000
	Estimated Surplus as Regards Debenture Holders and Bank, Unsecured Creditors (As per List E)		2,75,400
	Estimated Unsecured Balance of Claims of	₹	
	Creditors Partly Secured on Specific Assets	40,000	
	Unsecured Creditors	5,20,000	
5,80,000	Liability on Bills Discounted	20,000	5,80,000
11,45,000			

	Estimated Deficiency as Regards Creditors, being the Difference Between Gross Liabilities and Gross Assets (₹ 11,45,000 – ₹ 8,40,400)		3,04,600
	Issued and Paid-up Capital:		
	6,000, 10% Preference Shares of ₹ 100 Each Fully Paid-up (As per List F)		6,00,000
	40,000 Equity Shares of ₹ 10 Each Fully Paid-up (As per List G)	4,00,000	
	Less: Irrecoverable Calls-in-Arrears	4,000	3,96,000
	Estimated Deficiency as Regards Contributories (As per List H)		13,00,6000

Illustration 10.5

Model: Statement of affairs and deficiency account

Mr. Eswar is appointed liquidator of a company in voluntary liquidation on 1 July 2010 and the following balances are extracted from the books on that date:

Liabilities	₹	**Assets**	₹
Share Capital:		Machinery	1,20,000
32,000 Shares of ₹ 10 Each	3,20,000	Leasehold Properties	1,60,000
Provision for Bad Debts	40,000	Stock in Trade	4,000
Debentures	2,00,000	Book Debts	2,40,000
Bank Overdraft	72,000	Investments	24,0000
Liabilities for Purchases	80,000	Calls-in-Arrears	20,000
		Cash in Hand	4,000
		Profit & Loss A/c	1,40,000
	7,12,000		7,12,000

The assets are revalued as follows:

Investments at ₹ 16,000
Stock in trade at ₹ 8,000
Machinery at ₹ 2,40,000
Leasehold properties at ₹ 2,92,000

Bad debts are ₹ 8,000; Doubtful debts are ₹ 16,000, estimated to realize ₹ 8,000.

The bank overdraft is secured by deposit of title deeds of leasehold properties.

Preferential creditors for tax and wages are ₹ 4,000.

Telephone rent owing is ₹ 320.

You are required to prepare:

(i) Statement of affairs as regards creditors and contributories
(ii) Deficiency/surplus account

Solution

Assumption: Calls-in-arrears will be realized fully.

Statement of Affairs of ……. Ltd.
as on 1 July 2010

Assets					**Estimated Realizable Value** ₹
Assets Not Specifically Pledged (As per List A):					
Cash in Hand					4,000
Trade Debtors ₹ (2,40,000 – 8,000 – 8,000)					2,24,000
Calls-in-Arrears (Full)					20,000
Investments					16,000
Stock					8,000
Machinery					2,40,000
Assets Specifically Pledged (As per List B):					5,12,000
	Estimated Realizable Value ₹	**Due to Secured Creditors** ₹	**Deficiency Ranking as Unsecured** ₹	**Surplus Credited to Last Column** ₹	
Leasehold Properties	2,92,000	72,000	—	2,20,000	
Estimated Surplus from Assets Specifically Pledged					2,20,000
Estimated Total Assets Available for Preferential Creditors, Debenture Holders Secured by a Floating Charge and Unsecured Creditors					7,32,000

Summary of Gross Assets	
	₹
Gross Realizable Value of Assets Specifically Pledged	2,92,000
Other Assets	5,12,000
	8,04,000

Gross Liabilities ₹	**Liabilities**	
72,000	Secured Creditors (As per List B) to the Extent to Which Claims are Estimated to Be Covered by Assets Specifically Pledged	—
4,000	Preferential Creditors (As per List C)	4,000
—	Estimated Balance of Assets Available for Debenture Holders Secured by a Floating Charge and Unsecured Creditors	7,28,000
2,00,000	Debenture Holders Secured by a Floating Charge (As per List D)	2,00,000
—	Estimated Surplus as Regards Debenture Holders	5,28,000

80,320	Unsecured Creditors (As per List E):	
	Liabilities for Purchases 80,000	
	Telephone Rent Outstanding 320	80,320
	Estimated Surplus as Regards Creditors	4,47,680
	Issued and Called-up Capital (As per List G)	3,20,000
3,56,320	Estimated Surplus as Regards Contributories (As per List H)	1,26,680

Deficiency/Surplus Account (List H)

				₹
Items Reducing Surplus:				
Excess of Capital and Liabilities over Assets (P&L A/c)				1, 40,000
Estimated Losses Written Off for Which Provision Has Been Made for the Purpose of Preparing the Statement:			₹	
Investments (₹ 24,000 – ₹ 16,000)			8,000	
Preferential Creditors for Taxes and Wages			4,000	
Telephone Rent Outstanding			320	12,320
				1,52,320
Items Contributing to Surplus:				
Machinery (₹ 2,40,2000 – ₹ 1,20,000)			1,20,000	
Leasehold Properties (₹ 2,92,000 – ₹ 1,60,000)			1,32,000	
Stock (₹ 8,000 – ₹ 4,000)			4,000	
Provision for Bad Debts:		40,000		
Less: Bad Debts	8,000			
Doubtful Debts	8,000	16,000	24,000	2,80,000
Surplus as Shown by Statement of Affairs				1,26,680

Note: Estimated surplus as shown in statement of affairs and surplus arrived by deficiency/surplus A/c must tally.

Here in both the cases, surplus = ₹ 1,26,680.

10.5 LIQUIDATOR'S FINAL STATEMENT OF ACCOUNT

Liquidator's prime duty is to realize the assets of the company and to make payment to creditors. For this purpose, he has to prepare a statement how much he realized and how the same was paid to the claimants. This will be in the form of cash A/c. Such a statement of account is known as liquidator's final statement of account.

After its preparation, the liquidator has to submit it to the court in case of compulsory winding up and to the company in case of voluntary winding up.

As it resembles a cashbook, this statement of account consists of:

(i) Amounts realized by the liquidator (all receipts)

(ii) Payment of various liabilities (all payments)

10.5.1 Amounts Realized by the Liquidator

The following are the sources to realize amount or liquidation:

1. **Cash in hand and at bank:** Not much effort is needed on the part of a liquidator to realize amount from this source.
2. **Sale proceeds of assets**: The liquidator has to realize the assets of the company as well as from debtors of the company.
3. **Surplus from secured creditors:** For secured creditors, payment may be made to them on their claims or up to the amount realized by sale of securities held by them, whichever is less.

   In case the creditor disposes off the securities and if the realization exceeds their claims, then the excess or surplus is handed over to the liquidator. Surplus is to be shown as receipt but payment to creditors is not to be shown in the liquidator's final statement of account. On the other hand, realization is less than the claim, such deficit is to be added to the unsecured creditors.
4. **Contributions by contributories:** The liquidator can make a call on partly paid shares to meet inevitable payments.

10.5.2 Payment of Various Liabilities

10.5.2.1 Liquidator's Remuneration

A liquidator is entitled to get remuneration for his services. Generally his remuneration is in the form of commission based on assets realized and on payments made to unsecured creditors. While determining his commission, the following factors have to be taken into account.

(a) **Cash in hand and at bank**: Not much effort is needed on the part of a liquidator to realize amount from this source.

(b) **Assets given as security of fully and partly secured creditors**: For calculating commission, the surplus realized from such assets should be taken into account.

(c) **Preferential creditors**: Preferential creditors are like unsecured creditors, and the commission is based on the amount paid to them.

(d) **Deficiency**: The amount left to pay unsecured creditors may be less than the required amount. In such cases, the amount left has to be divided between creditors and liquidators. This is explained as follows:

Creditors to be Paid	₹ 1,00,000
Commission to Be Given on the Amount Paid to Creditors	= 10%
Total Amount Available	= ₹ 88,000

Then commission to the liquidator will be calculated as

$$₹\,88{,}000 \times \frac{10}{100 + 10} = ₹\,8{,}000$$

i.e., Apply this formuls:

$$\text{Commission} = \text{Amount avaible to unsecued creditor} \times \frac{\text{Percentage of Remuneration}}{100 + \text{Percentage of Remuneration}}$$

(e) When the amount is sufficient, it can be calculated as

$$\text{Commission} = \text{Amount to unsecured creditors} \times \frac{\text{Percentage of Remuneration}}{100}$$

(f) Calculation of liquidator's remuneration or the payment made to shareholders of the company:

Remuneration of Liquidator = Balance Amount Available to Contributores

$$\times \frac{\text{Percentage of Remuneratin}}{100 + \text{Percentage of Remuneration}}$$

Balance available to contributories is determined as:		₹
Total of All Amounts on the Debit Side of Liquidator's Final Statement of A/c		……
Less:	₹	
(i) Legal Expenses	…….	
(ii) Liquidator's Remuneration:	…….	
On Assets Realized	…….	
On Payments to Preferential Creditors	…….	
On Payments to Unsecured Creditors	…….	
(iii) Liquidation Expenses	…….	
(iv) Payments on Debentures	…….	
(v) Payment to Preferential Creditors	…….	
(vi) Payment to Unsecured Creditors	…….	xx
Balance Amount Available to Contributories		xxx

Illustration 10.6

Model: Liquidator's remuneration

The liquidator of a company in voluntary liquidation is entitled to a remuneration of 5% on the amount realized (excluding the cash in hand) and at 2% on the amount distributed to the unsecured creditors. Unsecured creditors including preferential creditors of ₹ 10,000 amounted to ₹ 50,000.

Debenture holders were paid ₹ 60,000 together with interest. Preferential creditors were paid in full. ₹ 1,000 was spent as costs of liquidation.

Cash in hand was ₹ 2,000 and assets realized ₹ 93,000. Find out the liquidator's total remuneration.

Solution

	₹	₹	₹
Assets Realized (Given)	93,000	—	—
5% on Assets Realized	—	—	4,650
Total Amount Available for Distribution (Given)	—	95,000	—
(₹ 93,000 + ₹ 2,000 Cash)			
Less: Liquidation Expenses	1,000	—	—
Part of Liquidator's Remuneration	4,650		
Debenture Holders	60,000	65,650	—
∴ Amount Available for Distribution =		29,350	
2% on Amount Distributed to Unsecured Creditors			
Apply the formula:			
$₹ 29,350 \times \frac{2\%}{(100 + 2\%)} = ₹ 29,350 \times \frac{2}{102}$			575.50
Liquidator's Total Remuneration:			5,225.50

Illustration 10.7

Model: Liquidator's remuneration

A liquidator is entitled to receive remuneration @ 2% of the assets realized and 3% on the amount distributed among the unsecured creditors. The assets realized are ₹ 50,00,000 against which payments were made as follows:

Liquidation Expenses	₹ 20,000
Preferential Creditors	₹ 70,000
Secured Creditors	₹ 30,00,000
Unsecured Creditors	₹ 20,00,000

Calculate the total remuneration payable to the liquidator.

Solution

		₹
Step 1:	Liquidator's Commission on Assets Realized $\left(₹\,50,00,000 \times \frac{2}{100}\right)$	1,00,000
Step 2:	Liquidator's Commission on Amount Paid to Preferential Creditors $\left(₹\,70,000 \times \frac{3}{100}\right)$	2,100
Step 3:	Liquidator's commission on amount distributed among unsecured creditors. $\left(₹\,18,07,900 \times \frac{3\%}{100+3\%} : \frac{3}{103} \times ₹\,18,07,900\right)$	52,657
Step 4:	Total Liquidator's Commission (Step 1 + Step 2 + Step 3)	1,54,757
Step 5:	Amount Available to Unsecured Creditor is Calculated as Follows: (Find Out and Transfer to Step 3)	

		₹	₹
1.	Total Assets Realized (Given)		50,00,000
2.	Less:		
	(i) Liquidation Expenses	20,000	
	(ii) Preferential Creditors	70,000	
	(iii) Secured Creditors	30,00,000	
	(iv) 2% Commission on Assets Realized (Ref: Step 1)	1,00,000	
	(v) 3% Commission on Amount Paid to Preferential Creditors (Ref: Step 2)	2,100	31,92,100
3.	Amount Available to Unsecured Creditors Including Remuneration on Payment to Unsecured Creditors =		18,07,900

Form of Liquidator's Final Statement of Account

Form No. 156

(See Rule 329)

Companies Act, 1956

* Here, state whether the winding up is a members' or creditors' voluntary winding up or a winding up under the supervision of the Court. If under the supervision of the Court, mention the number of the petition in which the order was made and the date of the order.

** Strike out what does not apply.

Liquidator's Statement of Account of the Winding up (Members'/Creditors' Voluntary Winding up)

Pursuant to Section 497/509

1. Name of the company……Ltd.
2. Nature of proceeding
3. Date of commencement of the winding up
4. Name and address of the liquidator

Statement showing how the winding up has been conducted and the property of the Company has been disposed off from……20…. (Commencement of winding up) to……20…… (Close of winding up)

Receipts	**Estimated Value** ₹	**Value Realized** ₹	**Payments**	₹
Assets:			Legal Charges	
Cash at Bank			Liquidator's Remuneration:	
Cash in Hand			Where Applicable	
Marketable Securities			Percentage on ₹ ……	
Bills Receivable			Realized……	
Trade Debtors			Percentage on ₹ ..... Distributed	
Loans & Advances			Total: ……	
Stock in Trade			(By Whom, Fixed…..)	
Work-in-Progress			Auctioneers and Value's Charges	
Freehold Property			Cost of Possession and Cost of	
Plant & Machinery			Notice in Gazette & Newspapers	
Furniture, Fittings, etc.			Incidental Outlay (Establishment Charges and Other Expenses of Liquidation)	
Patents, Trademarks, etc.			Total Costs & Charges	
Investments Other than Marketable Securities			(i) Debenture Holders: Payment of ₹ ….per ₹ … Debenture	
Surplus from Securities			(ii) Creditors:	
Unpaid Calls at Commencement of Winding up			*Preferential	
Amounts Received from Calls on Contribution Made in the Winding up			*Unsecured	
Receipts per Trading Account other Property viz.			Dividend (s) ……..P. in the rupee on ₹ (The Estimate of the Amount Expected to rank for Dividend was ₹ ……..)	
Total			(iii) Returns to Contributories……. P. per Rupee …….. Share**	
Less: Payment to Redeem Securities				
Cost of Execution				
Payment per Trading A/c				
Net Realizations	xxx	xxx	Add Balance	xxx

* State the member; preferential creditors need not be separately shown if all creditors have been paid in full.

** Statement nominal value and class of share.

1. The following assets estimated to be of ₹…….have proved to be unrealizable:
   (Give details of the assets which have proved to be unrealizable)
2. Amount paid into the company's liquidation A/c in respect of:
   (a) Unclaimed dividends payable to creditors in the winding up ₹……
   (b) Other unclaimed distributions in the winding up ₹……
   (c) Moneys held by the company in trust in respect of dividends or other sum due before the commencement of winding up to any person as a member of the company. ₹……
3. Add here any remarks the liquidator thinks desirable.

Dated This……..Day of……20……. (sd)……..
Liquidator

I declare that the above statement is true and contains a full and accurate account of the winding up from the commencement to the close of the winding up.

Dated this……..day of……20…….

(sd).....
Liquidator

Illustration 10.8

Model: Liquidator's final statement of A/c

The following particulars relate to a limited company which went into voluntary liquidation:

Preferential Creditors ₹1,00,000
Unsecured Creditors ₹2,32,000
6% Debentures ₹1,20,000

The assets realized ₹3,20,000. The expenses of liquidation amounted to ₹6,000. and the liquidator's remuneration was agreed at 2½% on the amount realized and 2% of the amount paid to unsecured creditors including the preferential creditors.

Show the liquidator's final statement of account.

Solution

Note: First, liquidator's remuneration is calculated and only then, the final statement of account may be prepared to avoid, confusion in determining the unsecured creditors value as amount is not sufficient to pay off unsecured creditors in full.

[*1] **Liquidator's Remuneration:**		₹
(i) 2½% on Assets Realized—₹3,20,000	=	8,000
(ii) 2% on Preferential Creditors—₹1,00,000	=	2,000
(iii) 2% on Unsecured Creditors:		
(₹3,20,000 – ₹8,000 –₹2,000 – ₹6,000 – 1,20,000 – 1,00,000)	=	1,647
i.e., ₹ $\frac{84,000 \times 2}{102}$	=	11,647

Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
To Assets Realized	3,20,000	*[1]By Liquidator's Remuneration	
		(i) 2½% on ₹ 3,20,000	8,000
		(ii) 2% on ₹ 1,00,000	2,000
		(iii) 2% on ₹ 84,000	1,647
		By Liquidation Expenses	6,000
		By Debenture Holders	1,20,000
		By Preferential Creditors	1,00,000
		By Unsecured Creditors (Balancing Figure)	82,353
	3,20,000		3,20,000

[In this question, unsecured creditors is ₹ 2,32,000 but the amount available, i.e., ₹ 84,000, is not sufficient to pay off unsecured creditors in full. Hence, the remuneration is also calculated on this amount and not on ₹ 2,32,000.]

Illustration 10.9

Model: Liquidator's final statement of A/c

ED Ltd. went into liquidation with the following liabilities:

Secured Creditors - ₹ 50,000
Preferential Creditors - ₹ 2,400
Unsecured Creditors - ₹ 1,22,000
Liquidation Expenses - ₹ 1,000

Securities realized ₹ 1,00,000; the liquidator is entitled to a remuneration of 3% on the amount realized (including securities in the banks of secured creditors) and 1.5% on the amount distributing to the unsecured creditors. The various assets (excluding the securities in the hands of the secured creditors) realized ₹ 1,04,000.

Prepare the liquidator's statement of account showing the payment made to unsecured creditors.

[C.S (Inter). Modified]

Solution

Calculations

*Calculation of Liquidator's Remuneration:	₹
(i) 3% on Assets + Securities Realized	
3% of ₹ 1,04,000 + ₹ 1,00,00	6,120
(ii) 1.5% or Preferential Creditors, i.e. ₹ 2,400	36
(iii) 1.5% or Payments to Unsecured Creditors	
₹ 1,04,000 + ₹ 20,000 (Secured Creditors Surplus)	
(1,00,000 – 80,000) – 1,000 – 2,400 – 6,156)	1,544
$= ₹\ 1,04,444 \times \frac{1.5\%}{101.5\%}$	
	7,640

ED Ltd (In Liquidation)
Liquidator's Final Statement Account

Liabilities	₹	Assets	₹
To Assets Realized	1,04,000	By Liquidation Expenses	1,000
To Surplus from Secured Creditors (Securities Realized— ₹1,00,000 – ₹80,000)	20,000	By Liquidator's Remuneration	7,640
		By Unsecured Creditors (Balance Figure)	1,15,360
	1,24,000		1,24,000

Illustration 10.10

Model: Liquidator's final statement of A/c interest on debentures and calculation of cash availability

Sibi Co. Ltd. went into liquidation on 31 December 2010. Its capital is divided into 40,000 shares of ₹50 each. Its assets and liabilities on this date were as follows:

Cash in hand: ₹3,000; Realized from stock: ₹1,18,400; from book debts: 1,96,800; from furniture: ₹4,200; Investment with bank for overdraft: ₹19,600; Unsecured creditors: ₹2,15,100; Preferential creditors: ₹21,180; Bank overdraft: ₹16,000 ; 6% Debentures having a floating charge of ₹1,76,000.

Bank, after deducting its amount from investments of ₹19,600, gave the surplus to the liquidator. Debentures were paid on 30 June 2011 with interest.

Remuneration of liquidator; 3% of the net amount realized (excluding the amount given to secured creditors but including cash in hand); 2% on the amount paid to unsecured creditors (excluding preferential creditors). Cost of liquidation is ₹4,060. Prepare liquidator's final statement of account.

Solution

Stage I: Calculation of Total Cash Available: ₹

Assets Realized: (₹3,000 + ₹1,96,800 + ₹1,18,400 + ₹4,200) + (₹19,600 – 16,000) 3,26,000

Stage II: Calculation of Cash Available for Unsecured Creditors:

$₹3,26,000 - ₹\left(3\% \text{ of } 3,26,000 - ₹4,060 - ₹1,76,000 - \left(₹1,76,000 \times \frac{6}{12} \times \frac{6}{100}\right) - ₹21,180\right)$ 1,09,700

Stage III: Liquidator's Remuneration:

3% on ₹3,26,000	=	9,780
2% on ₹1,07,550 $\left(\frac{2}{102} \text{ on } ₹1,09,700\right)$	=	2,150
		11,930

Stage IV: Preparation of Final Statement of Account:

Liquidator's Final Statement of A/c

Receipts		₹	Payments		₹
To Assets Realized			By Liquidator's Remuneration		
Cash	3,000		3% on ₹ 3,26,000	9,780	
Debtors	1,96,800		2% on ₹ 1,07,550:	2,150	11,930
Stock	1,18,400		(Ref: Stage III)		
Furniture	4,200	3,22,400	By Liquidation Expenses		4,060
To Surplus from Secured Creditors (₹ 19,600 – ₹ 16,000)		3,600	By Debentures + Interest – ₹ $1,76,000 + \left(₹\ 1,76,000 \times \frac{6}{12} \times \frac{6}{100}\right)$		1,81,280
			By Preferential Creditors		21,150
			By Unsecured Creditors (Balance Figure)		1,07,550
		3,26,000			3,26,000

Illustration 10.11

Model: Final statement of account calls-in-arrears

From the data relating to a company (in voluntary liquidation), you are asked to prepare liquidator's final statement of account:

(i) Cash with liquidator (after all assets are realized and secured creditors and debenture holders are paid) is ₹ 3,36,900
(ii) Preferential creditors to be paid are ₹ 15,000
(iii) Other unsecured creditors are ₹ 1,07,500
(iv) 2,000 6% Preference shares of ₹ 100 each, fully paid
(v) 1,000 Equity shares of ₹ 100 each, ₹ 75 per share paid-up
(vi) 3,000 Equity shares of ₹ 100 each, ₹ 60 per share paid-up
(vii) Liquidator's remuneration 2% on preferential and other unsecured creditors
(viii) Preference dividends were in arrears for 2 years

[B.Com Madurai Kamaraj Modified]

Solution

Note: As different classes of shares are given with varied calls-in-arrear, calculation of amount receivable from equity shareholders and payable to equity shareholders is to be carried out as follows:

			₹
Step 1:	Assets Realized (Given as Cash with Liquidator)		3,36,900
Step 2:	Less: Payments:	₹	
	(i) Liquidator's Remuneration 2% on ₹ (15,000 + 1,07,500)	2,450	
	(ii) Preferential Creditors	15,000	
	(iii) Unsecured Creditors	1,07,500	
	(iv) Preference Shareholders [₹ (2,000 × 100) + 6% of 2,00,000]	2,24,000	3,48,950

Step 3:	Amount Required for Preference Shareholders:	12,050
Add:	Amount Payable to Equity Shareholders:	
	(i) 1,000 Equity Shares @ ₹ 75 (Paid-up)	75,000
	(ii) 3,000 Equity Shares @ ₹ 60 (Paid-up)	1,80,000
Step 5:	Total Loss to Be Borne by Equity Shareholders =	2,67,050

Step 6: Number of Equity Shares = (1,000 + 3,000) = 4,000

Step 7: Loss per Equity Share $= \frac{\text{Total Loss}}{\text{Number of Equity Shares}}$

$= ₹ \frac{2,67,050}{4,000}$ (Step 5 ÷ Step 6)

$= ₹ 66.7625$

Step 8:	Amount Receivable per Share	=	(Paid-up Value – Loss per Share)
	Amount Receivable on 3,000 Shares	=	3,000 (₹ 60 – ₹ 66.7625)
		=	3,000 (₹ 6.76250)
		=	₹ 20,287.50
Step 9:	Amount Payable per Share	=	(Paid-up value – Loss)
	Amount Payable on 1,000 Shares	=	1,000 (₹ 75 – ₹ 66.7625)
		=	1,000 (₹ 8.2375)
		=	₹ 8237.50

Assumption: Preference dividend is declared but not paid. It is in arrears for 2 years.
Now, liquidator's final statement of account is to be prepared as follows:

Liquidator's Final Statement of Account

Receipts	₹	Payments		₹.
To Cash in Hand	3,36,900	By Liquidator's Remuneration		2,450
To Amount Received on Call for	20,287.50	By Preferential Creditors		15,000
3,000 Share @ ₹ 6.6725		By Unsecured Creditors		1,07,500
		By Preference Shareholders		
		Capital	2,00,000	
		Dividend for 2 years @ 6% p.a.	24,000	2,24,000
		By Equity Shareholders Amount Paid to Holders of 1,000 Equity Shares Ref : Step 9		8,237.50
	3,57,187.50			3,57,187.50

Illustration 10.12

Model: Adjustment of rights of contributories

Beta Ltd. went into voluntary liquidation. The details regarding liquidation are as follows:

Share Capital:

(i) 1,000 8% Preference shares of ₹100 each (fully paid-up)

(ii) Class A—1,000 equity Shares of ₹100 each (₹75 paid-up)

(iii) Class B—800 Equity shares of ₹100 each (₹60 paid-up)

(iv) Class C—700 Equity shares of ₹100 each (₹50 paid-up)

Assets including machinery realized: ₹2,10,000; and liquidation expenses amount to ₹7,500.

Beta Ltd. has borrowed a loan of ₹25,000 from Alpha Brothers against the mortgage of machinery (which realized ₹40,250). In the books of the company, salaries of four clerks for four months at the rate of ₹250 per month and salaries of four peons for 3 months at the rate of ₹150 per month are outstanding. In addition to this, the company's books show the creditors worth ₹41,200. Prepare liquidator's statement of receipts and payments.

Solution

Surplus available to equity shareholders has to be calculated. Prior to this, total preferential creditors are to be determined.

Stage I:	Calculation of Total of Preferential Creditors:			₹
	(i) Salary of Clerks: 4 × ₹250 × 4 months		=	4,000
	(ii) Salary of Peons: 4 × ₹150 × 3 months		=	1,800
	Total			5,800
Stage II:	Adjustment of Rights of Contributories:			
	(a) Determination of Surplus:			₹
Step 1:	Assets Realized			2,10,000
Step 2:	*Less:* (i) Liquidation Expense	7,500		
	(ii) Preference Creditors (Ref: Stage I)	5,800		
	(iii) Secured Creditors	25,000		
	(iv) Unsecured Creditors	41,200		79,500
	Balance:			1,30,500
Step 3:	Capital to be Returned to Preference Shareholders 1,000 × ₹100			1,00,000
Step 4:	*Surplus* (Available to Equity Shareholders)			30,500
	(b) Calculation of Deficiency:			
	Equity Share Capital to be Returned:			
Step 1:	1,000 Shares of ₹75 per Share (Paid-up)			75,000
Step 2:	800 Shares of ₹60 per Share (Paid-up)			48,000
Step 3:	700 Shares of ₹50 per Share (Paid-up)			35,000

Step 4:	Total to be Returned (Step 1 +Step 2 + Step 3)	=	1,58,000
Step 5:	Less: Surplus Available (Ref: Stage II Step 4)	=	30,500
Step 6:	*Deficiency* (To Be Borne by Equity Shareholders)	=	1,27,500

Stage III: Deficiency Distribution for Each Class of Shares:

Step 1: Percentage of Deficiency:

$$= \frac{\text{Total Deficiency}}{\text{Number of Shares}} \times 100$$

$$= \frac{₹1,27,50}{(1,000 + 800 + 7000)} = \frac{1,27,500}{2,500} \times 100$$

$$= 51\%$$

Step 2:

	Particulars	A Shares	B Shares	C Shares
(i)	Paid-up Value	75	60	50
(ii)	Less: Loss at 51%	51	51	51
(iii)	Net Amount Returnable or Receivable (i) – (ii)	24	9	(–1)

Stage IV: Return of Amount for Each Class of Share:

Step 1:	Return of A Class Share ₹24 × 1,000 shares	₹24,000
Step 2:	Return of B Class Share ₹9 × 800 shares	₹7,200
Step 3:	Receipt of C Class Shares ₹1 × 700 shares	₹700

Stage V: Preparation of Liquidator's Final Statement of Account:

Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
To Assets Realized (₹2,10,000 – ₹40,250)	1,69,750	By Liquidation Expenses	7,500
		By Preferential Creditors (Ref: Stage I)	5,800
To Surplus from Secured Creditors (₹40,250 – ₹25,000)	15,250	By Unsecured Creditors	41,200
		By Preference Shareholders	1,00,000
To Proceeds of Call at ₹1 psser share on C Class shares (700 × ₹1) (Ref: Stage III Step 3)	700	By Return of ₹24 per Share on A Class Shares (Ref: Stage III Step 1)	24,000
		By Return of ₹9 per Share on B Class Shares (Ref: Stage III Step 2)	7,200
	1,85,700		1,85,700

Illustration 10.13

Model: Deficiency distribution—amount receivable from/payable to equity shareholders

Given below is the balance sheet of ABC Ltd. as on 1 August 2010 on which date it goes into liquidation:

Liabilities		₹	Assets	₹
Share Capital:			Cash at Bank	10,000
20,000 Pref. Shares of ₹ 10 Each Fully Paid		2,00,000	Stock of Raw Material	1,00,000
			Other Stocks	3,00,000
10,000 Equity Shares of ₹ 10 Each,			Other Assets	2,90,000
Fully Called:	1,00,000		Profit & Loss A/c (Dr.)	1,00,000
Less: Calls-in-Arrear				
2,000 Shares @ ₹ 1	2,000	98,000		
20,000 Equity Shares of ₹ 10 Each, ₹ 5 per Share Paid		1,00,000		
40,000 Equity Shares of ₹ 10 Each, ₹ 3 per Share Paid		1,20,000		
Secured Loan from Bank		76,000		
(Against Pledge of Raw Material)				
Unsecured Dues:				
Preference	2,400			
Others	2,03,600	2,06,000		
		8,00,000		8,00,000

The assets were realized as follows:

(i) Stock of Raw Materials Realized by Bank: ₹ 60,000
(ii) Other Stocks: ₹ 1,60,000
(iii) Remaining Assets: ₹ 40,000

The liquidator is entitled to a fixed remuneration of ₹ 4,000 plus 2% of the gross amounts realized by him. Other costs and charges amounted to ₹ 22,000. Equity shares carry the same rights, regardless of the amount paid, as far as the capital repayment is concerned.

Show the liquidator's final statement of account.

Solution

Stage I: Calculation of Amount Due to Unsecured Creditors:	₹	₹
(i) Unsecured Dues as Given in the Question	2,03,600	
(ii) Add: Bank Loan Not Covered by Security (₹ 76,000 – ₹ 60,000)	16,000	2,19,600
(iii) Less: Balance Amount Available After Paying to Liquidator's Remuneration, Expenses and Preferential Creditors		1,77,600
(iv) Amount Payable to Unsecured Creditors		42,000

Stage II: Calculation of Deficiency:

(i) Add: Amount Payable to Preference and Equity Shareholders	5,18,000
(ii) Deficiency (To Be Borne by Equity Shareholders)	
(Total loss)	5,60,000

Stage III: Calculation of Loss per Equity Share:

$$\text{Loss per Equity Share} = \frac{\text{Total Loss (Deficiency)}}{\text{Number of Equity Shares}}$$

$$= \frac{₹\,5,60,000}{10,000 + 20,000 + 40,000}$$

$$= \frac{₹\,5,60,000}{70,00 \text{ Shares}} = ₹\,8 \text{ per Share}$$

Stage IV: Distribution of Deficiency Among Different Classes of Shares:

		Holders of		
		10,000 Equity Shares ₹	**20,000 Equity Shares** ₹	**40,000 Equity Shares** ₹
(i)	Paid-up Value per Share	10	5	3
(ii)	Less: Loss per Share	8	8	8
(iii)	Amount Returnable per Share	2	–3	–5

Stage V: Calculation of Amount Receivable/Payable to Shareholders:

Step 1:	Amount Receivable on 20,000 Equity Shares: 20,000 × ₹ 3	= ₹	60,000
Step 2:	Amount Receivable on 40,000 Equity Shares: 40,000 × ₹ 5	= ₹	2,00,00
Step 3:	Amount Payable on 10,000 Equity Shares: 10,000 × ₹ 2	= ₹	20,000
	Less: Calls-in-arrears	= ₹	2,000
		₹	18,000

Liquidator's Final Statement of Account

Receipts		₹	**Payments**		₹
Cash at Bank		10,000	Liquidator's Remuneration		
Assets Realized:			Fixed:	₹ 4,000	
Other Stock	1,60,000		2% on Realization	₹ 4,000	8,000
Other Assets	40,000	2,00,000	Liquidation Expenses		22,000
Call on 20,000 Equity Shares		60,000	Preferential Creditors		2,400
(Ref: Stage V Step 1)			Unsecured Creditors:		
Call on 40,000 Equity Shares		2,00,000	As Shown	2,03,600	
(Ref: Stage V Step 2)			Bank Loan Not Covered by Security	16,000	2,19,600
			Preference Shareholders		2,00,000
			Equity Shareholders (Ref: Stage V Step 3)		18,000
		4,70,000			4,70,000

Illustration 10.14

Model: Calls-in-arrear and calls-in-advance and calculation of deficiency

The position of Ess Ltd. in liquidation is as follows:

Issued shares capital:

3,000, 6% Preference shares of ₹ 100 each, fully paid (arrear of dividend of one year)

3,000, Equity shares of ₹ 50 each, fully paid.

3,000, Equity shares of ₹ 40 each, ₹ 30 paid;

Calls-in-arrear: ₹ 12,000;

Calls-in-advance: ₹ 18,000;

Cash left after making payments to creditors but before making any call: ₹ 3,48,000.

You are required to prepare liquidator's final statement of account.

What will be the position if cash in hand is ₹ 4,02,000? Assume Articles include the provision relating to payment of preference dividend in priority to the equity capital.

Solution

A: When Cash in Hand is ₹ 3,48,000:

Stage I:	Calculation of Total Amount to Be Paid (Deficiency):		₹
Step 1:	Amount to Be Paid on Preference Shares: (3,000 × ₹ 100)		3,00,000
Step 2:	Add:		
	(i) Amount to Be Paid on Pref. Dividend 6% on ₹ 3,00,000 for 1 year		18,000
	(ii) Amount to Be Paid on ₹ 50 Equity Capital (3,000 × ₹ 50) Fully Paid		1,50,000
	(iii) Amount to Be Paid on ₹ 40 Equity Capital		
	3,000 × ₹ 30 Paid	= 90,000	
	Less: Calls-in-Arrear	= 12,000	
		= 78,000	
	Add: Calls-in-Advance	18,000	96,000
Step 3:	Total Amount (Step 2 [i + ii + iii] + Step 1	=	5,64,000
Step 4:	Less: Cash in Hand (As Given)	=	3,48,000
Step 5:	Total Deficiency (Step 3 – Step 4)	=	2,16,000

Stage II: Calculation of Percentage of Deficiency:

$$= \frac{₹\,2,16,00}{₹\,1,50,00 + ₹\,1,20,00} \times 100$$

$$= \frac{₹\,2,16,000}{₹\,2,70,000} \times 100 = 80\%$$

Stage III: Deficiency Distribution, i.e., Actual Loss Suffered:

(i) ₹ 50 Equity Shares Will Suffer $= \frac{80}{100} \times 50 = ₹ 40$

(ii) ₹ 40 Equity Shares Will Suffer $= \frac{80}{100} \times ₹ 40 = ₹ 32$

Stage IV: Preparation of Final Statement of Account:

Liquidator's Final Statement of Account

Receipts	₹	Payments	₹
Cash in Hand	3,48,000	Calls-in-Advance	18,000
Calls-in-Arrear	12,000	Preference Share Capital	3,00,000
Cash at (₹ 32 – ₹ 30) ₹ 2 on ₹ 40 Share Capital (3,000 × ₹ 2)	6,000	Preference Dividend	18,000
		Return of ₹ 10 on ₹ 50 Equity Capital (50 – 40) × 3,000 Shares	30,000
	3,66,000		3,66,000

B. When Cash in Hand is ₹ 4,02,000:

Step 1: Deficiency = ₹ 5,64,000 – ₹ 4,02,000 = ₹ 1,62,000

Step 2: Percentage of Deficiency $= \frac{1,62,000}{2,70,000} \times 100 = 60\%$

Step 3: Actual Loss to Be Suffered:

(i) On ₹ 50 Equity Shares $= \frac{60}{100 \times 50} = ₹ 30$

(ii) On ₹ 40 Equity Shares $= \frac{60}{100 \times 40} = ₹ 24$

Step 4: Liquidator's Statement:

Liquidator's Final Statement of A/c

Receipts	₹	Payments		₹
Balance of Cash	4,02,000	Calls-in-Advance		18,000
		Preference Share Capital		3,00,000
		Preference Dividend		18,000
		Return on ₹ 50 Equity Capital (₹ 50 – ₹ 30) = ₹ 20 × 3,000		60,000
		Return on ₹ 40 Equity Capital (₹ 30 – ₹ 24) = ₹ 6 × 3,000	18,000	
		Less: Calls-in-Arrear:	12,000	6,000
	4,02,000			4,02,000

Illustration 10.15

Model: Piecemeal distribution

You 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 January 2010

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	4,00,000
4,000 Equity Shares of ₹100 Each, Called ₹90	3,60,000	Sundry Debtors	3,00,000
		Profit & Loss A/c	1,30,000
1,000 Preference Shares of ₹100 Each, Called ₹60	60,000		
Secured Loans from Bank on:			
Plant & Machinery	1,50,000		
Sundry Creditors	2,60,000		
	8,30,000		8,30,000

The assets realized as follows:

		₹
On 1 April 2010	Sundry Debtors	1,00,000
	Fixed Assets	1,00,000
	Expenses Paid	4,000
On 1 June 2010	Fixed Assets (Final)	2,00,000
	Sundry Debtors	1,00,000
On 1 August 2010	Sundry Debtors (Final)	50,000

The liquidator is entitled to 4% on collections from debtors 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

Disbursement is to be made as and when cash is available on 1 April. Cash available is distributed proportionately between creditors and secured loan (bank) on 1 June. The bank loan is shown as settled completely.

Liquidator's Final Statement of A/c
from 1 January 2010 to 1 August 2010

Date	Receipts	₹	Date	Payments	₹
1 April 2010	Realization of Assets: Sundry Debtors	1,00,000	1 April 2010	Liquidator's Remuneration (4% on 1,00,000)	4,000

				Liquidation Expenses	4,000
				Bank Loan	
				(1,00,000 – 8,000: 92,000 in Proportion 10/62)	14,839
				Sundry Creditors (₹ 92,000 × 52/62)	77,161
		1,00,000			1,00,000
1 June 2010	Realization of Assets:		1 June	Liquidator's Remuneration	
	Sundry Debtors	1,00,000	2010	4% on ₹ 1,00,000	4,000
	Surplus from Secured Creditors	1,64,839		2% on ₹ 22,059	441
				Sundry Creditors	1,78,339
	(₹ 2,00,000 – ₹ 35,161)			Pref. Shareholders	60,000
				(1000 × ₹ 60)	
				Equity Shareholders	
				(400 × ₹ 5.51475)	22,059
		2,64,839			2,64,839
1 August 2010	Realization of Assets:		1 August 2010	Liquidator's Remuneration 4% on ₹ 50,000	2,000
	Sundry Debtors	50,000		2% on 47,059	941
				Equity Shareholders	
				4,000 shares × 11.76475	47,059
		50,000			50,000

10.6 "B" LIST OF CONTRIBUTORIES

As already said, the present members of the Company are placed on the "List A" and the past members, who have ceased to be members within one year of the commencement of winding up, are placed on the "List B".

The liability of A List contributory: This consists of the amount unpaid on the shares held.

The liability of B List contributory: These contributories are liable to pay unpaid amount on shares sold by them. That means, if the Company is unable to pay its creditors, and further, the amount of deficiency is not recovered from A List contributories, the liquidators may make a call on "B List" contributories. Their liability is limited to call on B List contributories. Their liability is limited to the debts that exist at the time when they relinquished their membership from the Company. These contributories are not liable to pay more than the amount which remains unpaid on their shares. The reason is that liability of a member is limited to the nominal value of shares held by them.

According to the provisions of the Companies Act, the liability of B List contributory is subject to:

(a) "He is liable only to the extent to which the transferee of his shares has failed to pay them up in full;

(b) He can be only called upon to pay so much of this amount as is necessary to pay so much of the debts incurred while he was a member as remain unpaid after applying all the contributions of the A List contributories and all the assets of the Company Pari Paasu towards payment of all its debts, irrespective of the date when they were incurred."

Illustration 10.16

Model: B List contributories

In a winding up which commenced on 15 September 2010, certain creditors of the Company could not receive payments out of the realization of assets and out of contribution from A List contributories. Following are the details of certain share transfers that took place prior to liquidation and the amount of creditors remaining unpaid:

Shareholders	Number of Shares Transferred	Date when Ceased to Be a Member	Creditors Remaining Unpaid and Outstanding on the Date of Ceasing to Be a Member ₹
A	4,000	31 August 2009	16,000
B	3,600	20 September 2009	24,000
C	2,400	15 November 2009	34,800
D	2,000	22 April 2010	37,200
E	1,000	10 July 2010	44,000

All the shares were of ₹10 each, on which ₹5 had been called and paid-up. Ignoring expenses of liquidation, remuneration to liquidator, etc., workout the amount to be realized from the above contributories.

[C.A. (Inter). Modified]

Solution

As per law, only persons who transfer his shares within 12 months preceding the date of winding up will be liable for contribution under List B. In this question, shareholder A transfers on 31 August 2009. Winding up is on 15 September 2010. That means he transferred his shares more than 12 months prior to the date of winding up. Hence, he is not liable as contributory.

The remaining transferors' (i.e., from B to E) liability is restricted to unpaid value of shares.

The liability of each contributory is to be determined proportionately. The ratio is to be found out for this purpose as follows:

(i) A is not eligible as B List contributory

(ii) Ratio is to be determined on the basis of shares transferred

B	:	C	:	D	:	E
3,600	:	2,400	:	2,000	:	1,000
		(OR)				
36	:	24	:	20	:	10
		(OR)				
18	:	12	:	10	:	5

Statement Showing Liability of "List B" Contributories

Creditors Outstanding on Date of Ceasing to be Member		B 3,600 Shares	C 2,400 Shares	D 2,000 Shares	E 1,000 Shares	Amount Paid to Creditor ₹
(i)	24,000 in the Ratio of (18:12:10:5)	9,600	6,400	5,334	2,666	24,000
(ii)	(34,800 – 24,000) 10,800 (12:10:5)	—	4,800	4,000	2,000	10,800
(iii)	(37,200 – 34,800) = 2,400 (10:5)	—	—	1,600	800	*1,000
(iv)	(44,000 – 37,000) = 6,800	—	—	—	6,800	NIL
(v)	TOTAL	9,600	11,200	10,934	12,266	—
(vi)	Maximum Liability of Shares Held	18,000 (3,600 × 5)	12,000 (2,400 × 5)	10,000 (2,000 × 5)	5,000 (1,000×5)	— —
(vii)	Amount Paid Lower of (v) and (vi)	9,600	11,200	10,000	5,000	—

[*Rounded off D and E to make amount paid to creditor ₹ 1,000, i.e. ₹ 666 from D and ₹ 334 from E is taken to create this ₹ 1,000]

Total liability of the B List contributories: ₹ 40,800.

Illustration 10.17

Model: B List of contributories

In a winding up of a company, certain creditors remained unpaid. The following persons had transferred their holding sometime before winding up.

Name	Date of Transfer 2010	Number of Shares Transferred	Amount due to Creditors on the Date of Transfer ₹
A	1 January	2,000	15,000
B	15 February	500	25,000
C	15 March	1,400	36,000
D	31 March	1,800	42,000
E	5 April	2,000	60,000

The shares were of ₹ 100 each, ₹ 80 being called up and paid-up on the date of transfers.

A member, F, who held 400 shares died on 28 February 2010, when the amount due to creditors was ₹ 30,000. His shares were transmitted.

G was the transferee of shares held by D. G paid ₹ 20 per share as calls-in-advance immediately on becoming a member.

The liquidation of the company commenced on 1 February 2011 when the liquidator made a call on the present and past contributories to pay the amount.

You are asked to quantity the maximum liability of the transferors of shares mentioned in the above table, when the transferees:

(i) Pay the amount due as "present" member contributories

(ii) Do not pay the amount due as "present" member contributories

Also quantity the liability of FF', to whom the shares were transmitted on the demise of his father F.

[C.A. (Inter). Modified]

Solution

Note:

1. "A" is not liable to pay any amount because the winding up proceedings commenced after one year from the date of transfer.
2. "D" is also not liable because the transferee "G" has paid the balance ₹ 20 per share as calls-in-advance.
3. The remaining members, i.e., B, FF', C and E, are liable, provided the transferees do not pay the calls.
4. FF' to whom shares were transmitted on demise of his father "F" is liable as an existing member contributory as per Section 430. His liability is limited to 400 shares @ ₹ 20 per share.
5. When the transferees pay the amount due as "present" member contributories, there is no liability on the transferors.
6. When the transferees do not pay as "present" members, then the liability arises in the case of "past" members as contributories.

Statement of Liability as Contributories of Former Members

Creditors Outstanding on the Date of Ceasing to be Member		**B** **800** ₹	**F/FF'** **400** ₹	**C** **1,400** ₹	**E** **2,000** ₹	**Amount to be Paid to Creditors** ₹
15 February	₹ 25,000					
	8:4:14:20 (4:2:7:10)	4,348	2,174	7,608	10,870	25,000
28 February	(₹ 30,000 – ₹ 25,000) = ₹ 5,000	—	526	1,842	2,632	5,000
	(4:14:20)					
15 March	(₹ 36,000 – ₹ 30,000) ₹ 6,000	—	632	2,210	3,158	6,000
	(4:14:20)					
5 April	(₹ 60,000 – ₹ 36,000)	—	4,000	—	20,000	24,000
	₹ 24,000					
	(4:20)					
(A):	TOTAL	4,138	7,332	11,660	36,660	60,000
(B): Max. Liability at ₹ 20 per Share on Shares Held		16,000 (800 × 20)	8,000 (400 × 20)	28,000 (14,000 × 20)	40,000 (2,000 × 20)	—
Lower of (A) or (B)		4,138	7,332	11,660	36,660	—

Total of liability of "B" List contributories = 59,790.

10.7 RECEIVER FOR DEBENTURES

A receiver is an independent person appointed by the Court or an individual or a group of individuals to take possession of certain property and receive income. They may be appointed by debenture holders. In such a case, the mortgaged properties of the company given to debenture holders come into the possession of the receiver. The receiver sells these properties, meets his own expenses and remuneration and makes the payment to debenture holders. If the debentures are secured by a floating charge, preferential payments must first be paid before making any payment to debenture holders. Any surplus has to be handed over to the liquidator of the company.

When a receiver is appointed, two statements of accounts will be prepared:

1. To be prepared by the receiver
2. To be prepared by the liquidator

Illustration 10.18

Model: Receiver for debentures

The following is the balance sheet of a public limited company as at 30 September. 2010:

Liabilities		₹	Assets	₹
Share Capital:			Land & Buildings	2,40,000
Issued : 11% Preference			Sundry Current Assets	7,90,000
Shares of ₹ 10 Each		2,00,000	Profit & Loss A/c	77,000
20,000 Equity Shares of ₹ 10 Each Fully Paid-up		2,00,000	Debentures Issue Expenses Not Written Off	4,000
10,000 Equity Shares of ₹ 10 Each, ₹ 7.50 per Share Paid-up		75,000		
13% Debentures		3,00,000		
Mortgage Loan		1,60,000		
Bank Overdraft		60,000		
Creditors for Trade		64,000		
Income Tax Arrears:				
(Assessments Concluded in July 2010)				
Assessment Year:				
2008–09:	₹ 42,000			
2009–10:	₹ 10,000	52,000		
		11,11,000		11,11,000

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 ₹ 3,00,000. He also took charge of sundry assets of the value of ₹ 4,80,000 and realized ₹ 4,00,000. The liquidator realized ₹ 2,00,000 on the sale of the balance of sundry 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. Cost incurred by the receiver was ₹4,000 and that by the liquidator was ₹5,600. The receiver was not entitled to any remuneration but the liquidator was to receive 3% fee on the value of assets realized by him. Preference shareholders had not been paid dividend for the period after 30 September 2008 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.

[C.A. (Inter). Modified]

Solution

(A): Preparation of Receiver's Receipts and Payments A/c

Receiver's Receipts and Payments A/c

Receipts		₹	Payments		₹
Sundry Assets Realized		4,00,000	Cost of the Receiver		4,000
Surplus Received:			Preferential Payments – Creditors: Taxes Raised Within 12 months Paid		52,000
Sale Value of Land & Buildings	3,00,000		Debenture Holders:		
Less: Discharge of Mortgage	1,60,000	1,40,000	Principal	3,00,000	
			Interest for Half Year	19,500	3,19,500
			Surplus—Transferred to the Liquidator		
			(Balancing Figure)		1,64,500
		5,40,000			5,40,000

Calculation of amount receivable from/payable to equity shareholders:

			₹
Step 1:	Total Amount Payable to Preference Shareholders + Arrears of Dividend ₹2,00,000 + ₹11% on ₹2,00,000 for 2 years	=	2,44,000
Step 2:	Less: Balance Available After Paying to Liquidator's Remuneration, Expenses, Unsecured Creditors, etc. (₹3,64,5000 – ₹1,35,600)	=	2,28,900
Step 3:	Amount Payable to Pref. Shareholders	=	15,100
Step 4:	Add: Equity Share Capital: (₹2,00,000 + ₹75,000 (Paid-up)	=	2,75,000
Step 5:	Total Deficiency to Be Borne by 30,000 Shares		2,90,000

Step 6: Deficiency per Equity Share $= \frac{₹2,90,100}{30,000} = ₹9.6$

Step 7: Calculation of Amount Receivable per Share:

(Holders of 10,000 Equity Shares)

Paid-up Value per Share = ₹7.50

Deficiency per Share = ₹9.67

= ₹2.17

∴ Amount Receivable on 10,000 Shares = 10,000 × ₹2.17 = 21,700

Step 8: Amount Returnable (Payable) per Share: (20,000 Equity Shares)

Paid-up Value per Share	=	₹10.00
Less: Deficiency per Share	=	₹9.67
	=	₹0.33

∴ Amount Returnable on 20,000 Shares = 20,000 × ₹0.33
= ₹6,600

(B) Liquidator's Final Statement of Account

Receipts	₹	Payments		₹
Surplus Received from Receiver (Ref: A)	1,64,500	Liquidator's Remuneration		6,000
Assets Realized	2,00,000	Liquidation Expenses		5,600
Call on Contributories	21,700	Unsecured Creditors:		
(Ref: Step 7)		Trade	64,000	
		Directors O/D Clearance	60,000	1,24,000
		Preference Shareholders:		
		Principal	2,00,000	
		Dividend 2 years	44,000	2,44,000
		Equity Shareholders (Ref: Step 8)		6,600
	3,86,200			3,86,200

Summary

Liquidation is a process in which a company is dissolved. A person called liquidator is appointed with whom the task of dissolution of a company is entrusted.

A company may be wound up in any one of the ways:

1. Compulsory winding up—by the Court
2. Voluntary winding up
   (i) Members' voluntary winding up
   (ii) Creditors' voluntary winding up
3. Winding up subject to supervision of Court

Each one is explained in detail

Contributory: "Every person liable to contribute to the assets of the company in the event of being wound up and includes any holder of shares which are fully paid-up".

Adjustment of rights of contributories and accounting treatment of B List contributories—Refer text.

Order of payments:

(i) Secured creditors
(ii) Costs
(iii) Preferential creditors
(iv) Debenture holders having floating charge
(v) Unsecured creditors
(vi) Preference shareholders
(vii) Equity shareholders

Statement of affairs: Statement regarding the affairs of the company in the prescribed form should be submitted to the liquidator. For format and preparation of statement of affairs, refer the text.

Deficit or surplus account: This account explains how the Company incurs loss. For prescribed format and accounting treatment, refer the text.

Liquidator's final statement of account: A document is to be prepared showing receipts and

payments by the liquidator and has to be submitted to the Court. This consists of (i) amounts realized by the liquidator and (ii) payments of various liabilities. For this, calculation of liquidator's remuneration is illustrated in detail. For format and preparation of liquidator's statement of account, refer the text.

Receiver for debenture holders: Preparation of account—Refer Illustration 10.18.

Key Terms

Liquidation of Companies: A process by which a company is dissolved.

Contributory: It refers to any person liable to contribute to the assets of the company in the event of liquidation.

Preferential Creditors: A category of creditors who will be paid prior to any others while liabilities are discharged.

Statement of Affairs: A statement as to affairs of the company to be submitted to the liquidator in the prescribed format with an affidavit of verification.

Deficiency/Surplus Account: An account that explains how the company incurred loss.

Liquidator's Final Statement of Account: A statement of account in the form of cashbook depicting receipts and payments of a company under liquidation, to be prepared by the liquidator.

Receiver for Debenture Holders: An independent person appointed by the Court or debenture holders to take possession of specified property for protective purpose or receive income and profits and apply the same as required.

"B" List of Contributories: List that comprises past members of the company, who have ceased to be members within one year of the commencement of winding up.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. When the company's financial position is good, then such solvent company cannot be liquidated.
2. When a company is unable to commence its business within a year from its incorporation, it can be wound up.
3. Voluntary winding up can be possible only when both the members and creditors of the company agree to it.
4. Declaration of solvency is essential for creditors' voluntary winding up of a company.
5. Contributory may also include holders of fully paid shares.
6. A shareholder can set off any debt due to him from the company against calls made on him for payment of unpaid capital.
7. All wages and salaries payable belong to the category of preferential creditors.
8. Secured creditors mean "fully secured" creditors.
9. Statement of affairs is prepared by the liquidator.
10. Uncalled capital is shown along with the capital in the statement of affairs.
11. If the financial position of the company is sound, then surplus alone will be shown as a not result in the statement of affairs.
12. Supplementary schedules, other than Lists A to G, are also annexed to statement of affairs.
13. The deficiency shown by deficiency account will be equal to the deficiency shown by the statement of affairs.
14. Liquidator's final statement of account is nothing but an account of receipts and payments of the company undergoing liquidation.
15. While calculating the liquidator's remuneration, the preferential creditors are also treated as unsecured creditors.
16. While making payment to debenture holders, the treatment is similar to both categories of debenture holders carrying a fixed charge or a floating charge.
17. Liability relating to dividend declared but not paid will be included in the category of unsecured creditors.
18. A contributory can only be a present member of the liquidated company.

19. The liquidator has a legal right of forfeiting the shares of the defaulters.
20. Interest on liabilities is to be paid up to the date of actual payment if the company is solvent and up to the date of commencement of insolvency if it is insolvent.

Answers:

1. False	6. False	11. True	16. False
2. True	7. True	12. False	17. True
3. False	8. False	13. True	18. False
4. False	9. False	14. True	19. True
5. True	10. False	15. True	20. True

II: Fill in the blanks with apt word(s)

1. Liquidation or winding up is a process by which a company is _____.
2. A person who is entrusted with the job of realizing assets and discharging liabilities in the process of liquidation is called _____.
3. Liquidation may take place under both the cases, when the company is insolvent and when the company is _____.
4. When winding up takes place in a company, the shareholders are called _____.
5. There are two kinds of voluntary winding up. One is members' and the other is _____ voluntary winding up.
6. The liability of a contributory is limited to the _____ value of shares held by him.
7. A past member who has ceased to be a member for at least _____ before the commencement of winding up is not liable to contribute.
8. The first item in the order of payment to be made by the liquidator is _____.
9. A creditor for ₹ 20,000 holding a charge on the stock of the book value ₹ 25,000 (market value ₹ 19,000) is termed as _____.
10. According to Section 530, some creditors have to be paid before any payment is made to any creditors. Such creditors who get priority in the order of payment are called _____.
11. The statement relating to the affairs of the company to be prepared in the prescribed form, verified by an affidavit and submitted to the liquidator is known as _____.
12. "List C" annexed to statement of affairs consists a list of _____.
13. "List _____" is also known as deficiency or surplus account.
14. The amount recoverable on calls-in-arrears is to be shown in "_____".
15. Debentures, unless specifically mentioned otherwise, will ever be treated as having a ____ charge on all the assets of the company.
16. The deficiency shown in deficiency or surplus A/c and the amount of shown in statement of affairs must be the _____ one.
17. A document prepared by the liquidator depicting receipts and payments of the company under liquidation is called _____ of account.
18. Assets not specifically pledged are shown in the statement of affairs at _____ values.
19. If the company is solvent, the interest on liabilities should be paid up to the date of ____.
20. According to Section 205 A, unclaimed dividend should be included in _____.

Answers:

1. dissolved	2. liquidator
3. solvent	4. contributories
5. creditors	6. unpaid
7. 1 year	8. liquidation expenses

9. partly secured creditors
10. preferential creditors.
11. statement of affairs
12. preferential creditors

13. H	14. List A
15. floating	16. same

17. liquidator's final statement of account
18. estimated realizable
19. actual payment of liabilities
20. List E

III: Multiple choice questions—Choose the correct answer

1. Which of the following way is not legally permitted for the liquidation of a company:
   (a) by the Court
   (b) by the order of directors of company
   (c) voluntary winding up by members
   (d) voluntary winding up by creditors
2. Which of the following activity is not entrusted with a liquidator:
   (a) receipts on sale of assets
   (b) payments on liabilities
   (c) forfeiture of shares
   (d) raising resources by mortgage of company's properties

3. A contributory is a
   (a) shareholder (b) creditor
   (c) debenture holder (d) none of these
4. A past member is included as contributory in the
   (a) list of A (b) list of H
   (c) list of B (d) list of C
5. Which of the following is the correct order of payment:
   (a) legal charge, equality shareholders, preferential creditors, secured creditors
   (b) secured creditors, legal charge, preferential creditors, equity shareholders
   (c) preferential creditors, secured creditors, legal charge, equity shareholders
   (d) equity shareholders, legal charge, secured creditors, preferential creditors
6. Which of the following does not belong to the category of preferential creditors:
   (a) taxes to government
   (b) wages and salaries
   (c) commission due 2 years before the commencement of winding up
   (d) amount payable under Workmen Compensation Act
7. Liquidator's final statement of account is in the form of
   (a) receipts and payments A/c
   (b) profit and loss A/c
   (c) balance sheet
   (d) income and expenditure A/c
8. "List A" annexed to statement of affairs consists the list of
   (a) preferential creditors
   (b) unsecured creditors
   (c) assets specifically pledged
   (d) assets not specifically pledged
9. Preferential creditors are shown in the statement of affairs under
   (a) List A (b) List C
   (c) List B (d) List D
10. Liquidator's final statement of account is prepared in the case of
    (a) creditors' voluntary winding up
    (b) compulsory winding up by Court
    (c) members' voluntary winding up
    (d) all of these
11. In the sale proceeds of pledged security is not sufficient to pay off secured creditors fully, the balance is to be added to
    (a) preferential creditors
    (b) preference share capital
    (c) unsecured creditors
    (d) secured creditors
12. The salary of three clerks for a period of 4 months before relevant date was in arrears. If the salary of each clerk is ₹ 8,000 per month, the amount to be included in preferential creditors will be
    (a) ₹ 60,000 (b) ₹ 3,000
    (c) ₹ 96,000 (d) ₹ 24,000
13. The liquidator of a company is entitled to a remuneration of 2% on assets realized and 3% on the amount distributed to unsecured creditors. The assets realized ₹ 2,50,000 including cash balance of ₹ 5,000. Amount available for distribution to unsecured creditors before paying liquidator's remuneration was ₹ 32,960. The liquidator's remuneration will be
    (a) ₹ 5,860
    (b) ₹ 5,988.80
    (c) ₹ 5,900
    (d) ₹ 5,600
14. "Relevant date" means (in the case of compulsory winding up):
    (a) the date of appointment of a provisional liquidator
    (b) the date of winding up order
    (c) both of these
    (d) none of these
15. When a receiver is appointed there will be
    (a) one statement of account prepared the receiver
    (b) one statement of account prepared by the liquidator
    (c) one statement of account prepared by the company's auditor
    (d) two statement of accounts—one prepared by the receiver and the other by the liquidator

Answers:

1. (b)	5. (b)	9. (b)	13. (a)
2. (d)	6. (c)	10. (d)	14. (c)
3. (a)	7. (a)	11. (c)	15. (d)
4. (c)	8. (d)	12. (a)	

Short Answer Questions

1. What do you mean by "liquidation' of a company?
2. Name the various ways that a company can be wound up.
3. On what occasions a company can be wound up compulsorily?
4. When can a company be wound up voluntarily?
5. What is the main difference between members' and creditors' voluntary winding up?
6. Explain: winding up subject to supervision of the Court.
7. Define: contributory.
8. The liability of the contributory is subject to certain limitations. Name any two limitations.
9. How can a liquidator adjust the rights and interests of contributories?
10. Mention the order of payment in the process liquidation.
11. What do you mean by "second creditors"?
12. What are the rights of a secured creditor?
13. Who are "preferential creditors", as per Section 530?
14. Mention any six preferential creditors.
15. Mention any four items included in "unsecured creditors".
16. Explain the term: statement of affairs.
17. Mention the important items that are included in the statement of affairs.
18. Enumerate the lists that are to be annexed to statement of affairs.
19. Explain: deficiency or surplus account.
20. Mention the items that contribute to the deficiency of a company under liquidation.
21. Mention the items contributing to surplus.
22. Who is a "liquidator"? What are his main duties?
23. Explain: liquidator's final statement of account.
24. What do you mean by preferential payments?
25. How can a liquidator's remuneration be determined?
26. Explain the accounting treatment for debenture interest at the time of liquidation.
27. How would you deal with "interest on liabilities"?
28. Explain the treatment of calls-in-advance and calls-in-arrears, when a company is under liquidation.
29. Explain the lists of contributories.
30. Explain the role of receive for debenture holders.

Essay Type Questions

1. What is "liquidation"? Explain the various ways of winding up of a company emplacing the legal provisions in each such case.
2. Who is a contributory? How the rights and interest of contributories will be adjusted? Explain the List A and B List contributories.
3. Who are preferential creditors? Enumerate the various items included under this category?
4. Explain "statement of affairs" with a rough sketch and also explain how it is prepared?
5. Explain "deficiency or surplus account" through specimen of it with emphasis on items contributing to deficiency as well as surplus.
6. What is liquidator's final statement of account? How is it prepared?

Exercises

Part A—For Undergraduate Level

[Model: Liquidator's remuneration]

1. The liquidator of a company is entitled to a remuneration of 2% on assets realized and 3% on the amount distributed to unsecured creditors. The assets realized is ₹ 3,00,000 including a cash balance of ₹ 15,000. Amount available for distribution to unsecured creditors before paying liquidator's remuneration was ₹ 1,29,300. Calculate liquidator's remuneration.

[**Ans:** Liquidator's remuneration on assets realized: ₹ 5,700; On payment to unsecured creditors: ₹ 3,765]

2. The liquidator of AB & Co Ltd. is entitled to get a remuneration of 3% on the amount realized from assets and 2% on the amount distributed to the unsecured creditors from the following particulars. Calculate the remuneration payable.

	₹
Cash Realized from Assets	1,50,000
Preferential Creditors	5,000
Amount due to Unsecured Creditor	2,00,000

[**Ans:** Liquidator's remuneration—On assets realized: ₹ 4,500; On payment to preferential creditors: ₹ 100; On payment to unsecured creditors: ₹ 2,753]

3. The liquidator of a company is entitled to a remuneration of 3% on the amounts realized (excluding cash in hand) and 2% on the amount distributed to the unsecured creditors, including preferential creditors of ₹ 25,000 amounting to ₹ 2,00,000.

Debenture holders were paid ₹ 2,59,375 together with interest preferential creditors were pain in full. Expenses of liquidation came to ₹ 2,550.

Cash on hand was ₹ 5,000, and assets realized ₹ 3,95,000. Calculate the liquidator's remuneration.

[**Ans:** ₹ 14,325]

[Model: Interest payable to debenture holders]

4. Calculate the interest payable to debenture holders from the following information assuming the liquidated company has sufficient cash to pay off all side liabilities:

8% Debentures	₹ 8,00,000
Date of Liquidation	31 December 2010
Date of Repayment of Debentures	30 June 2011
Date Up To Which Interest on Debentures Paid So Far	30 June 2010

[**Ans:** ₹ 64,000]

5. The following information was extracted from the books of a limited company on 31 December 2010:

Equity Share Capital:	₹
12,000 Shares of ₹ 10 Each	1,20,000
6% Preference Share Capital:	
18,000 Shares of ₹ 10 Each	1,80,000
Calls-in-Arrear (Estimated to Prudence ₹ 1,200)	2,400
5% First Mortgage Debentures Secured by a Floating Charge on the Whole of the Assets of the Company (Interest Paid To Date)	1,20,000
Creditors Fully Secured (Value of Securities ₹ 24,000)	21,000
Creditors Partly Secured (Value of Securities ₹ 12,000)	24,000
Preferential Creditors for Wages, Rates, Taxes	4,500
Unsecured Creditors	1,62,000
Bank Overdraft, Secured by a Second Charge on the Whole Assets of the Company	12,000
Cash in Hand	720
Book Debts:	
Good	22,800
Doubtful Debts (Estimated to Produce ₹ 1,800)	4,800
Bad	2,700
Stock in Trade (Estimated to Produce ₹ 36,000)	37,200
Freehold Land & Buildings (Estimated to Produce ₹ 1,11,000)	1,26,000
Plant & Machinery (Estimated to Produce ₹ 37,800)	36,000
Fixtures & Fittings (Estimated to Produce ₹ 4,800)	7,200

Prepare a statement of affairs of the company.

[**Ans:** Estimated deficiency as regards creditors: ₹ 91,380; Estimated deficiency as regards customers (members): ₹ 3,90,180]

6. R. Co. Ltd. went into voluntary liquidation on 1 March 2011.

The following balances are extracted from its books on that date:

Liabilities	₹	Assets	₹
Capital:		Buildings	75,000
25,000 Equity Shares of ₹10 Each	2,50,000	Plant & Machinery	1,05,000
		Stock in Trade	47,500
Debentures (Secured by Floating Charge)	1,00,000	Book Debts	37,500
		Less: Provision	5,000
Bank Overdraft	15,000		32,500
Creditors	20,000	Calls-in-Arrears	50,000
		Cash on Hand	5,000
		Profit & Loss A/c	70,000
	3,85,000		3,85,000

Plant & Machinery and buildings are valued at ₹75,000 and ₹60,000, respectively. On realization, losses of ₹7,500 are expected on stock. Book debts will realize ₹35,000. Calls-in-arrears are expected to realize 90%. Bank overdraft is secured against buildings. Preferential creditors for taxes and wages are ₹3,000 and miscellaneous expenses outstanding are ₹1,000.

Prepare a statement of affairs to be submitted to the meeting of creditors.

[**Ans:** Estimated surplus as regards creditors: ₹1,24,000; Miscellaneous expenses outstanding not a part of creditors shown in the b/s]

[Model: Statement of affairs]

7. Mr. Prem is appointed liquidator of X Ltd in voluntary liquidation on 1 December 2010. Following balances are extracted from the books on that date:

Liabilities	₹	Assets	₹
Share Capital:		Machinery	1,80,000
96,000 Shares of ₹5 Each	4,80,000	Leasehold Properties	2,40,000
Reserve for Bad debts	60,000	Stock in Trade	6,000
		Book Debts	3,60,000
Debentures	3,00,000	Investments	36,000
Bank Overdraft	1,08,000	Calls-in-Arrear	30,000
Liabilities for Purchases	1,20,000	Cash in Hand	6,000
		Profit & Loss A/c	2,10,000
	10,68,000		10,68,000

Prepare a statement of affairs to be submitted in the meeting of the creditors. The following assets are valued as follows:

Machinery: ₹3,60,000; Leasehold properties: ₹4,36,000; Investments: ₹24,000; Stock in trade: ₹12,000; Bad debts: – ₹12,000 and doubtful debts: ₹24,000 which are estimated to realize ₹12,000. The bank overdraft is secured by deposit of title deeds of leasehold properties. Preferential creditors are ₹6,000. Telephone rent outstanding is ₹480.

[**Ans:** Estimated surplus as regards creditors: ₹6,69,520]

Assumptions:

1. Calls-in-arrears realized in full
2. Preferential creditors and telephone rent outstanding are not included in any liability shown in b/s

[Model: Statement of affairs and deficiency account]

8. The following information is extracted from the books of Veer & Co Ltd. on 31 December 2010 on which date a winding up order was passed.

	₹
Unsecured Creditors	1,90,000
Salary Due for 5 months	20,000
Bills Payable	53,000
Debtors:	
Good	2,15,000
Doubtful (Estimated Recovery ₹31,000)	65,000
Bad	44,000
Bills Receivable (Good ₹8,000)	8,000
Bank Overdraft	20,000
Land (Estimated to Produce ₹2,50,000)	1,80,000
Stock (Estimated to Produce ₹2,90,000)	4,10,000
Furniture & Fixtures	40,000
Cash in Hand	2,000
Estimated Liability for Bills Discounted	30,000

First Mortgage Creditors on Land	2,00,000
Second Mortgage Creditors on Land	1,00,000
Wages Unpaid	3,000
Liabilities Under Workmen's Compensation Act	1,000
Income Tax Due	4,000
2,500 9% Debentures of ₹ 100 Each (Interest Paid on 30 June 2010)	2,50,000
Share Capital:	
10,000 10% Preference Shares of ₹ 10 Each	1,00,000
25,000 Equity Shares of ₹ 10 Each	2,50,000
General Reserve on 31 December 2010	50,000

In 2006, the company earned a profit of ₹ 2,25,000 but thereafter it suffered a trading loss totaling ₹ 2,92,000. The company also suffered a loss on account of fire ₹ 25,000 during the year 2007.

Excise authorities imposed a penalty of ₹ 1,75,000 in 2008 for evasion of tax which was paid in 2009.

From the above information, prepare a statement of affairs and a deficiency account.

[**Ans:** Estimated deficiency as regards creditors: ₹ 36,250; As regards contributories ₹ 3,86,250; Unsecured creditors: ₹ 3,45,000]

[Model: Statement of affairs and deficiency account]

9. In January 2011 a compulsory order for winding up was made against a public limited company, the following particulars being disclosed:

	Book Value ₹	Estimated to Produce ₹
Cash in Hand	500	500
Debtors	20,000	18,000
Buildings	3,00,000	2,40,000
Furniture	1,00,000	1,00,000
Unsecured Creditors	1,00,000	—
Debentures:		
Secured on Buildings	2,10,000	
Secured on Floating Charge	50,000	
Preferential Creditors	30,000	
Share Capital: 1,60,000 shares of ₹ 10 Each	16,00,000	

Estimated liability for bills discounted was ₹ 30,000 estimated to rank ₹ 30,000. Other contingent liabilities were ₹ 60,000 estimated to rank ₹ 60,000.

The Company was formed on 1 January 2006 and had made losses of ₹ 15,69,500.

Prepare statement of affairs and deficiency account.

[**Ans:** Deficiency as regards creditors: ₹ 1,21,500; Deficiency as regards contributories: ₹ 17,21,500]

Model: Liquidator's final statement of account]

10. From the following particulars, prepare liquidator's final statement of account.

Capital: ₹ 5,00,000; loss: ₹ 5,57,500, cash: ₹ 5,000; cash received from sale of machinery, stock and collection from debtors: ₹ 3,95,000; 6% secured debentures ₹ 3,00,000; interest due on the above: ₹ 7,500; preferential creditors: ₹ 25,000; unsecured creditors: ₹ 1,75,000; liquidation expenses: ₹ 2,500; liquidator's remuneration to be calculated at 3% on the assets sold and 2% on the amount paid to unsecured creditors.

[**Ans:** Cash paid to unsecured creditors: ₹ 1,00,635; Liquidator's commission (Total): ₹ 14,365]

11. X Ltd. went into liquidation with the following liabilities:

(a) Secured creditor: ₹ 1,00,000 (Securities realized: ₹ 1,25,000)

(b) Preferential creditors: ₹ 3,000

(c) Unsecured creditors: ₹ 1,52,500

Liquidation expenses are ₹ 1,260. Liquidator is entitled to a remuneration of 3% on the amounts realized (including securities with creditors) and 1½% on the amount distributed to unsecured creditors. The various assets realized ₹ 1,30,000 (excluding securities with secured creditors). Prepare the liquidator's final statement of account.

[**Ans:** Payment to unsecured creditors: ₹ 1,40,930; Liquidator's remuneration (Total): ₹ 9,810]

12. The following particulars relate to a limited company which has gone into voluntary liquidation. Yon are required to prepare the liquidator's final account, allowing for his remuneration @ 2% on the amount realized and 2% on the amount distributed among unsecured creditors other than preferential creditors:

	₹
Preferential Creditors	1,20,000
Unsecured Creditors	3,84,000
Debentures	1,20,00

The assets realized the following sums:

Land & Buildings	2,40,000
Plant & Machinery	2,23,800
Fixtures & Fittings	12,000

The liquidation expenses amounted to ₹12,000.

[**Ans:** Liquidator's remuneration: ₹13,716; Amount paid to unsecured creditors: ₹2,10,084]

13. X Ltd. went into liquidation. Its assets realized ₹1,75,000, excluding the amount realized by sale of securities held by the secured creditors. The following was the position:

	₹
Share Capital 5,000 Shares of ₹10 Each	
Secured Creditors (Securities Realized ₹20,000)	17, 500
Preferential Creditors	3,000
Unsecured Creditors	70,000
Debentures Having a Floating Charge on the Assets of the Company	1,25,000
Liquidation Expenses	2,500
Liquidator's Remuneration	3,750

Prepare the liquidator's final statement of account.

[**Ans:** Amount Paid to Unsecured Creditors: ₹43,250]

14. Gama Ltd. went into liquidation on 31 December, 2010.

Following information is available with the liquidator: Sundry creditors amount to ₹1,51,320 of which ₹16,000 are preferential. 6% Debentures carrying floating charge on the assets amounted to ₹1,60,000. Debentures were paid interest up to 30 June 2010. The assets realized as follows:

Stock in trade: ₹1,68,000;

Plant & Machinery: ₹1,20,000

Cash in hand stood at ₹1,000. Debentures were paid off on 30 June of the following year with interest. Liquidator's expenses amounted to ₹3,804 and they were entitled to remuneration at 3% on the amount realized and 2% on the amount distributed to unsecured creditors.

Prepare liquidator's final statement of account.

[**Ans:** Amount paid to unsecured creditors: ₹90,000; Liquidator's remuneration; ₹10,796]

15. The following particulars are related to a company which has gone into liquidation. You are required to prepare liquidator's final statement of account allowing for his remuneration at 2% on the amounts realized on assets and 2% on the amounts distributed to unsecured creditors other than preferential creditors.

	₹.
Unsecured Creditors	6,72,000
Preferential Creditors	2,10,000
Debentures	2,25,000

The assets realized the following amounts:

	₹
Cash in Hand	60,000
Land & Buildings	3,90,000
Plant & Machinery	3,31,500
Furniture & Fittings	22,500

The liquidation expenses amounted to ₹6,000.

A call of ₹2 per share on the partly paid 30,000 equity shares was made and duly paid except in case of one shareholder owning 1,500 shares.

[**Ans:** Liquidator's remuneration: ₹24,000; Amount paid to unsecured creditors: ₹3,96,000]

***Note*:** Calls collection is not taken into account for remuneration.

16. Zeen Ltd. went into liquidation on 31 March 2011 where the following balance sheet was prepared:

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	3,00,000
1,17,000 Equity Shares of ₹ 10 Each	11,70,000	Building	2,88,000
Sundry Creditors:		Machinery	3,93,000
Partly Secured Creditors (Secured on Building)	3,31,860	Stock	3,40,800
Unsecured Creditors	5,98,740	Sundry Debtors	3,88,920
Preferential Creditors	1,45,200	Cash	15,000
Bank Overdraft (Unsecured)	72,000	P&L A/c	5,92,080
	23,17,800		23,17,800

Assets realized as follows:

Building: ₹ 2,10,000; Machinery: ₹ 3,06,000; Stock: ₹ 2,34,000; Sundry debtors; ₹ 3,51,000; Cash: ₹ 5,000

The expenses on liquidation amounted to ₹ 6,000.

The liquidator's remuneration was agreed at $2\frac{1}{2}\%$ on the amount realized (including cash) and 2% on the amount paid to the unsecured creditors.

You are required to prepare the liquidator's final statement of account.

[**Ans:** Amount paid to unsecured creditors: ₹ 7,09,800; Liquidator's remuneration; ₹ 45,000]

17. A company went into liquidation on 30 April 2011. The position of the company on that date was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Machinery	3,20,000
2,00,000 Shares of ₹ 10 Each, ₹ 8 Paid-up	16,00,000	Other Fixed Assets	10,40,00
Land (Secured by Mortgage of Machinery)	4,00,000	Stock	4,20,000
Unsecured Creditors (Including Preferential Creditors ₹ 40,000)	8,00,000	Debtors	4,00,000
		Bills Receivable	1,60,000
		Cash	20,000
		P&L A/c	4,40,000
	28,00,000		28,00,000

Machinery was realized by the secured creditors for ₹ 4,80,000; Other fixed assets realized ₹ 1,60,000; debtors ₹ 80,000; and stock ₹ 40,000; Bills receivable was wholly dishonoured. The liquidator is entitled to a fixed remuneration of ₹ 4,000 plus 2% of the amount paid to unsecured creditors.

Liquidation expenses amounted to ₹ 4,000.

Prepare liquidator's statement of account.

[**Ans:** Amount paid to unsecured creditors: ₹ 7,16,864; Liquidator's remuneration: ₹ 19,136 (Total)]

18. The balance sheet of Blue Sky Ltd. as on 31 September 2010 was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Land & Buildings	1,25,000
4,000 Preference Shares of ₹ 100 Each	4,00,000	Other Fixed Assets	10,00,000
60,000 Equity Shares of ₹ 10 Each	6,00,000	Stock	26,25,000
Bank Loan	20,00,000	Debtors	5,00,000
8% Debentures	5,00,000	Profit & Loss A/c	2,90,000
Interest Outstanding on Debentures	40,000		
Creditors	10,00,000		
	45,40,000		45,40,000

The company went into liquidation on that date. Prepare liquidator's final statement of account after taking into account the following:

(a) Liquidation expenses and liquidator's remuneration amounted to ₹ 15,000 and ₹ 50,000, respectively.

(b) Bank loan was secured by pledge of stock.

(c) Debentures and interest thereon are secured by a floating change of all assets.

(d) Fixed assets were realized at book value and current assets at 80% of book values.

[**Ans:** Preference shareholders get ₹ 20,000]

19. Base & Co. has been appointed liquidator to Abbas Ltd. The balance sheet at the time of liquidation, i.e., 1 January 2011, is given below:

Liabilities	₹	**Assets**	₹
Equity Share Capital (₹ 10)	8,00,000	Fixed Assets	8,00,000
Debentures	4,00,000	Stock	1,00,000
Loans	2,80,000	Sundry Debtors	5,00,000
Creditors	2,00,000	Cash	20,000
		P&L A/c	1,80,000
	16,00,000		16,00,000

Fixed assets are sold for ₹ 4,80,000 to a debenture holder holding ₹ 1,60,000 debentures and cash in received after off. Cash realized from debtors were ₹ 3,20,000 and the liquidation expenses amounted to ₹ 4,000. The liquidator is paid ₹ 4,000 fixed allowance plus 2% commission including cash in hand as remuneration Stock is sold for ₹ 40,000.

Prepare the liquidator's final statement of accounts.

[**Ans:** Payment to equity shareholders: ₹ 38,000; Liquidators remuneration: ₹ 18,000]

20. The capital of Sharma Co. Ltd. was as follows:

(i) 12,000 equity shares of ₹ 100 each, fully paid

(ii) 12,000 equity shares of₹ 100 each, ₹ 80 per share paid-up

(iii) 3,000 preference shares of ₹ 00 each, fully paid

(These shares, under the articles of the company have preference as to capital)

The various creditors amounted in all to ₹ 3,00,000 including the liquidator's remuneration of ₹ 7,500. The liquidator made a call of ₹ 16 per share on the equity shares which were partly paid-up. This was paid in full. The liquidator realized all the assets amounting to ₹ 5,73,000.

Prepare the liquidator's final statement of account.

[**Ans:** Deficiency per share; ₹ 91.25; 12,000 fully paid equity shareholder get ₹ 1,06,500 at ₹ 8.875 per share; 12,000 partly paid-up shareholders get ₹ 58,500 at ₹ 4.875 per share]

21. Akash Ltd. (in voluntary liquidation) has paid of its creditors in full, and the liquidator is in a position to make a return to the shareholders. The position is as follows:

Share capital issued:

2000 Preference shares of ₹ 10 each, fully paid

8000 Equity shares of ₹ 10 each, fully paid

8000 Equity shares of ₹ 10 each, ₹ 8 paid

The Articles of the Company provide that the preference shares shall have priority over the equity shares as to repayment of capital.

The cost of liquidation is ₹ 2,800, creditors amount to ₹ 44,500 and the assets realized are ₹ 74,800. A call of ₹ 2 per share on partly paid equity shares (to adjust the rights of shareholders interest) was duly paid except in the case of one shareholder owning 2,000 shares.

Prepare liquidator's final statement of account.

[**Ans:** Call money received: ₹ 2,000; Amount paid to equity shareholders on 14,000 shares @ ₹ 1.393 per share: ₹ 19,500]

[Model: Piecemeal distribution]

22. You are asked by a liquidator of a company to prepare a statement of account to be placed before the meeting of the shareholders from the following particulars:

Balance Sheet of the Company as on the Date of Liquidation 1 January 2010

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets	2,00,000
20,000 Equity Shares of ₹ 10 Each, ₹ 8 Called Up	1,60,000	Book Debts	1,50,000
5,000 Preference Shares of ₹ 10 Each, ₹ 7 Called Up	35,000	Loss to Date	50,000

Secured Loan from Banks Secured on Buildings and Machinery	75,000		
Trade Creditors	1,30,000		
	4,00,000		4,00,000

The assets were realized as follows:

1 April 2010: Fixed assets: ₹50,000; Book debts: ₹50,000; Expenses paid: ₹2,000

1 June 2010: Fixed assets (Final): ₹1,00,000; Book debts; ₹50,000

1 August 2010: Book debts final payment: ₹25,000

The liquidator is entitled to a commission of 5% on collections from book debts and 2% on the amounts paid to equity shareholders. Prepare the statement on the assumption that disbursements are made in accordance with the law as and when cash is available.

[**Ans:** 1 April 2010— Expenses: ₹2,000; Liquidator's remuneration: ₹2,500; Bank loan: ₹7,338; Trade creditors: ₹38,162

1 June 2010—Liquidator's remuneration: ₹2,500 + ₹59; Trade creditors paid: ₹91,838; Pref. share capital in full and equity shareholders: ₹2,941.

1 August 2010—Liquidator's remuneration: ₹1,250 + ₹461; Equity shareholders get ₹ 23,285]

23. ABC Ltd. went into voluntary liquidation on 1 January 2011. The liquidation gets remuneration at 3% on assets realized and 2% on distribution among shareholders. From the following particulars prepare liquidator's final statement.

	₹
Assets Realized	10,00,000
Expenses of Liquidation	18,000
Unsecured Creditors	1,24,000
Salary and Wages Outstanding	12,000
10,000, 6% Preference Share Capital	
Dividend Paid Up To 31 December 2009	3,00,000
20,000 Equity Share Capital	1,80,000
General Reserve as on 31 December 2009	2,40,000
P&L A/c as on 31 December 2009	40,000

Under the Articles of Association of the company, the preference shareholders have the right to receive one-third of the surplus remaining after paying the equity share capital.

[**Ans:** Preference shareholders: ₹4,18,666;

Equity shareholders: ₹3,81,334;

Liquidator's remuneration: ₹ 46,000]

24. Dua & Co. Ltd. went into voluntary liquidation on 1 January 2010. The dividend on its preference shares had not been paid for 2 years.

The subscribed capital of the company was 5,000 6% cumulative preference shares of ₹10 cash, fully paid. (They were preferential for both dividend and capital); 40,000 ordinary shares of ₹10 each (₹6.25 per share called and paid); 7,500 ordinary shares of ₹10 each (₹7.50 per share called and paid)

The assets realized ₹1,31,375, the cost of liquidation was ₹5,750 and liabilities were ₹1,10,000.

Prepare the statement of account assuming the liquidator made the necessary calls, received all the money due and that the outstanding dividend was not payable.

[**Ans:** Deficiency for preference shareholders: ₹34,375

Equity shareholders holding 40,000 shares will pay at ₹0.9211 per share ₹36,844

Equity shareholders holding 7,500 shares will receive at ₹0.3289 per share ₹2,466]

[Model: Receive for debenture holders]

25. The following is the balance sheet of X Ltd. as at 30 June 2010:

Liabilities	₹	**Assets**	₹
Issued Share Capital:		Sundry Assets	2,39,500
500 7% Preference Shares of ₹100 Each Fully Paid	50,000	Buildings	50,000
		Preliminary Expenses	5,000
		P&L A/c	16,750

750 Equity Shares of ₹100 Each, ₹95 Paid	71,250		
5% Debentures	1,00,000		
Loan on Mortgage	40,000		
Bank A/c	12,500		
Creditors Included ₹27,500 for the Assets Tax	37,500		
	3,11,250		3,1,250

The mortgage was secured on the buildings and debentures were secured by a floating charge on the "sundry assets". The debenture holders appointed a receiver who took charge of the sundry assets amounting to ₹1,57,500. A liquidator was also appointed as the Company went into voluntary liquidation. The receiver realized the assets for ₹1,47,500 and his costs and remuneration were ₹750 and ₹1,000, respectively. ₹45,000 was realized from buildings and ₹72,500 from the sale of remaining sundry assets. The bank had the guarantee of the directors amounting to ₹11,000 which was duly honoured by them. The cost of liquidation was ₹1,500 and the liquidator's remuneration amounted to ₹625. Prepare the receiver's receipts and payments account and liquidator's final statement of account.

[**Ans:** Surplus transferred to liquidator: ₹23,250; Equity shareholders will get; ₹21,125, i.e., @ ₹14.08 per share]

Exercises

Part B—For Advanced Level

26. Bad Luck Ltd. went into voluntary liquidation and the proceedings commenced on 2 July 2010. Certain creditors could not receive payment out of the realization of assets and out of the contribution from the contributories of "A" List. The following details of share transfers are made available:

Name of the Transferor Shareholder	Number of Shares Transferred	Date of the Transfer Ceasing to Be a Member	Creditors Remaining Unpaid and Outstanding at the Time of Transfer Ceasing to Be a Member ₹
(i) L	3,000	1 March 2009	18,000
(ii) M	3,750	15 August 2009	24,000
(iii) N	1,500	1 October 2009	32,250
(iv) O	6,000	1 December 2009	39,000
(v) P	750	1 April 2010	45,000

All the shares were of ₹10 each, on which ₹5 per share had been paid-up. Ignoring other details like liquidator's expense, etc., you are required to work out the liability of the individual contributories listed above.

[C.A. (Inter). Modified]

[**Ans:** L does not come under the list; M, N, O and P are liable for ₹7,500, ₹4,500, ₹24,000, and ₹2,750, respectively]

27. Karat Co. Ltd. went into voluntary liquidation on 1 March 210. The following balances are extracted from its books on that date:

Liabilities	₹	Assets	₹
Capital	2,50,000	Buildings	75,000
25,000 Equity Shares of ₹10 each		Plant & Machinery	1,05,000
		Stock in Trade	47,500
Debentures (Secured by a Floating Charge)	1,00,000	Book Debts 37,500 Less: Provision	
Bank Overdraft	15,000	5,000	32,500
Creditors	20,000	Calls-in-Arrears	50,000
		Cash in Hand	5,000
		P&L A/c	70,000
	3,35,00		3,35,000

Plant & Machinery and buildings are valued at ₹75,000 and ₹60,000, respectively. On realization, losses of ₹7,500 are expected on stock. Book debts will realize ₹35,000. Calls-in-arrears are expected to realize 90%. Bank O/D is secured against buildings.

Preferential creditors for taxes and wages are ₹3,000 and miscellaneous expenses outstanding ₹1,000. Prepare a statement of affairs to be submitted to the meeting of creditors.

[C.A. (Inter). Modified]

[**Ans:** Deficiency as regards contributories: ₹1,25,000]

28. X Ltd. went into liquidation on 31 March 2011, when its position was as follows:

Liabilities	₹	**Assets**	₹
40,000 Equity Shares of ₹10 Each, ₹8 per Share Called Up: ₹3,20,000		Factory Shed (₹1,00,000)	1,40,000
		Plant & Machinery (₹1,70,000)	2,00,000
Less: Calls-in-arrear	3,10,000	Furniture (₹14,000)	24,000
	10,000		
11% Preference Shares of ₹100 Each Fully Paid	2,00,000	Investments (₹36,000)	40,000
13% Debentures (Secured by a Floating Charge on All Assets Other than Calls-in-Arrear	1,50,000	Stock (₹1,10,000)	1,30,000
		Debtors (₹3,00,000)	3,70,000
		Cash	20,000
Bank Overdraft (Secured Against Hypothecation of Stock)	80,000	Preliminary Expenses	16,000
		P&L A/c	2,00,000
Loan from ICICI (Secured by a Second Charge on Stock and a First Charge on Plant & Machinery)	2,00,000		
Trade Creditors	1,20,000		
Outstanding Expenses	80,000		
	11,40,000		11,40,000

Contingent liabilities:

(i) Preference dividends ₹44,000

(ii) Bills discounted ₹30,000

Estimated realizable value of assets have been indicated in brackets. Three years earlier, the company had a general reserve of ₹30,000. The company earned a profit of ₹60,000 for one of the three years. ₹50,000 had been paid as income tax in this period and a dividend of 10% on equity shares paid in one of the years. For another year, the Company incurred a loss of ₹1,60,000.

₹9,000 out of the outstanding expenses is preferential. Bills discounted on likely to be dishonoured ₹16,000. Prepare statement of affairs and deficiency account on the basis that the Company decides on a voluntary liquidation.

[I.C.W.A. (Final). Modified]

[**Ans:** Deficiency as regards contributories: ₹4,50,000]

29. The following is the balance sheet of X Ltd. As at 30 September 2010:

Liabilities	₹	**Assets**	₹
Share Capital:		Land & Buildings	3,60,000
Issued:		Sundry Current Assets	11,85,000
11% Preference Shares of ₹10 Each	3,00,000	P&L A/c	1,15,500
30,000 Equity Shares of ₹10 Each, Fully Paid-up	3,00,000	Debenture Issue Expenses Not Written Off	6,000
15,000 Equity Shares of ₹10 Each, ₹7.50 per Share Paid-up	1,12,500		
13% Debentures	4,50,000		
Mortgage Loan	2,40,000		
Bank Overdraft	90,000		
Creditors for Trade	96,000		
Income Tax Arrears:			

(Assessment Concluded in July 2010) Assessment Year 2008–09 ₹63,000 Assessment Year 2009–10 ₹15,000	78,000		
	16,66,500		16,66,500

Mortgage loan was secured against land and buildings. Debentures were secured by a floating change 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 ₹4,50,000. He also took charge of assets of the value of ₹. 7,20,000 and realized ₹6,00,000. The liquidator realized ₹3,00,000 on the sale of the balance of sundry current assets. The Bank overdraft was secured by a personal guarantee of two 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 ₹6,000 and by the liquidator ₹8,400. The receiver was not entitled to any remuneration but the liquidator was to receive 3% fee on the value of assets realized by him. Preference shareholders had not been paid dividend for the period after 30 September 2008 and the interest for the last half-year was due to the debenture holders. Prepare the accounts to be submitted by the receiver and the liquidator.

[C.A. (Inter). – Modified]

[**Ans:** Surplus transferred to the liquidator: ₹2,46,750; Return of money to holders of 30,000 shares @ 0.33; ₹9,900]

30. The Sundry Vally Mining Co. Ltd. went into voluntary liquidation on 1 April 2011, as its mines reached such a state of depletion that it became too costly to excavate further minerals. The liquidator, whose remuneration is 3% on realization of assets and 2% on distribution among the shareholders, realized all the assets. The following was the position of the company on 31 March 2011:

	₹
Cash on Realization of Assets	15,00,000
Expenses of Liquidation	27,000
Unsecured Creditors (Including Salaries and Wages for One Month Prior to Liquidation ₹18,000)	2,04,000
4,500 14% Preference Shares of ₹100 Each Dividend Paid Up To 31 March 2010	4,50,000
30,000 Equity Shares of ₹10 Each, ₹9 per Share Called and Paid-Up	2,70,000
General Reserve as on 31 March 2011	3,60,000
Profit & Loss A/c as on 31 March 2011	60,000

Under the Articles of Association of the Company, the preference shareholders have the right to receive one-third of the surplus remaining after repaying the equity share capital.

[**Ans:** Preference shareholders receive ₹6,51,999; Equity shareholders receive ₹5,48,001]

31. The following particulars were extracted from the books of X Ltd. on 31 April 2011, the day on which a winding up order was made:

	₹
Equity Share Capital:	
1,00,000 Shares of ₹10 Each, ₹5 Paid-up	5,00,000
14% Preference Share Capital:	
1,00,000 Shares of ₹10 Each, Fully Paid	10,00,000
14% First Mortgage Debentures, Secured by a Floating Charge Up on the Whole Assets of the Company, Exclusive of the Uncalled Capital	7,50,000
Fully Secured Creditors (Values of Securities: ₹1,75,000)	1,50,000
Partly Secured Creditors (Values of Securities: ₹50,000)	1,00,000
Preferential Creditors, for Taxes, Rates, Wages, Etc.	30,000
Bills Payable	5,00,000

Unsecured Creditors	3,50,000
Bank Overdraft	50,000
Bills Receivable in Hand	75,000
Bills Discounted (One Bill for ₹ 50,000 Known to be Bad)	2,00,000
Book Debts: – Good	50,000
–Doubtful (Estimated to Produce 50%)	35,000
–Bad	30,000
Land & Building (Estimated to Produce ₹ 5,00,000)	7,50,000
Stock in Trade (Estimated to Produce ₹ 2,00,000)	2,50,000
Machinery, Tools, Etc. (Estimated to Produce ₹ 10,000)	25,000
Cash in Hand	500

Make out (i) statement of affairs as regards creditors and contributories and (ii) deficiency account.

[C.A. (Final). Modified]

[**Ans:** Deficiency as regards creditors: ₹ 9,00,000; Deficiency as regards contributories: ₹ 24,02,000; Prepare b/s also → excess of liabilities and capital over assets: ₹ 18,99,500]

32. In a winding up which commenced on 15 September 2010, certain creditors could not receive payments out of the realities of assets and out of contribution from "A" List of contributories. Following are the details of certain share transfers that took place prior to liquidation and its amount creditors remain unpaid:

Name of the Share-holders trans-ferred	Num-ber of Shares	Date when Ceased to be Member	Creditors Remaining Unpaid and Out-standing on the Date of Ceasing to be a Member ₹
P	10,000	31 De-cember 2010	40,000
Q	9,000	20 Sep-tember 2010	60,000
R	6,000	15 No-vember 2010	87,000
S	5,000	22 April 2011	93,000
T	2,500	10 July 2011	1,10,000

All the shares were of ₹ 10 each, on which ₹ 5 per share had been caused and paid-up. Ignoring expenses of liquidation, remuneration to liquidator, etc., work out the amount to be realized from the above contributories.

[C.A. (Inter). Modified]

[**Ans:** P does not come under List "B". Q, R, S and T are liable for ₹ 24,000, ₹ 28,000, ₹ 25,000 and ₹ 12,500, respectively]

Internal Reconstruction 11

LEARNING OBJECTIVES

After studying this chapter you should be able to understand:

1. The nature of internal reconstruction.
2. The need for internal reconstruction.
3. Sections 94 to 97 of the Companies Act relating to alteration of share capital.
4. Sections 100 to 105 of the Companies Act with respect to reduction of share capital.
5. Section 106 relating to variation of shareholders' rights.
6. Section 391 to 393 and Section 394A of the Companies Act pertaining to compromise/ arrangement.
7. Significance of surrender of shares.
8. The accounting entries for the methods of reconstruction.
9. The construction of balance sheet after internal reconstruction.
10. The preparation of reconstruction account.
11. The important key terms associated with "internal reconstruction".

Nowadays, companies have been constantly engaged in restructuring their financial structure to effect economy and enhance profitability. Of the many devices adopted by them, reconstruction is one such device to achieve the desired goal. During such reorganization process, if the task is accomplished without liquidating the company, it is referred to as "internal reconstruction". It is primarily concerned with creating a robust financial position of a company. It brings forth a true, fair and real value of assets through which the true financial position of a company can be projected. In this chapter, the need and various methods employed for internal reconstruction are discussed in detail.

11.1 NEED FOR INTERNAL RECONSTRUCTION

1. **True and fair view of financial position**: A company may be incurring losses for several years. In such cases, the financial position cannot reflect a true and fair view. Hence, it necessitates reorganization in order to disclose the actual financial position of an enterprise.
2. **Value of assets**: On a careful analysis, it may reveal that such continuous loss-making companies consist either overvalued tangible assets or insignificant intangible assets. To get rid of these unreal values of assets, they should be updated to their real values by way of reconstruction.

3. **External liabilities**: External liabilities include loan, payment of preference dividends, debentures, etc. These cannot be discharged on stipulated and specified time. These have to be reduced to a great extent to maximize profitability through reorganization.
4. **Share capital**: The capital figure (i.e., the value of net assets) is not reliable as it tends to show a higher figure than the real figure due to various factors such as overvalued tangible assets, idle and valueless intangible assets and fictitious assets, and outstanding liabilities not discharged on maturity date. Because of this, the share capital of such loss-incurring companies will not reflect the real and fair value of the net assets of the company. To set right this sort of over capitalization, reconstruction is of vital importance.
5. **Remedial measure**: If proper reorganization does not take place, it will lead to total disaster. To escape from such a scenario, reconstruction is necessary. To a certain extent, reconstruction is remedy to avoid unforeseen disaster to companies. Proper diagnosis and reorganization may alleviate such evils.

11.2 METHODS OF INTERNAL RECONSTRUCTION

The following are the methods employed for internal reconstruction:

1. Alteration of share capital
2. Reduction of share capital
3. Compromise/arrangement as per Sections 391 to 394(A)
4. Variation of shareholder's rights
5. Surrender of shares
6. Cancellation of unissued shares

11.2.1 Alteration of Share Capital

Under this method, alteration of share capital involving increase, consolidation or sub-division of share capital is done according to Section 94, 95 and 97 of the Companies Act.

Alteration will not involve reduction of share capital. Any public limited company can alter the capital clause of its Memorandum of Association (i) if it is authorized by its Articles of Association to carry out alteration and (ii) by an ordinary resolution passed in its general meeting. Alteration of share capital can be carried out in the following ways:

11.2.1.1 Increase of Share Capital

A company may increase its share capital by issuing new shares:

Accounting Entries:	(Full Amount Payable on Application)		
(i) Bank A/c	Dr.	…	
To Share Application & Allotment A/c			…
(ii) Share Application & Allotment A/c	Dr.	…	
To Share Capital A/c	.		…

11.2.1.2 Consolidation of Shares

In this type, the existing shares of lower denomination are converted into shares of higher denomination.

Accounting Entry:

Share (Equity or…. % Preference) Capital A/c	Dr.	…	
To Share (Equity or ……% Preference) Capital A/c			…

Example: A company having 1,00,000 12% preference shares of ₹ 10 each decided to consolidate the shares into shares of ₹ 100 each. Pass the needed journal entry.

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	12% Preference Share Capital (1,00,000 × ₹ 10) Dr. To 12% Preference Share Capital (10,000 × ₹ 100) (Consolidation of 1,00,000 Pref. Shares of ₹ 10 into 10,000 Preference Shares of ₹ 100 Each)		10,00,000	10,00,000

One should note here that the paid up share capital remains the same, i.e. ₹ 10,00,000 only, but total number of shares is reduced to 10,000 from 1,00,000 shares. The face value of shares is increased from ₹ 10 to ₹ 100.

Care should be taken in case of partly paid shares to keep the proportion between the paid-up and unpaid amount at the same level after consolidation.

Example: A company with a subscribed capital of ₹ 1,00,000 divided into 10,000 equity shares of ₹ 10 each on which ₹ 6 per share are paid up. The company decides to consolidate equity shares of ₹ 10 each into ₹ 100 each. Pass the journal entry.

Accounting Entry:

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c (10,000 × ₹ 6) Dr. To Equity Share Capital A/c (1,000 × ₹ 60) (Consolidation of 10,000 Equity Shares of ₹ 10 Each (₹ 6 Paid up) into 1,000 Equity Shares of ₹ 100 Each (₹ 60 Paid up)		60,000	60,000

Note: After consolidation, there is no change in the paid-up share capital i.e. ₹ 60,000. But the number of shares and its face value have changed. Paid-up value is also increased proportionately from ₹ 6 to ₹ 60.

11.2.1.3 Conversion of Fully Paid Shares into Stock

In this case, all or any of its fully paid shares may be converted into one unit of stock.

Example: A company decided to convert its 10,000 equity shares of ₹ 10 each into ₹ 1,00,000 equity stock. Pass the entry.

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Capital A/c Dr. To Equity Stock A/c (Conversion of 10,000 Equity Shares of ₹ 10 Each Fully Paid up into ₹ 1,00,000 Equity Stock (One Unit)		1,00,000	1,00,000

11.2.1.4 Reconversion of Stock into Shares (Fully Paid up)

Stock (of one unit) may be converted into shares.

Example: ₹ 1,00,000 equity stock is converted into 1,000 equity shares of ₹ 100 each fully paid. Pass the entry.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Capital A/c Dr. To Equity Share Capital A/c (₹ 1,00,000 Equity Stock Is Converted into 1,000 Equity Shares of ₹ 100 Each)		1,00,000	 1,00,000

11.2.1.5 Sub-division of Shares

A company may sub-divide its shares of higher denomination into shares of smaller denomination.

Example: A company has 5,000 equity shares of ₹ 100 each. It decides to sub-divide these shares into ₹ 10 each. Pass the required journal entry:

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Capital A/c Dr. To Equity Share Capital A/c (₹ 100) (5,000 Equity Shares of ₹ 100 Each Sub-divided into 50,000 Shares of ₹ 10 Each)		5,00,000	 5,00,000

Paid-up capital remains unaffected whereas the face value of shares is reduced and the number of shares is increased.

11.2.1.6 Cancellation of Unissued Shares

Shares which have not been issued (till date) by the company are cancelled. These unissued shares are neither taken by any person nor agreed to be taken by any one.

On cancellation of unissued shares, the amount of share capital will be reduced to that extent that it only results in diminution of authorized share capital and it does not mean reduction share capital.

Example: A limited company has an authorized capital of ₹ 10,00,000 and issued capital of ₹ 7,50,000. It decides to alter its authorized capital (for unissued shares cancelled) to ₹ 7,50,000 and issued capital to ₹ 7,50,000.

There is no accounting entry for any cancellation of unissued shares. The reduced authorized capital is to be shown in the balance sheet of next accounting year only.

11.2.2 Capital Reduction

A Company can reduce its share capital as per the provisions of the Companies Act. Sections 100 to 105 of the Act laid down certain provisions with respect to reduction of capital. The following is the procedure to be followed for effecting reduction of share capital:

1. There should be a specific clause relating to reduction of share capital in the Articles of Association.
2. In case the articles of association are silent on this matter, a special resolution has to be passed to effect reduction of share capital in the general meeting.
3. Court order has to be obtained for any reduction in share capital. (It should be observed here that for alteration of share capital, court permission is not necessary.)
4. A copy of special resolution in reduction of share capital and the order of confirming such reduction must be filed with the Registrar of Companies.

11.2.2.1 Accounting Treatment for Capital Reduction

Reduction of share capital may take place in more than one form.

Form 1: Reducing the liability or extinguishing entirely the liability of the shareholders with respect to uncalled or unpaid amount.

When the uncalled amount of the share capital is reduced or entirely extinguished, the shareholders will be exempted from paying that amount to that extent in future. The shareholders are benefitted by such form of reduction of share capital.

Example: A company whose capital consists of 1,000 shares of ₹ 100 each, ₹ 75 called and paid, decides to reduce the shares into 1,000 shares of ₹ 75 each fully paid. Pass journal entry.

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Share Capital A/c (1,000 × ₹ 75)		75,000	
	To Share Capital A/c			75,000
	(Conversion of 1,000 Shares of ₹ 100 Each ₹ 75 (Partly) Paid up into 1,000 Shares of ₹ 75 Each Fully Paid up)			

Net result: (i) Reduction in nominal value; (ii) No reduction in paid-up value.

Form 2—Refunding surplus capital: At times, some companies may be confronted with the problem of excess capital. Hence the company is forced to refund the excess capital to its members. The members will raise vehement objections because it will affect the security enjoyed by the creditors. Such a scheme of capital requiring the refund of surplus capital needs the approval of the Court.

(i)	Share Capital A/c	Dr. …		(With the Amount to
	To Sundry Shareholder's A/c		…	Be Refunded)
(ii)	Sundry Shareholders' A/c	Dr. …		(With the Amount
	To Bank A/c		…	Actually Refunded)

Example: A company whose paid-up capital includes 5,000 equity shares of ₹ 100 each fully paid decides to return ₹ 25 per share to the members, this reducing each share to ₹ 75 each, fully paid. Pass entries.

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)	Equity Share Capital (₹ 100) A/c Dr.		5,00,000	
	To Equity Share Capital (₹ 75) A/c			3,75,000
	To Sundry Shareholders' A/c			1,25,000
	(Conversion of 5,000 Shares of ₹ 100 Each into Shares of ₹ 75 Each and the Balance to Be Refunded Transferred to the Members)			
(ii)	Sundry Shareholders A/c Dr.		1,25,000	
	To Bank A/c			1,25,000
	(Refund of Surplus Capital on Account of Reduction of Capital to the Shareholders)			

Net result: The share capital of the company will be reduced by the amount refunded. In this problem, the share capital is reduced from ₹ 5,00,000 to ₹ 3,75,000 because of the refund of ₹ 1,25,000 to the shareholders.

Form 3—Reducing the paid up capital (Writing off of lost capital not represented by assets): The share capital of the company which has been facing losses for a considerable period, usually continuously for a long period, may not be truly represented by the assets. The extent of loss will also get reflected in the form of goodwill, over-valuation of assets, etc. Hence, in the scheme of capital reduction, it is essential to write off or cancel that portion of capital which is already lost, not represented by assets accounting treatment.

A new account—reconstruction A/c or capital reduction A/c—has to be opened. The amount of reduction has to be credited to this account. This scheme of capital reduction may be carried out in the following two situations:

Situation 1—Reduction in the paid-up value and nominal value: In this case, the nominal value of the shares and the paid-up value is reduced.

Example: In a limited company, the shareholders agree to reduce the paid-up capital of ₹ 100 per share (10,000 shares) to fully paid shares of ₹ 60 per share. Pass entries.

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c (₹ 100) Dr.		10,00,000	
	To Equity Share Capital A/c (₹ 60)			6,00,000
	To Reconstruction A/c			4,00,000
	or			
	To Capital Reduction A/c			
	(Conversion of 10,000 Shares of ₹ 100 Each Into Shares of ₹ 60 Fully paid, and the Balance Transferred to Reconstruction A/c or Capital Reduction A/c)			

Situation 2—Reduction in the paid-up value only: In this case, the nominal value of the shares remains the same. But the paid-up value is reduced.

Example: A company decides to reduce ₹ 30 per share on its 50,000 equity shares of ₹ 100 each fully paid. Pass the required journal entry.

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c Dr.		15,00,000	
	To Reconstruction A/c			15,00,000
	(Reduction of ₹ 30 per Share on 50,000 Shares of ₹ 100 Each as per Capital Reduction Scheme)			

11.2.3 Compromise and Arrangement

The scheme of compromise and arrangement is a kind of agreement between a company, its members and outside creditors. They agree to give up their claims. This scheme involves sacrifices by shareholders and creditors. This is dealt with in the Sections 390 to 396(A) of the Companies Act. There are many ways in such a scheme of compromise and arrangement as follows:

(i) When equity shareholders give up their claims to the reserves and accumulated profits (Sacrifice their amount due to company's financial crisis):

Accounting Treatment:

Reserves A/c	Dr.	…	{With the Amount of Reserves}
To Reconstruction A/c			…

(ii) When there is appreciation in the value of assets on revaluation:

Entry:

Fixed Assets A/c	Dr.	…	
To Reconstruction A/c			…

(iii) When there is profit on sale of fixed assets:

During internal reconstruction scheme, some fixed assets may be sold to meet the external liabilities. Profit arises on sale of fixed assets is to be credited to capital reduction A/c or reconstruction A/c.

Entry:

Fixed Assets A/c	Dr.	…	
To Reconstruction A/c			…

(iv) Outside liabilities settled at a lesser amount:

Creditors, debenture holders and others (external liabilities) may accept less amount instead of their original claim (waiting for a long period for final settlement). This difference (sacrifice) between the original claim and agreed amount is to be credited to reconstruction A/c.

Entry:

Outside Liabilities A/c	Dr.	…	
Provisions A/c	Dr.	…	
To Reconstruction A/c			…

(v) Payment of outside liabilities:

All the outside liabilities will have to be paid in any one of the following forms to settle their claims: cash, shares, new debentures, assets of the company.

Entry:

Outside Liabilities A/c	Dr.	…	
To Bank A/c			… (In Cash)
To Share Capital A/c			… (In Cash)
To New Debenture A/c			… (In Cash)
To Assets A/c			… (In Cash)

(vi) Preference dividend:

Case I: Dividend declared (Shown in b/s) but sacrificed:

Entry:

Proposed Preference Dividend A/c	Dr.	…	
To Reconstruction A/c			…

Case II: Arrears of dividend (not shown in b/s) but paid now:

Entry:

Reconstruction A/c	Dr.	…	
To Bank A/c			…

Case III: Dividend neither declared nor paid:

No Entry

11.2.4 Variation of Shareholders' Right

Limited companies issue various classes of shares with different rights. Some of such rights attached to the shares are voting rights, rights as to dividend, repayment of capital. The companies may change rate of dividend (on preference shares), cumulative preference shares into non-cumulative preference shares. These changes can be carried out without change in the amount of share capital.

Accounting Treatment:

(i) Entry for Reduction in the Rate of Dividend:

10% Cumulative Preference Share Capital A/c	Dr.	…	
To 9% Cumulative Preference Share Capital A/c			…

(10% Cumulative Pref. Shares Are Changed into 9% Cumulative Preference Shares)

Net result: Rate of dividend is changed from 10% to 9%. But there is no change in the amount of share capital.

(ii) Entry for Change from Cumulative to Non-cumulative Preference Share:

10% Cumulative Preference Share Capital A/c	Dr.	…	
To 10% Non-cumulative Pref. Share Capital A/c			…

(10% Cumulative Pref. Share Is Changed into 10% Non-cumulative Pref. Shares)

Net result: Only the right to dividend is changed from cumulative to Non-cumulative. But there is no change in the rate of dividend and the amount of share capital.

11.2.5 Surrender of Shares

During internal reconstruction, the shareholders may be asked to surrender their shares. In order to reduce the liabilities of the company, such surrendered shares are allotted to debenture holders and creditors. The balance, if any, i.e. the unutilized surrendered shares, is then cancelled.

11.3 HANDLING OF RECONSTRUCTION ACCOUNT

The primary aim of reconstruction is to show the true value of assets, liabilities and share capital of the company. The reconstruction A/c is to be utilized in the following ways one by one:

(i) Fictitious assets and intangible assets to be written off:

The first task of internal reconstruction is to write off the fictitious assets and intangible assets from the books of accounts of the sick companies. Miscellaneous expenditures and P&L A/c debit balance are some fictitious assets. Invaluable patents, copyrights, trade marks, goodwill are some examples of intangible assets.

Account Treatment:

Entry:

Reconstruction A/c	Dr.	…	
To Fictitious Assets (Individually)			…
To Intangible Assets (Individually)			…

(ii) Overvalued fixed assets and current assets to be lowered down:

The next step in the task of internal reconstruction is to bring down the particular assets to their correct values. This is done with the help of the following entry:

Entry:

Reconstruction A/c	Dr.	….	
To Fixed Assets A/c (Individually)			…
To Current Assets A/c (Individually)			…

Note: Only the amount of reduction is to be entered here.

(iii) New liability & new provisions to be brought into books of account:

Some liabilities would not have been recorded. Some items may have to be treated as new liabilities. A new provision will have to be created during the course of internal reconstruction. Some unrecorded liability and provisions must be recorded now:

Entry:

Reconstruction A/c	Dr.	…	
To Liability A/c (Individually)			…
To Provision A/c (Individually)			…

In case, if unrecorded liability is paid in cash, entry will be:

Reconstruction A/c	Dr.	…	
To Bank A/c			…

(iv) Reconstructions expenses:

All the expenses that are incurred in this process of internal reconstruction should be entered as:

Reconstruction A/c	Dr.	…	
To Bank A/c			…

(v) Transfer of credit balance to capital reserve A/c:

Finally, the reconstruction account thus prepared has to be balanced like any other ledger accounts. In case, if there is credit balance (more sacrifice than write offs), it should be transferred to capital reserve A/c.

Entry:

Reconstruction A/c	Dr.	…	
To Capital Reserve A/c			…

With this entry, the scheme of internal reconstruction comes to an end, from the accounting point of view.

11.3.1 Specimen of Reconstruction Account

Particulars	₹	Particulars	₹
P & L A/c (Loss Written off)	...	Share Capital Account (Reduction in Paid-up Value)	...
Intangible Assets Account (Useless Intangible Assets Written off—Individually)	...	Debentures Account (Amount of Reduction)	...
Miscellaneous Expenditures (Written off—Each Expense Individually)	...	Creditors Account (Amount of Sacrifice)	...
Discount on Issue of Shares (Written off)	...	Fixed Assets Account (Increase in Value)	...
Discount on Issue of Debentures (Written off)	...	Current Assets Account (Increase in Value)	...
Fixed Assets A/c (Decrease in Value—Individually)	...	Bank Account (Sale Amount of Unrecorded Assets)	…
Current Assets A/c (Decrease in Value—Individually)	...	Reserves Account	…

Provision for Doubtful Debts	...	Provisions Account (To the Extent Not Required)	...
Bank Account (Unrecorded Liability—Paid)	...		
Bank Account (Arrears of Pref. Dividend—Paid)	...		
Bank Account (Reconstruction expenses—Paid)	...		
New Liability Account	...		
Bank Account (Directors' Fees Refunded)	...		
Capital Reserve A/c (If Any)	...		
(Bal. Fig.)			
	xxx		xxx

The next stage is the preparation of balance sheet.

11.4 BALANCE SHEET AFTER RECONSTRUCTION

The factors that should be taken into account while preparing the balance sheet after the completion of internal reconstruction are as follows:

1. The words "And Reduced" must be added to the name of the company. This should be continued for certain accounting period as ordered by the court.
2. (i) The revised appreciated values of the assets on the date of internal reconstruction must be shown in the balance sheet. The book values should be ignored.
   (ii) The amount of increase in the value of assets on account of revaluation should be shown in the balance sheet.
   (iii) The revised lower figures, i.e., original cost-depreciation should be shown instead of book values.
3. (i) For fixed assets, the amount written off should be shown separately for a period of 5 years.
   (ii) For current assets, and investments, the amount written off need not be shown. They should be shown only at their revised lower values.
   (iii) For provisions, such amount of provision should be shown as a deduction from the gross amount in the inner column and only the net amount in the outer column.

GRADED ILLUSTRATIONS

PART I—FOR UNDERGRADUATE COURSE

Illustration 11.1

Model: Alteration of share capital

Raj Co. Ltd. has the following shares as a part of its share capital:

(i) 20,000 10% Preference shares of ₹ 100 each fully paid

(ii) 1,00,000 Equity shares of ₹ 5 each fully paid

(iii) 40,000 Equity shares of ₹ 10 each, ₹ 7.50 called and paid up

The Company has decided to alter the share capital as follows:

(a) To sub-divide the preference shares into shares of ₹ 10 each.

(b) To consolidate the equity shares of ₹ 5 each into shares of ₹ 10 each.

(c) To convert the partly paid-up equity shares into fully paid-up shares of ₹ 7.50 each, with necessary legal sanctions.

Journalize the alterations.

Solution

Books of Raj Co. Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(a)	10% Preference Share Capital (₹ 100) A/c Dr.		20,00,000	
	To 10% Preference Share Capital (₹ 10) A/c			20,00,000
	(20,000 10% Preference Shares of ₹ 100 Each Are Sub-divided into 2,00,000 10% Preference Shares of ₹ 10 Each)			
(b)	Equity Share Capital (₹ 5) A/c (1,00,000 × 5) Dr.		5,00,000	
	To Equity Share Capital (₹ 10) A/c (50,000×10)			5,00,000
	(1,00,000 Equity Shares of ₹ 5 Each Are Consolidated into 50,000 Equity Shares of ₹ 10 Each			
(c)	Equity Share Capital A/c (40,000 × ₹ 7.50) Dr.		3,00,000	
	(Partly Paid)			
	To Equity Share Capital A/c (40,000 × ₹ 7.50)			3,00,000
	(Fully Paid)			
	(Partly Paid Shares Are Converted into Fully Paid Shares)			

Illustration 11.2

Model: Surplus in capital reduction

XYZ Co. Ltd. passed resolution and got Court permission for the reduction of its share capital by ₹ 2,50,000 for the purposes mentioned in the following:

(i) To write off the debit balances of P&L A/c of ₹ 1,05,000

(ii) To reduce the value of plant & machinery by ₹ 45,000 and goodwill by ₹ 20,000

(iii) To reduce the value of investments by ₹ 40,000

The reduction was made by converting 25,000 preference shares of ₹ 20 each fully paid to the same number of preference shares of ₹ 15 each fully paid and by converting 25,000 equity shares of ₹ 20 each on which ₹ 15 is paid up into 25,000 equity shares of ₹ 10 each fully paid up.

Pass journal entries to record the share capital reduction.

[B.Com Madras University Modified]

Solution

Books of XYZ Co. Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Preference Share Capital A/c (₹ 20) Dr.		5,00,000	
	To Preference Share Capital A/c (₹ 15)			3,75,000
	To Capital Reduction A/c			1,25,000
	(25,000 Preference Shares of ₹ 20 Each Fully Paid Are Converted into Preference Shares of ₹ 15 Each Fully Paid and the Balance Transferred to Capital Reduction A/c)			

	Equity Share Capital (Partly Paid) A/c Dr.		3,75,000	
	To Equity Share Capital (Fully Paid) A/c			2,50,000
	To Capital Reduction A/c			1,25,000
	(25,000 Partly Paid Equity Shares into Fully Paid Shares and the Balance Transferred to Capital Reduction A/c)			
	Capital Reduction A/c Dr.		2,50,000	
	To P&L A/c			1,05,000
	To Plant & Machinery A/c			45,000
	To Goodwill A/c			20,000
	To Investments A/c			40,000
	To Capital Reserve A/c (Bal. Fig.)			40,000
	(Losses Written off, Assets Written down and the Balance Transferred to Capital Reserve)			
	Note: Capital Reduction A/c; Reconstruction A/c and Reorganization A/c All Represent the Same Meaning			

Illustration 11.3

Model: Capital reduction A/c (Reconstruction or reorganization A/c)—Issue of new debentures

The following scheme of reconstruction has been legally approved for Bhagya Ltd:

1. In lieu of their present holding of 1,20,000 shares of ₹10 each fully paid, the shareholders are to receive the following:
   (i) Fully paid new equity shares equal to one-third of their holding
   (ii) 10% Preference shares fully paid to the extent of one-fifth of the above new equity shares
   (iii) ₹1,20,000, 10% secured debentures
2. The debenture holders' total claim of ₹1,50,000 to be reduced to ₹50,000. This will be satisfied by issue of 5,000 10% preference shares of ₹10 each fully paid.
3. An issue of ₹1,00,000 5% first debentures was made and allotted, payment for the same having been received in cash.
4. The goodwill which stood at ₹6,00,000 was written down to ₹1,00,000. Plant & machinery which stood at ₹2,00,000 was written down to ₹1,50,000.
5. The freehold premises which stood at ₹3,50,000 was written down by ₹1,50,000.

Given the journal entries in the books of Bhagya Ltd. for the above reconstruction scheme.

Solution

Books of Bhagya Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital (₹10) A/c Dr.		12,00,000	
	To Equity Share Capital (New) A/c			4,00,000
	To 10% Preference Share Capital A/c			80,000
	To 10% Secured Debentures A/c			1,20,000
	To Reconstruction A/c			6,00,000
	(New Equity Shares; 1/3 × 1,20,000 Shares 40,000 Equity Shares, ₹4,00,000			

	New Preference Shares; 1/5 × 40,000 Shares 8,000 Preference Shares; ₹80,000 40,000 equity shares; 8,000 10% Pref. Shares; ₹1,20,000 10% Debentures Issued and the Balance of Old Share Capital ₹6,00,000 Transferred to Reconstruction A/c)			
	Debentures A/c Dr.		1,50,000	
	To 10% Preference Share Capital A/c			50,000
	To Reconstruction A/c			1,00,000
	(Claim of Debenture Holders Reduced to ₹50,000 and the Balance Transferred to Reconstruction A/c (Capital Reduction A/c)			
	Reconstruction A/c Dr.		7,00,000	
	To Goodwill A/c			5,00,000
	To Plant & Machinery A/c			50,000
	To Freehold Premises A/c			1,50,000
	(Value of Various Assets Are Reduced as per Scheme of Reconstruction)			
	Bank A/c Dr.		1,00,000	
	To 8% First Debentures A/c			1,00,000
	(New Debentures Issued)			

Illustration 11.4

Model: Preparation of reconstruction A/c and treatment of surplus in it

Veer Ltd. passed the necessary resolution and received sanction of the Court for the reduction of its share capital by ₹10,00,000 for the purposes numerated in the following:

(a) To write off the debit balance of P&L A/c ₹4,20,000

(b) To reduce the value of plant & machinery by ₹1,80,000 and of goodwill by ₹80,000

(c) To reduce the value of investments to market value by writing off ₹1,60,000

The reduction was made by converting 1,00,000 preference shares of ₹20 each fully paid to the same number of preferences shares of ₹15 each fully paid and by converting 1,00,00 ordinary shares of ₹20 each ₹15 paid up into 1,00,000 ordinary shares of ₹10 each fully paid.

Give journal entries necessary with respect to reduction of share capital and show how would you deal with the balance of the reduction of share capital account?

Solution

Important note: Reconstruction A/c, capital reduction A/c and capital reorganization A/c all denote one and the same.

In the Books of Veer Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
Entry (i)	Preference Share Capital (₹20) A/c (1,00,000 × ₹20) Dr.		20,00,000	
	To Preference Share Capital (₹15) A/c (1,00,000 × ₹15)			15,00,000
	To Reconstruction A/c			5,00,000
	(Reduction of 1,00,000 Pref. Shares of ₹20 Each Fully Paid into 1,00,000 Pref. Shares of ₹15 Each Fully Paid			

Entry (ii)	Ordinary Share Capital (₹ 20) A/c Dr. (1,00,000 × ₹ 15 Paid up)		15,00,000	
	To Ordinary Share Capital (₹ 10) A/c (1,00,000 × ₹ 10)			10,00,000
	To Reconstruction A/c (Reduction of 1,00,000 Ordinary Shares of ₹ 20 Each, ₹ 15 Paid up, into 1,00,000 Ordinary Shares of ₹ 10 Each Fully Paid)			5,00,000
Entry (iii)	Reconstruction A/c Dr.		8,40,000	
	To P&L A/c			4,20,000
	To Goodwill A/c			80,000
	To Plant & Machinery A/c			1,80,000
	To Investments A/c (Utilization of the Amount in the Credit of Reconstruction A/c (₹ 5,00,000 (Entry (i)) + ₹ 5,00,000 (Entry (ii)); ₹ 10,00,000 for Writing off the Debit Balance in P&L A/c, and to Write down the Value of Plant & Machinery, Goodwill & Investments)			1,60,000
Entry (iv)	Reconstruction A/c Dr.		1,60,000	
	To Capital Reserve A/c (Surplus (₹ 10,00,000 – ₹ 8,40,000) ₹ 1,60,000 in the Reconstruction A/c (Ref. Reconstruction A/c below) Transferred to Capital Reserve A/c)			1,60,000

Reconstruction Account

Particulars	₹	Particulars	₹
Profit & Loss A/c	4,20,000	Preference Share Capital A/c	5,00,000
Goodwill A/c	80,000	Ordinary Share Capital A/c	5,00,000
Plant & Machinery A/c	1,80,000		
Investments A/c (Surplus – transferred to)	1,60,000		
Capital Reserve A/c (Bal. Fig.)	1,60,000		
	10,00,000		10,00,000

Illustration 11.5

Preparation and utilization of capital reorganization account

The paid-up capital of Duari Ltd; amounted to ₹ 2,50,000 consisting of 25,000 equity shares of ₹ 10 each. Due to losses incurred by the company continuously, the directors of the company prepared a scheme of reconstruction which was duly approved by the Court as per following terms:

1. In lieu of their present holdings, the shareholders are to receive:
   (a) Fully paid equity shares equal to two-fifth of their holdings
   (b) 12% Preference shares fully paid up to the extent of the above new equity shares
   (c) 250 15% second debentures of ₹ 100 each

2. An issue of 2,500 12% first debentures of ₹ 100 each was made and allotted; payment for the same being received in cash for forthwith
3. The assets were reduced as follows:
   (a) Goodwill from ₹ 1,50,000 to ₹ 75,000
   (b) Machinery from ₹ 50,000 to ₹ 37,500
   (c) Leasehold premises from ₹ 75,000 to ₹ 62,500

Pass journal entries to give effect to the above-mentioned scheme of reconstruction and prepare capital reorganization account.

Solution

Note: Capital reduction A/c; capital reorganization A/c and reconstruction A/c all mean one and same.

Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital (Old) A/c (25,000 × ₹ 10) Dr.		2,50,000	
	To Equity Share Capital (New) A/c			1,00,000
	To 12% Preference Share Capital A/c			25,000
	(25% of 10,000; 2,500 Shares × ₹ 10)			
	To 15% Second Debentures A/c (250 × ₹ 100)			25,000
	To Capital Reorganization A/c (₹ 2,50,000 – ₹ 1,50,000)			1,00,000
	(Conversion of Old Equity Share Capital of ₹ 2,50,000 into New Equity Share Capital Consisting of 10,000 Equity Shares of ₹ 10 Each, 12% Pref. Shares 2,500 of ₹ 10 Each and 250 15% Second Debentures of ₹ 100 Each)			
	Capital Reorganization A/c Dr.		1,00,000	
	To Goodwill A/c			75,000
	To Machinery A/c			12,500
	To Leasehold Premises A/c			12,500
	(Utilization of Capital Reorganization Account (Pref. the Above Entry) to Write off Overvalued Assets: Goodwill by ₹ 75,000; Machinery by ₹ 12,500 and Leasehold Premises by ₹ 12,500)			
	Bank A/c Dr.		2,50,000	
	To 12% First Debenture Application A/c			2,50,000
	(On Receipt of Application Money on 2,500 12% First Debentures of ₹ 100 each)			
	12% First Debenture Application A/c Dr.		2,50,000	
	To 12% First Debentures A/c			2,50,000
	(On Allotment of 12% First Debentures)			

Capital Reorganization A/c

Particulars	₹	Particulars	₹
Goodwill A/c	75,000	Equity Share Capital A/c	1,00,000
Machinery A/c	12,500		
Leasehold Premises A/c	12,500		
	1,00,000		1,00,000

Illustration 11.6

Model: Preparation of balance sheet

Following a series of losses, ABC Co. Ltd. resolved to reduce its capital to 1,00,000 fully paid ₹5 shares and to eliminate share premium account. The company's balance sheet prior to implementation of the reconstruction scheme was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	2,00,000
1,00,000 Fully Paid Shares of ₹10 Each	10,00,000	Land & Buildings	3,24,000
Securities Premium A/c	1,00,000	Plant & Machinery	4,14,000
Creditors	1,24,000	Stock	1,84,000
Bank Overdraft	1,46,000	Debtors	1,48,000
		Profit & Loss A/c	1,00,000
	13,70,000		13,70,000

It was resolved to apply the sum available under the scheme:

(i) To write off the goodwill account

(ii) To write off the debit balance of P&L A/c

(iii) To reduce the book values of the assets by the following amounts:

Land & Building ₹84,000
Plant & Machinery ₹1,34,000
Stock ₹67,200

(iv) To provide a bad debts reserve of 10% of the book value of debtors

Show the journal entries to give effect to the scheme and prepare the revised balance sheet after its implementation.

Books of ABC Ltd.

Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Share Capital A/c (1,00,000 × ₹5)	Dr.		5,00,000	
	To Reconstruction A/c				5,00,000
	(Reduction of 1,00,000 Shares by ₹5 per Share				
	Securities Premium A/c	Dr.		1,00,000	
	To Reconstruction A/c				1,00,000
	(Share Premium A/c Transferred)				
	Reconstruction A/c	Dr.		6,00,000	
	To Goodwill A/c				2,00,000
	To P&L A/c				1,00,000
	To Land & Buildings A/c				84,000
	To Plant & Machinery A/c				1,34,000
	To Stock A/c				67,200
	To Provision for Bad Debts				14,800
	(Losses Written off and Value of Assets Reduced)				

Balance Sheet of ABC Co. Ltd. as on ….. (And Reduced)

Liabilities	₹	Assets		₹
Share Capital:		Land & Buildings		2,40,000
1,00,000 Fully Paid Shares of ₹ 5 Each	5,00,000	Plant & Machinery		2,80,000
Creditors	1,24,000	Stock		1,16,800
Bank Overdraft	1,46,000	Debtors	1,48,000	
		Less: Provision for Bad Debts	14,800	
				1,33,200
	7,70,000			7,70,000

Illustration 11.7

Model: Issue of shares for arrears of preference dividend

The summarized balance sheet of Somnath Ltd. as at December 2010 was as follows:

Balance Sheet of ABC Co. Ltd. as on ….. (And Reduced)

Liabilities	₹	Assets	₹
Authorized & Issued Capital:		Land & Buildings	7,50,000
1,00,000 Equity Shares of ₹ 10 Each Fully Paid	10,00,000	Plant & Machinery	5,00,000
		Goodwill	1,00,000
5,000 6% Cumulative Pref. Shares of ₹ 100 Each Fully Paid	5,00,000	Patents & Trademarks	50,000
		Stocks	2,00,000
Bank Overdraft	3,50,000	Sundry Debtors	1,50,000
Sundry Creditors	2,50,000	Preliminary Expenses	50,000
Note: The Cumulative Pref. Dividend is in Arrears for 3 Years)		Profit & Loss A/c	3,00,000
	21,00,000		21,00,000

A scheme of capital reduction was approved on the following terms:

(i) The preference shareholders agree that their shares be reduced to fully paid shares of ₹ 50 each and to accept equity shares of ₹ 54 each fully paid in lieu of the dividend arrears

(ii) The equity shareholders agree that their shares be reduced to a fully paid value of ₹ 5 each

(iii) The authorized capital of the company is to remain at ₹ 15,00,000 divided into 2,00,000 equity shares of ₹ 5 each and 10,000 6% cumulative preference shares of ₹ 50 each

(iv) All the intangible and fictitious assets are to be eliminated and bad debts of ₹ 25,000 and obsolete stocks of ₹ 40,000 are to be written off

Give the necessary journal entries to record the capital reduction and draw up the revised balance sheet.

[B.Com Calcutta University Modified]

Solution

Note: Preliminary expenses and P&L A/c are fictitious assets.

Goodwill and patents & trademarks are intangible assets.

Books of Somnath Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2010	6% Cumulative Preference Share Capital A/c (5,000 × ₹ 50) Dr.		2,50,000	
	To Reconstruction A/c			2,50,000
	(Reduction of 5,000 Pref. Shares of ₹ 100 Each into ₹ 50 per Share)			
2010	Equity Share Capital A/c (1,00,000 × ₹ 5) Dr.		5,00,000	
	To Reconstruction A/c			5,00,000
	(Reduction of ₹ 5 per Share on 1,00,000 Equity Shares)			
2010	Preference Dividend A/c (18,000 × ₹ 5) Dr.		90,000	
	To Equity Share Capital A/c			90,000
	(For Arrears of Pref. Dividend for 3 years: 6/100 × ₹ 5,00,000 × 3 years 18,000 Equity Shares @ ₹ 5 Each Issued)			
2010	Reconstruction A/c Dr.		7,50,000	
	To Goodwill A/c			1,00,000
	To Patents & Trademarks A/c			50,000
	To Preliminary Expenses A/c			50,000
	To Profit & Loss A/c			3,00,000
	To Sundry Debtors A/c			25,000
	To Stock A/c			40,000
	To Preference Dividend A/c			90,000
	To Capital Reserve A/c (Bal. Fig.)			95,000
	(All Fictitious Assets and Intangible Assets Written off; Sundry Assets Written down; and the Balance Transferred to Capital Reserve A/c)			

Fictitious assets and intangible assets will not be shown in the revised balance sheet, as they are to be eliminated off according to the direction given in the problem (As per terms of internal reconstruction).

Balance Sheet of Somnath Ltd. (And Reduced)
as on 31 December 2010

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Authorized:		Land & Buildings	7,50,000
2,00,000 Equity Shares of ₹ 5 Each	10,00,000	Plant & Machinery	5,00,000
10,000 6% Cumulative Preference Shares of ₹ 50	5,00,000	Current Assets:	
		Stock	1,60,000

Issued & Paid up:	15,00,000	Sundry Debtors	1,25,000
1,18,000 Equity Shares of ₹ 5 Each Fully Paid	5,90,000		
5,000 6% Cumulative Pref. Shares of ₹ 50 Fully Paid	2,50,000		
Reserves & Surplus:			
Capital Reserve	95,000		
Unsecured Loan:			
Bank Overdraft	3,50,000		
Current Liabilities:			
Sundry Creditors	2,50,000		
	15,35,000		15,35,000

Illustration 11.8

Model: Assets written off in proportion of book values

The balance sheet of Parul Ltd. on 31 March 2011 was as follows:

Liabilities	₹	**Assets**	₹
10% Preference Shares of ₹ 10 Each		Goodwill	1,80,000
Equity Shares of ₹ 10 Each	5,00,000	Land & Buildings	2,80,000
General Reserve	40,000	Machinery	75,000
8% Debentures (₹ 100 Each)	40,000	Furniture	30,000
Bank Overdraft	57,000	Preliminary Expenses	2,000
Creditors	80,000	Profit and Loss A/c	2,50,000
	8,17,000		8,17,000

The capital reduction scheme, approved by the Court is as follows:

(i) Holders of 8% debentures of ₹ 100 are to be given 10% debentures of ₹ 50 and preference shares of ₹ 10 each of equal amount for the remaining amount of ₹ 50

(ii) The value of all preference shares including the preference shares given to debentures, as shown above, is to be reduced to ₹ 6 and dividend rate is to be increased up to 12%

(iii) The value of equity shares is to be reduced to ₹ 2 each

(iv) The existing equity shareholders are to purchase additional equity shares of ₹ 2,00,000 for cash to pay off the Bank overdraft

(v) All fictitious and intangible assets are to be written off and machinery and furniture are to be written off in proportion of book values, with the help of general reserve and capital reduction account.

Pass necessary journal entries in the books of the company to record the above transactions. Prepare the company's balance sheet after such changes.

Solution

Book of Parul Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
31 March 2011	8% Debentures A/c Dr.		40,000	
	To 10% Debentures A/c			20,000
	To 10% Preference Share Capital A/c			20,000
	(10% Debentures and 2000 10% Preference Shares of ₹ 10 Each Given to Debenture Holders to Settle Their Claims)			
31 March 2010	10% Preference Share Capital A/c Dr.		1,20,000	
	(10,000 + 2,000) Shares × ₹ 10			
	To 12% Preference Share Capital A/c (12,000 × ₹ 6)			72,000
	To Reconstruction A/c			48,000
	(Conversion of 10% Pref. Shares of ₹ 10 Each into Shares of ₹ 6 and Transfer of Balance to Reconstruction A/c)			
31 March 2010	Equity Share Capital A/c Dr.		4,00,000	
	To Reconstruction A/c			4,00,000
	(Reduction of Equity Shares of ₹ 10 Each into Shares of ₹ 2 Each)			
	Bank A/c Dr.		2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Issue of 1,00,000 Equity Shares of ₹ 2 Each to Existing Equity Shareholders)			
31 March 2010	Bank Overdraft A/c Dr.		57,000	
	To Bank A/c			57,000
	(Bank o/d paid)			
31 March 2010	Reconstruction A/c Dr.		4,48,000	
	General Reserve A/c Dr.		40,000	
	To Goodwill A/c			1,80,000
	To Preliminary Expenses A/c			2,000
	To P&L A/c			2,50,000
	To Machinery A/c (₹ 56,000 × 37.5/52.5)			40,000
	To Furniture A/c (₹ 56,000 × 15/52.5)			16,000
	(Losses, Fictitious & Intangible Assets Written off; Other Assets Are Written down in Proportion to Their Book Values)			

Balance Sheet of Parul Ltd. (And Reduced)
As on 31st March 2011.

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
12,000 12% Preference Shares of ₹ 6 Each	72,000	Land & Building	2,80,000
		Machinery (₹ 75,000 – ₹ 40,000)	35,000
1,50,000 Equity Shares of ₹ 2 Each	3,00,000	Furniture (₹ 30,000 – ₹ 16,000)	14,000
Secured Loans:		Current Assets:	
10% Debentures (₹ 50 Each)	20,000	Cash (₹ 2,00,000 – ₹ 57,000)	1,43,000
Current Liabilities:			
Creditors	80,000		
	4,72,000		4,72,000

Illustration 11.9

Model: Issue of shares for arrears of preference dividend—Assets written down in proportion to written down values

The following is the summarized balance sheet as on 31 March 2011:

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets:		
4,500 8% Cumulative Pref. Shares of ₹ 100 Each	4,50,000	Property at Cost	3,30,000	
		Less: Depreciation	60,000	2,70,000
6,000 Equity Shares of ₹ 100 Each	6,00,000	Machinery at Cost	6,60,000	
		Less: Depreciation	1,20,000	5,40,000
6% Debenture	1,50,000	Goodwill		51,000
Debenture Interest outstanding	9,000	Patents		66,000
Securities Premium	1,50,000	Current Assets:		
Creditors	60,000	Stock		45,000
		Debtors		93,000
		Preliminary Expenses		96,000
		P&L A/c		2,57,400
	14,19,000			14,19,000

The following schemes of capital reduction were duly sanctioned by Court:

(i) Equity shares to be reduced by ₹ 90 each

(ii) Preference shares to be reduced to ₹ 90 each

(iii) The debenture holders to waive their right over outstanding interest

(iv) One new equity share paid up to the extent of 50% only to be issued for each ₹ 100 of gross preference dividend, which has not been declared since April 2009

(v) All credit balances not being the outside liabilities and all debt balances not being the amounts receivable as well as the intangible assets are to be written off

(vi) Any balance available is to be utilized in writing down the fixed assets in proportion to their written down values.

You are required to give journal entries and balance sheet after the scheme of internal reconstruction is completed.

Solution

Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
31 March 2011	Equity Share Capital A/c (6,000 × ₹ 90) Dr.		5,40,000	
	To Capital Reduction A/c			5,40,000
	or			
	To Reconstruction A/c			
	(6,000 Equity Shares of ₹ 100 Each Reduced to Shares of ₹ 90 Each Fully Paid up)			
,,	8% Preference Share Capital A/c Dr.		45,000	
	To Reconstruction A/c			45,000
	(4,500 Preference Shares of ₹ 100 Each Reduced at ₹ 10 per Share)			
,,	Debenture Interest Outstanding A/c Dr.		9,000	
	To Reconstruction A/c			9,000
	(Debenture Holders Waived off Their Right over Outstanding Interest)			
31 March 2011	Reconstruction A/c Dr.		54,000	
	To Equity Share Capital A/c			54,000
	(50% of 3 years Dividend as Pref. Shares ₹ 4,50,000 × 8/100 × 3: 54,000—Paid by Issue of 1,080 Shares of ₹ 100 Each, ₹ 50 Paid up)			
	Securities Premium A/c Dr.		1,50,000	
	To Reconstruction A/c			1,50,000
	(Balance of Share premium A/c Transferred to Reconstruction A/c)			
,,	Reconstruction A/c Dr.		6,90,000	
	To Preliminary Expenses A/c			96,000
	To Patents A/c			66,000
	To Goodwill A/c			51,000
	To P&L A/c			2,57,400
	To Property A/c (₹ 2,19,600 × 9/27)			73,200
	To Plant & Machinery A/c (₹ 2,19,600 × 18/27)			1,46,400
	(Assets Written down in Proportion to Their Written-down Values)			

Balance Sheet of … (And Reduced)
as on 31 March 2011

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets		
4,500 8% Cumulative Pref. Shares of ₹100 Each, ₹90 Paid	4,05,000	Property at Cost	3,30,000	
		Less: Depreciation	60,000	
			2,70,000	
6,000 Equity Shares of ₹100 Each ₹10 Paid up	60,000	Less Reduction	73,200	1,96,200
		Machinery at Cost	6,60,000	
1,080 Equity Shares of ₹100 Each, ₹50 per Share Paid	54,000	Less: Depreciation	1,20,000	
			5,40,000	
Secured Loan:		Less: Reduction	1,46,400	3,93,600
6% Debentures	1,50,000	Current Assets:		
Current Liabilities:		Stock		45,000
Creditors	50,000	Debtors		93,600
	7,29,000			7,29,000

Illustration 11.10

Model: Sale of assets to settle debenture holders claim

The following is the balance sheet of Devi Ltd. As at 31 March 2011:

Liabilities		₹	Assets		₹
Share Capital:			Sundry Assets:		
1,00,000 Equity Shares of ₹10 Each Fully Paid		10,00,000	Workmen's Compensation Fund Investments		7,50,000
90,000 8% Preference Shares of ₹10 Each Fully Paid		9,00,000			1,50,000
6% First Debentures			Property:		
(Secured on Delhi Property)		1,50,000	Delhi	8,00,000	
6% Second Debentures			Chennai	6,00,000	14,00,000
(Secured on Chennai Property		1,75,000	P&L A/c		2,00,000
Workmen's Compensation					
Delhi	1,00,000				
Chennai	50,000	1,50,000			
Creditors		1,25,000			
		25,00,000			25,00,000

The following reconstruction scheme was duly sanctioned by Court:

(i) Equity shares were to be reduced to ₹1 each.

(ii) Preference shares were to be reduced to ₹8 each.

(iii) Debenture holders to forego their interest of ₹26,000, which is included among sundry creditors.

(iv) Second debenture holders agreed to take over Chennai property at ₹2,50,000, accept an allotment of 15,000 Re 1 equity shares at par, and upon their forming a company called Roses Ltd.. to take over the Chennai property, they allotted Devi Ltd. 9,000 shares of ₹10 fully paid at par.

(v) The Chennai workmen's compensation disclosed the fact that there were liabilities to the extent of ₹ 10,000. The investments pertaining to it were sold at a profit of 10% on book value and the liability was paid.

(vi) Sundry assets were to be written down by ₹ 4,00,000.

Show the journal entries to give effect to the above and prepare the reconstructed balance sheet.

Solution

Books of Devi Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
31 March 2011	Equity Share Capital A/c Dr.		9,00,000	
	To Reconstruction A/c			9,00,000
	(1,00,000 Equity Shares of ₹ 10 Each Reduced to ₹ 9 Each)			
31 March 2011	8% Preference Share Capital A/c Dr.		1,80,000	
	To Reconstruction A/c			1,80,000
	(90,000 8% Preference Shares of ₹ 10 Each Reduced to ₹ 2 per Share)			
31 March 2011	Sundry Creditors A/c Dr.		26,000	
	To Reconstruction A/c			26,000
	(Debenture Interest Included in Creditor's A/c Waived)			
31 March 2011	6% Second Debentures A/c Dr.		1,75,000	
	Shares in Roses Ltd. Dr.		90,000	
	Loss on Sale of Chennai Property Dr.		3,50,000	
	To Chennai Property			6,00,000
	To Equity Share Capital A/c			15,000
	(Second Debenture Holders Claim Settled by Issuing 15,000 Equity Shares of ₹ 1 Each and Sale of Chennai Property and 9,000 Shares of ₹ 10 Each)			
31 March 2011	Bank A/c Dr.		55,000	
	To Workmen Compensation Fund Investment A/c			50,000
	To Workmen Compensation Fund A/c			5,000
	(Investments Realized at a Profit)			
31 March 2011	Workmen Compensation Fund A/c Dr.		55,000	
	To Bank A/c			10,000
	To Reconstruction A/c			45,000
	(Liability Due to Workmen Compensation Discharged)			
31 March 2011	Reconstruction A/c Dr.		11,51,000	
	To Loss on Sale of Chennai Property			3,50,000
	To P&L A/c			2,00,000
	To Sundry Assets A/c			4,00,000
	To Capital Reserve A/c (Bal. Fig)			2,01,000
	(Losses, P&L A/c, Assets Written off and the Balance Inferred to Capital Reserve A/c)			

Balance Sheet of Devi Ltd (And Reduced)
as on 31 March 2011

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets:		
Authorized Issued & Subscribed:		Sundry Assets		3,50,000
1,15,000 Shares of ₹1 Each 90,000 8%	1,15,000	Property—Delhi		8,00,000
Pref. Shares of ₹8 Each	7,20,000	Investments:		
Reserves & Surplus:		Workmen's Compensation		
Capital Reserve	2,01,000	Fund Investment	1,00,000	
Workmen's Compensation		Add: 9,000 Shares of	90,000	1,90,000
Fund—Delhi	1,00,000	Rose Ltd. of ₹10		
Secured Loans:		Current Assets:		
6% First Debentures	1,50,000			
(Secured on Delhi Property)		Bank (₹55,000 – ₹10,000)		45,000
Current Liabilities:				
Creditors	99,000			
	13,85,000			13,85,000

Illustration 11.11

Model: Surrender of shares

In order to reconstruct the balance sheet, Thomas Co. Ltd. passed the following resolutions:

(i) The share capital of the company consisting of 10,000 ordinary shares of ₹100 each to be converted into 1, 00,000 share of ₹10 each

(ii) The shareholders to surrender 70% of their shares after such conversion

(iii) The amount available should be utilized to write off machinery of ₹3, 00,000 stock ₹1, 50,000 and the balance available to write off the debit balance in P&L A/c

You are required to pass the necessary journal entries.

Solution

Books of Thomas Co. Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c (₹100) Dr.		10,00,000	
	To Equity Share Capital A/c (₹10)			10,00,000
	(10,000 Ordinary Shares of ₹100 Each Sub-divided into 1,00,000 Shares of ₹10 Each)			
	Equity Share Capital A/c (₹10) Dr.		7,00,000	
	To Surrendered Shares A/c			7,00,000
	(Shareholders Surrendered 70% of Shares)			
	Surrendered Shares A/c Dr.		7,00,000	
	To Reconstruction A/c			7,00,000
	(Surrendered Shares Are Transferred to Reconstruction A/c)			

	Reconstruction A/c Dr.		7,00,000	
	To Machinery A/c			3,00,000
	To Stock A/c			1,50,000
	To Profit & Loss A/c			2,50,000
	(Reconstruction A/c Utilized to Write off Machinery, Stock and Accumulated Losses).			

Illustration 11.12

Model: Surrender of shares

A company's position on 31 December 2010 was as follows:

	₹
60,000 Equity Shares of ₹ 100 Each	60,00,000
30,000 8% Debenture of ₹ 100 Each	30,00,000
Interest outstanding of Debentures	3,60,000
Creditors	15,00,000
Assets on that date were as follows:	
Fixed Assets	60,00,000
Current Assets	19,50,000

Fixed assets were revalued at ₹ 28,80,000 and current assets at ₹ 14,40,000.

The reconstruction scheme approved by the Court was as follows:

(i) The shares were sub-divided into shares of ₹ 5 each and 90% of the shares were surrendered

(ii) Claims of debenture holders were reduced to ₹ 14,70,000 for which ₹ 7,50,000 equity shares were allotted

(iii) Creditors agreed to reduce their claims to ₹ 9,00,000, one-third of which was satisfied by issue of equity shares out of those surrendered

Draft journal entries.

Solution

Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
31 December 2010	Equity Share Capital A/c (₹ 100) Dr.		60,00,000	
	To Equity Share Capital A/c (₹ 5)			60,00,000
	(60,000 Equity Share of ₹ 100 Each Sub-divided into 12,00,000 Shares of ₹ 5 Each)			
31 December 2010	Equity Share Capital A/c Dr.		54,00,000	
	To Surrendered Shares A/c			54,00,000
	(90% of Equity Shares Surrendered)			
31 December 2010	8% Debentures A/c (₹ 30,00,000 – ₹ 14,70,000) Dr.		15,30,000	
	Interest on Debentures A/c Dr.		3,60,000	
	To Reconstruction A/c			18,90,000
	(Debenture Holders Claim Reduced)			

31 December 2010	Surrendered Shares A/c Dr. To Equity Share Capital A/c (Issue of 1,50,000 Shares of ₹ 5 Each out of Surrendered Shares to Debenture Holders		7,50,000	 7,50,000
31 December 2010	Creditors A/c Dr. To Reconstruction (Reduction in Creditor's Claim ₹ 6,00,000 and for ₹ 3,00,000 Surrendered Shares to Be Re-issued)		9,00,000	 9,00,000
31 December 2010	Surrendered Shares A/c Dr. To Equity Share Capital A/c (Issue of 60,000 Shares of ₹ 5 Each out of Surrender Shares)		3,00,000	 3,00,000
31 December 2010	Surrendered Shares A/c Dr. To Reconstruction A/c (Unissued Surrendered Shares Cancelled and Transferred to Reconstruction A/c)		43,50,000	 43,50,000
	Reconstruction A/c Dr. To P&L A/c To Fixed Assets A/c To Current Assets A/c To Capital Reserve A/c (Bal. Fig.) (Loss Written off, Assets Written down and Balance Transferred to Capital Reserve) *Sacrifices: (i) Equity Shareholders 90% × ₹ 60,00,000 : ₹ 54, 00,000 (ii) Debenture Holders : ₹ 11,40,000 [₹ 33,60,000 – (₹ 14,70,000 + ₹ 7,50,000)] (iii) Creditors (₹ 15,00,000 – ₹ 9,00,000) : ₹ 6,00,000 71,40,000		*71,40,000	 29,10,000 31,20,000 5,10,000 6,00,000

Balance Sheet of…
as on 31 December 2010

Liabilities	₹	Assets	₹
60,000 Equity Shares of ₹ 100	60,00,000	Fixed Assets	60,00,000
30,000 8% Debentures of ₹ 100	30,00,00	Current Assets	19,50,000
Outstanding Interest on Debentures	3,60,000	P&L A/c (Bal. Fig.)	29,10,000
Creditors	15,00,000		
	1,08,60,000		1,08,60,000

PART II—ADVANCED LEVEL

[B.Com (Hons); C.A.; I.C.W.A.; C.S. and M.Com)]

Illustration 11.13

Model: Dealing with taxes

The following is the balance sheet of Sick Ltd as on 31 March 2011:

Liabilities	₹	Assets	₹
13% Cumulative Pref. Shares of ₹100 Each	50,000	Fixed Assets	7,50,000
Equity Shares of ₹10 Each	3,50,000	Current Assets	17,50,000
8% Debentures	1,50,000	P&L A/c	1,50,000
Current Liabilities	19,50,000		
Provision for Taxation	1,50,000		
	26,50,000		26,50,000

The following scheme of reorganization is sanctioned:

(i) Fixed assets are to be written down by $33\frac{1}{3}$%.

(ii) Current assets are to be revalued at ₹13,50,000.

(iii) Preference shareholders decide to forego their right to arrows of dividend which are in arrears for 3 years.

(iv) The taxation liability of the company is settled at ₹2,00,000 and the same is paid immediately.

(v) One of the creditors of the company to whom it owes ₹12,50,000 decides to forego 50% of his claim. He is allotted 50,000 equity shares of ₹5 each in part satisfaction of the balance of his claim.

(vi) The rate of interest on debentures is increased to 11%. The debenture holders surrender their debentures of ₹100 each and exchange the same for fresh debentures of ₹75 each.

(vii) The existing equity and preference shares are reduced to ₹5 and ₹75 each, respectively.

[B.Com (Hons) Delhi Modified]

Solution

		₹
(a)	Equity Share Capital as Shown in Balance Sheet	3,50,000
Less:	Reduced from ₹10 to 5 per Share} i.e. 50%	1,75,000
		1,75,000
Add:	Allotment to Creditors 50,000 × ₹5:	2,50,000
	(i.e. (35,000 + 50,000 Shares) × ₹5	4,25,000
(b)	Preference Share Capital: as Shown in Balance Sheet	50,000
Less:	Reduced to ₹75 per Share	12,500
	i.e. 500 × 25 (100 – 75)	37,500
	(500 Pref. Shares × ₹75)	

(c)	Current Assets:		
	As Shown in Balance Sheet		17,50,000
Less:	(i) Written off	4,00,000	
	(ii) Cash Paid to Taxes	2,00,000	6,00,000
			11,50,000
(d)	Current Liabilities:		
	As Shown in Balance Sheet		19,50,000
Less:	(i) Amount Foregone	: 6,25,000	
	(ii) Amount Paid off	: 2,50,000	8,75,000
			10,75,000

Sick Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital (₹ 10) A/c Dr.		3,50,000	
	To Equity Share Capital (₹ 5) A/c			1,75,000
	To Reconstruction A/c			1,75,000
	(35,000 Equity Shares of ₹ 10 Each Reduced to 35,000 Equity Shares of ₹ 5 Each)			
	13% Cumulative Preference Share Capital (₹ 100) A/c Dr.		50,000	
	To Cumulative Pref. Share (₹ 75) Capital A/c			37,500
	To Reconstruction A/c			12,500
	(500 Pref. Shares of ₹ 100 Each Reduced to 500 Pref. Shares of ₹ 75 Each)			
	8% Debentures A/c Dr.		1,50,000	
	To 11% Debentures A/c			1,12,500
	To Reconstruction A/c			37,500
	(11% Debentures Issued for 8% Debentures to the Extent of ₹ 1,12,500 and the balance ₹ 37, 500 Transferred to Reconstruction A/c)			
	Sunday Creditors A/c Dr.		8,75,000	
	To Equity Share Capital A/c			2,50,000
	To Reconstruction A/c			6,25,000
	(One Creditor has Foregone 50% of His Claim on ₹ 12,50,000 and to Him 50,000 Equity Shares of ₹ 5 Each Were Allotted)			
	Provision for Taxation A/c Dr.		1,50,000	
	To Liability for Taxation A/c			1,50,000
	(Provision for Taxation Converted into Liability for Taxation for Settlement)			

	Reconstruction A/c Dr.		8,00,000	
	To Profit & Loss A/c			1,50,000
	To Fixed Assets A/c			2,50,000
	To Current Assets A/c			4,00,000
	(P&L A/c, Fixed Assets and Current Assets Written off)			
	Liability for Taxation A/c Dr.		1,50,000	
	Reconstruction A/c Dr.		50,000	
	To Current Assets A/c (Bank)			2,00,000
	(Liability for Taxation Discharged from Current Assets)			

Balance Sheet of Sick Ltd. (And Reduced)*
as at 31 March 2011

Liabilities	₹	**Assets**		₹
Share Capital:		Fixed Assets:	7,50,000	
Issued & Subscribed:		Less: Writing off	2,50,000	5,00,000
85,000 Equity Shares of ₹5 Each, Fully Paid	4,25,000			
500, 13% Cumulative Preference Shares of ₹75 Each, Fully Paid	37,5000	Current Assets:		11,50,000
Secured Loans:				
11% Debentures	1,12,500			
Current Liabilities	10,75,000			
	16,50,000			16,50,000

*"And Reduced" has to be added only when directed by the Court.

Illustration 11.14

Model: Forfeiture of shares

The following is the balance sheet of Taurus Ltd. as on 31 March 2011:

Liabilities	₹	**Assets**	₹
Authorized Capital:		Goodwill	50,000
1,00,000 Ordinary Shares of ₹10 Each	10,00,000	Buildings	1,02.5000
Issued, Subscribed & Paid up:		Machinery	2,54,250
60,000 Shares of ₹10 Each 6,00,000		Preliminary Expenses	7,500
Less: Calls-in-Arrears 45,000	5,55,000	Stock	51,375
₹3 per Share on 15,000		Book Debts	75,000
		Cash at Bank	7,500
		P&L A/c	1,04,000

Sunday Creditors	77,125		
Provision for Taxes	20,000		
	6,52,125		6,52,125

The directors find that the machinery is overvalued by ₹ 50,000. It is now proposed to write down these assets to its true value and extinguish goodwill account, profit and loss and preliminary expenses accounts by adopting the following scheme:

(a) Forfeit the shares on which the calls are outstanding

(b) Reduce the paid-up capital by ₹ 3 per share

(c) Re-issue the forfeited shares as ₹ 5 per share

(d) Utilize the provision for taxes, if necessary

Draft the journal for taxes, if necessary for giving effect to the above scheme, and prepare the reconstructed balance sheet of the company.

[B.Com (Hons) Delhi Modified]

Solution

Taurus Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c Dr.		1,50,000	
	To Share Forfeited A/c			1,05,000
	To Calls-in-Arrears A/c			45,000
	(15,000 Equity Shares Forfeited for Non-payment of Calls-in-Arrears)			
	Equity Share Capital A/c Dr.		1,35,000	
	To Reconstruction A/c			1,35,000
	(Reduction of Ordinary Share Capital Consisting of 45,000 Shares by ₹ 3)			
	Bank A/c Dr.		75,000	
	Share Forfeited A/c Dr.		30,000	
	To Ordinary Share Capital A/c			1,05,000
	(Re-issue of 15,000 Forfeited Shares @ ₹ 5 per Share, Discount ₹ 2 per Share)			
	Share Forfeited A/c Dr.		75,000	
	To Capital Reserve A/c			75,000
	(Surplus in Share Forfeited Account Transferred to Capital Reserve A/c)			
	Provision for Taxes A/c Dr.		1,500	
	To Reconstruction A/c			1,500
	(Utilization of Provision for Taxes for Reconstruction)			

	Capital Reserve A/c Dr.		1,36,500	
	To Machinery A/c			50,000
	To Goodwill A/c			50,000
	To P&L A/c			1,04,000
	To Preliminary Expenses A/c			7,500
	(Utilization of Reconstruction & Capital Reserve Account for Writing off Goodwill Preliminary Expenses, Accumulated Loss and to Write down the Value of Machinery)			

Balance Sheet of Taurus Ltd. (And Reduced)
as on 1 April 2011

Liabilities	₹	Assets		₹
Share Capital:		Fixed Assets:		
Authorized: 1,00,000 Equity Shares of ₹ 10	10,00,000	Goodwill		NIL
Issued, Subscribed & Paid up:		Land & Building		1,02,500
60,000 Shares of ₹ 10 Each ₹ 7 Paid up	4,20,000	Machinery	2,54,250	
		Less: Written off	50,000	2,04,250
Current Liabilities:		Currents Assets:		
Sunday Creditors	77,125	Stock		51,375
Provisions:		Book Debts		75,000
Provision for Taxation	18,500	Cash at Bank		82,500
	5,15,625			5,15,625

Illustration 11.15

Model: Arrears of dividend on pref. shares (Surrender of shares)

The balance sheet of Naina Lohia Ltd. as on 31 March 2011 was as follows:

Liabilities	₹	Assets	₹
1,50,000 Equity Shares of ₹ 10 Each	15,00,000	Patents	2,50,000
10,000, 10% Preference Shares of ₹ 100 Each	10,00,000	Plant & Machinery	15,00,000
		Equipments	50,000
Securities Premium	4,50,000	Book Debts	12,50,000
Loan (Unsecured)	2,50,000	Inventories	7,50,000
Creditors	15,00,000	Bank Balance	75,000
Expenses Due	1,25,000	Preliminary Expenses	25,000
Employees Provident Fund	2,25,000	Profit & Loss A/c	10,00,000
		Goodwill	1,50,000
	50,50,000		50,50,000

Dividend on preference shares is in arrears for 5 years. The following scheme of reconstruction was approved by the Court:

(i) Equity shares are to be converted into 3,00,000 shares of ₹ 5 each.

(ii) Equity shareholders agreed to surrender to the company 80% of their holdings.

(iii) Preference shareholders agreed to forego their right to unpaid dividend. They also agreed to reduce each preference share from ₹ 100 to ₹ 80.

(iv) Creditors agreed to reduce their claim by two-fifths in consideration of their getting shares of ₹ 1,80,000 out of surrendered equity shares.

(v) Unsecured loan is converted into ₹ 1,50,000 equity shares out of shares surrendered and remaining amount of loan is waived.

(vi) Surrendered shares not utilized are to be cancelled.

(vii) Assets are to be reduced as follows:

Goodwill by ₹ 1,50,000; plant by ₹ 2,00,000; equipments by ₹ 40,000; book debts by ₹ 80,000; inventories by ₹ 1,00,000. All intangible and fictitious assets are to be written off.

(viii) Any surplus left should be utilized in writing down the machinery plant further.

(ix) Cost of reconstruction amounted to ₹ 50,000.

(x) Further 2,00,000 shares were issued to existing shareholders to increase working capital. The issue was fully subscribed and paid for.

Draft journal entries for the above arrangement. Also prepare reconstruction A/c.

[B.Com (Hons) Delhi 2010 Modified]

Solution

Books of Naina Lohia Ltd.
Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
31 March 2011	Equity Share Capital A/c (₹ 10)	Dr.		15,00,000	
	To Equity Share Capital A/c				15,00,000
	(Conversion of ₹ 10 Shares into ₹ 5 Shares)				
31 March 2011	Equity Share Capital A/c	Dr.		12,00,000	
	To Shares Surrendered A/c				12,00,000
	(Equity Shares Surrendered)				
31 March 2011	10% Preference Share Capital A/c (₹ 100)	Dr.		10,00,000	
	To 10% Pref. Share Capital A/c (₹ 20)				8,00,000
	To Reconstruction A/c				2,00,000
	(Sacrifice by Preference Shareholders Transferred to Reconstruction A/c)				
31 March 2011	Shares Surrendered A/c	Dr.		1,80,000	
	To Equity Share Capital A/c				1,80,000
	(Shares Surrendered Converted into New Equity Shares for Creditors)				

31 March 2011	Creditors A/c Dr. To Reconstruction A/c (Issue of Equity Shares to Creditors)		6,00,000	 6,00,000
31 March 2011	Shares Surrendered A/c Dr. To Equity Shares Capital A/c (Conversion of Surrendered Shares into Equity Shares to Discharge Unsecured Loan)		1,50,000	 1,50,000
31 March 2011	Unsecured Loan A/c Dr. To Reconstruction A/c (Unsecured Loan cancelled in Lieu of Equity Shares)		2,50,000	 2,50,000
31 March 2011	Shares Surrendered A/c Dr. To Reconstruction A/c (Cancellation of Shares Surrendered)		8,70,000	 8,70,000
31 March 2011	Reconstruction A/c Dr. To Bank A/c (Expenses Paid for Reconstruction)		50,000	 50,000
31 March 2011	Reconstruction A/c Dr. To Preliminary Expenses A/c To P&L A/c To Goodwill A/c To Plant A/c To Equipments A/c To Book Debts A/c To Inventories A/c To Patents A/c To Plant A/c (Balancing Figure) (Utilization of Reconstruction A/c to Write off Overvalued Assets & Fictitious Assets)		18,70,000	 25,000 10,00,000 1,50,000 2,00,000 40,000 80,000 1,00,000 2,50,000 25,000
31 March 2011	Bank A/c Dr. To Share Application & Allotment A/c (Issue of 12,00,000 Equity Shares @ ₹ 5)		10,00,000	 10,00,000
31 March 2011	Share Application & Allotment A/c Dr. To Equity Share Capital A/c (2,00,000 Equity Shares Allotted)		10,00,000	 10,00,000

Reconstruction Account

Particulars	₹	Particulars	₹
Goodwill A/c	1,50,000	Pref. Share Capital A/c	2,00,000

Bank A/c	50,000	Creditors A/c	6,00,000
Preliminary Expenses A/c	25,000	Unsecured Loan A/c	2,50,000
P&L A/c	10,00,000	Shares Surrendered A/c	8,70,000
Plant A/c	2,25,000		
Equipment A/c	40,000		
Book Debts A/c	80,000		
Inventories A/c	1,00,000		
Patents A/c	2,50,000		
	19,20,000		19,20,000

Illustration 11.16

The following is the Balance Sheet of X Ltd. as at 31 March 2011:

Liabilities	₹	**Assets**	₹
Share Capital		Goodwill	50,000
40,000 Equity Shares of ₹ 100 Each	40,00,000	Land & Buildings	3,00,000
12% Debentures	10,00,000	Plant & Machinery	6,00,000
Outstanding Debentures Interest	2,40,000	Furniture	1,60,000
Creditors	6,00,000	Stock	5,40,000
		Debtors	1,20,000
		Cash at Bank	70,000
		Preliminary Expenses	40,000
		Profit & Loss A/c	39,60,000
	58,40,000		58,40,000

The following scheme of reconstruction is executed:

(i) Equity shares are reduced by ₹ 95 per share. They are then consolidated into 20,000 equity shares of ₹ 10 each.

(ii) Debenture holders agree to forego outstanding debenture interest. As a compensation, 12% debentures are converted into 14% debentures, the amount remaining ₹ 10,00,000.

(iii) Creditors are given the option to either accept 50% of their claim in cash in full settlement or to convert their claim into equity shares of ₹ 10 each. Creditors for ₹ 4,00,000 opt for shares in satisfaction of their claims and the rest accepted cash.

(iv) To make payment to creditors and to augment working capital, the company issued 1,00,000 equity shares of ₹ 10 each at par, the entire amount being payable along with application. The issue was fully subscribed.

(v) Land and building are revalued at ₹ 4,00,000; plant and machinery at ₹ 4,20,000 and provision amounting to ₹ 10,000 is made for doubtful debts.

Pass journal entries to record the above.

[B.Com (Hons) Delhi 2007 Modified]

Solution

Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
31 March 2011	Equity Share Capital (₹ 100) A/c	Dr.		38,00,000	
	To Reconstruction A/c				38,00,000
	(40,000 Equity Shares of ₹ 100 Each are Reduced by ₹ 95 Each)				
31 March 2011	Equity Share Capital A/c (₹ 5)	Dr.		2,00,000	
	To Equity Share Capital A/c (₹ 10)				2,00,000
	(On Consolidation of Equity Shares of ₹ 10 Each				
31 March 2011	Outstanding Debenture Interest A/c	Dr.		2,40,000	
	To Reconstruction A/c				2,40,000
	(Debenture Holders Foregone Their Claim)				
31 March 2011	12% Debentures A/c	Dr.		10,00,000	
	To 14% Debentures A/c				10,00,000
	(Conversion of 12% Debentures into 14% Debentures)				
31 March 2011	Bank A/c	Dr.		10,00,000	
	To Equity Share Application & Allotment A/c				10,00,000
	(Issue of Shares to Creditors)				
31 March 2011	Equity Share Application & Allotment A/c	Dr.		10,00,000	
	To Equity Share Capital A/c				10,00,000
	(Allotment of Shares to Creditors)				
31 March 2011	Creditors A/c	Dr.		6,00,000	
	To Bank A/c				1,00,000
	To Equity Share Capital A/c				4,00,000
	To Reconstruction A/c				1,00,000
	(50% Creditors Claim Settled)				
31 March 2011	Land & Building A/c	Dr.		1,00,000	
	To Reconstruction A/c				1,00,000
	(Revaluation Profit Transferred)				
31 March 2011	Reconstruction A/c	Dr.		42,40,000	
	To P&L A/c				39,60,000
	To Preliminary Expenses A/c				40,000
	To Provision for Bad Debts A/c				10,000
	To Plant & Machinery A/c				1,80,000
	To Goodwill A/c				50,000
	(Utilization of Reconstruction A/c				
	(Losses Written off, Assets Written down)				

Illustration 11.17

Model: Revaluation of assets—Surrender of shares.

The following information relates to Sick Ltd. as on 31 December 2010:

	₹
12,000 Equity Share of ₹ 100 Each	12,00,000
6,000 6% Debentures of ₹ 100 Each	6,00,000
Interest on Debentures Outstanding	72,000
Trade Creditors	3,00,000
Fixed Assets	12,00,000
Current Assets	3,90,000

The following scheme was duly agreed and approved by the Court:

(i) The shares were sub-divided into shares of ₹ 5 each and 90% of the shares were surrendered

(ii) The total claims of debenture holders were reduced to ₹ 2,94,000 and in consideration of this, they were allotted shares (out of the surrendered shares) amounting to ₹ 1,50,000

(iii) Creditors agreed to reduce their claims to ₹ 90,000, one-third of which was satisfied by issue of equity shares out of those surrendered

(iv) Fixed assets were revalued at ₹ 5,76,000 and current assets were revalued at ₹ 2,88,000

(v) The shares surrendered but not re-issued were cancelled

You are required to draft the necessary journal entries and give the balance sheet of the company after reconstruction.

[B.Com (Hons) Delhi 2008 Modified]

Solution

Note: As P&L A/c is not given, it has to be ascertained by preparing the balance sheet as follows:

Balance Sheet (Before Reconstruction)

Liabilities	₹	Assets	₹
Equity Share Capital A/c	12,00,000	Fixed Assets	12,00,000
6% Debentures	6,00,000	Current Assets	3,90,000
Interest on Debentures Outstanding	72,000	*[1]Profit & Loss A/c	5,82,000
Trade Creditors	3,00,000	(Balancing Figure)	
	21,72,000		21,72,000

Books of Sick Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
31 December 2010	Equity Share Capital A/c (₹ 100) Dr. To Equity Share Capital A/c (₹ 5) (Sub-division of ₹ 100 Equity Shares into Equity Shares of ₹ 5 Each)		12,00,000	12,00,000

31 December 2010	Equity Share Capital A/c (₹ 5)	Dr.		10,80,000	
	To Shares Surrendered A/c				10,80,000
	(Surrender of 90% of Shares)				
31 December 2010	Share Surrendered A/c	Dr.		1,50,000	
	To Equity Share Capital A/c (₹ 5)				1,50,000
	(Conversion of Surrendered Shares into Equity Shares of ₹ 5 Each)				
31 December 2010	6% Debentures A/c	Dr.		72,000	
	Interest on Debentures A/c	Dr.		3,06,000	
	To Reconstruction A/c				3,78,000
	(Sacrifice by Debenture Holder Transferred to Reconstruction A/c)				
31 December 2010	Creditors A/c	Dr.		2,10,000	2,10,000
	To Reconstruction A/c				
	(Reduction of Claims of Creditors)				
31 December 2010	Creditors A/c	Dr.		30,000	
	To Reconstruction A/c				30,000
	(Issue of Equity Shares out of Surrendered Shares)				
31 December 2010	Surrendered Share A/c	Dr.		30,000	
	To Equity Share Capital A/c				30,000
	(Conversion of Surrendered Shares into New Equity Shares)				
31 December 2010	Shares Surrendered A/c	Dr.		9,00,000	
	To Reconstruction A/c				9,00,000
	(Cancellation of Unused Surrendered Shares)				
31 December 2010	Reconstruction A/c	Dr.		15,18,000	
	To Fixed Assets A/c				6,24,000
	To Current Assets A/c				1,02,000
	To P&L A/c (Ref: *1)				5,82,000
	To Capital Reserve A/c (Bal. Fig.)				2,10,000
	(Utilization of Reconstruction A/c)				

Reconstruction Account

Liabilities	₹	**Assets**	₹
Fixed Assets A/c		Debentures A/c	3,06,000
(₹ 12,00,000 – ₹ 5,76,000)	6,24,000	Creditors A/c	2,10,000
Current Assets A/c		Creditors A/c	30,000
(₹ 3,90,000 – ₹ 2,88,000)	1,02,000	Shares Surrendered A/c	9,00,000
P&L A/c		Interest Outstanding on Debentures	72,000
(Ref: *1)	5,82,000		
Capital Reserve A/c			
(Bal. Fig.)	2,10,000		
	15,18,000		15,18,000

Balance Sheet of Sick Ltd. (And Reduced)
as on 18 January 2011

Liabilities	₹	Assets	₹
60,000 Equity Shares of ₹5 Each Fully Paid	3,00,00	Fixed Assets	5,76,000
		Current Assets	3,88,000
Capital Reserve	2,10,000		
6% Debentures	2,94,000		
Trade Creditors	60,000		
	8,64,000		8,64,000

Illustration 11.18

Model: Maintenance of working capital

ABC Ltd., whose balance sheet as on 31 March 2011 given in the following, formulated a scheme of reconstruction details of which follow and secured approval of all concerned :

Liabilities	₹	Assets	₹
2,00,000 Equity Shares of ₹20 Each ₹10 Paid	20,00,000	Fixed Assets	22,40,000
8% 16,000 Pref. Shares of ₹100 Each, ₹75 Paid up	12,00,000	Patents & Copyrights	1,60,000
19% Debentures	12,00,000	Investments at Cost (Market Value ₹1,10,000)	1,30,000
Interest Due there on	2,16,000		
Bank Overdraft	3,00,000	Current Assets	16,98,000
Sundry Creditors (Including Interest of ₹30,000 Due to Bank)	1,68,000	Profit & Loss A/c	8,56,000
	50,84,000		50,84,000

Preference dividend is in arrears for 1 year.

(i) Preference shareholders to give up their claims, inclusive of dividends, to the extent of 30% and desire to be paid off.

(ii) Debenture holders agree to give up their claims to interest in consideration of their rate of interest being enhanced to 10%.

(iii) Bank agrees to give up 50% of its interest outstanding in consideration of their claim being paid off at once.

(iv) Sundry creditors would like to grant a discount of 5% if they were to be paid off immediately.

(v) Balances of P&L A/c, patents & copyrights and 25% of the sundry debtors of ₹2,40,000 to be written off. Fixed assets to be written down by ₹28,000. Investments to reflect their market value.

(vi) To the extent not specifically stated, equity shareholders suffer no reduction of their rights.

(vii) Cost of reconstruction is ₹6,700.

Pass journal entries in the books of the company assuming that the scheme has been put through fully with the equity shareholders bringing in necessary cash to pay off the parties and to leave a working capital of ₹4,40,000.

Draw the balance sheet after reconstruction.

[B.Com (Hons) Modified]

Solution

Calculations.

I: Determination of Necessary Cash Brought in by Equity Shareholders:

		₹
(i) Amount Paid to Pref. Shareholders (₹ 8,40,000 + ₹ 67,200) 70% of Face Value 70% of Interest	:	9,07,200
(ii) Bank Overdraft	:	3,00,000
(iii) Sundry Creditors (₹ 1,28,000 – ₹ 15,000 – ₹ 7,000)		1,46,100
(iv) Reconstruction Costs	:	6,700
		13,60,000
(v) Working Capital to Be Maintained	:	4,40,000
(vi) Needed Cash Brought in by Shareholders	:	18,00,000

II: Calculation of Equity Share Capital A/c:

Reduction of paid-up capital to make up the balance of reconstruction account is determined by preparing reconstruction account as follows:

Reconstruction A/c

Particulars	₹	Particulars	₹
Pref. Dividends	67,200	Pref. Share Capital A/c	3,60,000
P&L A/c	8,56,000	9% Debentures A/c	2,16,000
Patents & Copyrights	1,60,00	Sundry Creditors A/c	21,900
Sundry Debtors	60,000	(₹ 15,000 + ₹ 6,900)	
Fixed Assets	28,000	Equity Share Capital A/c	6,00,000
Investments	20,000	(Bal. Fig.)	
Bank	6,700		
	11,97,900		11,97,900

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
31 March 2011	8% Preference Share Capital A/c Dr. To Preference Shareholders A/c To Reconstruction A/c (Amount Payable to Pref. Shareholders 70% of Nominal Value)		12,00,000	 8,40,000 3,60,000
31 March 2011	Reconstruction A/c Dr. To Preference Shareholders A/c (8% on ₹ 12,00,000: ₹ 96,000 × $\frac{70}{100}$) (Amount Payable to Pref. Shareholders)		67,200	 67,200
31 March 2011	9% Debentures A/c Dr. Interest on Debentures A/c Dr. To 10% Debentures A/c To Reconstruction A/c (Convention of 9% Debentures into 10% Debentures & Transfer of Interest)		12,00,000 2,16,000	 12,00,000 2,16,000

31 March 2011	Sundry Creditors A/c Dr. To Reconstruction A/c (Interest Given up by the Bank)		15,000	 15,000
31 March 2011	Sundry Creditors A/c Dr. To Reconstruction A/c 5% on ₹ 1,38,000 → (₹ 1,68,000 – ₹ 30,000) (Discount Granted by Creditors)		6,900	 6,900
31 March 2011	*Equity Share Capital A/c Dr. To Reconstruction A/c (Ref: Calculation *1) Reduction of Paid-up Capital to Make up the Balance in Reconstruction A/c)		6,00,000	 6,00,000
31 March 2011	Reconstruction A/c Dr. To Profit & Loss A/c To Patents & Copyrights A/c To Sundry Debtors A/c To Fixed Assets A/c To Investments A/c To Bank A/c (Expenses) (Utilization of Balance in Reconstruction A/c to Write off Fictitious Assets, and Overvalued Fixed Assets, Debtors and Investments and Reconstruction Expenses Paid)		11,30,700	 8,56,000 1,60,000 60,000 28,000 20,000 6,700
31 March 2011	Bank A/c To Equity Share Capital A/c Dr. (To Maintain Working Capital (Ref: *2) The Issue of Equity Shares (₹ 2,00,000 @ ₹ 9))		18,00,000	 18,00,000
31 March 2011	Preference Shareholders A/c Dr. Bank Overdraft A/c Dr. Sundry Creditors A/c Dr. To Bank A/c (Amount Settled as per Scheme)		9,07,200 3,00,000 1,46,100	 13,53,300

Balance Sheet of ABC Ltd. (And Reduced)
as on 31 March 2011

Liabilities	₹	Assets		₹
Authorized Share Capital		Fixed Assets:	22,40,000	
2,00,000 Equity Shares of ₹ 20 Each	40,00,000	Less: Written off	28,000	22,12,000
Issued & Subscribed:		Investments (1,30,000 – 20,000)		1,10,000

2,00,000 Equity Share of ₹ 20 Each, ₹ 16 Paid up	32,00,000	Current Assets:		
		Sundry Debtors	2,40,000	
Secured Loan:		Less: Written Debt	60,000	1,80,000
10% Debentures	12,00,000	Cash at Bank		4,40,000
		Others	16,98,000	
		Less: Debtors	2,40,000	14,58,000
	44,00,000			44,00,000

Illustration 11.19

Model: Forfeiture of shares and utilizing the provision for taxes

The following is the balance sheet of Leo Ltd. as at 31 March 2011:

Liabilities	₹	**Assets**		₹
Share Capital:		Goodwill		4,00,000
4,80,000 Equity Shares of ₹ 10 Each:		Machinery		20,34,000
48,00,000		Furniture		4,11,000
Less: Calls-in-Arrears (₹ 3)		Stock		8,20,000
Per Share on 1,20,000 Shares 3,60,000	44,40,000	Debtors		6,00,000
Sundry Creditors	6,17,000	Cash at Bank		60,000
Provision for Taxation	1,60,000	Preliminary Expenses		60,000
		P&L A/c	8,80,000	
		Less: Profit for the Year	48,000	8,32,000
	52,17,000			52,17,000

The directors have had a valuation made of the machinery and find it overvalued by ₹ 4,00,000. It is proposed to write down this asset to its true value and to extinguish the deficiency in the P&L A/c and to write off goodwill and preliminary expenses, by the adoption of the following course:

(i) Forfeit the shares on which the call is outstanding

(ii) Reduce the paid-up capital by ₹ 3 per share

(iii) Re-issue the forfeited share as fully paid shares of ₹ 7 each at ₹ 5 per share

(iv) Utilize the provision for taxation, if necessary

(a) Draft the necessary journal entries

(b) Draw the company's balance Sheet immediately after the implementation of the scheme of reconstruction [B.Com (Hons) Delhi Modified]

Solution

Books of Leo Ltd.

Journal Entries

Date	**Particulars**	**L.F.**	**Dr. (₹)**	**Cr. (₹)**
31 March 2011	Share Capital A/c (1,20,000 Shares × ₹ 10)		12,00,000	
	To Shares Forfeited A/c (1,20,000 × ₹ 7)			8,40,000
	To Calls-in-Arrears A/c (1,20,000 × ₹ 3)			3,60,000
	(1,20,000 Shares Forfeited for Non-payment of Final Call of ₹ 5 Per Share)			

	Bank A/c (1,20,000 × ₹ 5) Dr.		6,00,000	
	Shares Forfeited A/c (1,20,000 × ₹ 2) Dr.		2,40,000	
	To Share Capital A/c (1,20,000 × ₹ 7)			8,40,000
	(1,20,000 Re-issued (Shares of ₹ 7) at ₹ 5)			
31 March 2011	Share Forfeited A/c Dr.		6,00,000	
	To Capital Reserve A/c			6,00,000
	(₹ 8,40,000 – ₹ 2,40,000)			
	(Balance in Shares Forfeited A/c Transferred to Capital Reserve A/c)			
31 March 2011	Share Capital A/c (3,60,000 Shares × ₹ 3) Dr.		10,80,000	
	To Reconstruction A/c			10,80,000
	(3,60,000 Shares Reduced by ₹ 3 Each)			
31 March 2011	Capital Reserve A/c Dr.		6,00,000	
	Provision for Taxes A/c Dr.		12,000	
	To Reconstruction A/c			6,12,000
	(Balance of Capital Reserve & Provision of Tax Utilized for the Scheme of Reconstruction) (Ref. *2 for Provision for Taxes)			
31 March 2011	Reconstruction A/c Dr.		16,92,000	
	To Machinery A/c			4,00,000
	To P&L A/c			8,32,000
	To Goodwill A/c			4,00,000
	To Preliminary Expenses A/c			60,000
	(Goodwill & Preliminary Expenses Written off; Deficiency in P&L A/c Waived and Assets Written down to Its True Value)			

Reconstruction A/c

Particulars	₹	Particulars	₹
Goodwill A/c	4,00,000	Share Capital A/c	10,80,000
Preliminary Expenses at	60,000	Capital Reserve A/c	6,00,000
P&L A/c	8,32,000	*2Provision for Tax A/c	12,000
Machinery A/c	4,00,000	(Bal. Fig.)	
	16,92,000		16,92,000

Balance Sheet of Leo Ltd.
as on 1 April 2011

Liabilities	₹	Assets		₹
Share Capital:		Machinery	20,34,000	
4,80,000 Shares of ₹ 7 Each	33,60,000	Less: Written off	4,00,000	16,34,000
Sundry Creditors	6,17,000	Furniture		4,11,000
Provision for Taxation	1,48,000	Stock		8,20,000
(₹ 1,60,000 – ₹ 12,000)		Debtors		6,00,000
		Cash at Bank		6,60,000
	41,25,000			41,25,000

Illustration 11.20

Model: Issue of shares—Redemption of debentures At premium bonus shares

The share capital of Gemini Ltd. consisted of 1,00,000 equity shares of ₹10 each fully paid. The company has accumulated out of profits a reserve fund of ₹10,00,000. It issued further 20,000 equity shares during 2010 at a premium of ₹30 per share and the entire amount had been realized.

An independent valuation of its assets increased the balance sheet values as thus:

Land and Buildings by ₹12,00,000
Plant and Machinery by ₹ 6,00,000
Stores and Spares by ₹5,00,000

The valuation reduced the amounts of the following:

Goodwill by ₹ 3,00,000
Patents by ₹2,00,000

At the end of 2010, it was decided to redeem 6,000 debentures of ₹100 each as 5% premium; to adopt the new valuation; and to allot two equity shares of ₹10 each as fully paid bonus shares for every equity share held.

It was also decided that the balance of reserve fund, after carrying out all the above arrangements, was to be capitalized. Pass journal entries to record these transactions in the books of Gemini Ltd.

[B.Com (Hons) Delhi Modified]

Solution

Books of Gemini Ltd.
Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
(i)	Bank A/c	Dr.		8,00,000	
	To Share Application & Allotment A/c				8,00,000
	[Amount Received on 20,000 Shares, (₹10 + ₹30 Premium) Per Share]				
(ii)	Share Application & Allotment A/c	Dr.		8,00,000	
	To Share Capital A/c				2,00,000
	To Share Premium A/c				6,00,000
	(20,000 Shares of ₹10 Each Allotted with Premium ₹30)				
(iii)	Land & Buildings A/c	Dr.		12,00,000	
	Plant & Machinery A/c	Dr.		6,00,000	
	Stores & Spares A/c	Dr.		5,00,000	
	To Reconstruction A/c				23,00,000
	(Assets on Revaluation Enhanced Values)				
(iv)	Reconstruction A/c	Dr.		5,00,000	
	To Goodwill A/c				3,00,000
	To Patents A/c				2,00,000
	(Assets Written Down)				

(v)	Reconstruction A/c Dr.		18,00,000	
	To Capital Reserve A/c			18,00,000
	(Profit on Revaluation (or) Balance in Reconstruction A/c Transferred to Capital Reserve A/c)			
(vi)	Debentures A/c Dr.		6,00,000	
	Premium on Redemption A/c Dr.		30,000	
	To Debenture Holders A/c			6,30,000
	(6,000 Debentures of ₹ 100 Each Due for Redemption at a Premium of 5%)			
(vii)	Reserve Fund A/c Dr.		6,00,000	
	To Capital Reserve A/c			6,00,000
	(Amount Equal to Redemption Transferred)			
(viii)	Share Premium A/c Dr.		30,000	
	To Premium on Redemption A/c			30,000
	(Premium on Redemption Is Met out from Share Premium A/c)			
(ix)	Debenture Holders A/c Dr.		6,30,000	
	To Bank A/c			6,30,000
	(Amount Paid to Debenture Holders)			
(x)	Share Premium A/c Dr.		5,70,000	
	Capital Reserve A/c Dr.		14,30,000	
	To Bonus to Shareholders A/c			20,00,000
	(Bonus Shares to the Existing 1,00,000 Equity Shares in the Ratio of Two Shares of ₹ 10 Each for Every One Equity Share Held)			
(xi)	Bonus to Shareholders A/c Dr.		20,00,000	
	To Equity Share Capital A/c			20,00,000
	(Issue of Bonus Shares)			

Illustration 11.21

Model: Interest of individuals in the company's reconstruction scheme

Having accumulated huge losses, Aries Ltd. adopts a scheme of reconstruction on 31 March 2011, on which date its balance sheet is as follows:

Balance Sheet of Aries Ltd.
as on 31 March 2011

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
Authorized:		Goodwill	6,50,000
75,000 Equity Shares of ₹ 50 Each	37,50,000	Plant	5,00,000
Subscribed & Paid up:		Computers	12,50,000
25,000 Equity Shares of ₹ 50 Each	12,50,000	Furniture	1,00,000
50,000 Equity Shares of ₹ 50 Each		Current Assets:	

₹40 per Share Paid up	20,00,000	Stock	3,50,000
Secured Loans:		Cash at Bank	50,000
11.5% First Debentures	2,50,000	Profit & Loss A/c	13,50,000
12% Second Debentures	5,00,000		
Current Liabilities:			
Sundry Creditors	2,50,000		
	42,50,000		42,50,000

The following is the interest of Mr. X and Mr. Y in Aries Ltd.:

	Mr.X (₹)	Mr. Y (₹)
11.5% First Debentures	1,50,000	1,00,000
12% Second Debentures	3,50,000	1,50,000
Sundry Creditors	1,00,000	50,000
	6,00,000	3,00,000
Fully Paid up ₹50 Shares	1,50,000	1,00,000
Partly Paid up ₹40 Paid up	2,50,000	2,50,000

The following scheme of reconstruction is approved by all parties interested and also by the Court:

(a) Uncalled capital is to be called up in full and such shares and also fully paid-up shares pertaining to the earlier issue be converted into equal number of fully paid-up equity shares of ₹20 each

(b) Mr. X is to cancel ₹3,50,000 of his total debt (other than share amount), is to pay ₹1,00,000 to the company and to receive new 13% first debentures in full settlement

(c) Mr. Y is to cancel ₹1,50,000 of his total debt (excluding shares) and to accept new 13% first debentures for the balance

(d) The amount thus rendered available by the scheme be utilized in writing off goodwill, the debit balance of P&L A/c and in reducing the book value of computers by ₹7,50,000

You are required to pass the journal entries for all the above-mentioned transactions and prepare the initial balance sheet of the reconstructed company. [C.A. (Inter). Modified]

Solution

Books of Aries Ltd.
Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Final Call A/c	Dr.		5,00,000	
	To Equity Share Capital A/c				5,00,000
	(Final Call on 50,000 Equity Shares @ ₹10)				
	Bank A/c	Dr.		5,00,000	
	To Equity Share Final Call A/c				5,00,000
	(Final Call Money Received)				

	Equity Share Capital (₹ 50) A/c Dr.		37,50,000	
	To Equity Share Capital A/c			15,00,000
	To Reconstruction A/c			22,50,000
	(Conversion of 75,000 Fully Paid Equity Shares of ₹ 50 Each into 75,000 Fully Paid Equity Shares of ₹ 20 Each, Balance Transferred to Reconstruction A/c)			
	11.5% First Debentures A/c Dr.		1,50,000	
	12% Second Debentures A/c Dr.		3,50,000	
	Sundry Creditors A/c Dr.		1,00,000	
	Bank A/c Dr.		1,00,000	
	To 13% New First Debentures A/c			3,50,000
	To Reconstruction A/c			3,50,000
	(Cancellation of ₹ 3,50,000 of Total Debt Due to Mr. X, Receipt of ₹ 1,00,000 from Him & Issue of 13% New First Debentures for ₹ 3,50,000 in Full Settlement)			
	11.5% First Debentures A/c Dr.		1,00,000	
	12% Second Debentures A/c Dr.		1,50,000	
	Sundry Creditors A/c Dr.		50,000	
	To 13% New First Debentures A/c			1,50,000
	To Reconstruction A/c			1,50,000
	(Cancellation of ₹ 1,50,000 of Total Debt Due to Y & Issue of 13% New First Debentures for the Remaining Amount)			
	Reconstruction A/c Dr.		27,50,000	
	To Goodwill A/c			6,50,000
	To P&L A/c			13,50,000
	To Computers A/c			7,50,000
	(Utilization of Reconstruction A/c to Write off Goodwill, Debt Balance of P&L A/c and to Write down the Value of Computers by ₹ 7,50,000)			

Balance Sheet Aries Ltd. (And Reduced)
as on 31 March 2011

Liabilities	₹	**Assets**		₹
Share Capital:		Fixed Assets:		
Authorized 1,87,500 Equity Shares of ₹ 20 Each	37,50,000	Goodwill	6,50,000	
		Less: Written off	6,50,000	Nil
Issued & Subscribed:		Plant		5,00,000
75,000 Equity Shares of ₹ 20 Each Fully Paid up	15,00,000	Computers	12,50,00	
		Less: Written off	7,50,000	5,00,000

Secured Loan:		Furniture	1,00,000
13% First Debentures	5,00,000	Current Assets:	
Current Liabilities:		Stock	3,50,000
Sundry Creditors	1,00,000	Cash at Bank	6,50,000
	21,00,000		21,00,000

Illustration 11.22

The following is the balance sheet of Singh Ltd. as at 31 March 2011:

Liabilities	₹	**Assets**	₹
Authorized Share Capital:			
30,000 Shares of ₹ 10 Each	30,00,000	Goodwill	3,00,000
Issued, Subscribed & Paid up 3,000 9%		Fixed Assets	11,40,000
Cumulative Pref. Shares of ₹ 100 Each	3,00,000	Cash	27,000
9,000 Equity Shares of ₹ 100	9,00,000	P&L A/c	1,83,l000
13.5% Debentures	3,00,000		
Creditors (Including ₹ 30,000) Holding lien on Some Assets)	1,50,000		
	16,50,000		16,50,000

The company decided on a scheme of reduction of capital which was duly authorized. The scheme provided as follows:

(i) The equity shares of ₹ 100 each, ₹ 50 paid up per share to be issued for each preference share

(ii) Each existing equity share is to be reduced to ₹ 50 paid up, the face value remaining the same at ₹ 100

(iii) 3,000 Equity shares were taken up by the directors and paid for by them to the extent of ₹ 50 each

(iv) Arrears of preference dividend for the last four years is to be cancelled

(v) Debenture holders to receive 2,400 equity share of ₹ 100 each credited as fully paid up

(vi) Unsecured creditors to be paid immediately to the extent of 10% of their claims and they accepting a remission of 20% of their claims

(vii) The amount available as a result of the scheme to be used to write off the debit balance in the P&L A/c, to write down fixed assets by ₹ 30,000 and to adjust goodwill

You are required to give journal entries to record the above and give the balance sheet after the reconstruction is effected.

[I.C.W.A. (Final). Modified]

Solution

Singh Ltd.
Journal Entries

Date	**Particulars**	**L.F.**	**Dr. (₹)**	**Cr. (₹)**
	9% Cumulative Preference Share Capital A/c Dr.		3,00,000	
	To Equity Share Capital A/c			3,00,000
	(Two Equity Shares of ₹ 100 Each, ₹ 50 Paid up per Share is Issued for Each Pref. Share)			

	Equity Share Capital A/c Dr.		4,50,000	
	To Reconstruction A/c			4,50,000
	(Existing Equity Shares Reduced to ₹ 50 Paid up, Face Value Remains at ₹ 100)			
	Bank A/c Dr.		1,50,000	
	To Equity Share Capital A/c			1,50,000
	(3,000 Equity Shares Taken up by Directors Paid for by Them for ₹ 50 Each)			
	13.5% Debentures A/c Dr.		3,00,000	
	To Equity Share Capital A/c			2,40,000
	To Reconstruction A/c			60,000
	(2,400 Equity Shares of ₹ 100 Each as Fully Paid up; Issued to Debenture Holders)			
	Sundry Creditors A/c Dr.		36,000	
	To Bank A/c			12,000
	To Reconstruction A/c			24,000
	(Unsecured Creditors Paid)			
	Reconstruction A/c Dr.		5,13,000	
	To P&L A/c			1,83,000
	To Fixed Assets A/c			30,000
	To Goodwill A/c			3,00,000
	(Utilization of Reconstruction A/c to Write off Debit Balance in P&L A/c, to Write down Fixed Assets by ₹ 30,000 and to Adjust Goodwill A/c)			
	Reconstruction A/c Dr.		21,000	
	To Capital Reserve A/c			21,000
	(Balance in Reconstruction A/c Transferred)			

Singh Ltd.
Balance Sheet as on 31 March 2011

Liabilities	₹	**Assets**	₹
Authorized Share Capital:			
30,000 Shares of ₹100 Each	30,00,000	Fixed Assets	11,10,000
Issued & Subscribed		Cash	1,65,000
18,000 Equity Shares of ₹ 100 Each, ₹ 50 per Share Paid up	9,00,000		
2,400 Equity Shares of ₹ 100 Each, Fully Paid up	2,40,000		

Capital Reserve	21,000		
Sundry Creditors			
(Including ₹ 30,000 Holding			
Lien on Some Assets)	1,14,000		
	12,75,000		12,75,000

Illustration 11.23

Model: Typical

The balance sheet of A Ltd. as at 31 March 2011 was as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Intangibles	1,36,000
Authorized	28,00,000	Freehold Premises at Cost	2,80,000
1,28,000 8% Cumulative Preference Shares of ₹ 10 Each Fully Paid	12,80,000	Plant & Equipment at Cost	4,80,000
1,28,000 Equity Shares of ₹ 10 Each, ₹ 7.50 Paid	9,60,000	Investment in Shares in B Ltd. at Cost	6,48,000
		Stocks	4,96,000
Loan from Directors	1,20,000	Debtors	6,40,000
Sundry Creditors	8,80,000	Deferred Revenue Expenditure	96,000
Bank Overdraft	4,16,000	Profit & Loss A/c	8,80,000
	36,56,000		36,56,000

Note: The arrears of preference dividends amounted to ₹ 1,02,400.

A Scheme of reconstruction was duly approved with effect from 1 April 2011 under the conditions stated in the following:

(a) The unpaid amount on equity shares would be called up.

(b) The preference shareholders would forego their arrears of dividends. In addition, they would accept a reduction of ₹ 2.50 per share. The dividend rate would be enhanced to 10%.

(c) The equity shareholders would accept a reduction of ₹ 7.50 per share.

(d) A Ltd. holds 43,200 shares in B. Ltd. This represents 15% of the share capital of that company. B Ltd. is not a quoted company. The average net profit (after tax) of the company is ₹ 5,00,000. The shares would be valued based on 12% capitalization rate.

(e) A bad debt provision @ 2% would be created.

(f) The other assets would be valued as follows:

	₹
Intangibles	96,000
Plant	2,80,000
Freehold Premises	7,60,000
Stocks	5,00,000

(g) The P&L A/c debit balance and the balance standing to the debt of deferred revenue expenditure A/c would be eliminated.

(h) The directors would have to take equity shares at the new face value of ₹ 2.50 per share in settlement of their loan.

(i) The equity shareholders, including the directors, who would receive equity shares in settlement of their loans, would take up two new equity shares for every one held.

(j) The preference shareholders would take up one new preference share for every four held.

(k) The authorized share capital would be restated to ₹ 28,00,000.

(l) The new face value of the shares—preference & equity—will be maintained at their reduced levels.

You are required:

(1) To prepare the necessary ledger accounts to effect the above

(2) To prepare the balance sheet of the company after reconstruction [I.C.W.A. (Final). Modified]

Solution

Investments in B Ltd. is calculated as:

$$\frac{5,00,000}{0.12} \times \frac{15}{100} = ₹\,6,25,000$$

Reconstruction A/c

Particulars	₹	Particulars	₹
To Intangibles A/c	40,000	By 8% Cumulative Pref.	
To Plant & Equipment A/c	2,00,000	Share Capital A/c	3,20,000
To Deferred Revenue Expenditure	96,000	By Equity Share Capital A/c	9,60,000
To Profit & Loss A/c	8,80,000	By Freehold Premises A/c	4,80,000
To Investments A/c	23,000	By Stock A/c	4,000
To Provision for Bad Debts A/c	12,800		
To Capital Reserve A/c	5,12,200		
	17,64,000		17,64,000

Equity Share Capital A/c

Particulars	₹	Particulars	₹
To Reconstruction A/c	9,60,000	By Balance b/d	9,60,000
To Balance b/d	13,20,000	By Bank A/c (1,28,000 × ₹ 2.50)	3,20,000
		By Directors' Loan A/c	1,20,000
		By Bank A/c	
		(1,28,000 + 48,000) × 2 × 2.50)	8,80,000
	22,80,000		22,80,000

Bank A/c

Particulars	₹	Particulars	₹
To Equity Share Capital A/c	3,20,000	By Balance b/d (Overdraft)	4,16,000
To Equity Share Capital A/c	8,80,000	By Balance c/d	10,24,000
To 8% Cumulative Pref. Share Capital A/c	2,40,000		
	14,40,000		14,40,000

10% Cumulative Pref. Share Capital A/c

Particulars	₹	Particulars	₹
To Balance c/d	12,00,000	By 8% Cumulative Pref. Share Capital A/c	12,00,000
	12,00,000		12,00,000

A Ltd. (And Reduced)
Balance Sheet as on 1 April 2011

Liabilities	₹	Assets		₹
Share Capital:		Intangibles		96,000
Authorized	28,00,000	Freehold Premises		7,60,000
Issued & Paid up:		Plant & Equipment		2,80,000
5,28,000 Equity Shares of ₹ 2.50 Each	13,20,000	Investments in B Ltd.		6,25,000
1,60,000 Preference Shares of ₹ 7.50 Each	12,00,000	Stock		5,00,000
		Debtors	6,40,000	
Capital Reserve	5,12,200	Less: Provision for Bad debts	12,800	6,27,200
Sundry Creditors	8,80,000	Bank		10,24,000
	39,12,200			39,12,200

Illustration 11.24

Model: Distribution of anticipated profits unrecorded liability

ABC Ltd. decided to recognize itself following a period of adverse trading conditions. The summarized balance sheet at 31 March 20… was as follows:

(₹ in Lakhs)

Liabilities	₹	Assets	₹
12% Cumulative Preference Shares of ₹ 10 Each	84.00	Goodwill	6.00
		Patents & Franchises	5.20
Equity Shares of ₹ 10 Each	240.00	Land & Buildings	160.40
Share Premium A/c	10.00	Plant & Machinery	12.40
14% Debentures	96.00	Investments	32.00
Interest Payable on Debentures	26.88	Stocks	124.00
Loan from Directors	9.60	Debtors	84.00
Sundry Creditors	33.52	Deferred Charges	2.00
Bank Overdraft	20.00	Profit & Loss A/c	94.00
	520.00		520.00

Preference dividend is in arrears for 3 years. The authorized share capital is ₹ 12 lakh 12% cumulative preference shares of ₹ 10 each and 24 lakh equity shares of ₹ 10 each. The following reconstruction scheme was formulated and duly approved:

(i) The existing equity shares were to be converted into fully paid up equity shares of ₹ 2 each. The equity shareholders were to accept a consequent reduction in their value of holdings. They further agree to subscribe to a new issue of equity shares on the basis of 2 for 3 at a price of ₹ 3.50 per share.

(ii) The Preference Shareholders were to forego their right to arrear dividends. The existing 8,40,000 preference shares were to be exchanged for a new issue of 4,20,000 14% cumulative preference shares of ₹ 10 each and ₹ 42,00,000 in equity shares of ₹ 2 each.

(iii) The debenture holders were to accept 5,00,000 equity shares of ₹ 2 each in settlement of their arrear interest and the interest rate on debentures was to be enhanced to 15%. The debenture holders were also to accept further 15% debentures of ₹ 16,00,000 at ₹ 90 per ₹ 100.

(iv) Half of the directors' loan was to be cancelled. The balance was to be settled by the issue of 96,000 equity shares of ₹ 2 each.

(v) Investments were to be sold at the current market value of ₹ 20,00,000.

(vi) The bank overdraft was to be repaid in full.

(vii) An amount of ₹ 20,00,000 was to be paid immediately to creditors. The balance amount would have to be paid in quarterly investments.

(viii) All intangibles, deferred charges and the debit balance to P&L A/c were to be written off.

(ix) Liability for damages unrecorded in books was to be settled for ₹ 17,60,000. A sum of ₹ 3,00,000 was to be recovered in this connection from the insurance company.

(x) The existing share premium account was to be utilized in full.

(xi) Tangible fixed assets were to be revalued as:

1. Land & Buildings ₹ 1,76,00,000
2. Plant & Machinery ₹ 10,00,000

(xii) Stocks were to be written down by ₹ 84,00,000.

(xiii) Debtors account was to be adjusted for an uncontrolled debt of ₹ 9,00,000.

It is expected that with the new arrangements, the company will be able to earn a return of ₹ 50,00,000 p.a. before interest and taxes. The company will not attract any tax liability for the next 5 years.

You are required to:

(a) Show the journal entries necessary to record the above scheme

(b) Prepare the summarized balance sheet of the company immediately after reconstruction

(c) Show how the anticipated profit will be distributed after the reconstruction

[I.C.W.A. (Final). Modified]

Solution

Books of ABC Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)	Equity Share Capital A/c (₹ 10) Dr.		2,40,00,000	
	To Equity Share Capital A/c (₹ 2)			48,00,000
	To Reconstruction A/c			1,92,00,000
	(Conversion of ₹ 10 Equity Shares into Equivalent Equity Shares of ₹ 2 Each and Transfer of Balance to Reconstruction A/c)			

(ii)	Cash/Bank A/c Dr.		56,00,000	
	To Equity Share Capital A/c			32,00,000
	To Share Premium A/c			24,00,000
	(Issue of New Equity Shares on the basis of 2 for 3 at ₹ 1.50 Premium per Share)			
(iii)	12% Cumulative Preference Share Capital A/c Dr.		84,00,000	
	To 14% Cumulative Pref. Shares Capital A/c			42,00,000
	To Equity Share Capital A/c			42,00,000
	(Exchange of 12% Cum. Pref. Shares for 14% Cum. Pref. Shares & ₹ 2 Equity Shares)			
(iv)	Interest Payable on Debentures A/c Dr.		26,88,000	
	To Equity Share Capital A/c			10,00,000
	To Reconstruction A/c			16,88,000
	(Unpaid Debenture Interest Adjusted)			
(v)	14% Debentures A/c Dr.		96,00,000	
	Cash A/c Dr.		14,40,000	
	Reconstruction A/c Dr.		1,60,000	
	To 15% Debentures A/c			1,12,00,000
	(Conversion of 14% Debentures into 15% Debentures & Issue of Debentures at a Discount of 10%)			
(vi)	Loan from Directors' A/c Dr.		9,60,000	
	To Reconstruction A/c			4,80,000
	To Equity Share Capital A/c			1,92,000
	To Share Premium A/c			2,88,000
	(Part of Loan Cancelled and Issued 96,000 Equity Shares for the Balance)			
(vii)	Cash A/c Dr.		20,00,000	
	Reconstruction A/c Dr.		12,00,000	
	To Investments A/c			32,00,000
	(Sale of Investments at a Loss)			
(viii)	Bank Overdraft A/c Dr.		20,00,000	
	To Cash A/c			20,00,000
	(Bank o/d Repaid)			
(ix)	Sundry Creditors A/c Dr.		20,00,000	
	To Cash A/c			20,00,000
	(Payment to Creditors)			

(x)	Reconstruction A/c	Dr.		1,07,20,000	
	To Goodwill A/c				6,00,000
	To Patents & Franchises A/c				5,20,000
	To P&L A/c				94,00,000
	To Deferred Charges A/c				2,00,000
	(Intangibles, P&L Debit Balances Eliminated)				
(xi)	Share Premium A/c	Dr.		10,00,000	
	To Reconstruction Ac				10,00,000
	(Utilization of Share Premium A/c)				
(xii)	Liability for Damages A/c	Dr.		17,60,000	
	To Cash A/c				17,60,000
	(Liability for Damages Discharged)				
(xiii)	Insurance Claim Receivable A/c	Dr.		3,00,000	
	Reconstruction A/c	Dr.		14,60,000	
	To Liability for Damages A/c				17,60,000
	(Liability for Damages Adjusted)				
(xiv)	Reconstruction A/c	Dr.		95,40,000	
	To Plant & Machinery A/c				2,40,000
	To Stock A/c				84,00,000
	To Debtors A/c				9,00,000
	(Revaluation of Assets Written down)				
(xv)	Land & Building A/c	Dr.		15,60,000	
	To Reconstruction A/c				15,60,000
	(Revaluation of Assets (Gain) Transferred)				
(xvi)	Reconstruction A/c	Dr.		8,48,000	
	To Capital Reserve A/c				8,48,000
	(Balance—Surplus of Reconstruction A/c Transferred to Capital Reserve A/c)				

ABC Ltd. (And Reduced)
Balance Sheet as at 1 April…

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets:	
		Land & Building	1,76,00,000
Authorized:		Plant & Machinery	10,00,000
1,20,00,000 Equity Shares of ₹ 2 Each	2,40,00,000	Current Assets:	
14% Cumulative Pref. Shares of ₹ 10 Each	1,20,00,000	Stocks	40,00,000
Issued & Subscribed:		Sundry Debtors	75,00,000
66,96,000 Equity Shares of ₹ 2 Each	1,33,92,000	Insurance Claim Receivable	3,00,000

4,20,000 14% Cum. Pref. Shares of ₹10 Each	42,00,000	Cash and Bank	32,80,000
Reserves & Surplus:			
Share Premium	26,88,000		
Capital Reserve	8,48,000		
Secured Loans:			
15% Debentures	1,12,00,000		
Current Liabilities:			
Sundry Creditors	13,52,000		
	3,36,80,000		3,36,80,000

Distribution of Anticipated Profits:

		₹
Anticipated Profits (Before Interest & Taxes)		50,00,000
Less:	Debentures Interest 15% of ₹1,12,00,000	16,80,000
	Profit Before Tax	33,20,000
Less:	Tax	Nil
	Profit After Tax	33,20,000
Less:	Preference Dividend 14% on ₹42,00,000	5,88,000
	Profit Available for Equity Shareholders	27,32,000
Less:	Equity Dividend (Taken to be @ 20%)	26,78,400
Retained Profit		53,600

Summary

Internal reconstruction is concerned with the assessment of the financial position of a company by revaluation of assets and liabilities to their true values.

Need for reconstruction: (i) To reflect a true and fair view of financial position (ii) To update the value of assets by eliminating fictitious and valueless intangible assets and bringing down the value of assets to their true value (iii) To correct override liabilities (iv) To ascertain real value of the net assets and (v) For a proper diagnostic and remedial measure.

Methods of internal reconstruction: (i) Alteration of share capital (ii) Reduction of share capital (iii) Variation of shareholders' rights (iv) Compromise or arrangement and (v) Surrender of shares.

Accounting treatment for each method of internal reconstruction is explained in detail in the main part of the text. Reconstruction account—Preparation and utilization: For details refer text.

Preparation of balance sheet after reconstruction: Important factors to be taken into account: (i) Name of the company … (And reduced) (ii) To show revised appreciated figures in the valuation of assets and (iii) Strict compliance with the rules for amounts written off.

Various methods of internal reconstruction are explained in graded manner—Ref: Illustrations 11.1 to 11.24.

Key Terms

Internal Reconstruction: A scheme of re-organization of the company (Corrections on the value of assets and liabilities) without liquidation of the company.

Alternation of Share Capital: It involves increase, consolidation or sub-division of share capital. It does not involve reduction of share capital.

Reconstruction Account: The account to be prepared during the process of scheme of internal reconstruction.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. Only unsuccessful companies can undertake capital reduction.
2. Internal reconstruction means reorganization of capital structure of a company by liquidating the company.
3. Consolidation of shares will result in reduction in number of shares.
4. Due to sub-division of shares, the paid-up capital will not be affected.
5. A company can convert shares in to stock but cannot convert stock into shares.
6. The authorized capital gets reduced, to the extent of unissued shares cancelled.
7. Cancellation of unissued capital is not a case of capital reduction.
8. Ordinary resolution will be sufficient for reduction of share capital.
9. Consent of the creditors is required for return of capital.
10. Amounts sacrificed by shareholders are credited to capital reserve A/c.
11. In a scheme of reorganization, the amount of shares surrendered by shareholders is transferred to reconstruction.
12. A company is free to reduce or extinguish the uncalled liability of its members.
13. Any balance in securities premium A/c can be transferred to capital reorganization A/c.
14. If the Articles of Association is silent on reduction of the share capital, the same cannot be carried out.
15. If preference dividend is not declared, it is to be treated as contingent liability.

Answers:

1. True	2. False	3. False
4. True	5. False	6. True
7. False	8. False	9. True
10. False	11. False	12. False
13. True	14. False	15. True

II: Fill in the blanks with apt word(s)

1. Increasing the share capital by issue of new shares does not require_____ approval.
2. The process of converting the existing shares of lower denomination into shares of higher denomination is known as_____.
3. Consolidation of shares will not affect the amount of _____.
4. In sub-division of shares, _____ capital does not change.
5. A company can make alteration of share capital if it is authorized by _____ of the company and by passing an ordinary resolution.
6. A company can convert fully paid shares into _____ and also reconvert_____ back into shares.
7. Cancellation of unissued share capital does not amount to _____ of capital.
8. In external reconstruction, the existing company will be _____.
9. Confirmation of the _____ is necessary for capital reduction.

10. After granting the scheme of capital reduction, the court may order the use of words_____ after the name of the company for a specified period.
11. No journal entry is required for the cancellation of _____ share capital.
12. Reconstruction A/c (Capital reduction A/c) is used in the scheme of _____.
13. Any surplus in capital reduction A/c is to be transferred to _____.
14. If preference dividend is declared, it appears under the head _____ in the balance sheet.
15. In a scheme of capital reduction, any new liability to be provided for such as arrears of preference dividend has to be met out of_____.
16. A _____ balance in P&L A/c represents accumulated losses in the scheme of internal reconstruction.
17. _____ is not required if capital reduction involves the writing off of paid-up capital not represented by available assets.
18. "_____ A/c" is an alternative term for "capital reorganization A/c".
19. Claim foregone by debenture holders should be transferred to _____.
20. Any gain on revolution of assets at the time of internal reconstruction will be _____ to reconstruction A/c.

Answers:

1. court
2. consolidation
3. share capital
4. paid-up
5. Articles of Association
6. stock
7. reduction
8. liquidated
9. Court
10. "And Reduced"
11. Unissued
12. internal reconstruction
13. capital reserve A/c
14. current liabilities
15. capital reduction
16. debit
17. Consent of Creditors
18. Reconstruction A/c
19. capital reduction
20. credited

III: Multiple choice questions—Choose the correct answer

1. The capital reduction scheme can be implemented after getting permission from
   (a) Competent Court
   (b) Central Government
   (c) State Government
   (d) SEBI
2. 'Reconstruction A/c' is used in the case of
   (a) external reconstruction
   (b) internal reconstruction
   (c) amalgamation
   (d) absorption
3. Which of the following is not "alteration of share capital":
   (a) consolidation of shares
   (b) sub-division of shares
   (c) cancelling or writing off lost capital, not represented by assets
   (d) conversion of shares into stock and vice versa
4. Any surplus in capital reduction account is transferred to
   (a) general reserve A/c
   (b) profit & loss A/c
   (c) share capital A/c
   (d) capital reserve A/c
5. Preference shareholders' sacrifice of undeclared preference dividend is to be credited to
   (a) preference share capital A/c
   (b) paid-up capital A/c.
   (c) equity capital stock A/c
   (d) none of these
6. Any gain on revaluation of assets will be credited to
   (a) capital reduction A/c
   (b) general reserve A/c
   (c) profit & loss A/c
   (d) capital reserve A/c

7. Any loss on revaluation of assets will be transferred to
   (a) profit & loss A/c
   (b) reconstruction A/c
   (c) capital reserve A/c
   (d) none of these
8. Amounts sacrificed by shareholders are credited to
   (a) capital reserve A/c
   (b) profit & loss A/c
   (c) reconstruction A/c
   (d) balance sheet
9. In consolidation of shares, total number of shares
   (a) increases
   (b) decreases
   (c) does not change
   (d) changes proportionately
10. Effect of sub-division of shares:
   (a) Paid-up capital and number of shares increase
   (b) Paid-up capital increases but number of shares reduces
   (c) Paid-up capital does not change but number of shares increases
   (d) Paid-up capital does not change but number of shares reduces

Answers:

1. (a)	4. (d)	7. (b)	10. (d)
2. (b)	5. (d)	8. (c)	
3. (c)	6. (a)	9. (b)	

Short Answer Questions

1. Name the two types of alteration of the share capital of a company.
2. What do you mean by "internal reconstruction"?
3. What is meant by "external reconstruction"?
4. What are the differences between "internal" and "external" reconstruction?
5. Name the alternation of share capital, which does not require Court approval?
6. What is the procedure laid down in Companies Act to alter the share capital?
7. What is 'consolidation" of shares? What is its net effect?
8. What do you mean by "sub-division of shares"? Illustrate.
9. What do you mean by "conversion of shares in the stock"? Give an example.
10. Explain: cancellation of unissued shares.
11. "Internal reconstruction" is preferred by companies—Why?
12. Enlist the different forms of reduction of capital.
13. How will you treat the following:
   (i) Surplus/deficit in capital reduction account
   (ii) Arrears of preference dividend
   (iii) Surrender of shares
14. What is the accounting treatment for "revaluation of assets" in the scheme of internal reconstruction?
15. What are the statutory provisions for reducing share capital?
16. Write short notes on reconstruction A/c.
17. What are the important factors to be taken into consideration while drafting the restructured balance sheet after the scheme of reconstruction is completed?

Essay Type Questions

18. Explain the salient provisions of Sections 94 to 97 of the Companies Act.
19. Elucidate the different kinds of alterations of share capital with required accounting entries.
20. Explain the procedure to be adopted for reduction of share capital.
21. Write a note on the significance of reconstruction A/c. What special attention will you take to construct the balance sheet after the scheme of internal reconstruction is completed?

Exercises

Part A—For Undergraduate Level

1. The share capital of VIR Ltd. consisted of the following:
   (a) 30,000 6% Preference shares of ₹100 each and
   (b) 1,50,000 Equity shares of ₹10 each
   (c) The shares were fully paid

   The company had accumulated losses totaling ₹10,50,000 besides preliminary expenses of ₹60,000. It was also ascertained that fixed assets which stood in the books at

   ₹42,00,000 were over valued to the extent of ₹12,00,000. The following scheme was adopted to write off the losses and reduce the assets:
   (i) 6% Preference shares were to be converted into 7% pref. shares of ₹60 each
   (ii) Equity shares were to be reduced to ₹2 each

   Journalize.

   [**Ans:** Capital reduction (Total): ₹32,00,000; Transferred to capital reserve A/c: ₹1,20,000]
2. The following scheme of reconstruction has been duly approved:
   (i) The shareholders to receive the following in lieu of their present holding of 25,000 shares of ₹10 each:
      (a) Fully paid equity shares equal to two-fifths of their holding
      (b) 10% Preference shares, fully paid, to the extent of one-fifths the above new equity shares
      (c) ₹30,000 14% second debentures
   (ii) An issue of ₹25,000 12% first debentures was made and allotted, payment for the same being received in cash forth with
   (iii) Goodwill which stood at ₹75,000 was completely written off
   (iv) Plant & machinery which stood at ₹50,000 was written down to ₹37,500
   (v) Freehold & leasehold premises which stood at ₹87,500 were written down to ₹75,000

   Give journal entries in the books of the company necessitated by the above reconstruction.

   [**Ans:** Capital reduction (Total): ₹1,00,000]
3. M/s Shiva Co. Ltd. was floated with a capital of ₹10,00,000 in 50,000 equity shares of ₹10 each and 50,000 preference shares of ₹10 each and the capital was fully subscribed and paid. The preference shares carried cumulative preference rights as to dividend but not as to capital repayment. The company was unsuccessful and sustained trading losses amounting to ₹1,50,000. In addition, the majority of the patents acquired by the company proved to be worthless.

   It was resolved to write off ₹5,00,000 of the subscribed capital by reducing each class of shares by ₹5 per share and to reduce the assets correspondingly by:
   (i) Wiping out the debit balance of P&L A/c ₹1,50,000
   (ii) Writing down goodwill to the extent of ₹1,50,000
   (iii) Writing off patents by ₹1,50,000 and preliminary expenses of ₹50,000

   Pass the journal entries to give effect to the above transactions.

   [**Ans:** Capital reduction (Total): ₹5,00,000]
4. **Balance Sheet of ABC Ltd. as on 31 March 20 …**

Liabilities	₹	Assets	₹
Issued & Paid up Share Capital		Goodwill	60,000
		Other Fixed	5,40,000
60,000 Equity	6,00,000	Assets	
Shares of ₹10		Stock	1,50,000
Each Fully Paid		Debtors	1,80,000
60,000 7%	6,00,000	P&L A/c	2,70,000
Preference			
Shares of ₹10			
Each Fully Paid			
	12,00,000		12,00,000

   It was resolved that equity share capital of ₹10 each be reduced to fully paid shares of

₹ 6 each and 7% preference shares of ₹ 10 each be reduced to 7½% fully paid preference shares of ₹ 7 each. Number of shares in each case remained the same. It was further resolved that amount so available be used for writing off the debit balance of P&L A/c and goodwill account and other fixed assets to the extent possible.

There were arrears of preference dividend for the last 3 years and it was decided that they be cancelled.

Draft the journal entries and prepare the revised balance sheet.

[**Ans:** Capital reduction: ₹ 4,20,000; Fixed assets written off to the extent of ₹ 90,000; Balance sheet total: ₹ 7,80,000]

5. Weak Ltd. had the following balance sheet as on 31 December 2010:

Liabilities	₹	**Assets**	₹
6% Preference Shares of ₹ 100 Each	6,00,000	Goodwill	1,80,000
		Fixed Assets	9,00,000
		Stock	4,50,000
Equity Shares of ₹ 100 Each	12,00,000	Debtors	1,80,000
		Discount on Debentures	30,000
Sundry Creditors	4,50,000	Bank	3,000
		P&L A/c	8,07,000
	25,50,000		25,50,000

The following reconstruction scheme was approved:

(a) Preference shares to be reduced to 8% pref. shares of ₹ 60 each

(b) Equity shares to be reduced by ₹ 80 each

(c) The amount thus made available to be utilized to write off fictitious assets including goodwill and ₹ 1,50,000 from fixed assets

Give entries for the reconstruction and the final balance sheet.

[**Ans:** Total capital reduction: ₹ 12,00,000; Balance transferred to capital reserve: ₹ 33,000; B/s total: ₹ 13,83,000]

6. The Balance sheet of Swasthik Ltd. as at 31 December 2010 was as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Goodwill	60,000
8,000 Pref. Shares of ₹ 100 Each	8,00,000	Freehold Properties	8,00,000
16,000 Equity Shares of ₹ 100 Each	16,00,000	Plant & Machinery	12,00,000
		Stock	2,00,000
5% Mortgage Debentures	4,00,000	Debtors	1,60,000
		P&L A/c	9,80,000
Bank Overdraft	2,00,000		
Creditors	4,00,000		
	34,00,000		34,00,000

The company got the following scheme of capital reduction approved by the Court:

(a) The preference shares to be reduced to ₹ 75 per share, fully paid up and the equity shares to ₹ 37.50

(b) The debenture holders took over the stock and book debts in full satisfaction of the amount due to them

(c) The goodwill A/c is to be eliminated

(d) The freehold properties to be depreciated by 50%

(e) The value of the plant & machinery to be increased by ₹ 2,00,000

Give journal entries for the above and prepare the revised balance sheet.

[**Ans:** Capital reduction A/c: ₹ 14,40,000; Balance sheet total: ₹ 18,00,000]

7. Vee & Vee Ltd. was promoted to the year 2006. The working of the company was not successful. On 31 December 2010, the company's balance sheet stood as follows:

Liabilities	₹	**Assets**	₹
Nominal Capital:		Land	3,00,000
60,000 Shares of ₹ 100 each	60,00,000	Machinery	7,80,000
Subscribed Capital:		Furniture	60,000
57,000 Shares of ₹ 100 Each Fully Paid	57,00,000	Stock	11,10,000

Creditors	3,00,000	Debtors	5,40,000
Stalin & Co.	3,00,000	Goodwill	6,00,000
		P&L A/c	29,10,000
	63,00,000		63,00,00

The company is to be reconstructed on the basis of the following scheme:

(a) 57,000 Shares of ₹ 100 each are to be reduced to an equal number of fully paid shares of ₹ 40 each

(b) The debt of ₹ 3,00,000 due to Stalin & Co. was also to be reduced the remaining 3,000 unissued shares being issued to them as fully paid up shares of ₹ 40 each in full settlement of the amount due to them

(c) The amount thus rendered available by the reduction of capital and by the above arrangement with Stalin & Co. is to be utilized in wiping off goodwill and P&L A/c and in writing down the value of machinery

You are required to follow the scheme of reconstruction and prepare the new balance sheet of the company.

[**Ans:** Hint: Machinery written off ₹ 90,000. Reconstruction A/c: ₹ 36,00,000; Balance sheet total: ₹ 27,00,000

8. The following was the balance sheet of XYZ Ltd. as on 31 December 2010:

Liabilities	₹	**Assets**	₹
Issued & Paid-up		Goodwill	60,000
Capital:		Land & Buildings	1,23,000
72,000 Shares of		Machinery	3,05,100
₹ 10 Each		Preliminary	9,000
₹ 7,20,000		Expenses	
Less: Calls-in-		Stock	61,650
Arrear ₹ 3 per		Bank	9,000
Share on 18,000		P&L A/c 1,32,000	
Shares ₹ 54,000	6,66,000		
Creditors	92,550	Less: Net Profit	
Provision for Tax	24,000	Profit of this Year	
		7,200	1,24,800
	7,82,550		7,82,550

Machinery value was ₹60,000 in excess. It is proposed to write down this asset and to extinguish P&L A/c debit balance and to write off goodwill and preliminary expenses by the adoption of the following scheme:

(a) Forfeit the shares on which the calls are outstanding

(b) Reduce the paid-up capital by ₹ 3 per share

(c) Re-issue the forfeited shares at ₹ 5 per share

(d) Utilize the provision for tax, if necessary

You are required to draft the journal entries necessary and the balance sheet after carrying out the scheme.

[**Ans:** Reconstruction A/c total: ₹ 2,53,800; B/s total: ₹ 6,18,750 provision for tax to be used ₹ 1,800]

9. The following was the balance sheet of ABC Ltd. as on 31 March 20…. :

Liabilities	₹	**Assets**	₹
Share Capital:		Goodwill	2,40,000
12,000 7% Preference Shares of ₹ 100 Each	12,00,000	Land & Buildings	6,00,000
		Plant & Machinery	12,00,000
16,000 Equity Shares of ₹ 100 Each	16,00,000	Patents	1,20,000
		Stock	8,80,000
		Sundry Debtors	6,00,000
Profit Prior to Incorporation	40,000	Cash at Bank	20,000
6% Debentures	12,00,000	Preliminary Expenses	1,00,000
Sundry Creditors	8,00,000	P&L A/c	10,80,000
	48,40,000		48,40,000

The following scheme of reconstruction was duly approved:

(a) 7% Preference shares be converted into 9% preference shares, the amount being received by 30%.

(b) Equity shares be reduced to fully paid shares of ₹ 50 each.

(c) Land & buildings be appreciated by 20%.

(d) Debentures be reduced by 20%.

(e) All intangible assets, fictitious assets including patents and accumulated losses be written off. Utilize profit prior to incorporation, if necessary.

(f) Equity shareholders to subscribe equity shares of ₹ 4,00,000.

The amount is to be utilized for acquiring new plant & machinery assuming the whole scheme to have been put through. Give journal entries and prepare the resultant balance sheet.

[**Ans:** Reconstruction A/c total: ₹15,20,000; Utilization of profit prior to incorporation: ₹20,000; Balance sheet total: ₹38,20,000]

10. On 31 December 20 …., the balance sheet of sick company stood as follows:

Liabilities	₹	**Assets**	₹
Authorized Capital:		Land & Buildings	9,00,000
		Machinery	15,00,000
50,000 Shares of ₹100 Each	50,00,000	Furniture	50,000
		Stock	4,50,000
Paid-up Capital:		Debtors	4,00,000
40,000 Shares of ₹100 Each	40,00,000	Goodwill	2,50,000
		Cash	50,000
Loan from Strong Ltd.	10,00,000	P&L A/c	24,00,000
Creditors	10,00,000		
	60,00,000		60,00,000

After carrying out the necessary formalities, the following scheme has been agreed upon the persons concerned:

(i) The ₹100 shares are to be reduced to ₹50 each

(ii) The 10,000 shares which are unissued, are now to be issued as fully paid (i.e., at ₹50 each), to Strong Ltd. in full settlement of their loan

(iii) The creditors accept ₹7,50,000 in fully paid debentures in full settlement of their debts

(iv) The amount thus rendered available is to be utilized towards writing off goodwill, P&L A/c entirely and the balance to be used for writing down the machinery account

Give journal entries to carry out the above scheme and prepare the balance sheet of the company after completion of the scheme.

[**Ans:** Reconstruction A/c total: ₹27,50,000; Balance sheet total: ₹39,00,000; Machinery to be written off: ₹1,00,000]

11. VRV Co. Ltd. resolved to write off one-half of its subscribed capital by reducing each ₹100 share, both preference & equity to ₹50 fully paid up and to reduce the book figures of its assets by an equivalent amount by wiping out the goodwill and the debit balance of P&L A/c and by writing down land and building by ₹75,000; plant & machinery by ₹50,000 and providing the balance for bad debts.

The balance sheet of the company before the reduction of capital is as follows:

Liabilities	₹	**Assets**	₹
Authorized Capital:		Goodwill	5,00,000
		Land & Buildings	5,50,000
15,000 Preference Shares of ₹100 Each	15,00,000	Plant & Machinery	4,50,000
		Stock	4,00,000
25,000 Equity Shares of ₹100 Each	25,00,000	Sundry Debtors	4,50,000
		Cash	50,000
		Profit & Loss A/c	6,00,000
	40,00,000		
Subscribed Capital:			
10,000 Pref. Shares of ₹100 Each	10,00,000		
15,000 Equity Shares of ₹100 Each	15,00,000		
Sundry Creditors	5,00,000		
	30,00,000		30,00,000

Pass journal entries to give effect to the above resolution, showing the new balance sheet of the company.

[**Ans:** Reconstruction A/c: ₹12,50,000; Balance sheet total: ₹17,50,000; Provision for bad debts: ₹25,000]

12. The following is the balance sheet of RR Ltd. on 31 March 2011:

Liabilities	₹	**Assets**	₹
Share Capital:		Goodwill	6,00,000
3,00,000 Equity Shares of ₹10 Each Fully Paid	30,00,000	Machinery	30,00,000
6,000 10% Cum. Pref. Shares of ₹100 Each Fully Paid	6,00,000	Stock	7,50,000

Sundry Liabilities	30,00,000	Debtors	6,00,000
		Bank	1,50,000
		P&L A/c	15,00,000
	66,00,000		66,00,000

Preference share dividends are in arrears for the last 4 years and the following scheme of reconstruction is passed by shareholders and approved by the Court:

(a) The 3,00,000 equity shares of ₹ 10 each are to be reduced to an equal number of equity shares of ₹ 1 each

(b) 50% of the preference dividend in arrears is to be paid in cash immediately and preference shareholders have agreed to forego the balance

(c) Plant & machinery are to be depreciated by 5% and a provision for doubtful debts is to be created @ 10% on debtors

(d) All intangible assets and fictitious assets are to be written off

Pass journal entries to implement the above scheme and draft the reconstructed balance sheet.

[B.Com Punjab University Modified]

[**Ans:** Reconstruction A/c total: ₹ 27,00,000; Balance transferred to capital reserve A/c: ₹ 2,70,000; Total of balance sheet: ₹ 41,70,000]

13. Below is given the balance sheet of Unlucky Ltd. as on 31 March 2011:

Liabilities	₹	**Assets**	₹
Share Capital: Authorized		Leasehold Premises	18,00,000
40,000 Pref. Shares of ₹ 50 Each	20,00,000	Plant	3,20,000
40,000 Equity Shares of ₹ 50 Each	20,00,000	Debtors	4,00,000
	40,00,000	Stock	2,80,000
Subscribed Capital:		Preliminary Expenses	2,00,000
32,000 Pref. Shares of ₹ 50 Each Fully Paid	16,00,000	P&L A/c	4,96,000
32,000 Equity Shares of ₹ 50 each fully paid	16,00,000	Cash at Bank	4,000
Sundry Creditors	1,60,000		
Bank Overdraft	1,40,000		
	35,00,000		35,00,000

Due to heavy losses, the company decided upon the following scheme of reconstruction:

(i) The preference shares were to be reduced to a value of ₹ 30 each. The equity shares were also to be reduced to the value of ₹ 30 each.

(ii) The balance available was to be used to write off the debit balance of the P&L A/c ₹ 80,000 from stock and the full amount of preliminary expenses account. A provision of ₹ 1,20,000 was to be made against sundry debtors.

The leasehold premises were to be reduced by ₹ 2,64,000 and the plant account to be reduced to ₹ 2,00,000.

You are required to journalize the above transactions and prepare the reconstructed balance sheet.

[B.Com (Pass). Calcutta University Modified]

[**Ans:** Reconstruction A/c: ₹ 12,80,000; Total of balance sheet: ₹ 22,20,000]

14. The balance sheet of Rita Ltd. as on 31 March 2011 was as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Goodwill	15,000
Issued & Subscribed Capital:		Land & Buildings	75,000
		Plant & Machinery	2,30,000
5,000 Pref. Shares of ₹ 100 Each Fully Paid	5,00,000	Patents	25,000
		Stock	1,48,000
		Sundry Debtors	2,52,000

7,500 Equity Shares of ₹ 50 Each Fully Paid	3,75,000	P&L A/c	2,55,000
Bank Loan Secured on Land & Building	22,000		
Sundry Creditors	1,03,000		
	10,00,000		10,00,000

The preference share dividends are in arrears since 2007. The company passed a special resolution to reduce its capital and the following scheme was sanctioned by the Court.

(a) The preference shares to be reduced to ₹ 75 each fully paid and the arrears of dividend to be cancelled.

(b) The equity shares to be reduced to ₹ 25 each fully paid.

(c) The debit balance on P&L A/c and goodwill to be written off. Plant & machinery to be reduced by ₹ 20,000; of the book debts, ₹ 12,000 known to be bad to be written off, available balance to be used for writing down patents.

The chairman of the company agreed to advance the sum of ₹ 50,000 to be secured by a mortgage at 5% p.a. on land & buildings. The cash is to be applied in paying off the bank loan and providing additional working capital.

Pass journal entries giving effect to the above scheme and prepare the revised balance sheet of the company.

[B.Com Kurukshetra Modified]

[**Ans:** Reconstruction A/c: ₹ 3,12,500; Balance sheet total: ₹ 7,15,500; Patents to be written of: ₹ 10,500]

15. The balance sheet of Disappointed Ltd. as at 31 March 2011 is as follows:

Liabilities	₹	**Assets**	₹
Issued & Subscribed Capital:		Sundry Assets	4,62,000
24,000 Shares of ₹ 10 Each Fully Paid	2,40,000	Investments	9,000
Debentures	4,02,000	P&L A/c	3,21,000
Add: Interest Due	12,000	4,14,000	
Creditors:			
Income Tax	3,000		
Others	1,35,000	1,38,000	
		7,92,000	7,92,000

The following reconstruction scheme is passed and duly sanctioned:

(a) Each share is to be sub-divided into ten fully paid equity shares of ₹ 1 each.

(b) After such sub-division, each shareholder shall surrender to the company 95% of his holding, for the purpose of re-issue to debenture holders and creditors as far as necessary and the balance cancelled.

(c) Of these surrendered, 69,000 shares of ₹ 1 each shall be converted into preference shares of ₹ 1 each fully paid.

(d) The claim of debenture holders shall be reduced by 5/6th and in consideration thereof, the debenture holders shall receive preference shares to the value of one-sixth of their claim as at 31 March 2011.

(e) The income tax liability is to be paid in full, and claims of other creditors to be reduced to one-fifth of their claims to be satisfied by the issue of equity shares of ₹ 1 each from the shares surrendered.

(f) The shares are surrendered and not re-issued to be cancelled.

Set out journal entries and the resultant balance sheet assuming that the income tax liability is still outstanding and the amounts of the assets are unaltered.

[B.Com Osmania University Modified]

[**Ans:** Reconstruction A/c: ₹ 6,12,000; Balance transferred to capital reserve: A/c ₹ 2,91,000; Total of balance sheet: ₹ 4,71,000]

Exercises

Part B—For Advanced Level

16. The ledger balances of X Ltd. on 31 December 20 … were as follows:

	₹
25,000 Equity Shares of ₹100 Each	25,00,000
12,500, 10% Preference Shares of ₹100 Each	12,50,000
Preference Dividend in Arrears	1,50,000
Creditors	6,25,000
Fixed Assets	25,00,000
Current Assets	8,12,000

The following scheme of reconstruction was adopted:

(i) The fixed assets were valued at ₹15,00,000 and current assets at ₹6,25,000

(ii) The equity shares were sub-divided into shares of ₹5 each fully paid and 90% of these shares were surrendered

(iii) The total claims of preference shareholders were reduced to ₹6,25,000 and in consideration of this, they were allotted equity shares, out of surrendered shares amounting to ₹3,12,500

(iv) The creditors agreed to reduce their claims to ₹3,75,000, one-third of which was to be satisfied by the issue of equity shares out of those surrendered

(v) The remaining surrendered shares were cancelled

Pass journal entries and give the balance sheet after re-construction.

[B.Com (Hons) Delhi 2003 Modified)

[**Ans:** Reconstruction A/c: ₹28,12,500; Capital reserve A/c: ₹5,62,500; Balance sheet: ₹21,25,000]

17. The position of Eknath & Co. Ltd. as on 31 December 2010 stood as follows:

Liabilities	₹	**Assets**	₹
9,000 Equity Shares of ₹100 Each Fully Paid	9,00,000	Goodwill	2,40,000
6,000, 6% Pref. Shares of ₹100 Each, Fully Paid	6,00,000	Land & Buildings	2,25,000
5% Debentures	3,00,000	Plant & Machinery	2,70,000
Interest Due on Debentures	30,000	Patents	60,000
Sundry Creditors	4,50,000	Stock at Cost	1,20,000
		Sundry Debtors	1,17,000
		Cash at Bank	18,000
		Preliminary Expenses	60,000
		P&L A/c	11,70,000
	22,80,000		22,80,000

A revaluation of assets reveals the following:
Land and Building: ₹2,85,000; Plant & Machinery: ₹3,36,000;
Stock: ₹75,000; Debtors: ₹96,000; and Patents: ₹15,000.
The following scheme of reconstruction is framed and approved by the Court:

(a) The 6% preference shares be converted into 7.5% preference shares of ₹30 each fully paid.

(b) The equity shares be converted into shares of ₹5 each fully paid.

(c) The sundry creditors be given the option to either accept 50% of their claims in cash in fully satisfaction or to convert their claims into shares of ₹5 each.

(d) The revaluation of assets be adopted.

One third (in value) of the creditors accepted equity shares for their claims. The rest were paid cash which was raised by issuing 51,000 equity shares to the existing shareholders. All shares including preference shares were then consolidated (or sub-divided) into equity shares of ₹10. In view of the unsatisfactory state of affairs of the company, the debenture holders agreed to forego the interest due on debentures.
Assuming that all necessary actions were taken, journalize the steps and also give the balance sheet after the scheme is put into effect.

[B.Com (Hons) Delhi 2006 Modified]

[**Ans:** Reconstruction A/c: ₹15,81,000; Balance sheet total: ₹9,30,000]

18. The following is the balance sheet of self-injured company as on 31 March 20…. :

(₹ in 000's)

Liabilities	₹	Assets	₹
Equity Share Capital @ ₹2,500 Each Fully Paid up	17,50,000	Fixed Assets	37,50,000
		Current Assets	87,50,000
500, 12% Preference Shares of ₹500 Each	2,50,000	P&L A/c	7,50,000
10% Debentures	7,50,000		
Current Liabilities	97,50,000		
Provision for Taxation	7,50,000		
	1,32,50,000		1,32,50,000

The following scheme of reconstruction is sanctioned:

(i) Fixed assets are to be written down to ₹25,00,000.

(ii) Current assets are to be revalued at ₹67,50,000.

(iii) Preference shareholders agree to forego their right to arrears of dividend which are in arrears for 3 years.

(iv) One of the creditors of the company, to whom the company owes ₹62,50,000 agree to forego one-half of this claims. He is allotted 10,000 equity shares of ₹25 each in part satisfaction of the balance of his claim.

(v) The taxation liability of the company is settled at ₹10,00,000.

(vi) The rate of interest on debentures is raised to 12%. The debenture holders surrender their existing debentures of ₹5,000 each and exchange the same for fresh debentures of ₹3,750 each.

(vii) All existing shares are reduced to ₹25 each.

(viii) All preference shares are reduced to ₹375 each.

Make journal entries and thereafter prepare the balance sheet.

[B.Com (Hons). Delhi 2007 Modified]

[**Ans:** Reconstruction A/c: ₹ 49,50,000; Capital reserve: ₹7,00,000; Balance sheet total: ₹82,50,000]

19. The following information relates to Sick Ltd. as on 31 December 2010:

	₹
16,000 Equity Shares of ₹100 Each	16,00,000
8,000 6% Debentures of ₹100 Each	8,00,000
Interest on Debentures Outstanding	96,000
Trade Creditors	4,00,000
Fixed Assets	16,00,000
Current Assets	5,20,000

The following scheme was duly agreed and approved by the Court:

(i) The shares were sub-divided into shares of ₹5 each and 90% of the shares were surrendered

(ii) The total claims of debenture holders were reduced to ₹3,92,000, and in consideration of this, they were allotted shares (out of the surrendered shares) amounting to ₹2,00,000

(iii) Creditors agreed to reduce their claims to ₹1,20,000, one-third of which was satisfied by issue of equity shares out of those surrendered

(iv) Fixed assets were revalued at ₹7,68,000 and current assets were revalued at ₹3,84,000

(v) The shares surrendered but not re-issued were cancelled

Make journal entries and give the balance sheet after reconstruction.

[B.Com (Hons) 2008 Modified]

[**Ans:** Reconstruction A/c: ₹20,24,000; Capital reserve: ₹2,80,000; B/s total: ₹11,52,000; P&L A/c: ₹7,76,000]

20. The following is the balance sheet of X Ltd. as at 31 March 20 …:

(₹ in 000's)

Liabilities	₹	Assets	₹
Share Capital		Goodwill	125
1,00,000 Equity Shares of ₹ 100 Each	10,000	Land & Buildings	750
		Plant & Machinery	1,500
12% Debentures	2,500	Furniture	400
Outstanding Debenture Interest	600	Stock	1,350
		Debtors	300
		Cash at Bank	175
Creditors	1,500	Preliminary Expenses	100
		P&L A/c	9,900
	14,600		14,600

The following scheme of reconstruction is executed:

(i) Equity shares are reduced by ₹ 95 per share. They are then consolidated into 50,000 equity shares of ₹ 10 each.

(ii) Debenture holders agree to forego outstanding debentures interest. As a compensation 12% debentures are converted into 14% debentures, the amount remaining ₹ 25,00,000.

(iii) Creditors are given the option either to accept 50% of their claim in cash in full settlement or to convert their claim into equity shares of ₹ 10 each. Creditors for ₹ 10,00,000 opt for shares in satisfaction of their claims and the rest accepted cash.

(iv) To make payment to creditors and to augment working capital, the company issued 2,50,000 equity shares of ₹ 10 each at par. The entire amount being payable along with application. The issue was fully subscribed.

(v) Land and building are revalued at ₹ 10,00,000; plant & machinery at ₹ 10,50,000 and provision amounting to ₹ 25,000 is made for doubtful debts.

Pass journal entries to record the above.

[B.Com (Hons) Delhi 2009 Modified]

[**Ans:** Reconstruction A/c: ₹ 1,06,00,000]

21. The balance sheet of Naina Lohia Ltd. as at 31 March 20… was as follows:

Liabilities	₹	Assets	₹
15,000 Equity Shares of ₹ 10 Each	1,50,000	Patents	25,000
		Plant & Machinery	1,50,000
1,000, 10% Pref. Shares of ₹ 100 Each	1,00,000	Equipments	5,000
		Book Debts	1,25,000
Securities Premium	45,000	Inventories	75,000
		Bank Balance	7,500
Loan (Unsecured)	25,000	Preliminary Expenses	2,500
Creditors	1,50,000		
Expenses Due	12,500	Profit & Loss A/c	1,00,000
Employees Provident Fund	22,000	Goodwill	15,000
	5,05,000		5,05,000

Dividend on preference shares is in arrears for 5 years. The following scheme of reconstruction was approved by Court:

(i) Equity shares are to be converted into 30,000 shares of ₹ 5 each.

(ii) Equity shareholders agreed to surrender to the company 80% of their holdings.

(iii) Preference shareholders agreed to forego their right to unpaid dividend. They also agreed to reduce each preference share from ₹ 100 to ₹ 80.

(iv) Creditors agreed to reduce their claim by two-fifth in consideration of their getting shares of ₹ 18,000 out of surrendered equity shares.

(v) Unsecured loan is converted into 15,000 equity shares out of shares surrendered and remaining amount of loan is waived.

(vi) Surrendered shares not utilized are to be cancelled.

(vii) Assets are to be reduced as follows:
Goodwill by ₹ 15,000; plant by ₹ 20,000; equipment by ₹ 4,000; book debts by ₹ 8,000; inventories by ₹ 10,000. All intangible and fictitious assets are to be written off.

(viii) Any surplus left should be utilized in writing down machinery and plant further.

(ix) Cost of reconstruction amounted to ₹ 5,000.

(x) Further 20,000 shares were issued to existing shareholders' increase working capital. The issue was fully subscribed and paid for.

Draft journal entries and prepare reconstruction A/c.

[B.Com (Hons) Delhi 2010 Modified]

[**Ans:** Reconstruction A/c: ₹1,92,000; Further amount utilized for plant A/c: ₹2,500]

22. The following information relates to Sick Ltd. as on 31 December 2010:

	₹
2,000 Equity Shares of ₹100 Each	20,00,000
10,000 6% Debentures of ₹100 Each	10,00,000
Interest on Debentures Outstanding	1,20,000
Trade Creditors	5,00,000
Fixed Assets	20,00,000
Current Assets	6,50,000

The following scheme was duly agreed and approved by the Court:

(i) The shares were subdivided into shares of ₹5 each and 90% of the shares were surrendered

(ii) The total claims of debenture holders were reduced to ₹4,90,000 and in consideration of this, they were allotted shares (out of the surrendered shares) amounting to ₹2,50,000

(iii) Creditors agreed to reduce their claims to ₹1,50,000, one-third of which was satisfied by issue of equity shares out of those surrendered

(iv) Fixed assets were revalued at ₹9,60,000 and current assets were revalued ₹4,80,000

(v) The shares surrendered but not re-issued were cancelled

You are required to draft the necessary journal entries and give the balance sheet of the company after reconstruction.

[B.Com (Hons) Delhi 2008 Modified]

[**Ans:** Old balance sheet—P&L A/c: ₹9,70,000; Reconstruction A/c Capital reserve: ₹3,50,000; New balance sheet total: ₹14,40,000]

23. Following is the balance sheet of W Ltd. as on 31 March 20…:

Liabilities:	₹
2,00,000 Equity Shares of ₹10 Each, Fully Paid up	20,00,000
6,000, 12% Preference Shares of ₹100 Each Paid up	6,00,000
11% Debentures	6,00,000
Interest Outstanding on Debentures	66,000
Loan from Bank (Including Interest Due)	1,72,800
Creditors	1,09,000
	35,47,800
Assets:	₹
Machinery	17,40,000
Furniture	2,00,000
Patents & Copyrights	80,000
Investments (Market Value ₹55,000)	65,000
Stock	6,00,000
Debtors	4,39,000
Cash at Bank	15,800
P&L A/c	4,08,000
	35,47,800

Note: Preference dividend is in arrears for 2 years.

The following scheme of reconstruction has been agreed upon and duly approved by the Court:

(i) The existing equity shares are converted into equal number of fully paid equity shares of ₹7 each. The equity shareholders also agree to take up 1,00,000 new equity shares of ₹7 each, the total amount being paid by them immediately.

(ii) The preference shareholders agree to forego arrears of dividend and accept 85% of their capital account by way of redemption of all the preference shares.

(iii) The debenture holders agree to give up their claim to outstanding interest in consideration of the rare of interest on debentures being enhanced to 13.5%.

(iv) Bank agrees to waive its claim to outstanding interest amounting to ₹12,800 provided the

balance of loan ₹1,60,000 be paid off forth with.

(v) Investments are to appear at market value.

(vi) Patents and copyrights are to be written off completely.

(vii) Machinery is to be written down to the extent possible after writing off all other losses.

Pass journal entries necessary to implement the above-mentioned scheme and prepare the balance sheet of the company in the prescribed form immediately after the implementation of the scheme.

[C.S. (Inter). Modified]

[**Ans:** Balance sheet total: ₹33,19,000; Machinery to be reduced to the extent of ₹2,71,200]

24. The following is the balance sheet of Sick Co. Ltd. as on 31 March 20… :

Liabilities	₹	**Assets**	₹
500 14% Redeemable Pref. Shares of ₹100 Each	50,000	Fixed Assets	7,50,000
Equity Shares of ₹10 Each	3,50,000	Current Assets	17,50,000
12% Debentures	1,50,000	P&L Ac	1,50,000
Current Liabilities	19,50,000		
Provision for Taxation	1,50,000		
	26,50,000		26,50,000

The following scheme of reorganization is sanctioned:

(i) Fixed assets are to be written down by $33\frac{1}{3}\%$.

(ii) Current assets are to be revalued at ₹13,50,000.

(iii) Preference shareholders decide to forego their right to arrears of dividend which are in arrears for 3 years.

(iv) The taxation liability of the company is settled at ₹2,00,000.

(v) One of the creditors of the company, to whom the company owes ₹12,50,000, decides to forego 50% of his claim. He is allotted 50,000 equity shares of ₹5 each in part satisfaction of the balance of his claim.

(vi) The rate of interest on debentures is increased to 14%. The debenture holders surrender their existing debentures of ₹100 each and exchange the same for fresh debentures of ₹75 each.

(vii) All existing equity shares are reduced to ₹5 each.

(viii) All preference shares are reduced to ₹75 each.

Pass journal entries and the show the balance sheet of the company after giving effect to the above.

[C.S. (Inter). Modified]

[**Ans:** Reconstruction A/c: ₹8,50,000; Balance sheet total: ₹16,50,000]

25. Geetha and Shweta Ltd. had to pass to the hands of a receiver for debenture holders who held charge on all assets except uncalled capital. The following is the position as prepared by the receiver.

Share Capital:	₹
40,000 Shares of ₹50 Each Fully Paid up	20,00,000
2,00,000 Shares of ₹50 Each, ₹25 per Share Paid up	50,00,000
First Debentures	50,00,000
Second Debentures	1,00,00,000
Unsecured Creditors	80,00,000
Bank Balance	60,00,000
Building, Plant & Machinery (Estimated to Realize ₹30,00,000)	80,00,000

The following is the interest of Geetha and Shweta in the company:

	Geetha ₹	**Shweta** ₹
First Debentures	40,00,000	10,00,000
Second Debentures	60,00,000	40,00,000
Unsecured Creditors	12,00,000	18,00,000
	1,12,00,000	68,00,000
Share Capital:		
Fully Paid Shares	10,00,000	10,00,000
Partly Paid Shares	20,00,000	20,00,000

The following scheme of reconstruction is proposed:

(a) Geeta is to cancel ₹62,00,000 of her total debt, pay cash ₹10,00,000 and she would be

issued ₹ 60,00,000 first debentures in lieu of first and second debentures to be cancelled

(b) (i) Shweta is to cancel her total debt by accepting ₹ 10,00,000 in cash and ₹ 10,00,000 in first debentures

(ii) Shweta is to surrender for cancellation of ₹ 10,00,000 worth of fully paid-up shares

(c) Unsecured creditors, other than Geetha and Shweta, agree to reduce their debt by 20%, and accept in lieu there of 2,00,000 shares of ₹ 10 each fully paid up and the balance in cash payable in five equal annual instalments

(d) Uncalled capital is to be called up in full and ₹ 40 per share to be cancelled thus making shares of ₹ 10 each

Assuming the scheme is duly approved by all parties interested and by the Court, show the reconstructed balance sheet and the journal entries in the books of the company.

[C.A. (Final). Modified]

[**Ans:** Reconstruction A/c total: ₹ 2,10,00,000; Balance sheet total: ₹ 1,40,00,000]

26. The balance sheet of Y Ltd. as on 31 March 20... was as follows:

Liabilities	₹	**Assets**	₹
2,50,000 Equity Shares of ₹ 10 Each Fully Paid	25,00,000	Goodwill	5,00,000
		Patent	2,50,000
9% 10,000 Preference Shares of ₹ 100 Each Fully Paid	10,00,000	Land & Building	15,00,000
		Plant & Machinery	5,00,000
10% First Debentures	3,00,000	Furniture & Fixtures	1,00,000
10% Second Debentures	5,00,000	Computers	1,50,000
Debentures Interest Outstanding	80,000	Trade Investment	2,50,000
Trade Creditors	2,50,000	Debtors	2,50,000
Directors' Loan	50,000	Stock	5,00,000
Bank Overdraft	50,000		
Outstanding Liabilities	20,000	Discount on Issue of Debentures	50,000
Provision for Tax	50,000	P&L A/c (Loss)	7,50,000
	48,00,000		48,00,000

Note: Preference dividend is in arrears for last 3 years. Mr. A holds 10% first debentures for ₹ 2,00,000 and 10% second debentures for ₹ 3,00,000. He is also creditor for ₹ 50,000. Mr. B. holds 10% first debentures for ₹ 1,00,000 and 10% second debentures for ₹ 2,00,000 and is also creditor for ₹ 25,000.

The following scheme of reconstruction has been agreed upon and duly approved by the Court:

(i) All the equity shares be converted into fully paid equity shares of ₹ 5 each.

(ii) The preference shares be reduced to ₹ 50 each and the pref. shareholders agree to forego their arrears of pref. dividends in consideration of which 9% preference shares are to be converted into 10% preference shares.

(iii) Mr. A is to cancel ₹ 3,00,000 of his total debt including interest on debentures and to pay ₹ 50,000 to the company to receive new 12% debentures for the balance amount.

(iv) Mr. B is to cancel ₹ 1,50,000 of his total debt including interest on debentures and to accept new 12% debentures for the balance amount.

(v) Trade creditors (other than A and B) agreed to forego 50% of their claim.

(vi) Directors to accept settlement of their loans as to 60% thereof by allotment of equity shares and balance waived.

(vii) There were capital commitments totalling ₹ 1,50,000. These contracts price as penalty.

(viii) The directors refund ₹ 55,000 of the fees previously received by them.

(ix) Reconstruction expenses paid ₹ 5,000.

(x) The taxation liability of the company is settled at ₹ 40,000 and the same is paid immediately.

The assets are revalued as follows:

Land & Building	14,00,000
Plant & Machinery	2,00,000
Stock	3,50,000
Debtors	1,50,000
Computers	90,000
Furniture & Fixtures	50,000
Trade Investment	2,00,000

Pass journal entries for all the above-mentioned transactions including amounts to be written off on goodwill, patents, loss in P&L A/c and discount on issue of debentures. Prepare bank A/c and working of allocation of interest on debentures between A and B.

[C.A. (Inter). Modified]

[**Ans:** Reconstruction A/c: ₹23,60,000; Interest on debentures: A—₹50,000, B—₹30,000; Bank A/c: ₹1,05,000]

27. The following is the balance sheet of ABC Ltd. as at 31 March 20...

(₹ in Lakhs)

Liabilities	₹	**Assets**	₹
Fully Paid Equity Shares of ₹10	2,500	Goodwill	75
		Land & Building	920
Capital Reserve	30	Patent &	1,430
12% Debentures	2,000	Machinery	
Debenture Interest O/s	240	Furniture & Fixtures	205
Trade Creditors	825	Stock	710
Directors' Remuneration O/s	50	Debtors	400
		Cash at Bank	135
Other Outstanding Expenses	55	Discount on Issue of Debenture	40
Provisions	165	P&L A/c	1,950
	5,865		5,865

The following scheme of internal reconstruction was framed, approved by the Court, all the concerned parties, and implemented:

(i) All the equity shares are converted into the same number of fully paid equity shares of ₹2.50 each.

(ii) Directors agree to forego their outstanding remuneration.

(iii) The debenture holders also agree to forego outstanding interest in return of their 12% debentures being converted into 13% debentures.

(iv) The existing shareholders agree to subscribe for cash fully paid equity shares of ₹2.50 each for ₹625 lakh.

(v) Trade creditors are given the option of either to accept fully paid equity shares of ₹2.50 each for the amount due to them or to accept 80% of the amount due in cash. Creditors for ₹325 lakh accept equity shares whereas those for ₹500 lakh accept ₹400 lakh in cash in full settlement.

The assets are revalued as follows:

	(₹ in Lakhs)
Land & Building	1,150
Plant & Machinery	1,100
Stock	600
Debtors	380

Pass journal entries for all the above-mentioned transactions and draft the company's balance sheet immediately after the reconstruction.

[**Ans:** Reconstruction A/c: ₹2,525 lakhs; Balance sheet total: ₹3,795 lakhs]

28. A Ltd. decided to reorganize its structure following a period of adverse trading conditions. The balance sheet of the company as on 31 March 20… showed the following:

Liabilities	₹	**Assets**	₹
Share Capital:		Fixed Assets:	
Authorized & Issued:		Goodwill	1,10,000
40,000 8% Cumulative Pref. Shares of ₹10 Each	4,00,000	Freehold Property at Cost	1,20,000
		Leasehold Property at Cost ₹2,80,000	
30,000 Equity Shares of ₹10 Each	3,00,000	Less: Depreciation ₹36,000	2,44,000
Share Premium A/c	10,000	Plant & Machinery at cost ₹4,40,000	
9% Debentures (Secured on Freehold Property) 1,20,000		Less: Depreciation ₹1,20,000	3,20,000
		Trade Investments at Cost	80,000

Add: Accrued Interest 5,400	1,25,400	Current Assets:	
		Stock	60,000
		Debtors	1,20,000
Creditors	1,70,000	Preliminary Expenses	5,000
Bank Overdraft	1,92,000	P&L A/c	1,38,400
	11,97,400		11,97,400

Note: Preference dividends are in arrears for 4 years.

Subsequent to approval by the Court, a scheme for the reduction of capital, the following steps were taken:

(i) The preference Shares were reduced to ₹ 7.50 per share and the equity shares to ₹ 2.00 per share. After reduction, the shares were consolidated into ₹ 10 shares. The authorized capital was restored to ₹ 4,00,000 8% cumulative preference shares and ₹ 3,00,000 equity shares, both of ₹ 10 each.

(ii) One new equity share of ₹ 10 was issued for every ₹ 40 of gross preference dividend in arrears.

(iii) The balance on share premium A/c was utilized.

(iv) The debenture holders took over the freehold property at an agreed figure of ₹ 1,50,000 and paid the balance to the company after deducting the amount due to them.

(v) Plant and machinery was written down to ₹ 2,80,000.

(vi) Trade investment was sold for ₹ 64,000.

(vii) Goodwill, preliminary expenses, debts of ₹ 17,200 and obsolete stock of ₹ 20,000 were written off.

(viii) Contingent liability for which no provisions had been made was settled at ₹ 14,000 and of the amount, ₹ 12,600 was recovered from the insurers.

(ix) Available cash is deposited in bank overdraft A/c

You are required:

(a) To show the journal entries necessary to record the above transactions in the company's books

(b) To show capital reduction A/c & cash A/c

(c) To prepare the balance sheet after completion of the scheme.

[C.A. (Inter). Modified]

[**Ans:** Capital reduction A/c (Total): ₹ 3,80,000; Cash A/c: ₹ 1,01,200; B/s total: ₹ 6,66,800]

29. MD & Co. is in the hands of a receiver for debenture holders. The following statement of affairs is prepared:

Assets	**Book Value** ₹	**Realizable Value** ₹
Buildings	20,00,000	24,00,000
Machinery	40,00,000	16,00,000
Stock	32,00,000	8,00,000
Debtors	32,00,000	20,00,000
Cash	4,00,000	4,00,000
	1,28,00,000	72,00,000
Less: 6% First Mortgage Debentures		= 40,00,000
		= 32,00,000
Less: 7% Second Mortgage Debentures		= 48,00,000
Deficiency Regarding Mortgage Debentures		= 16,00,000
Less: Unsecured Creditors		= 20,00,000
Deficiency Regarding Unsecured Creditors		= 36,00,000
Less: Contributions aries:		=
2,00,000 Fully Paid Shares of ₹ 10 Each	20,00,000	
2,00,000 Shares of ₹ 10 Each ₹ 4 Paid up	8,00,000	28,00,000
Deficiency Regarding Contributories		64,00,000

All the debentures are held by A and B. First mortgage debentures are held as ₹ 24,00,000 and ₹ 16,00,000 respectively by A and B. Second mortgage debentures are held as ₹ 32,00,000 and ₹ 16,00,000 by A and B, respectively.

In addition, ₹ 8,00,000 of unsecured creditors are debts due to A and B for ₹ 4,00,000 each.

Further, fully paid 20,000 and 8,000 partly paid shares respectively under a scheme of reconstruction.

(i) Partly paid shares of ₹10 are to be fully called up and all shares, except as shown in (iii) below, are to be reduced shares of ₹1 fully paid up.

(ii) A will cancel all his dues including debentures, pay ₹4,00,000 cash and will be issued new 8% first mortgage debentures of ₹44,00,000.

(iii) B will cancel all his dues and surrender all his shares and will be paid ₹4,00,000 cash and new 8% first mortgage debentures of ₹24,00,000.

(iv) Balance of unsecured creditors will sacrifice 20% and will be compensated to the extent of 10% of original amount by issue of equity shares of ₹1.

Pass the necessary journal entries and also draft the balance sheet after the scheme is put into operation.

[I.C.W.A. (Final). Modified]

[**Ans:** Hint: P&L A/c (prepared through B/L): ₹8,00,000. Reconstruction A/c (Total): ₹65,36,000; Balance sheet (Total): ₹84,000]

30. ABC Ltd. decided to reorganize itself following period of adverse trading conditions. The summarized balance sheet of the company at 31 March 2011 was as follows:

(₹ in Lakhs)

Liabilities	₹	**Assets**	₹
12% Cumulative Pref. Shares of ₹10 Each	210	Goodwill	15
		Patents & Franchises	13
Equity Shares of ₹10 Each	600	Land & Building	401
Share Premium A/c	25	Plant & Machinery	31
14% Debentures	240	Investments	80
Interest Payable on Debentures	67.20	Stocks	310
Loan from Directors	24	Debtors	210
Sundry Creditors	83.80	Deferred Charges	5
Bank Overdraft	50	P&L A/c	235
	1,300		1,300

Preference divided is in arrears for 3 years. The authorized share capital is 30,00,000 12% cumulative preference shares of ₹10 each and 60,00,000 equity shares of ₹10 each.

The following reconstruction scheme was formulated and duly approved:

(i) The existing shares were to be converted into fully up equity shares of ₹2 each. The equity shares holders were to accept a consequent reduction in their value of holdings. They further agree to subscribe to a new issue of equity shares on the basis of 2 for 3 at price of ₹3.5 per share.

(ii) The preference shareholders were to forego their right to arrear dividends. The existing 21,00,000 preference shares were to be exchanged for a new issue of 10,50,000 14% cumulative pref. shares of ₹10 each and ₹1,05,000 in equity shares of ₹2 each.

(iii) The debenture holders were to accept 12,50,000 equity shares of ₹2 each in settlement of their arrear interest and the interest rate on debentures was to be enhanced to 15%. The debenture holders were also to accept further 15% debentures of ₹40,00,000 at ₹90 per ₹100.

(iv) Half of the directors' loan was to be cancelled. The balance was to be settled by the issue of 2,20,000 equity shares of ₹2 each.

(v) Investments were to be solid at the current market value of ₹50,00,000.

(vi) The Bank overdraft was to be repaid in full.

(vii) An amount of ₹50,00,000 was to be paid immediately to creditors. The balance amount would have to be paid in quarterly instalments.

(viii) All intangibles, deferred charges and the debit balance to the P&L A/c were to be written off.

(ix) Liability for damages unrecorded in books was to be settled for ₹4,00,000. A sum of ₹7,50,000 was to be recovered in this connection from the insurance company.

(x) The existing share premium A/c was to be utilized in full.

(xi) Tangible fixed assets were to be revalued as:

Land & Building ₹4,40,00,000
Plant & Machinery ₹25,00,000

(xii) Stock were to be written down to by ₹ 2,10,000.

(xiii) Debtors A/c was to be adjusted for an uncollectable debt of ₹ 22,50,000.

It is expected that under the new arrangements, the company will be able to earn a return of ₹ 1,25,00,000 p.a. before interest and taxes. The company will not attract any tax liability for the next 5 years.

You are required to:

(a) Show the journal entries necessary to record the above scheme.

(b) Prepare the summarized balance sheet of the company immediately after reconstruction

(c) Show how the anticipated profit will be distributed after the reconstruction

[I.C.W.A. (Final). Modified]

[**Ans:** Balance sheet total: ₹ 8,42,00,000; Capital reserve: ₹ 21,20,000; Distribution of anticipated profit: Profit after tax—₹ 83,00,000; Profit available for equity—₹ 68,30,000; Retained profit—₹ 14,73,200]

Holding Company Accounts 12

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Define holding company and subsidiary company.
2. Understand the legal requirements relating to presentation of accounts by a holding company.
3. Understand the requirements of Schedule VI.
4. Explain Consolidated financial statements.
5. Prepare Consolidated balance sheet of a holding company and its subsidiaries.
6. Understand the important factors and their accounting treatment such as: (i) elimination of investment account; (ii) minority interest; (iii) cost of control or goodwill; (iv) revenue profits or post-acquisition profits; (v) revenue losses or post-acquisition losses; (vi) capital profit & losses or pre-acquisition profits and losses; (vii) revaluation of assets and liabilities; (viii) bonus shares issued by subsidiary company; (ix) dividend from subsidiary company; (x) preference shares in subsidiary company; (xi) mutual obligation/mutual indebtedness (xii) debentures in subsidiary company; (xiii) contingent liabilities; (xiv) provision for unrealized profits in stocks and (xv) abnormal losses.
7. Appreciate the various steps involved in preparation of consolidation balance sheet & consolidated profit & loss account.
8. Explain certain key terms associated with this chapter.

As we have already discussed the different forms of merger and acquisitions in the earlier chapters (amalgamation, absorption and external reconstruction), we can understand the need for such business combinations. Combinations act as a catalyst to accelerate the growth of business. One more technique being adopted by the corporate bodies is "to acquire controlling interest in a company". Acquiring control over other companies has become a popular method in the corporate world. The holding company's method of business combination works on this principle, i.e., acquiring control over other (businesses) companies. In this chapter, its method, salient features and accounting treatment are discussed in detail.

12.1 HOLDING COMPANY

The Companies Act, 1956 does not lay down any definition on holding company. However, Section 4(4) of the Companies Act stipulates: "A company shall be deemed to be the holding company of another, if, but only if, that the other is its subsidiary."

- A holding company is a limited company
- It acquires all or majority of equity shares of another limited company—called the subsidiary company
- It controls the composition of Board of Directors of another company (subsidiary)
- The subsidiary company continues to enjoy the status of a separate legal entity
- Even though the subsidiary company is virtually controlled by the holding company, it does not necessitate liquidating subsidiary companies

12.2 SUBSIDIARY COMPANY

Section 4(1) of the Companies Act defines subsidiary company. Accordingly, a company shall, subject to the provisions of sub-section (3), be deemed to be a subsidiary of another if, but only if:

(a) That other controls the composition of its Board of Directors

(b) That other

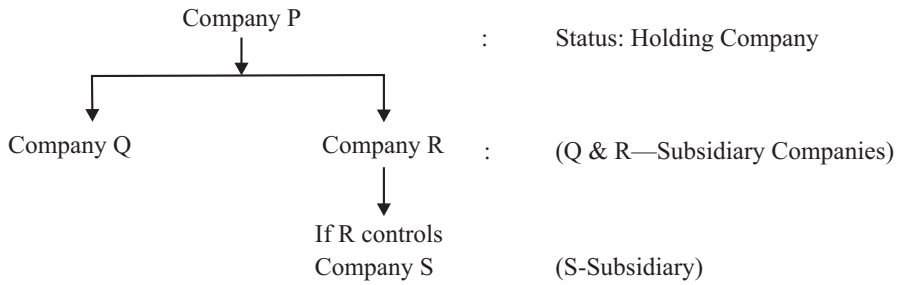
(i) Where the first-mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company;

(c) The first-mentioned company is a subsidiary of any company which is that other's subsidiary

By defining subsidiary, it unfolds the characteristics of a holding company, which can be easily comprehended by the following illustration:

Company Q is a subsidiary of Company P. That means Q is a subsidiary company and P is a holding company. Suppose Company R is a subsidiary of Company P, by virtue of clause (c) above. S is a subsidiary of company R, Company S will be a subsidiary of Company Q and consequently also of company P by virtue of clause (c) above, and so on.

This can be schematically represented as:



Company S attains the status of subsidiary companies of both Company P and Company R.

In other words, a company which is the subsidiary of a company, which in turn is a subsidiary of another company is also considered to be subsidiary of the ultimate holding company.

Control means acquiring required amount of equity share capital to ensure a majority vote. This concept of control may be explained by the following illustration.

Share Capital of P Ltd. has been raised as follows:

5,000	Equity Shares of ₹ 100 Each	₹ 5,00,000
5,000	12% Preference Shares of ₹ 100 Each	₹ 5,00,000

If, only equity shareholders have the right to vote at its general meetings as per the provisions of the Company's Articles, and if another company acquires 2,501 equity shares, it will have majority of vote power and can control the Board of Directors thereby resulting a relationship of holding company and subsidiary company. Such an occurrence may be continued as:

				₹
P Ltd.	Total Equity Capital: 5000 Equity Shares of ₹ 100 Each			5,00,000
Q Ltd.	Capital Acquired in 2,501 Shares of P Ltd.			
	(Shares are Rounded off To the Next Hundred even			
	Though a Majority of One Vote Would be Enough)	2,600 Shares	:	2,60,000
P Ltd.	Capital Acquired: 1400 Shares (1301 Shares)		:	1,40,000
S Ltd.	Capital Acquired: 800 Shares (701 Shares)		:	80,000

Suppose, at this juncture, if any company, say T Ltd., acquires 401 shares of S Ltd., then it can exercise control over all companies (P, Q & R Ltd.) and this establishes the relationship of holding company and subsidiary company.

12.2.1 Wholly Owned Subsidiary Company

A company in which all the shares with voting rights (i.e., 100%) are owned by the holding company, it is said to be a wholly owned subsidiary company.

12.2.2 Partly Owned Subsidiary Company

A company in which only the majority of shares (more than 50%) are owned by the holding company, it is said to be a partly owned subsidiary.

Minority shareholders: In partly owned subsidiary companies, shareholders who do not sell their shares to the holding company are termed "minority shareholders". Shares held by other than holding company, i.e., general public, represent this category.

Minority interest: Minority shareholder's interest or share in the assets of the subsidiary company is termed "minority interest."

12.3 LEGAL REQUIREMENTS FOR A HOLDING COMPANY

Section 212 of the Companies Act stipulates that the balance sheet of a holding company has to be accompanied by the below-mentioned documents of relating to each of its subsidiaries:

1. A copy of the balance sheet of the subsidiary
2. A copy of the P&L A/c of the subsidiary company
3. A copy of the report of its Board of Directors
4. A copy of the report of its auditors
5. A statement containing the following particulars:
   (i) the nature and extent of holding companies interest in the subsidiary at the end of the last financial year
   (ii) The net aggregate amount of profits or losses in the subsidiary so far as it concerns the members of the holding company and is not dealt within the holding company's accounts
6. If the financial year of the holding company and its subsidiary company coincide with each other, subsidiary company's balance sheet and other documents specified above with respect to the same financial year should be attached to the balance sheet of the holding company

7. If the financial year of the subsidiary company does not coincide with the financial year of the holding company, a statement showing the following should be attached:
   (i) Whether, and to what extent, there has been a change in the holding company's interest in the subsidiary company since the close of the financial year of the subsidiary company
   (ii) Details of any material changes which have occurred between the end of the financial year of the subsidiary company and the end of the financial year of the holding company in respect of:
      (a) The subsidiary's fixed assets
      (b) Its investments
      (c) The moneys lent by it
      (d) The moneys borrowed by it for any purpose other than that of meeting its current liabilities
      (e) If for any reason, the Board of Directors of the holding company is unable to obtain information on profits (capital or revenue), a report in writing to the effect.

In a nutshell, if the financial years of both the subsidiary and holding companies do not coincide, the preceding year's balance sheet and other statements of the subsidiary company should be attached. The information attached to the balance sheet of a holding company in respect of its subsidiary companies should not be more than 6 months.

12.4 CONSOLIDATED FINANCIAL STATEMENTS

"Consolidated financial statements" means the preparation and presentation of Profit and Loss account and balance sheet of a holding company and its subsidiaries in a single format. According to the Companies Act, there is no legal provision insisting a holding company to prepare and present "group accounts" or consolidated financial statements. Even though there is no statutory provision for a holding company to prepare Consolidated financial statements, the ICAI has issued AS-21 on "consolidated financial statements". It is not mandatory. As per AS-21, holding company means a parent company which has one or more subsidiaries. A "group" is a "parent" and all its subsidiaries. The main purpose of the preparation of consolidated statements is to reflect a true and fair view of the position and the profit or loss of the holding company "group". Further, by preparation of consolidated financial statements, the shareholders are in a position to get firsthand information on the company authentically.

The advantages of consolidation of financial statements are as follows:

1. **Facilitates easy comprehension:** Shareholders are in a position to get a clear insight about the financial position of the group (parent and all its subsidiaries) at a glance. Users of the financial statements are better informed through a single source document.
2. **Assists in ascertaining intrinsic value of shares:** For various accounting procedures, intrinsic value of shares serve as an essential tool. This can be attained on the basis of consolidated financial statements of companies.
3. **Proper assessment of return on investment:** Only consolidated financial statements can provide proper information on the total share of holding company in the revenue profit of its subsidiaries.
4. **Minority interests disclosure**: In the consolidated balance sheets, the item shown under the head "Minority Interest" discloses the total amount payable to outside shareholders. This is liability payable to outsiders, i.e., general public. This factor is the main factor to be considered in the process of acquisition of company.
5. **Helps in the "evaluation" of holding company:** As consolidated financial statements reflect a true and fair view of the position of the holding company (parent) as a group, the investors may be able to evaluate the performance of the company. Thereby, it enhances the overall performance of the group.

The following are its limitations:

1. **Varied information:** All the subsidiary companies may not carry the same type of business. As their activities differ from each other, information combined together in a single format may result in confusion and alternatives.
2. **Irrelevant or concealment of facts:** The data got from subsidiary companies may not be relevant in the combined form. Further, to arrive at common figures, some of the facts may be suppressed. In such a situation, a consolidated financial statement may not reflect a true and fair view of the position of the companies.

12.4.1 Contents and Format of Consolidated Balance Sheet

The Company's Act does not specify any standard prescribed format for Consolidated Balance Sheet.

However, Schedule VI of the Company's Act stipulates that a holding company will have to disclose the following items under the respective headings as shown below:

A: On the assets side of the balance sheet:

1. Under the head "Investments": Investments in equity shares, preference shares, debentures or bonds of subsidiary companies in detail.
2. Under the head "Loans and Advances": Loans and advances given to subsidiaries.

B: On the liabilities side of the balance sheet:

1. Under the head "Secured Loans": Loans and advances from subsidiaries against secured properties.
2. Under the head "Unsecured Loans": Other loans and advances from subsidiaries.
3. Under the heads "Current Liabilities" & "Provisions": Any amount due from subsidiaries.

The most accepted format in vogue is given in the following:

Note: Any form of consolidated balance sheet should be in conformity with Schedule VI to the Companies Act, 1956.

12.4.1.1 Format

Consolidated Balance Sheet
of
Holding Company and Its Subsidiaries
as on....

Liabilities	₹	₹	**Assets**	₹	₹
SHARE CAPITAL:			FIXED ASSETS:		
Share Capital of Holding Company		xx	(i) Cost of Control or Goodwill	…	
Reserves & Surplus:			Investments in Shares of Subsidiary	…	
(i) Capital Reserves of Holding Company			Less: Cost of Shares Acquired Excess	…	
Add:					
(a) Share in Pre-acquisition Reserve of Subsidiary	…		Add: Goodwill in B/S of Holding Company	…	
(b) Share in Pre-acquisition Profit of Subsidiary	…		Goodwill in B/S of Subsidiaries Goodwill	…	

Less: Goodwill (As per Contra)	…	xx	Less: Capital Reserve (as per Contra)	…	xx
			(ii) All Other Fixed Assets of Holding Co.	…	
			Add: All Other Fixed Assets of Subsidiaries	…	
				…	xx
(iii) Revenue Reserves of Holding Company	…		Investments:		
Add: Share in Revenue Reserves of Subsidiary	…	xx	(i) Investments of Holding Company (Except Shares in Subsidiaries)	…	
(iv) P&L A/c Balance (Profit) of Holding Company	…		Add: (ii) Investments of Subsidiaries	…	
					xx
Add: Share in Reserve Profits of Subsidiary	…		Current Assets and Loans & Advances:		
Less: Share in Unrealized Profit	…	xx	Current Assets of All Companies (Holding + Subsidiaries)	…	
Secured Loans:			Less: Inter-company Debts (Mutual Indebtedness)	…	
(i) Secured Loans of Holding Company	…			…	
Add: Secured Loans of Subsidiaries	…	xx	Less: Share of Unrealized Profit in Stock	…	xx
Unsecured Loans:					
(i) Unsecured Loans of Holding Company	…				
Add: (i) Unsecured Loan of Subsidiaries	…	xx			
Current Liablities & Provisions:					
(i) Current Liabilities & Provisions of Holding Companies	…				
Add: (ii) Current Liabilities & Provisions of Subsidiaries	…				
Less: Inter-company Indebtedness (Liabilities)	…	xx			

Minority Interest:		xx	Miscellaneous Expenditure:		xx
			Profit & Loss Account:		
			P&L A/c of Holding Company Only		xx
		xxx			xxx

Note: At times, "minority interest" may also be shown under the head "Share Capital".

12.4.2 Preparation of Consolidated Balance Sheet

Various factors have to be taken into account for the preparation of consolidated balance sheet of a holding company and its subsidiaries. They are explained item wise as follows:

12.4.2.1 Investment Account—Elimination or Cancellation

In consolidated balance sheet, the financial position of the parent company (holding) and all its subsidiaries is shown. The figures are shown as a single company. In general, a holding company shows the shares acquired in a subsidiary company—on the assets side of balance sheet—as an investment.

The assets shown in the balance sheet denote the resources owned by the group (holding company + all its subsidiaries). The liabilities shown are claims on the assets (resources) of the group. These internal items—that are assets to one and liabilities of another—will not appear in consolidated balance sheet. This type of process is termed as elimination or cancellation of respective items.

In other words, the investment of a holding company in the shares of the subsidiary company is replaced by the assets and liabilities of the subsidiary company by way of cancelling the said item.

The principle of cancellation is based on the following assumptions:

1. It should be a wholly owned subsidiary company
2. The holding company and the subsidiary company do not indulge in trade with each other
3. The shares are purchased at par

Illustration 12.1

Model: Cancellation of investment—Wholly owned subsidiary company

From the following balance sheet of H Ltd. (holding) and S Ltd. (subsidiary), prepare a consolidated balance sheet of H Ltd. and its subsidiary S Ltd.:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Sundry Assets	4,00,000	2,25,000
Shares of ₹ 10 Each	5,00,000	2,00,000	Investment:		
Sundry Liabilities	1,00,000	25,000	20,000 Shares of ₹ 10 Each of S Ltd.	2,00,000	—
	6,00,000	2,25,000		6,00,000	2,25,000

Solution

Notes

1. The balance sheet reveals that H Ltd. owns the whole of issued share capital of S Ltd. (wholly owned subsidiary).
2. The balance sheet of H Ltd. reveals the investment in shares of S Ltd. The amount is equal to the nominal value of issued share capital of S. Ltd.

3. These two amounts represent the same transaction but different in nature. (The issued capital of S Ltd. and investment held by H Ltd.).
4. These two are the internal items of H Ltd. and S Ltd.
5. Hence, these should be eliminated in the preparation of consolidated balance sheet shown in the following:

Consolidated Balance Sheet of
H Ltd. & S Ltd. as on …

Liabilities	₹	₹	Assets	₹	₹
Share Capital:			Sundry Assets:		
50,000 Shares of ₹ 10	—	5,00,000	H Ltd.	4,00,000	
Each (H. Ltd. Only)			S Ltd.	2,25,000	6,25,000
Sundry Liabilities:					
H Ltd.	1,00,000				
S Ltd.	25,000	1,25,000			
		6,25,000			6,25,000

Note: The investment account on the assets side of H Ltd. is replaced by the total assets of S Ltd. on the assets side of consolidated balance sheet and its liabilities are shown on the liabilities side.

12.4.2.2 Minority Interest

It will be sufficient to attain the status of holding company if that company acquires majority equity shares in a subsidiary. Here, majority means a simple majority in terms of democracy. The remaining shares naturally are in the hands of general public, i.e., outside shareholders. In such a partly owned subsidiary company, the share capital is being jointly held by the holding company and outsiders. The collective interest of such outside shareholders is termed "minority interest".

The minority interest is to be computed and shown as a separate item on the liabilities side of the consolidated balance sheet. Minority interest is the amount payable to the outsiders with respect to share capital and accumulated profits to the extent of their share.

Minority interest may be computed as follows:

Add:	₹
(i) Proportionate Value of Equity Shares Held:	…
(ii) Proportionate Value of Pref. Shares Held:	…
(iii) Proportionate Share in Capital Profits:	…
(iv) Proportionate Share in Revenue Profits:	…
(v) Proportionate Share of Bonus Shares:	…
(vi) Proportionate Share in P&L A/c (Cr.):	…
Step A: Add (i) to (vi):	xxx
(vii) Less: Proportionate Share in P&L A/c (Dr.):	…
(viii) Proportionate Share in Capital Loss:	…
(ix) Proportionate Share in Revenue Loss:	…
Step B: Add (vii) to (ix):	xxx
Step C: Minority Interest (Step A – Step B):	xxxx

Illustration 12.2

Model: Minority interest

From the following, prepare consolidated balance sheet of H Ltd. and its subsidiary S Ltd.

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Sundry Assets	4,00,000	3,20,000
Shares of ₹ 10 Each	5,00,000	3,00,000	Investments in		
Other Liabilities	1,40,000	20,000	Shares of S Ltd:	2,40,000	—
			24,000 Shares of ₹ 10 Each		
	6,40,000	3,20,000		6,40,000	3,20,000

Notes:

1. This partly owned subsidiary company H Ltd. owns to the extent:
   Issued capital of S Ltd.: ₹ 3,00,000
   Owned as investment in shares of S Ltd. : ₹ 2,40,000
   ∴ Proportionate share $\frac{₹\,2,40,000}{₹\,3,00,000} \times 100 = 80\ \%$
2. Outside shareholders share = (100 – 80)% = 20%
   ∴ Value of minority interest = 20% of ₹ 3,00,000
   = ₹ 60,000
   This amount may be shown in either of the following two ways:
   (i) As a separate item under the head "Minority Interest"
   (ii) Along with share capital of holding company
3. As in this problem, no items relating to capital reserve profit and loss; revenue reserve profit and loss or P&L A/c balance is given—Minority interest is computed straight away in Notes 1 and 2.

Solution

Consolidated Balance Sheet of
H Ltd. & S Ltd.
as on…

Liabilities		₹	Assets		₹
Share Capital (of H Ltd.):			Sundry Assets:	₹	
50,000 Shares of ₹ 10 Each		5,00,000	H Ltd.	4,00,000	
			S Ltd:	3,20,000	7,20,000
Minority Interest:					
(20% Proportionate Share		60,000			
in Share Capital.					
(Ref: Notes 1 & 2)					
Other Liabilities:	₹				
H Ltd.	1,40,000				
S Ltd.	20,000	1,60,000			
		7,20,000			7,20,000

12.4.2.3 Cost of Control (or) Goodwill

In general, the shares of a subsidiary company are purchased either as a premium or at a discount by the holding company. When the share capital of the subsidiary company held by the holding company is cancelled against investment in share (cost), difference will arise.

1. When the holding company purchases the shares at a price above the nominal value, the excess price paid represents cost of control or goodwill.
   It may be said that "cost of control" is the "excess" paid by the holding company to acquire "controlling interest" in the subsidiary company.
   This may be presented in the form of equation as:
   Cost of control or goodwill = Investment (At cost) – Face or paid-up value of shares purchased
2. When the holding company purchases shares at a price below the face value, the difference represents "capital reserve". This may be presented in the form of equation as:
   Capital reserve = Face or paid-up value of shares purchased – Investment at cost

Method of ascertaining cost of control (or) reserve:

		₹	₹
Step 1:	Amount Paid for Shares Purchased (by the Holding Company in a Subsidiary)		…
Add:			
Step2:	Holding Company's Share of Capital Loss		…
		₹	xx
Less:			
Step3:	(i) Face Value of Shares	…	
	(ii) Holding Company's Share of Capital Loss	…	
	(iii) Holding Company's Share of Bonus Shares Issued by Subsidiary	…	
	(iv) Holding Company's Share of Dividend Paid out of Capital Profit	…	xx
Step 4:	Goodwill (or) capital reserve:		xx

Notes:

1. In Step 4, if the balance is positive it is goodwill. On the other hand, if the balance is negative it is capital reserve
2. This amount will be merged with goodwill in the reserve balance sheets of Holding and Subsidiary companies.

Illustration 12.3

Model: Cost of control

From the following balance sheets of H Ltd. and its subsidiary S Ltd. as on 31 December 2010, prepare a consolidated balance sheet.

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Sundry Assets:	3,50,000	2,60,000
Shares of ₹ 50 Each	5,00,000	2,00,000	Investment in the Shares of S Ltd. 4,000 Shares (At Cost)	3,00,000	—

Creditors	1,00,000	20,000			
Reserves	—	10,000			
Profit & Loss A/c	50,000	30,000			
	6,50,000	2,60,000		6,50,000	2,60,000

H Ltd. purchases shares in S Ltd. on the balance sheet date.

Solution

Computation of Cost of Control (Goodwill):

		₹
Step 1:	Cost Price of Shares in S Ltd. (Investment): Given:	3,00,000
Step 2:	Less: Face Value of Shares:	2,00,000
		1,00,000
Step 3:	Less: Share in Reserves:	10,000
		90,000
Step 4:	Less: Share in Profit (P&L A/c):	30,000
	∴ Cost of Control or Goodwill:	60,000

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as on 31 December 2010

Liabilities		₹	**Assets**		₹
Share Capital			Goodwill (Ref: Step 4)		60,000
(Shares of ₹ 50 Each)		5,00,000	Sundry Assets:		
Creditors:			H Ltd.	3,50,000	
H Ltd.	1,00,000		S Ltd.	2,60,000	6,10,000
S Ltd.	20,000	1,20,000			
Profit & Loss A/c (H Ltd.)		50,000			
		6,70,000			6,70,000

Illustration 12.4

Model: Capital reserve

From the following balance sheets of H Ltd. and its subsidiary S Ltd. as on 31 December 2010, prepare a consolidated balance sheet.

Liabilities	**H Ltd.** ₹	**S Ltd.** ₹	**Assets**	**H Ltd.** ₹	**S Ltd.** ₹
Share Capital:					
(Shares of ₹ 100 Each)	6,00,000	4,00,000	Sundry Assets	5,00,000	4,85,000
Creditors	2,00,000	50,000	Investment in 4,000	4,10,000	—
Reserves	40,000	20,000	Shares of S. Ltd. (on 31 December 2010)		

Profit & Loss A/c	70,000	15,000			
	9,10,000	4,85,000		9,10,000	4,85,000

Solution

Computation of Capital Reserve:

			₹
Step 1:	Cost Price of Shares (on 31 December 2010)	:	4,10,000
Step 2:	Less: Paid-up Value of Shares (Face Value)	:	4,00,000
	Difference	:	10,000
Step 3:	Less: (Proportionate) Share in Reserve 100%	:	(20,000)
			(10,000)
Step 4:	Less: 100% Share in Profit (P&L A/c)	:	(15,000)
Step 5:	Less: Capital Reserve		(25,000)

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as on 31 December 2010

Liabilities		₹	**Assets**	₹	₹
Share Capital H Ltd.		6,00,000	Sundry Assets:	₹	
(Shares of ₹100 Each)			H Ltd.	5,00,000	
Capital Reserve (Ref: Step 4)		25,000	S Ltd.	4,85,000	9,85,000
Reserve (H Ltd.)		40,000			
Profit & Loss A/c (H Ltd.) Creditors		70,000			
H Ltd.	2,00,000				
S Ltd.	50,000	2,50,000			
		9,85,000			9,85,000

12.4.2.4 Pre-acquisition Profits–Reserves

The subsidiary company, on the date of acquisition of shares by the holding company, is having balances in the profit and loss and reserves accounts. The holding company not only purchases shares but also is entitled to purchase a certain proportion of profit and reserves. Such accumulated profits of the subsidiary company existing on the date of acquisition are known as "pre-acquisition profits" or "capital profits". They include capital reserve, general reserve, share premium, P&L A/c reserve fund.

For calculating the share of the holding company, reserves and profits are split into the following:

1. Pre-acquisition profit/reserve
   (i) Pre-acquisition profits:
   Treatment: They are treated as capital profits. They are to be included in capital reserves and adjusted against goodwill.
   (ii) Pre-acquisition reserves:
   Treatment: Same as pre-acquisition profit.

2. Post-acquisition profit/reserve
   (i) Post-acquisition profits:
   Treatment: They are treated as revenue profits. They are to be added to the surplus or profits of the company.
   (ii) Post-acquisition reserves: They are to be added to general reserves.

Important notes:

1. Capital reserves of the holding company must be adjusted with goodwill as both cannot be shown at a time in the balance sheet.
2. When computing the share of minority interest, a distinction should not be made between pre-acquisition and post-acquisition profits/reserves.
3. A distinction between the pre- and post-acquisition profit/reserves has to be made for accumulated profits/reserves of the subsidiary company for determining the share of the holding company.

Illustration 12.5

Model: Pre-acquisition profit/reserves

From the following information, prepare a consolidated balance sheet.

Balance Sheets
as on 31 December 2010

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital					
Shares of ₹10 Each	2,00,000	1,00,000	Sundry Assets	2,20,000	1,50,000
Reserves	50,000	20,000	Investments		
Profit & Loss A/c	20,000	10,000	6,000 Shares of S Ltd.	80,000	—
Creditors	30,000	20,000			
	3,00,000	1,50,000		3,00,000	1,50,000

H Ltd. acquired its shares in S Ltd. on 1 January 2010 when reserves of S Ltd. stood at ₹ 4,000 and its profit and loss account (Cr.) was ₹ 5,000.

Solution

Basic Calculations:

I: Calculation of H Ltd.'s Share in Capital Profit and Reserve:

Step 1: Ratio of Equity Acquired and Held by Minority Interests:

Total Number of Shares = ₹ $\frac{1,00,000}{10}$ = 10,000 Shares

Number of Shares Acquired by H Ltd. = 6,000 Shares

Number of Shares Held by Minority Interest by H Ltd. = 4,000 Shares

∴ Ratio of Shares Acquired and Held by Minority Interest

6,000 : 4,000

or 6 : 4

or 3 : 2

		₹
Step 2:	Shares in Pre-acquisition Profit: 3/5 × ₹ 5,000 =	3,000
	Share in Pre-acquisition Reserve: 3/5 × ₹ 4,000 =	2,400
Step 3:	Total Amount to Be Transferred to Capital Reserve or to be Adjusted Against Goodwill	5,400

II: Calculation of Goodwill:

		₹
Step 1:	Investment in Shares of S Ltd.:	80,000
Step 2:	Less: Face Value of Shares Held (6,000 × ₹ 10):	60,000
		20,000
Step 3:	Less: Company's Share of Pre-acquisition Profit & Reserve (Ref: Basic calculation I Step 3) i.e. Capital Reserve:	5,400
		14,600

III: Calculation of H Ltd.'s Share in Revenue Profit & Reserves:

(i)	Balance in Reserve Account (Given):	20,000
	Less: Pre-acquisition Reserve (Given):	4,000
	∴ Post-acquisition Reserve:	16,000
	of this, H Ltd.'s Share = $\frac{3}{5}$ × ₹ 16,000 =	9,600
(ii)	Balance in P&L A/c (Given):	10,000
	Less: pre-acquisition Profit (Given):	5,000
	∴ Post-acquisition Profit:	5,000
	Of this, H Ltd.'s Share = $\frac{3}{5}$ × ₹ 5,000 =	3,000

IV: Computation of Minority Interest:

(i)	Nominal Value of Equity Shares Held:	
	4,000 Shares (10,000 – H Ltd.'s Acquisition 6,000) × ₹ 10	40,000
(ii)	Share: $\frac{2}{5}$ i.e. Minority Shareholder's Share	
	Their Share in Reserve: $\frac{2}{5}$ × ₹ 20,000 =	8,000
(iii)	Share in Profit = $\frac{2}{5}$ × 10,000 =	4,000
		52,000

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as on 31 December 2010

Liabilities		₹	Assets		₹
Share Capital:			Fixed Assets:		
20,000 Equity Shares of ₹ 10 Each		2,00,000	Goodwill (Ref: II)		14,600
Minority Interest (Ref: IV)		52,000	Sundry Assets:		
Reserves & Surplus:			H Ltd.:	2,20,000	
Reserves: H Ltd.	50,000		S Ltd.:	1,50,000	3,70,000

Share in S Ltd.	9,600	59,600		
P&L A/c H Ltd.	20,000			
Share in S Ltd.	3,000	23,000		
Current Liabilities:				
Creditors: H Ltd.	30,000			
S Ltd.	20,000	50,000		
		3,84,600		3,84,600

Illustration 12.6

Model: Pre-acquisition profit and reserves

From the balance sheets given below, prepare a consolidated balance sheet of H Ltd. and its subsidiary S Ltd.

Liabilities	**H Ltd.** ₹	**S Ltd.** ₹	**Assets**	**H Ltd.** ₹	**S Ltd.** ₹
Share Capital:			Fixed Assets:		
Shares of ₹ 20 Each	3,60,000	90,000	Freehold Property	2,16,000	—
Reserves & Surplus:			Leasehold Property	—	75,000
General Reserve	75,000	18,000	Plant & Machinery	90,000	30,000
Profit & Loss A/c	36,000	27,000	Investments:		
Current Liabilities:			7,000 Shares in S Ltd.	75,000	—
Creditors	45,000	15,000	Current Assets:		
			Stock at Cost	54,000	9,000
			Debtors	66,000	21,000
			Bank	15,000	15,000
	5,16,000	1,50,000		5,16,000	1,50,000

At the date of acquisition by H Ltd., of 3,000 shares in S Ltd. the latter company had undistributed profits and reserves of ₹ 15,000, none of which have been distributed since acquisition.

Solution

Notes:

1. The total of general reserves and P&L A/C (Surplus in this problem = ₹ 18,000 + ₹ 27,000 = ₹ 45,000) of S Ltd.
2. Ratio between total reserves and total profits = ₹ 18,000 : ₹ 27,000
   = 18 : 27

   In the ratio of 2 : 3
3. No need to split accumulated profits and reserves into pre- and post-acquisition periods for determining share of minority interest in them.

Following is the statement showing share of majority and minority interests in S Ltd.

Particulars	Total ₹	H Ltd. ₹	Minority Interest ₹
	(1)	(2)	(1) – (2)
1. Share Capital	90,000	60,000	30,000
2. Reserves (Given ₹ 18,000) (Apportion in the Ratio of 2:3)			
(i) Pre-acquisition – Capital Reserve	6,000	3,999	2001
(ii) Post-acquisition – Revenue Reserve	12,000	8,001	3,999
3. (Profit) Surplus (Given ₹ 27,000)			
(i) Pre-acquisition – Capital Profit	9,000	6,000	3,000
(ii) Post-acquisition – Revenue Profit	18,000	12,000	6,000
	1,35,000	90,000	45,000

Consolidated Balance Sheet of H Ltd.
and Its Subsidiary S Ltd. as on…

Liabilities		₹	Assets		₹
Share Capital H Ltd.		3,60,000	Fixed Assets:	₹	
Minority Interest:		45,000	Goodwill:		
(Ref: The above statement)			Investment in Share of S Ltd.	75,000	
Reserves & Surplus:	₹		Less: Face Value	60,000	
(i) General Reserve H Ltd.	75,000		Paid as Goodwill Excess:	15,000	
Two-thirds Share in Revenue Reserve of S Ltd.	8,001	83,001	Less: Capital Res as per Contra	9,999	
(Ref: Above Statement)				5,001	5,001
(ii) Capital Reserves:			Freehold Property (H)		2,16,000
Two-thirds Share in S Ltd.	3,999		Leasehold Property (S)		75,000
Two-thirds Share in Profit:	6,000		Plant & Machinery (H)		90,000
	9,999		Plant & Machinery (S)		30,000
Deduct as per Contra	9,999		Current Assets and Loans & Advances:		
Profit on Surplus:		—	Current Assets:		
H Ltd.:	36,000		Stock H	54,000	
Two-thirds Rev. Profit S Ltd:	12,000	48,000	Stock S	9,000	63,000
Current Liabilities:			Debtors H	66,000	
Creditors H Ltd.	45,000		Debtors S	21,000	87,000
S Ltd.	15,000	60,000	Bank H	15,000	
			Bank S	15,000	30,000
		5,96,001			5,96,001

12.4.2.5 Pre-acquisition Losses

(i) Pre-acquisition losses are like capital losses relating to the share of holding company.

(ii) In consolidated balance sheets, it will increase the cost of control or decrease the capital reserve.

(iii) Post-acquisition losses are like revenue losses. Share of the holding company will be debited to accumulated balance in the P&L A/c of the holding company. In case sufficient profits do not exist, it will be shown as a separate item on the assets side of the balance sheet.

(iv) There is no necessity for distinction between pre- and post-acquisition losses with respect to minority interest.

Illustration 12.7

Model: Pre-acquisition loss

The balance sheet of H Ltd. and its subsidiary S Ltd. as on 31 December 2010 were as follows:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Sundry Assets	80,000	50,000
Shares of ₹ 10 Each	50,000	30,000	Investments:		
General Reserve	20,000	—	2,000 Shares in S Ltd.	20,000	—
Profit & Loss Account	20,000	9,000			
Creditors	10,000	11,000			
	1,00,000	50,000		1,00,000	50,000

The shares were purchased by H Ltd. and S Ltd. in 30 June 2010. On 1 January 2010, the P&L A/c of S Ltd. showed a loss of ₹ 15,000 which was written off from out of the profits earned during the year. Profits are earned uninformally over the year 2010. Prepare a consolidated balance sheet of H Ltd. and S Ltd. as on 31 December 2010 giving all workings.

Solution

Basic Calculations:

I: Computation of H Ltd.'s Share in Pre-acquisition Loss:

(i) Total Pre-acquisition Loss (Given): ₹ 15,000

(ii) H Ltd.'s Share = $\frac{2}{3}$ × ₹ 15,000:₹ 10,000

Note: This ₹ 10,000 is a capital loss for H Ltd.

∴ It is to be added to the cost of control or it is to be deducted from capital reserve.

II: Calculation of H Ltd.'s Share in Post-acquisition Profits:

		₹
Step 1:	Balance as per P&L A/c	9,000
Step 2:	Add: Pre-acquisition Losses Written off:	15,000
Step 3:	Total Profit for 2010 (Step 1 + Step 2)	24,000
Step 4:	Profits for 6 months from 1 July to December 2010: $\frac{6}{12}$ × ₹ 24,000	12,000
Step 5:	H Ltd.'s share: $\frac{2}{3}$ × ₹ 12,000:	8,000

III: Calculation of H Ltd.'s Share of Capital Profits:

		₹
Step 1:	Pre-acquisition Profits from 1 January 2010 to 30 June 2010:	
	6 months: $\frac{6}{12}$ × ₹ 24,000 =	12,000
Step 2:	H Ltd.'s Share: $\frac{2}{3}$ × ₹ 12,000 =	8,000

This ₹ 8,000 will Be Taken to Goodwill and will be Deducted from It (OR) to be Added with Capital Reserve

IV: Computation of Cost of Control or Goodwill:		₹
Step 1:	Investment in Shares of S Ltd.	20,000
Step 2:	Less: Paid-up Value of the Said Shares	20,000
Step 3:	Cost of Control or Goodwill (Step 1 – Step 2)	NIL
Step 4:	Add: Pre-acquisition Loss (Ref: I)	10,000
Step 5:	Less: Capital Reserve (Ref: II)	8,000
Step 6:	Goodwill (Step 4 – Step 5):	2,000

Important note

1. For determining minority interest, no need to distinguish between pre- and post-acquisition losses. Hence, ₹ 15,000, the pre-acquisition losses is ignored. Minority interest is determined as follows:

		₹
Step 1:	Nominal value of shares:	10,000
Step 2:	Less: One-third of pre-acquisition loss of ₹ 15,000	5,000
		5,000
Step 3:	Add: One-third of post-acquisition profit of ₹ 24,000	8,000
		13,000

2. Accumulated balance in P&L A/c is ₹ 9,000 (Given).
   ∴ One-third of ₹ 9,000: ₹ 3,000 will be added to minority interest.

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as on 31 December 2010

Liabilities		₹	**Assets**		₹
Share Capital:			Fixed Assets:		
Shares of ₹ 10 Each (H Ltd.)		50,000	Goodwill		2,000
Minority Interest:			Sundry Assets		
Equity Held	10,000		H Ltd.	80,000	
Add: $\frac{1}{3}$ × ₹ 9,000	3,000	13,000	S Ltd.	50,000	1,30,000
Reserves & Surplus:					
General Reserve (H Ltd.)		20,000			
Profit & Loss A/c:					
Balance H Ltd.	20,000				
Add: Share in S Ltd.	8,000	28,000			
Current Liabilities:					
H Ltd.	10,000				
S Ltd.	11,000	21,000			
		1,32,000			1,32,000

12.4.2.6 Inter-company Transactions (Elimination of Common Transactions or Mutual Obligation or Mutual Indebtedness

The companies in a group, i.e. the holding company and the subsidiary company, may trade each other. They owe money to each other on account of common transactions like buying and selling of goods, lending and borrowing of money, rendering service to each other and the like. This will culminate in common accounts appearing in the balance sheets of holding company as well as its subsidiaries. While preparing consolidated balance sheet, all such mutual obligations should be eliminated.

12.4.2.6.1 Debtors and Creditors

Transactions with respect to sale and purchase of goods on credit take place between the holding company and its subsidiaries. This will result in mutual indebtedness as debtors in the balance sheet of the company which sells goods and as creditors in the balance sheet of the company which purchases those goods on credit.

Treatment:

(i) If the same amount appears in both the companies, they can be eliminated by deducting common amounts both from the debtors and creditors (thus by reducing on both sides of the consolidated balance sheet).

(ii) If there is any difference between the two, it may be due to cash-in-transit or goods-in-transit. Such "transit" amount is to be reduced from the side on which higher amount is shown. Further, this item (cash or goods in transit) is to be shown on the assets side of the balance sheet as a separate item.

12.4.2.6.2 Loans Payable and Receivable

Loans are advanced to subsidiaries by the holding company or vice versa. It is shown as an asset in the balance sheet of the company which advances the loan and as a liability in the balance sheet of the company which receives that loan.

If interest on the loans is outstanding, the P&L A/c of the lender company will be credited with the amount of interest due. Loan account of the company that borrowed the loan will be debited.

In consolidated balance sheet, both loan and interest should be eliminated.

12.4.2.6.3 Bills Receivable and Bills Payable

Bills of exchange of the holding and subsidiary companies will include bills accepted and drawn by each other. To that extent, such bills which are included in the bills receivable should be eliminated while preparing the consolidated balance sheet. However, any bills endorsed or discounted causing a liability to a third party has to be shown as a separate item on the assets side of the balance sheet.

12.4.2.6.4 Services Rendered

Companies owing for services rendered, if entry is already passed by both the companies, should be subtracted from respective items in the balance sheet.

In case no entry is entered till now, such amount should be reduced from revenue profit of the subsidiary company and added to the P&L A/c of the holding company.

Illustration 12.8

Model: Common transactions (Bills and debtorsand creditors)

H Ltd. acquired 4,000 equity shares of S Ltd. on 31 March 2010. The following are the balance sheets of the two companies as at 31 March 2011:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Equity Shares of ₹ 100 Each	10,00,000	5,00,000	Land & Buildings	2,50,000	1,50,000
General Reserves 31 March 2010	2,00,000	1,00,000	Plant & Machinery	2,50,000	3,00,00
			Stock	75,000	50,000
Profit & Loss A/c 31 March 2010	50,000	30,000	Sundry Debtors	50,000	60,00
Profit for the Year 2010–11	1,00,000	40,000	Investment in Shares of S Ltd	5,00,000	—
Sundry Creditors	50,000	50,000	Bills Receivable	40,000	5,000
Bills Payable	15,000	5,000	Cash & Bank	2,50,000	1,60,000
	14,15,000	7,25,000		14,15,000	7,25,000

(i) Bills receivable of H Ltd include ₹ 5000 accepted by S Ltd.
(ii) Sundry debtors of H Ltd include ₹ 25,000 due from S Ltd.

Prepare a consolidated balance sheet of H Ltd. and its subsidiary S Ltd.

[C.S. (Inter). Modified]

Solution

Basic Calculations:

	₹
I. Calculation of Share of H Ltd. in Capital Profit:	
(i) General Reserve (31 March 2010)	1,00,000
(ii) P&L A/c (31 March 2010)	30,000
(iii) Total Capital Profit ((i) + (ii))	1,30,000
(iv) Share of H Ltd. $\frac{4}{5}$ × ₹ 1,30,000	1,04,000
II. Calculation of Cost of Control—Capital Reserve:	
(i) Cost of Investment in Shares of S Ltd.	5,00,000
(ii) Less: Paid-up Value of Equity Shares	4,00,000
	1,00,000
(iii) Less: Capital Profit (Ref: I (iv))	1,04,000
(iv) Capital Reserve	(4,000)
III. Calculation of Share of H Ltd in Revenue Profits:	
(i) Profit for the Year 2010–11	40,000
(ii) Share of H Ltd.: $\frac{4}{5}$ × ₹ 40,000	32,000
IV. Computation of Minority Interest:	
(i) Paid-up Value of Equity Shares Held Minority Share = $\frac{1}{5}$ × ₹ 5,00,000	1,00,000

(ii) Share of General Reserve: $\frac{1}{5}$ × ₹ 1,00,000	20,000
(iii) Share of Profit (31 March 2010—₹ 30,000 + 2010–11—₹ 40,000) $\frac{1}{5}$ × ₹ 70,000	14,000
(iv) Value of Minority Interest (Add (i) + (ii) + (iii))	1,34,000

Consolidated Balance Sheet
of H Ltd. and
Its Subsidiary S Ltd. as on 31 March 2011

Liabilities	₹	₹	Assets	₹	₹
Share Capital:			Fixed Assets:		
Issued, Subscribed & Paid-up			Land & Buildings:		
10,000 Equity Shares of ₹ 10 Each		10,00,000	H Ltd.	2,50,000	
			S Ltd.	1,50,000	4,00,000
Minority Interest		1,34,000	Plant & Machinery		
Reserves & Surplus			H Ltd.	2,50,000	
General Reserve (H Ltd.)		2,00,000	S Ltd.	3,00,000	5,50,000
Capital Reserve		4,000	Current Assets, Loans and Advances:		
P&L A/c:	₹				
H Ltd.	1,50,000		(A) Current Assets:		
S Ltd.	32,000	1,82,000	Stock:		
Current Liabilities:			H Ltd.	75,000	
H Ltd.	50,000		S Ltd.	50,000	1,25,000
S Ltd.	50,000		Sundry Debtors:		
	1,00,00		H Ltd.	50,000	
Less: Inter-company Debts	25,000	75,000	S Ltd.	60,000	
			Less: Inter-company Debts	1,10,000	
				25,000	85,000
Bills Payable:			Cash & Bank:		
H Ltd.	15,000		H Ltd.	2,50,000	
S Ltd.	5,000		S Ltd.	1,60,000	4,10,000
	20,000		(B) Loans & Advances:		
Less: Inter-company Bills	5,000	15,000	Bills Receivable:		
			H Ltd.	40,000	
			S Ltd.	5,000	
				45,000	
			Less: Intercompany Bills	5,000	40,000
		16,10,000			16,10,000

12.4.2.7 Contingent Liabilities

Transactions that may become liabilities in future are contingent liabilities. It may or may not occur. It is not certain.

Example: (i) Bills endorsed to creditors and discounted with Bank (ii) Investment in partly paid shares (iii) Arrears of dividend or cumulative preference shares (iv) Liability under guarantee, etc.

Treatment:

1. Contingent liability involving a third party is to be shown as a "foot note" to the consolidated balance sheet (External contingent liability).
2. Contingent liability involving the holding company and its subsidiaries is not to be shown as a footnote to consolidated balance sheet. (It will be shown as liability in the consolidated balance sheet) [Internal contingent liability].

12.4.2.8 Unrealized Profit in Stock

The holding company or the subsidiary, at times, has in its stock goods purchased from the other company that were sold at profit. Hence, the stock includes the unrealized profit charged by the selling company.

Such unrealized profit has to be eliminated from closing stock.

Treatment: First, the unrealized profit value would be deducted from the profit of the subsidiary company. Then it would be deducted from the closing stock. While preparing consolidated balance sheet, the unrealized profit should be reduced from the stock (on the assets side of B/S) and from the P&L A/c (on the liabilities side of B/S)

Unrealized profit may also be deducted from the revenue profit of subsidiary company while determining the share of holding company in the revenue profits of subsidiary company.

Illustration 12.9

Model: Contingent liabilities and unrealized profit in stock

The balance sheet of H Ltd. and S Ltd. on 31 March 2010 was as follows:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Equity Share of ₹ 10 Each	20,00,000	12,00,000	Land & Buildings	10,00,000	8,00,000
General Reserve on 1 April 2009	3,60,000	2,04,000	Plant & Machinery	5,00,000	6,40,000
Profit & Loss A/c	2,40,000	96,000	Stock	2,80,000	3,20,000
Balance on 1 April 2009			Debtors	4,80,000	4,20,000
Profit for 2009–10	4,40,000	3,36,000	80,000 Shares in S Ltd.	11,80,000	—
Bills Payable	—	80,000	Bills Receivable	1,20,000	—
Creditors	5,60,000	2,84,000	Cash	40,000	20,000
	36,00,000	22,00,000		36,00,000	22,00,000

H Ltd. acquires shares in S Ltd. on 1 January 2010. S Ltd. issued all bills payable to H Ltd. Bills receivable of H Ltd. include bills of S Ltd. for ₹ 48,000. Sundry debtors of S Ltd. include ₹ 40,000 owing by H Ltd. Stock of H Ltd. includes goods worth ₹ 60,000 purchased from S Ltd. for which the latter company has charged profit at 25% on cost. Contingent liability for bills discounted by H Ltd. is ₹ 1,00,000. Prepare a consolidated balance sheet.

Solution

Basic Calculations:

I: Calculation of H Ltd.'s Share in Capital Reserve:		₹
Step 1:	Balance of General Reserve on 1 April 2009	2,04,000
Step 2:	Share of H Ltd: $\frac{2}{3}$ × ₹2,04,000	1,36,000
II: Calculation of H Ltd.'s Share in Capital Profits:		
Step 1:	Balance as per P&L A/c on 1 April 2009	96,000
Step 2:	Profit from 1 April 2009 to 1 January 2010 i.e., 9 months; $\frac{9}{12}$ × ₹3,36,000 (Given)	2,52,000
Step 3:	Total Profit (Add: Step 1 + Step 2)	3,48,000
Step 4:	Share of H Ltd : $\frac{2}{3}$ × ₹3,48,000	1,74,000
III. Calculation of Cost of Control:		
Step 1:	Cost of Investment in Shares of S Ltd:	11,80,000
Step 2:	Less: Paid-up Value of Shares = (80,000 × ₹10)	8,00,000
Step 3:	Goodwill (Step 1 – Step 2)	3,80,000
Step 4:	Less: Capital Reserve	1,36,000
		2,44,000
Step 5:	Less: Capital Profits	2,32,000
Step 6:	Value of Goodwill to Be Shown in Consolidated Balance Sheet	12,000
IV: Computation of Minority Interest:		
Step 1:	Shares Held by Outsiders (1,20,000 – 80,000) 40,000 Shares × ₹10)	4,00,000
Step 2:	$\left(\frac{1}{3}\text{ of } ₹2,04,000\right)$ Share of General Reserve as on 1 April 2009	68,000
Step 3:	$\left(\frac{1}{3}\text{ of } ₹96,000\right)$ Share of Profit (1 April 2009)	32,000
Step 4:	$\left(\frac{1}{3} \times ₹3,36,000\right)$ Share of Profit (2009–10)	1,12,000
Step 5:	Minority Interest [Add: Step 1 to Step 4]	6,12,000
V: Calculation of H Ltd.'s Share in Revenue Profits:		
Step 1:	Profit for (1 January 2010 to 31 March2010) 3 months, i.e. $\frac{3}{12}$ × ₹3,36,000	84,000
Step 2:	Share of H Ltd.: $\frac{2}{3}$ × ₹84,000	56,000
VI: Calculation of Contingent Liability:		₹
Step 1:	S Ltd.'s Bills Payable in Favour of H Ltd.	80,000
Step 2:	Amount Available in H Ltd. as per B/S	48,000
Step 3:	Bills Receivable Discounted (Step 1 – Step 2)	32,000
Step 4:	Total Contingent Liability (Given)	1,00,000

Step 5: As, ₹ 32,000 Discounted Being Internal
Contingent Liability, to Be Deducted from Total Contingent Liability 32,000

Step 6: Amount Available for External Liability to Be Shown as footnote to B/S 68,000

VII: Calculation of Unrealized Profit in Stock:

Step 1: Stock of H Ltd. (Supplied by S Ltd.) 60,000

Step 2: Profit: 25% on Cost (Given)—25% on Cost is Equal to 20% on Sale, 12,000

$\frac{20}{100} \times ₹ 60,000$

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as on 31 March 2010

Liabilities	₹	₹	Assets	₹	₹
Share Capital:	₹		Fixed Assets:	₹	
Issued, Subscribed & Paid up Equity Shares of ₹ 10 Each Fully Paid	2,00,000	20,00,000	Goodwill		12,000
Reserves & Surplus			Land & Buildings:		
General Reserve (H Ltd.)		3,60,000	H Ltd.	10,00,000	
Profit & Loss A/c	6,80,000		S Ltd.	8,00,000	18,00,000
Add: Share in S Ltd.	56,000		Plant & Machinery:		
	7,36,000		H Ltd.	5,00,000	
Less: Unrealized Profit in			S Ltd.	6,40,000	11,40,000
Stock	12,000	7,24,000	Current Assets:		
Current Liabilities:			Stock:		
Creditors:			H Ltd.	2,80,000	
H Ltd.	5,60,000		S Ltd.	3,20,000	
S Ltd.	2,84,000			6,00,000	
	8,44,000		Less: Unrealized Profit	12,000	5,88,000
Less: Inter-company Debt	40,000	8,04,000	Debtors:		
			H Ltd.	4,80,000	
			S Ltd.	4,20,000	
			Less: Inter-company Debt	9,00,000	
				40,000	8,60,000
Bills Payable			Cash:		
S Ltd.	80,000		H Ltd.	40,000	
Less: Inter-company Debt	48,000	32,000	S Ltd.	20,000	60,000
			Loans & Advances:		
Minority Interest		6,12,000	Bills Receivable:		
			H Ltd.	1,20,000	
			Less: Inter-company Debt	48,000	72,000
		45,32,000			45,32,000

Note: Contingent liability is ₹ 68,000.

Illustration 12.10

Model: Unrealized profit in stock (Loss of stock by fire)

The following are the balance sheets as on 31 March 2011:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Fixed Assets	7,00,000	3,00,000
Shares of ₹ 10 Each	10,00,000	4,00,000	Stock	1,80,000	80,000
General Reserve	2,00,000	—	Debtors	1,20,000	60,000
Profit & Loss Account	1,60,000		6% Debentures in S Ltd. Acquired at Cost	1,20,000	—
6% Debentures	—	2,00,000	Shares in S Ltd 30,000 Shares at ₹ 8	2,40,000	—
Creditors	1,50,000	90,000	P&L A/c	—	2,00,000
			Cash	1,50,000	50,000
	15,10,000	6,90,000		15,10,000	6,90,000

H Ltd. acquired the shares on 1 August 2010. The P&L A/c of S Ltd. showed a debit balance of ₹ 3,00,000 on 1 April 2010. During June 2010, goods costing ₹ 12,000 were destroyed by fire against which insurer paid only ₹ 4,000. Trade creditors of S Ltd. include ₹ 40,000 for goods supplied by H Ltd. on which H Ltd. made a profit of ₹ 4,000. Half of the goods were still in stock on 31 March 2011. Prepare a consolidated balance sheet and show the complete working.

[B.Com (Hons) Delhi Modified]

Solution

Calculations:

I: Ratio of (Share Capital) Holding Minority Interest:

Step 1:	Total Number of Shares	40,000 Shares
Step 2:	Number of Shares Acquired by H Ltd. in S Ltd.	30,000 Shares
Step 3:	∴ Minority Holding in S Ltd.	10,000 Shares
Step 4:	∴ Ratio = H Ltd.:Minority	
	= 30,000:10,000	
	= 3:1	

II: Share of H Ltd in Pre-acquisition Loss of S Ltd.

		₹
Step 1:	Total Pre-acquisition Loss	3,00,000
Step 2:	Share of H Ltd.: $\frac{3}{4}$ × ₹ 3,00,000	2,25,000
	This Capital Loss Has to be Added to Cost of Control Goodwill or Deducted from Capital Reserve)	

III: Share of H Ltd. in Additional Pre-acquisition Profit:

Step 1:	Accumulated Loss (as on 31 March 2010)	3,00,000
Step 2:	Less: Accumulated Balance on 31 March 2011	2,00,000
Step 3:	Profit Made in 2010–11 (Step 1 – Step 2)	1,00,000

Step 4:	Add: Loss of Stock by Fire ₹12,000 – ₹4000 (Destroyed—Reimbursed by Insurer)		8,000
Step 5:	Adjusted Profit		1,08,000
Step 6:	Profit for Pre-acquisition Period from 1 April 2010 to 1 August 2010—4 months: $\frac{4}{12}$ × ₹1,08,000		36,000
Step 7:	Less: Loss of Stock by Fire		8,000
			28,000
Step 8:	Share of H Ltd: $\frac{3}{4}$ × ₹28,000		21,000
IV: H Ltd.'s Share in Post-acquisition Profit:			
Step 1:	Total Profits for Post-acquisition Period (from 1 August 2010 to 31 March 2011: 8 months) $\frac{8}{12}$ × 1,08,000 (Ref: III Step 5)		72,000
Step 2:	Share of H Ltd.: $\frac{3}{4}$ × ₹72,000		54,000
V: Minority Interest:			
Step 1:	Paid-up Equity Capital Held		1,00,000
Step 2:	Less: $\frac{1}{4}$ × ₹2,00,000 (Accumulated Loss)		50,000
			50,000
VI: Cost of Control:			₹
Step 1:	Cost of Shares in S Ltd.		2,40,000
Step 2:	Paid-up Equity Held:	3,00,000	
	(i) Share in Pre-acquisition Loss: ₹2,25,000		
	(ii) Less: Pre-acquisition Profit: ₹21,000	2,04,000	96,000
Step 3:	Goodwill/Cost of Control		1,44,000
VII: Unrealized Profit:			
Step 1:	Profit on ₹40,000 Goods Supplied		4,000
Step 2:	Profit in Stock of ₹20,000: $\frac{4,000}{40,000}$ × 20,000 =		2,000
Step 3:	Unrealized Profit in Stock (Step 1 – Step 2) =		2,000

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as on 31 March 2011

Liabilities		₹	**Assets**		₹
Share Capital:			Fixed Assets:	₹	
1,00,000 Equity Shares of ₹10 Each Fully Paid		10,00,000	Goodwill		1,44,000
Minority Interest		50,000	Others:		
Reserves & Surplus:			H Ltd.	7,00,000	
General Reserves		2,00,000	S Ltd.	3,00,000	10,00,000
Profit & Loss A/c:	₹		Current Assets:		
H Ltd.	1,60,000		Stock:		

Share in S Ltd.	54,000		H Ltd.	1,80,000	
	2,14,000		S Ltd.	80,000	
				2,60,000	
Less: Unrealized Profit	2,000	2,12,000	Less: Unrealized Profit	2,000	2,58,000
Secured Loans:			Debtors:		
6% Debentures	2,00,000		H Ltd.	1,20,000	
Less: Held by H Ltd.	1,20,000	80,000	S Ltd.	60,000	
Current Liabilities:				1,80,000	
Creditors:			Less: Inter-company Owings	40,000	1,40,000
H Ltd.	1,50,000		Cash:		
S Ltd.	90,000		H Ltd.	1,50,000	
	2,40,000		S Ltd.	50,000	2,00,000
Less: Inter-company					
Owning	40,000	2,00,000			
		17,42,000			17,42,000

12.4.2.9 Preference Share Capital in Subsidiary Company

Preference shares (part or full) in a subsidiary company may also be acquired by the holding company, in addition to equity shares.

Treatment:

(i) Preference share capital in subsidiary company has to be shown in the consolidated balance sheet along with minority interest.

(ii) While ascertaining the cost of control, amount paid by the holding company is added to the amount paid for equity shares. Face value of preference shares is reduced. Any difference between the face value and the amount paid is adjusted with goodwill/capital reserve.

(iii) Any dividend due on the preference shares up to the date of acquisition is also reduced while computing cost of controls, after deducting it from capital profits.

(iv) Any dividend due on the preference shares for the post-acquisition period is treated as revenue dividend payable.

(v) Minority share of preference shares is to be included in minority interest along with pre-acquisition dividend payable to the minority.

(vi) Premium payable on redeemable preference shares has to be provided for by annual instalments over the period between the date of the balance sheet and the date of redemption.

(vii) In case the profits of subsidiary company are not sufficient to provide for arrears of dividends, then it is not permitted to provide for such arrears from the consolidated profits of the holding and subsidiary companies.

Illustration 12.11

Model: Preference share capital in subsidiary company

The following are the balance sheets of A Ltd. and B Ltd. as on 31 March 2011:

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Share Capital:			Fixed Assets	15,00,000	7,20,000
Equity Shares of ₹ 100 Each Fully Paid	12,00,000	4,50,000	Investment in 4,500 quity Shares in B Ltd. on 1 April 2010	6,00,000	—
13% Preference Shares of ₹ 100 Each Fully Paid	—	3,00,000	Current Assets (Including ₹ 30,000 Stock-in-Trade Purchased from A Ltd.)	9,00,000	7,80,000
General Reserve	1,50,000	1,20,000			
P&L A/c (Before Appropriation for Dividends)	90,0000	75,000			
9% Debentures	6,00,000	—			
Current Liabilities and Provisions	9,60,000	5,55,000			
	30,00,000	15,00,000		30,00,000	15,00,000

Prepare the consolidated balance sheet as at 31 March 2011 assuming that:

(a) B Ltd.'s general reserve and P&L A/c (after appropriation for dividends) stood at ₹ 75,000 and ₹ 30,000, respectively, on 31 March 2010

(b) A Ltd. sells goods at a profit of 25% on cost

[B. Com Delhi Modified]

Solution

CALCULATIONS:

I: Calculation of Cost of Control:	₹	₹
(i) Cost of Investment in Shares of B Ltd.		6,00,000
Less:		
(ii) (a) Nominal Value of Share Held:	4,50,000	
(b) Pre-acquisition General Reserve	75,000	
(c) Pre-acquisition Profits	30,000	5,55,000
(iii) Goodwill		45,000
II: Computation of Minority Interest:		
(i) 13% Preference Share of ₹ 100 Each		3,00,000
(ii) Add: Dividends at 13%		39,000
		3,39,000
III: Calculation of A Ltd.'s Share in the Revenue Profits and Reserves:		₹
(A) (i) Balance in P&L A/c Appropriation A/c		75,000
(ii) Less: Pre-acquisition Balance		30,000
		45,000

(iii) Less: Preference Dividend	39,000
(iv) A Ltd.'s Share of Profit	6,000
(B) (i) General Reserve Balance	1,20,000
(ii) Less: Pre-acquisition Reserve	75,000
(iii) A Ltd.'s Share in Reserve	45,000

IV: Calculation of Unrealized Profit in Stock:

(i) Value of Unsold Stock Supplied by A Ltd.	30,000
(ii) Value of Unrealized Profit (25% on Cost = 20% on Sale Price) $\frac{20}{100} \times ₹30,000 = ₹6,000$	6,000
(iii) A Ltd.'s Share—here 100%	6,000

Consolidated Balance Sheet of
A Ltd. and Its Subsidiary B Ltd.
as on 31 March 2011

Liabilities		₹	Assets		₹
Share Capital:	₹		Fixed Assets:	₹	
12,000 Equity Shares of ₹ 100 Each		12,00,000	A Ltd.	15,00,000	
Minority Interest:		3,39,000	B Ltd.	7,20,000	22,20,000
					45,000
Reserves & Surplus:			Goodwill		
General Reserve (A)	1,50,000		Current Assets:		
Add: Shares in B Ltd.	45,000	1,95,000	A Ltd.	9,00,000	
P&L Appropriation A/c	90,000		B Ltd.	7,80,000	
				16,80,000	
Add: Shares in B Ltd.	6,000		Less: Unrealized Profit in Stock	6,000	16,74,000
	96,000				
Less: Unrealized Profit in Stock	6,000	90,000			
Secured Loans:					
9% Debentures		6,00,000			
Current Liabilities:					
A Ltd.	9,60,000				
B Ltd.	5,55,000	15,15,000			
		39,39,000			39,39,000

12.4.2.10 Debentures in Subsidiary Company

(i) Debentures of the holding company are to be treated in the same manner as that of share capital, i.e., they are to be shown in the consolidated balance sheet as a separate item

(ii) Debentures of the subsidiary company also will be treated in the same manner, as (i).

(iii) In case a part of the debentures of a subsidiary company is held as investments by the holding company, the amount of debentures would be reduced to the extent of investments.

(iv) The remaining part of debentures held by outsiders is to be shown on the liability side of the consolidated balance sheet as a separate item.

Illustration 12.12

Model: Debentures in subsidiary company

The following are the balance sheets of C Ltd. and its subsidiary D Ltd. as at 31 March 2011:

Liabilities	C Ltd. ₹	D Ltd. ₹	Assets	C Ltd. ₹	D Ltd. ₹
Equity Shares of ₹ 100 Each Fully Paid	9,00,000	6,00,000	Fixed Assets	18,00,000	10,20,000
Capital Redemption Reserve	3,60,000	—	Investments in 4,500 Equity Shares in D Ltd. on 30 September 2010	6,00,000	—
General Reserve	3,00,000	90,000			
P&L A/c (Before Any Appropriation)	1,80,000	1,20,000	Debentures of D Ltd. at Par	1,50,000	—
Debentures	6,00,000	3,00,000	Debentures of C Ltd. at Par	—	1,80,000
Outstanding Interest on Debenture for 1 year	90,000	45,000	Other Assets	4,50,000	3,00,000
Other Liabilities	5,70,000	3,45,000			
	30,00,000	15,00,000		30,00,000	15,00,000

Prepare the consolidated balance sheet as at 31 March 2011 assuming that D Ltd. earned uniformly in 2010–11 and its P&L A/c showed a debit balance of ₹ 60,000 on 1 April 2010. Also show the working.

[B.Com (Hons) Delhi Modified]

Solution

CALCULATIONS:

I: Calculation of Share of C Ltd. in Revenue Profits of D Ltd.:	₹
(i) P&L A/c Balance on 31 March 2011	1,20,000
(ii) Add: Pre-acquisition Loss	60,000
(iii) Total Profits for the Year	1,80,000
(iv) Profit from 1 October 2010 to 31 March 2011	
6 months—$\frac{6}{12}$ × ₹ 1,80,000	90,000
(v) Share of C Ltd.: $\frac{3}{4}$ × ₹ 90,000	67,500
II: Calculation of C Ltd.'s Share in Capital Profits and Capital Reserve:	
(i) Capital Profit: Pre-acquisition Period (Ref: I (i)–(iv))	90,000
(ii) General Reserve: Pre-acquisition Period	90,000

Total Capital Profit + Capital Reserve [(i) + (ii)]	1,80,000
Share of C Ltd.: $\frac{3}{4} \times$ ₹ 1,80,000	1,35,000
III: Calculation of Cost of Control:	
(i) Cost of Investment in Shares of D Ltd.	6,00,000
(ii) Add: Pre-acquisition Loss: $\frac{3}{4} \times$ ₹ 60,000	45,000
	6,45,000
(iii) Less: Share in Capital Profit + Reserve (Ref: II)	1,35,000
	5,10,000
(iv) Less: Nominal Value of Shares Held (4,500 Shares × ₹ 100)	4,50,000
(v) Goodwill	60,000
IV: Computation of Minority Interest:	
(i) Nominal Value of Shares Held by Outsiders $\frac{1}{4} \times$ ₹ 6,00,000	1,50,000
(ii) Add: $\frac{1}{4}$ of General Reserve $\left(\frac{1}{4} \times ₹ 90,000\right)$	22,500
	1,72,500
(iii) Add: ¼ of Profit $\left(\frac{1}{4} \times ₹ 1,20,000\right)$	30,000
(iv) Minority Interest	2,02,500

Note: No need to allocate the minority's share of profits/reserves into post- and pre-acquisition periods.

Consolidated Balance Sheet of
C Ltd. and Subsidiary D Ltd.
as on 31 March 2011

Liabilities	₹	₹	Assets	₹	₹
Share Capital:			Fixed Assets:		
9,000 Equity Shares of ₹ 100 Each		9,00,000	C Ltd.	18,00,000	
Minority Interest		2,02,500	D Ltd.	10,20,000	28,20,000
Reserves & Surplus:			Goodwill		60,000
Capital Redemption Reserve		3,60,000	Other Assets:		
General Reserve		3,00,000	C Ltd.	4,50,000	
P&L Approp. A/c	1,80,000		D Ltd.	3,00,000	
Add: Share in D Ltd.	67,500	2,47,500		7,50,000	
Secured Loans:					
Debentures: C Ltd.	6,00,000				

Less: Held by D Ltd.	1,80,000	4,20,000	Less: Outstanding Interest:		
Debentures: D Ltd.	3,00,000		Due to C Ltd.	27,000	
Less: Held by C Ltd.	1,50,000	1,50,000	Due to D Ltd.	22,500	7,00,500
Interest on Debentures:					
C Ltd.	90,000				
Less: Due to D Ltd.	27,000	63,000			
D Ltd.	45,000				
Less: Due to C Ltd.	22,500	22,500			
Current Liabilities:					
C Ltd.	5,70,000				
D Ltd.	3,45,000	9,15,000			
		35,80,500			35,80,500

12.4.2.11 Revaluation of Assets

When a holding company acquires shares in a subsidiary company, fixed assets of subsidiary company are revalued in order to assess its correct value of shares. Any profit or loss on revaluation of assets has to be shown in the consolidated balance sheet.

- Any increase in the value of any fixed assets is to be treated as capital profits, whether it is in pre- or post-acquisition period.
- Such capital profits will be apportioned between capital reserve and minority interests.
- The proportion of increase of the holding company is to be taken to investment account. This will reduce the cost of control/goodwill.
- In case, any decrease in the value of fixed assets is to be treated as capital loss. This will increase the cost of control/goodwill or reduce the capital reserve. But, it is a revenue loss, if the revaluation occurs in the post-acquisition period.
- Adjustment for depreciation:
  (i) If the value of fixed assets increases (revaluation profit), depreciation charge also will be increased accordingly. This is to be deducted from the revenue profits of the subsidiary company.
  (ii) If the value of fixed assets decreases, depreciation will also be decreased proportionately. This is to be added to the revenue profits of the subsidiary company.

Illustration 12.13

Model: Revaluation of assets–profits

The following are the balance sheets of P Ltd. and its subsidiary Q Ltd. as at 31 March 2011:

Liabilities	**P Ltd.** ₹	**Q Ltd.** ₹	**Assets**	**P Ltd.** ₹	**Q Ltd.** ₹
Equity Shares of ₹100 Each	16,00,000	4,00,000	Equipment	10,00,000	3,80,000
Profit & Loss A/c	2,00,000	80,000	Investment:		
External Liabilities	30,00,000	19,20,000	3,600 Equity Shares in Q Ltd. on 1 April 2010	5,60,000	—
			Other Assets	32,40,000	20,20,000
	48,00,000	24,00,000		48,00,000	24,00,000

On 1 April, 2010 P&L A/c of Q Ltd. showed a credit balance of ₹ 32,000 and equipment of Q Ltd. was revalued by P Ltd. 20% above its book value of ₹ 4,00,000 (but no such adjustment effected in the books of Q Ltd). Prepare the consolidated balance sheet as at 31 March 2011.

[B.Com (Hons) Delhi Modified]

Solution

CALCULATIONS:

		₹
I: Calculation of Pre-acquisition Profits:		
(i) Balance on 1 April 2010		32,000
(ii) Share of P Ltd. i.e. 90% × ₹ 32,000		28,800
(iii) Minority Interest [(i) – (ii)]		3,200
II: Revaluation of Equipment:		
(i) Profit on Revaluation (20% × ₹ 4,00,000)		80,000
(ii) Share of P Ltd. (i.e. $\frac{90}{100}$ × 80,000)		72,000
(iii) Minority Share [(i) – (ii)]		8,000
III: Calculation of Additional Depreciation:		
(i) Book Value on 1 April 2010	:	4,00,000
(ii) Less: Book Value on 31 March 2011		3,80,000
(iii) Depreciation [(i) – (ii)]		20,000
(iv) Rate of Depreciation = $\frac{20,000}{4,00,000} \times 100 = 5\%$		
(iv) ∴ Additional Depreciation on ₹ 80,000 5% = $\frac{5}{100}$ × ₹ 80,000		4,000
IV: Calculation of Post-acquisition of Profit:		
(i) Balance on 31 March 2011		80,000
(ii) Less: Balance on 31 March 2010		32,000
		48,000
		44,000
(iii) Less: Additional Depreciation (Ref: III)		4,000
(iv) Less: Share of P Ltd. $\frac{90}{100}$ × 44,000		39,600
(v) Minority Interest [(iii) – (iv)]		4,400
V: Calculation of Cost of Control:		
(i) Cost of Investment in Shares of Q Ltd.		5,60,000
(ii) Less: Paid-up Capital Held		3,60,000
		2,00,000
(iii) Less: Capital Profit—Pre-acquisition		28,800
		1,71,200
(iv) Less: Revaluation of Equipment (Capital Profit)		72,000
		99,200

VI: Computation of Minority Interest:

(i)	Paid-up Value of Shares Held	40,000
(ii)	Add: Share of Pre-acquisition Profit: [Ref: I (iii)] i.e. $\frac{1}{10} \times 32,000$	3,200
		43,200
(iii)	Add: Share of Profit on Revaluation [Ref: II (iii)] i.e., $\frac{1}{10} \times ₹ 80,000$	8,000
		51,200
(iv)	Add: Share of Post-acquisition Profit [Ref: IV (v)] i.e., $\frac{1}{10} \times 44,000$	4,400
		55,600

Consolidated Balance Sheet of
P Ltd. and Its Subsidiary Q Ltd.
as on 31 March 2011

Liabilities		₹	Assets		₹
Share Capital:			Fixed Assets:		
Issued & Subscribed		16,00,000	Goodwill [Ref: V (iv)		99,200
16,000 Equity Shares of ₹ 100 Each			Equipment:		
			P Ltd.	10,00,000	
Minority Interest		55,600	Q Ltd.	4,80,000	
Reserves & Surplus:				14,80,000	
P&L A/c	2,00,000				
Add: Share in Q Ltd.	39,600	2,39,600			
Current Liabilities:			Less: Depreciation 5% on ₹ 4,80,000	24,000	14,56,000
External Liabilities			Other Assets:		
P Ltd.	30,00,000		P Ltd.	32,40,000	
Q Ltd.	19,20,000	49,20,000	Q Ltd.	20,20,000	52,60,000
		68,15,200			68,15,200

12.4.2.12 Bonus Shares Issued by Subsidiary Company

A subsidiary company (after the holding company acquired controlling interest) may issue bonus share out of its profits to all the shareholders. This will increase the number of shares with the holding company. Naturally, the face value of shares held in the subsidiary company will also increase, as the holding company receives such bonus shares.

Treatment: "Source of profit" out of which the bonus issued is the basis of accounting treatment. They are:

1. Bonus shares issued out of capital profits (or) pre-acquisition profits
2. Bonus shares issued out of revenue profits (or) post-acquisition profits

1. **Bonus issue out of capital profits:** This does not have any accounting effect. The reason is that while determining the cost of control/goodwill, the share of the holding company in the pre-acquisition profit is reduced and the paid-up value of shares held is increased. At this juncture, the issue of bonus shares will in no way affect the cost of control. Minority share of the bonus is added to the minority interest.
2. **Bonus issue out of revenue profits:** This has its effect on the consolidated balance sheet. The amount of bonus is reduced from revenue profits before apportioning the revenue profits in the holding minority ratio.

While calculating "cost of control", the holding company's share of bonus is deducted. This will result in decrease in goodwill to the extent of the holding company's share of bonus. Minority share of the bonus is added to the minority interest.

Net result is that the bonus issue is in the nature of capital profits whether they are issued out of capital profits or out of revenue profits.

Illustration 12.14

Model: Bonus issue out of capital profit (Pre-acquisition profits

R Ltd. acquired 3,200 ordinary shares of ₹ 100 each in S Ltd. on 31 December 2010. Their summarized balance sheets as on that date were as follows:

Liabilities	R Ltd. ₹	S Ltd. ₹	Assets	R Ltd. ₹	S Ltd. ₹
Share Capital:			Land & Buildings	3,00,000	3,60,000
10,000 Ordinary Shares of ₹ 100 Each	10,00,000	—	Plant & Machinery	4,80,000	2,18,800
4,000 Shares of ₹ 100 Each	—	4,00,000	Investments in S Ltd. at Cost	6,80,000	—
Capital Reserve	—	2,40,000	Stocks	2,40,000	72,000
General Reserve	4,80,000	—	Debtors	88,000	80,000
Profit & Loss A/c	1,14,400	72,000	Bills Receivable (Including ₹ 6,000 from S Ltd.)	31,600	—
Bank Overdraft	1,60,000		Cash at Bank	29,000	16,000
Bills Payable (Including ₹ 8,000 to R Ltd.)	—	16,800			
Creditors	94,200	18,000			
	18,48,600	7,46,800		18,48,600	7,46,800

You are supplied the following information:

(a) S Ltd. has made a bonus issue on 31 December 2010 of one ordinary share for every two shares held by its shareholders. Effect has yet to be given in the accounts for the issue.

(b) The directors are advised that land & buildings of S Ltd. are undervalued by ₹ 40,000 and plant & machinery of S Ltd. are overvalued by ₹ 20,000. These assets have to be adjusted accordingly.

(c) Sundry creditors of X Ltd. include ₹ 24,000 due to S Ltd.

You are required to prepare the consolidated balance sheet as on 31 December 2010.

[B.Com Bangalore University Modified]

Solution

Calculations:

I: Calculation of Holding Minority Ratio:

Step 1: Total Shares in S Ltd. 4,000

Step 2: Shares Acquired by R Ltd. 3,200

Step 3: Minority Shares (Step 1 – 2) 800

Step 4: Ratio = 3,200:800 (or) 4:1

II: Calculation of Share of Bonus Issue:		₹
Step 1:	Bonus Issue 1 Share for Every 2 Shares Held (Not Yet Recorded) ₹ 4,00,000 × $\frac{1}{2}$:	2,00,000
Step 2:	Holding Company R Ltd.'s Share: ₹ 2,00,000 × $\frac{4}{5}$:	1,60,000
Step 3:	Minority's Share (Step 1 – Step 2) or ₹ 1,00,000 × $\frac{1}{5}$	40,000
III: Calculation of Capital Profits:		
Step 1:	Capital Reserve of S Ltd.	2,40,000
Step 2:	Less: Bonus Issue Made	2,00,000
		40,000
Step 3:	Add: Profit & Loss A/c	72,000
		1,12,000
Step 4:	Add: Undervaluation of Asset (Land & Buildings)	40,000
		1,52,000
Step 5:	Less: Overvaluation of Asset (Plant & Machinery)	20,000
Step 6:	Capital Profits	1,32,000
Step 7:	Share of R Ltd.: 1,32,000 × $\frac{4}{5}$ =	1,05,600
Step 8:	Minority's Share 1,32,000 × $\frac{1}{5}$	26,400
IV: Computation of Minority Interest:		
Step 1:	Face Value of Shares Held by Minority Shareholders (800 shares × ₹ 100)	80,000
Step 2:	Add: Minority's Share of Bonus Shares (Ref: III Step 3)	40,000
		1,20,000
Step 3:	Add: Minority's Share of Capital Profit (Ref: III Step 8)	26,400
Step 4:	Minority Interest	1,46,400
V: Calculation of Cost of Control/Goodwill:		₹
Step 1:	Amount Paid by R Ltd. for Shares in S Ltd.	6,80,000
Step 2:	Face Value of Shares Purchased: 3,200 shares × ₹ 100	3,20,000
		3,60,000
Step 3:	R Ltd.'s Share of Capital Profits (Ref: III Step 7)	1,05,600
		2,54,400
Step 4:	R Ltd.'s Share of Bonus Issue (Ref: II Step 2)	1,60,000
Step 5:	Cost of Control/Goodwill	94,400

Consolidated Balance Sheets
of R Ltd. and Its Subsidiary S Ltd.
as on 31 December 2010

Liabilities		₹	Assets		₹
Share Capital:			Goodwill		94,400
10,000 Shares of ₹ 100 Each		10,00,000	Land & Buildings:		
General Reserve		4,80,000	R Ltd.	3,00,000	
Profit & Loss A/c		1,14,400	S Ltd.	3,60,000	
Bank Overdraft		1,60,000		6,60,000	
Bill Payable	16,800		Add: Undervaluation	40,000	7,00,000
Less: Inter company Owings	6,000	10,800	Plant & Machinery	4,80,000	
Creditors:			S Ltd.	2,18,800	
R Ltd.	94,200			6,98,800	
S Ltd.	18,000		Less: Overvalue	20,000	6,78,800
	1,12,200		Stocks:z		
Less: Inter-company Owings	24,000	88,200	R Ltd.	2,40,000	
Minority Interest		1,46,400	S Ltd.	72,000	3,12,000
			Debtors:		
			R Ltd.	88,000	
			S Ltd.	80,000	
				1,68,000	
			Less: Inter-company Owings	24,000	1,44,000
			Bills Receivable	31,600	
			Less: Inter-company Owings	6,000	25,600
			Cash and Bank:		
			R Ltd.	29,000	
			S Ltd.	16,000	45,000
		19,99,800			19,99,800

Illustration 12.15

Model: Bonus shares issued out of revenue profits

The summarized balance sheet of H Ltd. and S Ltd. as on 31 December 2010 are as follows:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Sundry Assets	15,00,000	5,10,000
Shares of ₹ 10 Each	15,00,000	3,00,000	24,000 Shares in S Ltd.	4,20,000	—
Reserves	2,40,000	90,000			
Profit & Loss A/c	1,80,000	1,20,000			
	19,20,000	5,10,000		19,20,000	5,10,000

S Ltd. had reserves of ₹ 90,000 when H Ltd. acquired the shares in S Ltd. but the P&L A/c balance of S Ltd. was fully earned after the purchase of shares.

S Ltd. decided to issue bonus shares out of the post-acquisition profit in the ratio of 2 shares for every 5 shares held.

Calculate the cost of control before the issue of bonus shares and after the issue of bonus shares.

Solution

		₹
I:	Calculation of Cost of Control Before the Issue of Bonus Shares:	
Step 1:	Amount Paid by H Ltd. in Purchase of Shares in S Ltd.	4,20,000
Step 2:	Less: Face Value of Shares Acquired 24,000 × ₹ 10	2,40,000
		1,80,000
Step 3:	Less: H Ltd.'s Share of Capital Profits 2,40,000 × $\frac{8}{10}$ (or $\frac{4}{5}$)	72,000
Step 4:	Cost of Control/Goodwill	1,08,000

		₹
II:	Calculation of Cost of Control After the Issue of Bonus Shares:	
Step 1:	Amount Paid by H Ltd. for Purchase of Shares in S Ltd.	4,20,000
Step 2:	Less: Face Value of Shares Required (24,000 × ₹ 10)	2,40,000
		1,80,000
Step 3:	Less: H Ltd.'s Share of Capital Profits ₹ 90,000 × $\frac{2}{10}$	72,000
		1,08,000
Step 4:	Less: H Ltd.'s Share of Bonus $\left(3,00,000 \times \frac{8}{10} \times \frac{2}{5}\right)$	96,000
Step 5:	Cost of Control/Goodwill	12,000

Illustration 12.16

Model: Bonus issue out of revenue profits (Post-acquisition profits)

C Ltd. acquired 10,000 equity shares of ₹10 each in D Ltd. on 31 March 2010.

The summarized balance sheets of the two companies as on 31 March 2011 were as follows:

Particulars	**C Ltd.** ₹	**D Ltd.** ₹
Liabilities:		
Equity Share Capital (Shares of ₹ 10 Each)	4,00,000	1,25,000
Reserves	1,50,000	25,000
Profit and Loss Account	50,000	50,000
Creditors	1,00,000	25,000
	7,00,000	2,25,000
Assets:		
Fixed Assets	3,50,000	1,25,000
Current Assets	2,00,000	1,00,000
10,000 Shares in D Ltd. at Cost	1,50,000	—
	7,00,000	2,25,000

D Ltd. had a credit balance of ₹ 25,000 in the reserves and ₹ 10,000 in the P&L A/c when C Ltd. acquired shares in D Ltd. D Ltd. issued bonus shares in the ratio of 1 share for every 5 shares held out of the profits earned during 2010–11. This is not shown in the above balance sheet of D Ltd. Prepare a consolidated balance sheet of C Ltd. and its subsidiary on 31 March 2011 giving all the necessary workings.

[B.Com (Hons) Delhi Modified]

Solution

CALCULATIONS:

I: Determination of Holding–Minority Ratio		
(i) Total Shares in D Ltd.	12,500	Shares
(ii) C Ltd. Held 10,000 Shares in D Ltd.	10,000	Shares
(iii) Minority Shares [(i) – (ii)]	2,500	Shares
(iv) Ratio = 10,000 : 2,500 = 4:1		
II: Calculation of C Ltd.'s Share in Capital Profits and Reserves:	₹	
(i) Balance in the P&L A/c on 31 March 2010	10,000	
(ii) Add: Balance in Reserves P&L A/c on 31 March 2010	25,000	
	35,000	
(iii) Shares of C Ltd.: ₹ 35,000 × $\frac{4}{5}$	28,000	
III: Calculation of C Ltd.'s Share in Post-acquisition Profits	₹	
(i) Balance in P&L A/c on 31 March 2011	50,000	
(ii) Less: Balance in P&L A/c on 31 March 2010	10,000	
	40,000	
(iii) For Bonus Issue 1,25,000 × $\frac{1}{5}$ (1 for every 5 shares)	25,000	
(iv) Shares of C Ltd. ₹ 15,000 × $\frac{4}{5}$	12,000	
IV: Calculation of Share Capital of D Ltd.:		
(i) Share Capital as per Balance Sheet	1,25,000	
(ii) Add: Increase Due to Bonus Shares	25,000	
	1,50,000	
(iii) Share of C Ltd. ₹ 1,50,000 × $\frac{4}{5}$	1,20,000	
(iv) Minority Interest $\frac{1}{5}$ × ₹ 1,50,000	30,000	
V: Computation of Cost of Control:		
(i) Cost of Investment in Shares of D Ltd.	1,50,000	
(ii) Less: Paid-up Value of Shares (Including Bonus Shares)	1,20,000	
	30,000	
(iii) Less: Share in Pre-acquisition Profit & Reserves [Ref: (II (iii)]	28,000	
(iv) Cost of Control/Goodwill	2,000	

VI: Computation of Minority Interest:	₹
(i) Paid-up Value of Shares (Including Bonus Shares)	30,000
(ii) Add: (Profit + Reserves × Bonus Issue) $(50{,}000 + 25{,}000 - 25{,}000) \times \frac{1}{5}$	10,000
	40,000

Consolidated Balance Sheet
of C Ltd. and Its Subsidiary D Ltd.
as on 31 March 2011

Liabilities		₹	**Assets**		₹
Share Capital:			Fixed Assets:		
Subscribed Capital			C Ltd.	3,50,000	
40,000 Equity Shares of ₹ 10 Each		4,00,000	D Ltd.	1,25,000	4,75,000
Minority Interest [Ref: VI × (ii)]		40,000	Goodwill		8,000
Reserves & Surplus:			Current Assets:		
Reserves		1,50,000	C Ltd.	2,00,000	
P&L A/c:	50,000		D Ltd.	1,00,000	3,00,000
Add: Shares in D Ltd.	12,000	62,000			
Current Liabilities:					
Creditors:					
C Ltd.	1,00,000				
D Ltd.	25,000	1,25,000			
		7,77,000			7,77,000

12.4.2.13 Dividend

A subsidiary company can declare dividend on its shares. The holding company will receive such dividends on the paid-up value of the shares held by it. The source from which the dividends to be paid may be any one of the following categories:

Category I: Payment of dividends entirely from the pre-acquisition profits:

Treatment: It is treated as capital gains.

- On receipt of dividend, the following entry has to be passed:

  Bank A/c Dr. …
  To investment in shares of subsidiary company A/c …

- This type of dividends will not be utilized for distributing dividends to the shareholders of the holding company.

Important notes:

(i) If the dividend is paid wholly out of pre-acquisition profits, it has to be appropriated from previous years' profits.

(ii) Holding company's share has to be adjusted towards cost of control or capital reserve.
(iii) Holding company's share has to be deducted from the consolidated P&L A/c.
(iv) If by mistake this type of dividend is credited to P&L A/c of the holding company , it has to be rectified by debiting P&L A/c and crediting investment A/c.

Category II: Payment of dividends entirely from post-acquisition profits:

- It is treated as revenue income.
- Entry:

Bank A/c	Dr. …	
To P&L A/c of the holding company.		…

- This type of dividend can be utilized to distribute dividends to the shareholders of the holding company.

Category III: Payment of dividends partly out of pre-acquisition profits and partly out of Post-acquisition profits.

The main point to be observed is that the dividend up to the date of acquisition (pre-acquisition) is to be treated as capital profit (capital receipt) and after the date of acquisition (post-acquisition) is to be treated as revenue profit (revenue receipt).

Accounting Treatment:

(i) For pre-acquisition profit: (Capital profit)

(As in Category I)

Bank A/c	Dr. …	
To Investment in Shares of Subsidiary Company		…

(ii) For post-acquisition profit: (Revenue receipt)

(As in Category II)

Bank A/c	Dr. …	
To Profit & Loss A/c		…

(OR)

In a combined (compound) entry as follows:

Bank A/c	Dr. …	
To Investment in Shares of Subsidiary Company		…
To P&L A/c		

This means that the proportion of dividend out of pre-acquisition profit has to be credited to investment account and the proportion of dividend out of post-acquisition profit has to be credited to profit and loss account.

12.4.2.14 Goodwill (Goodwill Appearing in the Balance Sheet of Subsidiary Company)

At times, goodwill is shown in the balance sheet of the subsidiary company. That means goodwill already exists.

Accounting Treatment:

Approach I: Add: Goodwill Already Appearing in the Balance Sheet of Subsidiary Company to the Goodwill and/or Cost of Control in the Consolidated Balance Sheet.

Approach II: Add: Only Holding Company's Share to the Cost of Control/Goodwill, from the Goodwill of the Subsidiary Company.

Illustration 12.17

Model: Dividends paid out of pre-acquisition profits and goodwill of subsidiary company.

From the following balance sheets of a holding company and its subsidiary on 31 March 2011, prepare a consolidated balance sheet.

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital	15,00,000	6,00,000	Goodwill	90,000	30,000
(Shares of ₹ 10 Each)			Machinery	9,00,000	4,50,000
General Reserve	2,40,000	1,80,000	Stock	2,40,000	1,50,000
P&L Account	2,70,000	2,10,000	Debtors	3,60,000	4,80,000
Sundry Creditors	1,50,000	1,20,000	Cash and Bank	60,000	30,000
Outstanding Expenses	60,000	30,000	Investments:		
			48,000 Shares in S Ltd.	5,70,000	—
	22,20,000	11,40,000		22,20,000	11,40,000

When control was acquired, S Ltd. had ₹ 1,20,000 in general reserve and ₹ 90,000 in profit and loss account. Immediately on purchase of shares, H Ltd. received ₹ 48,000 as dividend from S Ltd., which was credited to profit and loss account. Debtors of H Ltd. include ₹ 60,000 due from S Ltd. whereas creditors of S Ltd. include ₹ 45,000 due to H Ltd.; the difference being accounted for by a cheque-in-transfer.

[B.Com (Hons) Modified]

Solution

Step 1: Determination of Holding–Minority Ratio:

(i) H Ltd.'s Investment in S Ltd: 48,000 Shares

(ii) Minority State in S Ltd.: (60,000 Shares – 48,000 Shares) 12,000 Shares

(iii) ∴ Holding–Minority Ratio = 48,000:12,000 = 4:1

$\left(\text{i.e., H Ltd. } \frac{4}{5} \text{ and S Ltd. } \frac{1}{5}\right)$

Step 2: Determination of H Ltd.'s Share in Capital Profits and Reserves:

	₹	₹
(i) Balance in Reserve (Pre-acquisition) (Given in Additional Information)		1,20,000
(ii) Add: Balance in P&L A/c (Pre-acquisition) (Given in Additional Information)	90,000	
(iii) Less: Dividends Paid:		
Shares 48,000 : 60,000 :: Dividend 48,000 : x	60,000	30,000
$x = \frac{48,000 \times 60,000}{48,000} = ₹\,60,000$		
(iv) Total Capital Profit =		1,50,000

	(v) H Ltd.'s Share = ($\frac{4}{5}$ × ₹ 1,50,000)		1,20,000
	(vi) S Ltd.'s Share (Minority) $\frac{1}{5}$ × ₹ 1,50,000 =		30,000
Step 3:	Determination of Current Year's Profit:		
	(i) Balance of Profits as on 31 March 2011 (Ref Balance Sheet)		2,10,000
	(ii) Less: Pre-acquisition Profits After Deducting Dividends Paid [Ref: Step 2 (iii)] (₹ 90,000 – ₹ 60,000)		30,000
	(iii) Profits During the Year		1,80,000
	(iv) H Ltd.'s Share ($\frac{4}{5}$ × ₹ 1,80,000)		1,44,000
	(v) S Ltd.'s Share ($\frac{1}{5}$ × ₹ 1,80,000)		36,000
Step 4:	Determination of Share in General Reserve:		
	(i) Balance as on 31 March 2011 (Shown in Balance Sheet)		1,80,000
	(ii) Less: Pre-acquisition Reserve (Given in Additional Information)		1,20,000
	(iii) Transfer to Reserve in the Year		60,000
	(iv) Share of H Ltd. ($\frac{4}{5}$ × ₹ 60,000)		48,000
	(v) Share of S Ltd. ($\frac{1}{5}$ × ₹ 60,000)		12,000
Step 5:	Determination of Goodwill/Capital Reserve:		
	(i) Cost of Investment in Shares of S Ltd. (Shown in Balance Sheet)		5,70,000
	(ii) Less: Paid-up Value of Shares Held (48,000 Shares × ₹ 10)		4,80,000
			90,000
	(iii) Less: Dividends Paid out from Pre-acquisition Profit (Given)		48,000
			42,000
	(iv) Add: Goodwill:		
	H Ltd.	90,000	
	S Ltd.	30,000	1,20,000
			1,62,000
	(v) Less: Capital Profits [Ref: Step 2 (v)]		1,20,000
	(vi) Goodwill—To Be Shown in Consolidated Balance Sheet		42,000
Step 6:	Ascertainment of Minority Interest:		
	(i) Face Value of Minority Shares Held (12,000 Shares × ₹ 10)		1,20,000
	(ii) Add: Minority Share of General Reserve $\left(\frac{1}{5} \times ₹ 1,80,000\right)$		36,000
			1,56,000
	(iii) Add: Minority Share in P&L $\left(\frac{1}{5} \times ₹ 2,10,000\right)$		42,000
			1,98,000

Step 7: Construction of Consolidated Balance Sheet:

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as on 31 March 2011

Liabilities		₹	Assets		₹
Share Capital:			Fixed Assets:		
Issued & Subscribed:			Goodwill (Step 5 (vi))		42,000
1,50,000 Equity Shares of ₹ 10 Each		15,00,000	Machinery H Ltd.	9,00,000	
Minority Interest (Step 6)		1,98,000	S Ltd.	4,50,000	13,50,000
Reserve & Surplus:			Current Assets:		
General Reserve:			Stock:		
H Ltd.	2,40,000		H Ltd.	2,40,000	
Share in S Ltd.	48,000	2,88,000	S Ltd.	1,50,000	3,90,000
Profit & Loss A/c:			Debtors:		
H Ltd.	2,70,000		S Ltd.	3,60,000	
Share in S Ltd.	1,44,000		S Ltd.	4,80,000	
	4,14,000			8,40,000	
Less: Dividend Paid	48,000	3,66,000	Less: Inter-company Debts Contra	60,000	7,80,000
Current Liabilities and Provisions			Cash and Bank H Ltd.	60,000	
Sundry Creditors			S Ltd.	30,000	90,000
H Ltd.	1,50,000		Remittance:		
S Ltd.	1,20,000		Cheque-in-transit		15,000
	2,70,000				
Less: Inter-company Debts—Contra	45,000	2,25,000			
Outstanding Expenses:					
H Ltd.	60,000				
S Ltd.	30,000	90,000			
		26,67,000			26,67,000

12.4.2.15 Proposed Dividend

The amount of proposed dividend, if any, will appear in the balance sheet of subsidiary company. In such a case, the accounting treatment will be:

(i) Such amount should be added to current year's profits of the subsidiary company.

(ii) Then, cost of control and minority interest should be determined.

(iii) Its share in the proposed dividend should be deducted from minority interest.

(iv) Finally, it should be shown as a separate item on the liability side of the consolidated balance sheet under the head "Provisions".

Illustration 12.18

Model: Proposed dividend—Already appearing in the balance sheet

R.R. Ltd. acquired 90% of the equity shares in S.S. Ltd. on 30 June 2010 at a cost of ₹3,00,000. No balance sheet was prepared at the date of acquisition. The balance sheet of S.S. Ltd. as at 31 December 2009 and 2010 were as follows:

Liabilities	2009 ₹	2010 ₹	Assets	2009 ₹	2010 ₹
Share Capital:			Sundry Assets	3,00,000	3,78,000
100,000 Equity Shares of ₹10 Each	1,00,000	1,00,000	Goodwill	50,000	50,000
Revenue Reserves	2,00,000	2,20,000			
Profit & Loss A/c	50,000	87,000			
Proposed Dividend	—	21,000			
	3,50,000	4,28,000		3,50,000	4,28,000

R.R. Ltd.'s Balance Sheet on 31 December 2010 was as follows:

Liabilities	₹	Assets	₹
10,000 Equity Shares of ₹10 Each	10,00,000	Net Assets	15,00,000
Capital Reserve	1,00,000	Investments:	
		9,000 Equity Shares of ₹10 Each in S.S.	3,00,000
General Reserve	5,00,000	Ltd.	
Profit & Loss Account	2,00,000		
	18,00,000		18,00,000

R.R. Ltd. has not passed entries for the dividend proposed by S.S. Ltd.

Prepare consolidated balance sheet of R.R. Ltd. and its subsidiary S.S. Ltd. as on 31 December 2010.

[Madras University Modified]

Solution

CALCULATIONS:

Step 1: Determination of Holding–Minority Ratio:

(i) R.R. Ltd.'s Acquisition of Shares (Control) : 90% in S.S. Ltd (Given)

(ii) Minority Interest in S.S. Ltd (100% – 90%): 10%

(iii) ∴ Holding Minority Ratio = 90%:10% or 9:1

Step 2: Determination of Share of Revenue Profits:

	₹
(i) Revenue Reserves of S.S. Ltd. on 31 December 2010	2,20,000
(ii) Add: P&L A/c of S.S. Ltd. on 31 December 2010	87,000
	3,07,000

(iii)	Add: Proposed Dividend of S.S. Ltd. as on 31 December 2010	21,000
		3,28,000
(iv)	Less: Revenue Reserves as on 31 December 2009	2,00,000
		1,28,000
(v)	Less: P&L A/c as on 31 December 2009	50,000
(vi)	∴Current Years' Profit	78,000
(vii)	Profit Earned after 30 June 2010 (Post-acquisition Profit/Revenue Profit) $\left(₹78,000 + \frac{6}{12}\right)$	39,000
(viii)	Share of R.R. Ltd: (₹39,000 × 9/10)	35,100
(ix)	Minority Share $\left(\frac{1}{10} \times ₹39,000\right)$	3,900

Here, it is assumed that the proposed dividend is out of revenue profit, i.e., post-acquisition profits.

Step 3: Determination of Share of Capital Profits:

(i)	Profits of (the Subsidiary) S.S. Ltd. (₹2,00,000 + ₹50,000—Given)	2,50,000
(ii)	Add: Current Year's Capital Profit $\left(₹78,000 \times \frac{6}{12}\right)$	39,000
(iii)	Total Capital Profits	2,89,000
(iv)	R.R. Ltd.'s Share: $\left(₹2,89,000 \times \frac{9}{10}\right)$	2,60,100
(v)	Minority Share: $\left(₹2,89,000 \times \frac{1}{10}\right)$	28,900

Step 4: Ascertainment of Minority Interest:

(i)	Paid-up Value of Minority Shares: ₹1,00,0000 × $\frac{10}{100}$	10,000
(ii)	Add: Minority Share of Revenue Profits: [Ref: Step 2 (ix)]	3,900
		13,900
(iii)	Add: Minority Share of Capital Profits [Ref: Step 3 (v)]	28,900
(iv)	∴ Minority Interest	42,800

Step 5: Determination of Cost of Control/Goodwill:

(i)	R.R. Ltd.'s Investment in Shares of S.S. Ltd.		3,00,000
(ii)	Less: (a) Face Value of Shares Purchased	90,000	
	(b) Share of R.R. Ltd. in Capital Profit	2,60,000	3,50,100
(iii)	Difference, i.e., Capital Reserve:		50,100
(iv)	Add: Capital Reserve Shown in R.R. Ltd.'s Balance Sheet		1,00,000
			1,50,100
(v)	Less: Goodwill (Shown in B/S)		50,000
(vi)	Capital Reserve to be Shown in Consolidated Balance Sheet		1,00,100

Step 6: Preparation of Consolidated Balance Sheet:

Consolidated Balance Sheet of
R.R. Ltd and Its Subsidiary S.S. Ltd.
as on 31 December 2010

Liabilities		₹	Assets		₹
Share Capital:			Fixed Assets:		
1,00,000 Equity Shares of ₹ 10 Each		10,00,000	Sundry Assets		
Minority Interest [Ref: Step 4 (iv)]		42,800	R.R. Ltd.	15,00,000	
Reserves & Surplus:			S.S. Ltd.	3,78,000	18,78,000
Capital Reserve [Ref: Step 5 (vi)]		1,00,100			
General Reserve		5,00,000			
Profit & Loss Account:	2,00,000				
Add: R.R. Ltd.'s Share of Revenue Profit [Step 2 (viii)]	35,100	2,35,100			
		18,78,000			18,78,000

12.4.2.16 Interim Dividend Paid by Subsidiary Company

Sometimes, interim dividend may be paid by the subsidiary company.

Accounting Treatment:

(i) Interim dividend paid should be added to the balance of current year profit of subsidiary company.
(ii) Then, share of holding company should be deducted from the consolidated profit.
(iii) Minority's share of interim dividend should be deducted from minority's interest.

Note: It should be noted that interim dividend should not be shown in the consolidated balance sheet.

Illustration 12.19

Model: Interim dividend by subsidiary company

The following are the summarized balance sheets of H Ltd. and S Ltd. at 30 June 2010:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Freehold Premises	7,68,000	2,70,000
₹ 10 Shares Each Fully paid	9,00,000	4,50,000	Machinery	1,80,000	2,43,900
General Reserve	5,70,000	18,000	Stock	2,04,000	1,81,800
Profit & Loss Account	4,80,000	3,24,000	Sundry Debtors	1,68,000	1,42,200
Sundry Creditors	90,000	1,44,900	Cash	1,80,000	99,000
			Investment in Shares of S Ltd. at Cost	5,40,000	—
	20,40,000	9,36,900		20,40,000	9,36,900

H Ltd. acquired 36,000 shares of S Ltd on 1 July 2009 at a total cost of ₹ 5,40,000. On scrutiny the balance sheet of H Ltd. as at 30 June 2010, the following details are obtained:

(a) Profit & loss A/c includes interim dividend at the rate of 10% p.a. free of tax from S Ltd.

(b) Stock includes ₹ 18,000 of stock at cost purchased from S Ltd.

(c) Sundry creditors include ₹ 54,000 for purchases from S Ltd. on which the latter company made a profit of ₹ 13,500.

It is further stated that on 1 July 2009, the P&L A/c of S Ltd. stood at ₹ 2,28,000 and the general reserve at ₹ 13,500. No final dividends are yet proposed to be declared by S Ltd.

[Calcutta University Modified]

Solution

Calculations:

Step 1:	Determination of Holding–Minority Ratio:			
	(i) Number of Shares Acquired by H Ltd.	12,000	Shares	
	(ii) Number of Shares Held by Minority (15,000 – 12,000 Shares)	3,000	Shares	
	(iii) ∴ Holding–Minority Ratio = 12,000:3,000 = 4:1			
Step 2:	Determination of Share of Capital Profits:	₹		₹
	(i) General Reserve as on 1 July 2009	13,500		
	(ii) Add: P&L A/c as on 1 July 2009	2,28,000		
	(iii) Total Capital Profits	2,41,500		
	(iv) H Ltd.'s Share: $\left(\frac{4}{5} \times ₹\,2,41,500\right)$	1,93,200		
Step 3:	Determination of Current Year's Profits:			
I.	(i) P&L A/c as per Balance Sheet	3,24,000		
	(ii) Less: Profit b/d (Given in Additional Information)	2,28,000		
		96,000		
	(iii) Add: Interim Dividend @ 10% p.a.	45,000		
	(iv) Available Profits	1,41,000		
	(v) H Ltd.'s Share $\left(\frac{4}{5} \times ₹\,1,41,000\right)$	1,12,800		
II.	Transfer to General Reserve:			
	(₹ 18,000 – ₹ 13,500)	4,500		
	(Given) (Additional Information)			
	Share of H Ltd: $\left(\frac{4}{5} \times 4,500\right)$	3,600		
Step 4:	Ascertainment of Minority Interest:			
	(i) Face Value of Shares Held (9,000 × ₹ 10)	90,000		
	(ii) Add: Share of General Reserve $\left(\frac{1}{5} \times 18,000\right)$	3,600		
		93,600		

(iii)	Add: Share of Profit + Interim Dividend ₹ 3,24,000 + ₹ 45,000 = ₹ 3,69,000 $\left(\frac{1}{5} \times ₹\,3,69,000\right)$	73,800 1,67,400	
(iv)	Less: Interim Dividend Paid	9,000	
(v)	∴ Minority Interest	1,58,400	

Step 5: Calculation of Cost of Control/ Capital Reserve:

(i)	Amount on investments in shares of S Ltd.		5,40,000
(ii)	Less: (a) Face Value of Shares Held	3,60,000	
	(b) Capital Profits	1,93,200	5,53,200
(iii)	Difference → Capital Reserve		13,200

Step 6: Determination of Unrealized Profit in Stock: 4,500

$\left(13,5000 \times \frac{18,000}{54,000}\right)$

Step 7: Preparation of Consolidated Balance Sheet:

Consolidated Balance Sheet
of H Ltd. and Its Subsidiary S Ltd.
as at 30 June 2010

Liabilities		₹	Assets		₹
Share Capital:			Fixed Assets:		
90,000 Shares of ₹ 10 Each Fully Paid		9,00,000	Freehold Premises		10,38,000
Minority Interest [Ref: Step 4 (v)]		1,58,400	Machinery Current Assets:	₹	4,23,900
Reserves & Surplus:	₹		Stock	3,85,800	
General Reserve	5,70,000		Less: Unrealized Profit	4,500	3,81,300
Add: Additions	3,600	5,73,600	Sundry Debtors	3,10,200	
Capital Reserve		13,200	Less: Internal Owings	54,000	2,56,200
P&L A/c :	4,80,000		Cash		2,79,000
Add: Profit S Ltd.	1,12,800				
	5,92,800				
Less: Unrealized Profit	4,500				
	5,88,300				
Less: Interim Dividend	36,000	5,52,300			
Current Liabilities:					
Sundry Creditors	2,34,900				
Less: Internal Owings	54,000	1,80,900			
		23,78,400			23,78,400

12.4.2.17 Unclaimed Dividends

In case, if unclaimed dividends appear in the balance sheet of the subsidiary company, it should be added to minority interest in the consolidated balance sheet.

12.4.2.18 Miscellaneous Expenditures

Preliminary expenses, discount on issue of shares and debentures, underwriting commission are some of the items that are shown under the head "Miscellaneous Expenditures". These items should never be shown in the consolidated balance sheet.

Accounting Treatment:

Approach I:

(i) Holding company's share in these items should be added to the cost of control or deducted from the capital reserve.

(ii) Share of minority interest in such items should be deducted from the minority interest itself.

Approach II:

These should be deducted from the pre-acquisition profits (capital profit). Then it is apportioned between holding company and minority interest in the holding minority ratio.

Illustration 12.20

Model: Miscellaneous expenditure and unclaimed dividend

The following are the balance sheets of H Ltd. and its subsidiary S Ltd. as on 31 December 2010:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital (₹ 10 Share)	3,00,000	1,00,000	Machinery	1,50,000	50,000
			Furniture	35,000	22,500
General Reserve	75,000	35,000	70% Shares in S Ltd. at Cost	1,30,000	—
Profit & Loss A/c	35,000	25,000	Stock	87,500	94,500
Creditors	45,000	27,500	Debtors	27,500	15,000
Unclaimed Dividends	—	2,500	Bank	20,000	2,500
			Preliminary Expenses	—	3,000
			Bills Receivable	5,000	2,500
	4,55,000	1,90,000		4,55,000	1,90,000

H Ltd. acquired the shares of S Ltd on 31 March 2010. On 1 January 2010, S Ltd.'s general reserve stood at ₹ 30,000 and P&L A/c at ₹ 10,000. No part of the preliminary expenses was written off during the year 2010. Prepare a consolidated balance sheet of H Ltd. and its subsidiary S Ltd. as at 31 December 2010.

Solution

Calculations:

Step 1: Calculation of Holding–Minority Ratio:

(i) Quantum of H Ltd.'s Acquisition of Shares in S Ltd. (Given): 70%

(ii) Share of Minority (100%– 70%): 30%

(iii) ∴ Holding–Minority Ratio 70:30 (or) 7:3

		₹
Step 2:	Determination of Pre-acquisition Profit & Reserves:	
(i)	Balance of P&L A/c as on 1 January 2010	10,000
(ii)	Add: Balance of General Reserve on 1 January 2010	30,000
		40,000
(iii)	Add: Pre-acquisition Profit (i.e., from 1 January 2010 to 31 March 2010—3 months) $\frac{3}{12}\times$ (₹ 25,000 – ₹ 10,000)	3,750
		43,750
(iv)	Add: Pre-acquisition Reserve 1 January 2010 to 31 March 2010—3 months: $\frac{3}{12}\times$ ₹ (35,000 – 30,000)	1,250
		45,000
(v)	Share of H Ltd.: $\frac{7}{10}\times 45{,}000$	31,500
(vi)	Minority Interest: $\frac{3}{10}\times 45{,}000$	13,500
Step 3:	Calculation of Post-acquisition Profit:	
(i)	Balance at the End of the Year:	25,000
(ii)	Less: Balance at the Beginning of the Year:	10,000
		15,000
(iii)	Less: Capital Profit (from 1 January 2010 to 31 March 2010—3 months: $\frac{3}{12}\times$ ₹ 15,000)	3,750
		11,250
(iv)	Share of H Ltd. $\left(\frac{7}{10}\times ₹\,11{,}250\right)$	7,875
(v)	Minority Interest $\left(\frac{3}{10}\times ₹\,11{,}250\right)$	3,375
Step 4:	Determination of Post-acquisition Reserve:	
(i)	Balance at the End of the Year	35,000
(ii)	Less: Balance at the Beginning	30,000
		5,000
(iii)	Less: Capital Reserve (from 1 January 2010 to 31 March 2010—3 months: $\frac{3}{12}\times$ ₹ 5,000)	1,250
		3,750
(iv)	Share of H Ltd. $\left(\frac{7}{10}\times ₹\,3{,}750\right)$	2,625
(v)	Minority Interest $\left(\frac{3}{10}\times ₹\,3{,}750\right)$	1,125
Step 5:	Determination of Cost of Control:	
(i)	Investment in Shares of S Ltd. (At Cost)	1,30,000
(ii)	Less: Paid-up Value of Shares Held	70,000
		60,000

(iii)	Share of H Ltd. in Capital Profit & Reserves [Ref: Step 2 (v) & (vi)]	31,500
		28,500
(iv)	Add: Proportionate Share in Preliminary Expenses $\frac{7}{10} \times ₹ 3,000$	2,100
		30,600

Step 6: Determination of Minority Interest:

(i)	Paid-up Value of Shares Held (3,000 × ₹ 10)	30,000
(ii)	Add: Share in Capital Profit & Reserves (Ref: Step 2)	13,500
		43,500
(iii)	Add: Share in Post-acquisition Profit (Ref: Step 3)	3,375
		46,875
(iv)	Add: Share in Post-acquisition Reserve (Ref: Step 4)	1,125
		48,000
(v)	Less: Share in Preliminary Expenses $\left(\frac{3}{10} \times ₹ 3,000\right)$	900
		47,100
(vi)	Add: Unclaimed Dividends	2,500
		49,600

Step 7: Preparation of Consolidated Balance Sheet:

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as at 31 December 2010

Liabilities		₹	Assets		₹
Share Capital:			Fixed Assets:		
Issued & Subscribed:			Goodwill (Ref: Step 5) ₹		30,600
30,000 Equity Shares of ₹ 10 Each Fully Paid		3,00,000	Machinery		
			H Ltd.	1,50,000	
Minority Interest (Ref: Step 6)		49,600	S Ltd.	50,000	2,00,000
Reserves & Surplus:	₹		Furniture		
General Reserve	75,000		H Ltd.	35,000	
Add: Share in S Ltd.	2,625	77,625	S Ltd.	22,500	57,500
Profit & Loss A/c:			Current Assets, Loans & Advances:		
H Ltd.	35,000		(A) Current Assets:		
S Ltd.	7,875	42,875	Stock		
Current Liabilities and Provisions:			H Ltd.	87,500	
Creditors			S Ltd.	94,500	1,82,000
H Ltd.	45,000		Debtors		
S Ltd.	27,500	72,500	H Ltd.	27,500	
			S Ltd.	15,000	42,500

		Bank		
		H Ltd. 20,000		
		S Ltd.	2,500	22,500
		(B) Loans & Advances:		
		Bills Receivable:		
		H Ltd.	5,000	
		S Ltd.	2,500	7,500
	5,42,600			5,42,600

12.4.2.19 Consolidated Profit & Loss Account

Consolidated profit & loss account is prepared to depict the aggregate profit of the group as a whole and also profit or loss of each individual company in the group.

Preparation of Consolidated Profit and Loss Account:

Step 1: P&L A/c Is to Be Presented in Columnar Form. So, on Both Sides of the Account (Dr. & Cr.),

(i) One Column Is Opened for Each Company

(ii) One Column for Adjustment

(iii) The Third Column for Total Amount

Step 2: All the Items (Revenues & Expenses) are Shown as Is Done in the Preparation of Ordinary P&L A/c

Step 3: Inter-company Transactions Have to Be Eliminated in the Total Column. Details Have to be Entered in the Column for Adjustments

(i) Purchases & Sales Within the Group Should be Eliminated on Both Sides of the Account

(ii) Similarly, Interest on Debentures and Dividends Received Should Be Eliminated on Both Sides of the Account

Step 4: After Entering All the Required Items, the Accounts are Balanced to Arrive at Profit/Loss of Each Individual Company and Group.

Step 5: Holding Company's Share of Pre-acquisition Profits is to be Determined. Then, This Amount Is to Be Debited to the Subsidiary and Also to Be Credited to Cost of Control or Capital Reserve.

Step 6: In the Same Manner, Minority Interest is to be Determined in the Subsidiary Company's Profits. Then It Is to Be Debited to the Subsidiary Company and Also to be Shown in the Total Column.

Step 7: Provision for Unrealized Profit in Stock, if Any, Is to Be Ascertained and to Be Debited to the Holding or Subsidiary Company as the Case May Be. Then it Is to Be Debited to Stock Reserve Account.

Step 8: All Such Items as Debited Above (Steps 5, 6 and 7) Should Be Shown in the Columns of Respective Companies and in the Total Column. Care Should Be Taken Not to Record Such Items in the Adjustment Column.

Step 9: Only the Balance in the Total Column is to be Carried to Consolidated Balance Sheet, to Be Shown as P&L A/c.

Illustration 12.21

Model: Consolidated profit & loss A/c

H Ltd. acquired 80% of the shares in S Ltd. on 1 January 2010.

The following is the summarized P&L A/c of the companies after ascertaining net profit:

Profit & Loss Account of
H Ltd. & S Ltd.
for the Year Ended 31 December 2010.

Particulars	H Ltd. ₹	₹	Particulars	S Ltd. ₹	₹
To Proposed Dividend	—	3,00,000	By Net Profit c/d	12,00,000	5,40,000
To Balance c/d	13,80,000	2,40,000	By Dividend Receivable from S Ltd.	1,80,000	—
	13,80,000	5,40,000		13,80,000	5,40,000

You are required to prepare a consolidated P&L A/c for the two companies.

Solution

Consolidated Profit & Loss Account
of H Ltd. and Its Subsidiary S Ltd.
for the Year Ended 31 December 2010

Particulars	₹	Particulars		₹
To Minority Interest		By Net Profit of Current Year b/d	₹	
(i) In Profit After Dividend:		H Ltd.	12,00,000	
(₹ 5,40,000 – ₹ 3,00,000) × $\frac{20}{100}$	48,000	S Ltd.	5,40,000	17,40,000
(ii) In Proposed Dividend: (₹ 3,00,000 × $\frac{20}{100}$)	60,000			
To Balance c/d	16,32,000			
	17,40,000			17,40,000

Illustration 12.22

Model: Revaluation of assets

The summarized balance sheets of H Ltd. and its subsidiary S Ltd. as at 31 December 2010 are as follows:

(₹ in Lakhs)

Liabilities	H Ltd. ₹	₹	Assets	S Ltd. ₹	₹
Equity Shares of ₹ 100 Each	3,600	1,800	Goodwill at Cost	750	225
Share Premium	540	—	Plant at Cost Less Depreciation	2,160	1,350

Capital Reserve on 1 January 2010	240	180	Fixtures at Cost Less Depreciation	390	171
General Reserve on 1 January 2010	450	300	Stock at Cost	540	360
			Debtors	1,881	633
P&L A/c on 1 January 2010	1,200	240			
Profit for 2010	480	150	Investment at Cost:		
Creditors	1,050	330	14,40,000 Equity Shares in S Ltd.	1,620	—
S Ltd.	81		Trade Investment	—	75
			Balance at Bank	300	90
			H Ltd.	—	96
	7,641	3,000		7,641	3,000

You are required to prepare a consolidated balance sheet of H Ltd. and its subsidiary S Ltd. as at 31 December 2010 together with working notes, after giving effect to the following relevant information:

(a) Plant of S Ltd. was to be revalued on 1 January 2010 at ₹1,620 lakh, fixtures at ₹150 lakh and trade investments were deemed to be valued less. There were no transactions of purchase or sales of these assets during the year 2010. The directors wish to give effect to the above revaluation in the consolidated accounts.

(b) Depreciation has been provided for the year 2010 on plant at 10% and on fixtures at 5%.

(c) The stock of S Ltd. included goods purchases of ₹120 lakh from H Ltd. who have invoiced these goods at cost plus 25%.

(d) A cheque of ₹15,00,000 from H Ltd. to S Ltd. was in transfer on December 2010.

(e) H Ltd. acquired the equity shares in S Ltd. on 1 January 2010.

[I.C.W.A. (Final). Modified]

Solution

CALCULATIONS:

Step 1: Determination of Capital Profit or Loss on Revaluation of Assets of S Ltd:

	(₹ in Lakhs)
(i) Plant on 1 January 2010 = $1,350 \times \frac{100}{90}$	1,500
(ii) Fixtures on 1 January 2010 = $171 \times \frac{100}{95}$	180
(iii) Gain or Loss on Revaluation of Plant:	
Revalued Amount – Book Value (₹1,620 – ₹1,500): Gain	120
(iv) Gain or Loss on Revaluation of Fixtures:	
(Revalued Amount – Book Value) ₹(150 – 180): ₹30 Loss	30
(v) Value of Plant of S Ltd. (To Be Included in Consolidated Balance Sheet)	
Revalued Amount – Depreciation @ 10% (₹810 – ₹81)	729
(vi) Value of Fixtures of S Ltd. Revalued Amount – Depreciation @ 5% (₹150 – ₹7.50)	142.50

Step 2:	Calculation of Unrealized Profit in Stock:		24
	₹ 1,20,00,000 × $\frac{1}{5}$: ₹ 24,00,000		
Step 3:	Determination of Pre-acquisition Profits		
	(i) P&L A/c on 1 January 2010		240
	(ii) Add: General Reserve on 1 January 2010		300
			540
	(iii) Add: Capital Reserve on 1 January 2010		180
	[Step 1 – iii]		720
	(iv) Add: Profit on Revaluation of Plant [Ref: (i) – (iii)]		120
	[Step 1 – iv]		840
	(v) Less: Loss on Revaluation of Fixtures [Ref: (i) – (iv)]		30
			810
	(vi) Less: Loss on Revaluation of Investments (Ref: Information)		75
			735
	(vii) Share of H Ltd: $\left(735 \times \frac{4}{5}\right)$:		588
	(viii) Minority Interest: $\left(735 \times \frac{1}{5}\right)$:		147
Step 4:	Determination of Post-acquisition Profits		
	(i) Profits Earned During 2010 (Given)		150
	(ii) Readjustment of Depreciation		
	Plant	₹ (12.00)	
	Fixtures	₹ 1.50	(10.50)
			139.50
	(iii) Share of H Ltd. (139.50 × 4/5):		111.60
	(iv) Minority Interest $\left(139.50 \times \frac{1}{5}\right)$:		27.90
Step 5:	Determination of Cost of Control:		
	(i) Cost of Investment in Shares in S Ltd.		620
	(ii) Less: Paid-up Value of Shares Held:		440
			180
	(iii) Less: Share of H Ltd. in Pre-acquisition Profit [Ref: Step 3 (vii)]		588
	(iv) Difference: Capital Reserve:		408
Step 6:	Calculation of Minority Interest:		
	(i) Share Value (3,60,000 × ₹ 100)		360
	(ii) Add: Share of Pre-acquisition Profit [Ref: Step 3 (viii)]		147
			507
	(iii) Add: Share of Post-acquisition Profits		(₹ in Lakhs)
	[Ref: Step 4 (iv)]		27.90
	(iv) Minority Interest		534.90

Step 7: Consolidated P&L A/c

(i) Opening Balance of Profit H Ltd.	1,200
(ii) Add: Profit of H Ltd. During the year 2010	480
	1,680
(iii) Add: Share of H Ltd. in Post-acquisition Profits from S Ltd. [Step 4 (iii)]	111.60
	1,791.60
(iv) Less: Unrealized Profit in Stock (Step 2)	24.00
	1,767.60

Step 8: Preparation of Consolidated Balance Sheet:

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as at 31 December 2010

Liabilities		₹ in Lakhs	Assets		₹ in Lakhs
Share Capital:			Fixed Assets:	₹	
Issued, Subscribed & Paid up:			Goodwill		
36,00,000 Equity Shares of ₹100 Each Fully Paid up		3,600	H Ltd.	750	
Minority Interest [Ref: Step 6 (iv)]		534.90	S Ltd.	225	
				975	
Reserves & Surplus:			Less: Capital Reserve	408	567
Share Premium		540	Plant as Cost Less Depreciation		
Capital Reserve		240	H Ltd.	2,160	
General Reserve		450	S Ltd.	1,458	3,618
P&L A/c (Ref: Step 7)		1,767.60	Fixtures as Cost Less Depreciation		
Current Liabilities & Provision:			H Ltd.	390	
Sundry Creditors:			S Ltd.	142.5	532.50
H Ltd.	1,050		Current Assets:		
S Ltd.	330	1,380	Stock		
			H Ltd.	540	
			S Ltd.	360	
				900	
			Less: Unrealized Profit	24	876
			Debtors		
			H Ltd.	1,881	
			S Ltd	633	2,514
			Balance as Bank		
			H Ltd.	300	
			S Ltd.	90	
			In Transit	15	405
		8,512.50			8,512.50

Illustration 12.23

Model: Bonus shares—Overvaluation of assets and contingent liability

X Ltd. acquired 16,000 shares of ₹10 each in Y Ltd. on 31 March 2011. The summarized balance sheets of the two companies as on that date were as follows:

Particulars	X Ltd. ₹	Y Ltd. ₹
Share Capital:		
60,000 Shares of ₹10 Each	6,00,000	-
20,000 Shares of ₹10 Each	—	2,00,000
Capital Reserve	—	1,04,000
General Reserve	50,000	10,000
Profit and Loss Account	76,400	36,000
Loan from Y Ltd.	4,200	—
Bills Payable (Including ₹1,000 to X Ltd.)	—	3,400
Creditors	35,800	10,000
Note on the Balance Sheet of X Ltd:		
There is a Contingent Liability for Bills Discounted of ₹2,000	7,66,400	3,63,400
Fixed Assets	3,00,000	2,89,400
Investments in Y Ltd. as Cost	3,40,000	—
Stock in Hand	80,000	40,000
Loan to X Ltd.	—	4,000
Bills Receivable (Including ₹400 from Y Ltd.)	2,400	—
Debtors	40,000	20,000
Bank	4,000	10,000
	7,66,400	3,63,400

You are given the following information:

(a) Y Ltd. made a bonus issue on 31 March 2010 of one share for every two shares held, reducing the capital reserve equivalently, but the transaction is not shown in the above balance sheets.

(b) Interest receivable (₹200) in respect of loan due by X Ltd. to Y Ltd. has not been credited in the accounts of Y Ltd.

(c) The directors decided that the fixed assets of Y Ltd. were overvalued and should be written down by ₹10,000.

Prepare the consolidated balance sheet as at 31 March 2011, showing your workings.

[C.A. (Final). Modified]

Solution

Step 1: Determination of Holding–Minority Ratio:

(i) Total Number of Shares in Y Ltd.	20,000
(ii) Number of Share Acquired by X Ltd.	16,000
(iii) Minority Shares (20,000 – 16,000):	4,000
(iv) Holding–Minority Ratio: 16,000 : 4,000	
(or) 4 : 1	

Step 2: Determination of Pre-acquisition Profits:

		₹
(i)	Capital Reserve as on 31 March 2011 (₹ 1,04,000 – ₹ 1,00,000) (Given) (Bonus)	4,000
(ii)	Add: General Reserve on 31 March 2011:	10,000
		14,000
(iii)	Add: P&L A/c on 31 March 2011 (₹ 36,000 + ₹ 200) Given Interest Receivable	36,200
		50,200
(iv)	Less: Loss on Revaluation of Fixed Assets (Given)	10,000
		40,200
(v)	Share of X Ltd. (₹ 40,200 × $\frac{4}{5}$):	32,160
(vi)	Minority Interest (₹ 40,200 × $\frac{1}{5}$):	8,040

Step 3: Post-acquisition Profits—Do Not Arise in this Problem

Step 4: Determination of Minority Interest:

(i)	Share Capital (Including Bonus Shares) (4,000 + 2,000 Shares) × ₹ 10:	60,000
(ii)	Add: Share of Pre-acquisition Profits [Ref: Step 2 (vi)]	8,040
(iii)	∴ Minority Interest:	68,040

Step 5: Ascertainment of Cost of Control:

(i)	Cost of Investments (Given)		3,40,000
(ii)	Less: (a) Paid-up Value of Shares (16,000 + 8,000) × ₹ 10 (↓ Held ↓ Bonus)	2,40,000	
	(b) Share of X Ltd. on Pre-acquisition Profits [Step 2 (v)]	32,160	2,72,160
			67,840

Step 6: Contingent Liability:

(i) Bills Discounted by X Ltd. out of Bills Received from Y Ltd. was ₹ 600. When Consolidated Balance Sheet is Prepared, This Will be Eliminated.

(ii) So, Contingent Liability in Respect of Bills Discounted Will Be Reduced to ₹ 1,400.

Step 7:

Consolidated Balance Sheet of
X Ltd. and Its Subsidiary
as at 31 March 2011

Liabilities	₹ in Lakhs	Assets	₹ in Lakhs
Share Capital:		Fixed Assets:	
Issued, Subscribed & Paid up:		Goodwill (Ref: Step 5)	67,840

60,000 Equity Shares of ₹10 Each Fully Paid up		6,00,000	Other Fixed Assets:	₹	
Minority Interest (Step 4)		68,040	X Ltd.	3,00,000	
Reserves & Surplus:			Y Ltd.	2,79,400	5,79,400
General Reserve		50,000	Current Assets, Loans & Advances:		
P&L A/c		76,400	Stock		
Current Liabilities & Provision:	₹		X Ltd.	80,000	
Creditors			Y Ltd.	40,000	1,20,000
X Ltd.	35,800		Debtors		
Y Ltd.	10,000	45,800	X Ltd.	40,000	
Bills Payable	3,400		Y Ltd.	20,000	60,000
Less: Mutual Owing	400	3,000	Bills Receivable	2,400	
			Less: Mutual Owing	400	2,000
			Bank		
			X Ltd.	4,000	
			Y Ltd.	10,000	14,000
		8,43,240			8,43,240

Illustration 12.24

Model: Investments in different dates.

The balance sheets of a holding company (H Ltd.) and its subsidiary (S Ltd.) at 31 December 2010 are as follows:

Particulars	**H Ltd.** ₹	**S Ltd.** ₹
Equity Share of ₹10 Each Fully Paid	12,00,000	6,00,000
Profit & Loss Account at 31 December 2008	6,00,000	3,00,000
Net Profit (Loss) 2009	3,60,000	(1,20,000)
Net Profit 2010	1,20,000	1,80,000
Creditors	3,00,000	1,20,000
	25,80,000	10,80,000
Investments in S Ltd. as Cost	7,80,000	—
Other Assets	18,00,000	10,80,000
	25,80,000	10,80,000

On 31 December 2008, H Ltd. acquired 36,000 shares in S Ltd. for ₹6,00,000. On 31 December 2009, it acquired a further 12,000 shares for ₹1,80,000.

No dividends have been paid or proposed by either company in relevant years. Prepare a consolidated balance sheet of the group as at 31 December 2010.

[I.C.W.A. (Final). Modified]

Solution

Step 1: H Ltd.'s Controlling Interest in S Ltd. on Different Dates:

	Date	No. of Shares	Percentage of Control
(i)	31 December 2002	36,000	$\frac{36,000}{60,000} \times 100 = 60\%$
(ii)	31 December 2003	12,000	$\frac{12,000}{60,000} \times 100 = 20\%$
(iii)	Total (1 + 2)	48,000	$\frac{48,000}{60,000} \times 100 = 80\%$

Step 2: Determination of Profits (Pre & Post acquisition) of S Ltd.:

		₹
(i)	For the year 2008:	
	(a) P&L A/c balance on 31 December 2008:	3,00,000
	(b) Share of H Ltd. (Pre-acquisition) 80% of ₹ 3,00,000	2,40,000
	(c) Share of Minority 20%	60,000
(ii)	For the Year 2009:	
	(a) Net Loss During the Year 2009	1,20,000
	(b) Share of H Ltd. (Post-acquisition) 60%	72,000
	(c) Share of H Ltd. (Pre-acquisition) 20%	24,000
	(d) Share of Minority 20%	24,000
(iii)	For the Year 2010:	
	(a) Net Profit During the Year 2010	1,80,000
	(b) Share of H Ltd. (Post-acquisition) 80%	1,44,000
	(c) Share of Minority 20%	36,000

Step 3: Calculation of Minority Interest:

(i)	Share Capital (12,000 Shares × ₹ 10)	1,20,000
(ii)	Add: P&L A/c balance on 31 December 2008 [Ref: Step 2 (i) (c)]	60,000
		1,80,000
(iii)	Less: P&L A/c Net Loss for 2009 [Step 2 (ii) (d)]	24,000
		1,56,000
(iv)	Add: P&L A/c Net Profit for 2010 (Step 2 (iii) (c)]	36,000
	∴ Minority Interest	1,92,000

Step 4: Calculation of Cost of Control/Goodwill

(i)	Cost of 48,000 Shares in S Ltd.	7,80,000
(ii)	Less: Face Value (48,000 × ₹ 10)	4,80,000
		3,00,000
(iii)	Less: Pre-acquisition Profit—	
	(₹ 2,40,000 – ₹ 24,000)	2,16,000
	↓ ↓	
	Step 2(i)(b) Step 2 (ii)	
	Goodwill	84,000

Step 5: Preparation of Consolidated Balance Sheet:

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as at 31 December 2010

Liabilities		₹	Assets		₹
Share Capital:					
Issued, Subscribed & Paid up:			Goodwill (Ref: Step 4)		84,000
1,20,000 Equity Shares of ₹ 10 Each Fully Paid up		12,00,000	Other Assets:		
Minority Interest (Ref: Step 3)	₹	1,92,000	H Ltd.	18,00,000	
Reserves & Surplus:			S Ltd.	10,80,000	28,80,000
P&L A/c	10,80,000				
Add: Share of Profit from S Ltd. (₹ 1,44,000 – ₹ 72000)	72,000	11,52,000			
Current Liabilities:					
Creditors					
H Ltd.	3,00,000				
S Ltd.	1,20,000	4,20,000			
		29,64,000			29,64,000

Illustration 12.25

Model: Controlling interest acquired during the course of the year

The following are the balance sheets of H Ltd. and its subsidiary S Ltd. as at 31 March 2011:

Liabilities	H Ltd.	S Ltd.	Assets	H Ltd.	S Ltd.
	₹	₹		₹	₹
Share Capital:			Machinery	9,00,000	3,00,000
Shares of ₹ 10 Each Fully Paid	18,00,000	6,00,000	Furniture	2,10,000	1,35,000
General Reserve	4,50,000	2,10,000	70% Shares in S Ltd. at Cost	7,80,000	—
Profit & Loss Account	2,10,000	1,50,000	Stock	5,25,000	5,67,000
Creditors	2,70,000	1,80,000	Debtors	1,65,000	90,000
			Cash at Bank	1,50,000	30,000
			Preliminary Expenses	—	18,000
	27,30,000	11,40,000		27,30,000	11,40,000

H Ltd. acquired the shares of S Ltd. on 30 June 2010. On 1 April 2010, S Ltd.'s general reserve and profit and loss account stood at ₹ 1,80,000 and ₹ 60,000, respectively.

No part of preliminary expenses was written off during the year ended 31 March 2010.

Prepare the consolidated balance sheet of H Ltd. and its subsidiary S Ltd. as at 31 March 2011.

[C.S. (Inter). Modified]

Solution

CALCULATIONS:

Step 1: Net Profit for the Year is Ascertained by Preparing P&L Appropriation A/c as follows:

P&L Appropriation Account
for the Year Ended 31 March 2010

	₹		₹
To General Reserve (₹ 2,10,000 – ₹ 1,80,000) (B/S) (Information)	30,000	By Balance b/d (See: Information)	60,000
To Balance c/d (B/S)	1,50,000	By Net Profit for the Year (Balancing Figure)	1,20,000
	1,80,000		1,80,000
		By Balance b/d	1,50,000

Step 2: Determination of Pre-acquisition Profits:

	₹
(i) Net Profits for the Year: (Ref: P&L Appropriation A/c)	1,20,000
(ii) Pre-acquisition Profit: 1 April 2010 to 30 June 2010—3 months ₹ 1,20,000 × $\frac{3}{2}$	30,000

Step 3: Determination of Share of Capital Profits:

	₹
(i) General Reserve on 1 April 2010 (Given):	1,80,000
(ii) Add: P&L A/c on 1 April 2010 (Given):	60,000
	2,40,000
(iii) Add: Pre-acquisition Profits [Ref: Step 1 (ii)]	30,000
	2,70,000
(iv) Less: Preliminary Expenses (Given):	18,000
	2,52,000

(v) Share of H Ltd: ₹ 2,52,000 × $\frac{70}{100}$: 1,76,400

(vi) Minority Share : ₹ 2,51,000 × $\frac{30}{100}$: 75,600

Step 4: Determination of Share of Revenue Profits:

	₹
(i) Profit for Post-acquisition from 1 July 2010 to 31 March 2011 9 months ₹ 1,20,000 × $\frac{9}{12}$	90,000

(ii)	Share of H Ltd.: ₹90,000 $\times \frac{70}{100}$:	63,000
(iii)	Minority Share 90,000 $\times \frac{30}{100}$:	27,000

Step 5: Determination of Cost of Control/Goodwill:

(i)	70% of Shares in S Ltd.	7,80,000
(ii)	Less: Paid-up Value of 70% Shares	4,20,000
		3,60,000
(iii)	Less: H Ltd.'s Share of Capital Profit: [Ref: Step 3 (v)]	1,76,400
(iv)	Goodwill	1,83,600

Step 6: Ascertainment of Minority Interest:

(i)	Paid-up Value of Shares Held in S Ltd. (30%)	1,80,000
(ii)	Add: Minority Share of Capital Profits [Step 3 (vi)]	75,600
		2,55,600
(iii)	Add: Minority Share of Revenue Profits [Step 4 (iii)]	27,000
(iv)	Minority Interest	2,82,600

Step 7: Preparation of Consolidated Balance Sheet:

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as at 31 March 2011

Liabilities		₹	Assets		₹
Share Capital:			Goodwill (Step 5)	₹	1,83,600
1,80,000 Shares of ₹100 Each Fully Paid up		18,00,000	Machinery		
			H Ltd.	9,00,000	
			S Ltd.	3,00,000	12,00,000
Minority Interest (Ref: Step 6)		2,82,600	Furniture		
General Reserve		4,50,000	H Ltd.	2,10,000	
Profit & Loss Account:	₹		S Ltd.	1,35,000	3,45,000
H Ltd.	2,10,000		Stock		
Add: Share in S Ltd.'s Profit			H Ltd.	5,25,000	
(Step 4) Profit}	63,000	2,73,000	S Ltd.	5,67,000	10,92,000
			Debtors		3,618
Creditors			H Ltd.	1,65,000	
H Ltd.	2,70,000		S Ltd.	90,000	2,55,000
S Ltd.	1,80,000	4,50,000	Cash at Bank		
			H Ltd.	1,50,000	
			S Ltd.	30,000	1,80,000
		32,55,600			32,55,600

Illustration 12.26

Model: Preference shares

On 1 April 2010, H Ltd. acquired 80% equity shares and 30% preference shares of S Ltd. for ₹3,90,000 and ₹61,000, respectively, on which date S Ltd.'s general reserve and profit and loss accounts showed balances of ₹60,000 and ₹8,000, respectively. On 31 March 2011, the balance sheets of two companies stood as follows:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Equity Share Capital	20,00,000	4,00,000	Sundry Assets	27,09,000	9,52,000
10% Preference Shares Capital	—	2,00,000	80% Equity Shares in S Ltd.	3,90,000	—
General Reserve	6,00,000	80,000			
P&L A/c	2,00,000	78,000	30% Preference Shares in S Ltd.	61,000	—
Creditors	3,60,000	1,94,000			
	31,60,000	9,52,000		31,60,000	9,52,000

You are required to draw the consolidated balance sheet as at 31 March 2011, assuming that on 1 April 2010, there were no arrears of preference dividend.

Solution

Step 1: Determination of Net Profit for the Year: P&L Appropriation A/c

Particulars	₹	Particulars	₹
To General Reserve (₹80,000 – ₹60,00 ↓ ↓ (B/S) Information	20,000	By Balance b/d (Given in Information)	8,000
To Balance c/d (B/S)	78,000	By Net Profit for the Year (Bal. Fig.)	90,000
	98,000		98,000

Step 2: Determination of Share of Revenue Profits: ₹.

(i) Net Profit for the Year (Revenue Profit)(Ref: Step 1)	90,000
(ii) Less: Preference Dividend @ 10% on ₹2,00,000:	20,000
(iii) Balance in Profit	70,000
(iv) Share of H Ltd. = ₹70,000× $\frac{80}{100}$	56,000
(v) Minority Share = ₹70,000× $\frac{20}{100}$	14,000

Step 3: Determination of Share of Capital Profits:

(i) General Reserve on 1 April 2010	60,000
(ii) Add: P&L A/c on 1 April 2010	8,000

	(iii) Capital Profit		68,000
	(iv) Share of H Ltd.: ₹ 68,000× $\frac{80}{100}$		54,400
	(v) Minority Share: ₹ 68,000× $\frac{20}{100}$		13,600
Step 4:	Determination of Share in Preference Dividend:		
	(i) Preference Dividend for 1 year:		20,000
	(ii) Share of H Ltd. in Pref. Dividend ₹ 20,000× $\frac{30}{100}$		6,000
	(iii) Minority Share in Pref. Dividend ₹ 20,000× $\frac{70}{100}$		14,000
	(iv) Share of H Ltd. in S Ltd.'s Profits (Revenue Profit + Pref. Dividend ₹ 56,000 + ₹ 6,000		62,000
Step 5:	Determination of Cost of Control/Goodwill:		₹
	(i) Acquisition of Equity Shares		3,90,000
	(ii) Add: Acquisition of Preference Shares		61,000
			4,51,000
	(iii) Less:		
	(a) Paid-up Value of Shares 80% Equity Shares	3,20,000	
	(b) Paid-up Value of Pref. Shares 30% Pref. Shares	60,000	
	(c) Share of H Ltd. in Capital Profit [Step 3 (iv)]	54,400	4,34,400
	(iv) Goodwill		16,600
Step 6:	Determination of Minor by Interest:		
	(i) Paid-up Value (20% Equity Shares)		80,000
Add:	(ii) Share in Capital Profits [(Step 3 (v)]	13,600	
	(iii) Share in Revenue Profits + Pref. Dividend [Step 4 (iv)]	14,000	
	(iv) Paid-up Value of 70% Pref. Shares	1,40,000	
	(v) Share in Pref. dividend	14,000	1,81,600
	(vi) Minority Interest		2,61,600
Step 7:	Preparation of Consolidated Balance Sheet:		

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as at 31 March 2011

Liabilities	₹	**Assets**		₹
Equity Share Capital	20,00,000	Goodwill [Step 5 (iv)]		16,600
Minority Interest	2,61,600	Other Assets	₹	
[Step 6 (vi)]		H Ltd.	27,09,000	
General Reserve	6,00,000	S Ltd.	9,52,000	36,61,000

Profit & Loss Account: H Ltd.	2,00,000			
Add: Share in Profits of S Ltd.	62, 000	2,62,000		
[Step 4 (iv)]				
Creditors: H Ltd.	3,60,000			
S Ltd.	1,94,000	5,54,000		
		36,77,600		36,77,600

Illustration 12.27

Model: Proposed dividend, received bonus shares, revaluation of assets, unrealized profit in stock and consolidation after some years of investment

One 1 January 2008, A Ltd. acquired 16,000 shares of ₹ 10 each of B Ltd. at ₹ 1,80,000. The respective balance sheets as on 31 December 2010 are given as follows:

Liabilities	**A Ltd.** ₹	**B Ltd.** ₹	**Assets**	**A Ltd.** ₹	**B Ltd.** ₹
Share Capital (₹ 10)	2,00,000	2,00,000	Fixed Assets	1,20,000	2,20,000
Reserve	80,000	52,000	Investments	2,00,000	30,000
Profit & Loss A/c	72,000	70,000	Debtors	50,000	40,000
Creditors	1,42,000	96,000	Stock	60,000	80,000
			Bank	64,000	48,000
	4,94,000	4,18,000		4,94,000	4,18,000

Additional information:

1. At the time of acquiring shares, B Ltd. had ₹ 48,000 in reserve and ₹ 30,000 in profit & loss account.
2. B Ltd. paid 10% dividends in 2008, 12% in 2009, 15% in 2010 for 2007, 2008 & 2009, respectively. All dividends received have been credited to P&L A/c of A Ltd.
3. Proposed dividends of both the companies for 2010 is 10%.
4. One bonus share for five fully paid shares held has been declared by B Ltd. Out of pre-acquisition reserves on 31 December 2010, no effect has been given to that in the above accounts.
5. On 1 January 2008, Building of B Ltd. which stood in the books as ₹ 1,00,000 was revalued as ₹ 1,20,000. But no adjustment has been made in the books. Depreciation has been charged @ 10% p.a. or reducing balance method.
6. In 2010, A Ltd. purchased from B Ltd. goods for ₹ 20,000 on which B Ltd. made a profit of 20% on sales. 25% of such goods are lying unsold on 31 December 2010.

You are required to prepare the consolidated balance sheet as 31 December 2010.

[C.A. (Final). Modified]

Solution

Step 1: Determination of Share of Capital Profit:

	₹
(i) Reserve on 1 January 2008	48,000
(ii) Add: P&L A/c on 1 January 2008 (₹ 30,000 – ₹ 20,000 Dividend for 2007)	10,000
	58,000

	(iii) Add: Revaluation–Building–Appreciation		20,000
			78,000
	(iv) Share of A Ltd. ₹ 78,000× $\frac{80}{100}$		62,400
	(v) Minority Share ₹ 78,000× $\frac{20}{100}$		15,600
Step 2:	Determination of Share of Revenue Profit:		
	(i) Increase in Profit After Dividend for 2008, 2009, & 2010 (₹ 70,000 – ₹ 10,000):		60,000
	(ii) Less: Depreciation on Appreciated Value of Building @10% for 3 years (₹ 2,000 + ₹ 1,800+₹ 1,620) (Reducing Balance Method)		5,420
			54,580
	Share of A Ltd. ₹ 54,580× $\frac{80}{100}$		43,664
	Minority Share ₹ 54,580× $\frac{20}{100}$		10,916
Step 3:	Determination of Share of Revenue Reserve:		
	(i) Increase in Reserve		4,000
	(ii) Share of A Ltd.: ₹ 4,000 × $\frac{80}{100}$		3,200
	(iii) Minority Share ₹ 4,000× $\frac{20}{100}$		800
Step 4:	Ascertainment of Cost of Control/Capital Reserve:	₹	₹
	(i) Cost of Investments		1,80,000
	(ii) Less (a) Paid-up Value of Shares	1,60,000	
	(b) Dividend Received for 2009	16,000	
	(c) Share of A Ltd. of Capital Profit [Ref: Step 1 (iv)]	62,400	
			2,38,400
	(iii) Difference: Capital Revenue		58,400
Step 5:	Ascertainment of Minority Interest:		
	(i) Share Capital (4,000× ₹ 10)		40,000
	(ii) Add: Share of Capital Profit [Ref: Step 1 (v)]		15,600
			55,600
	(iii) Add: Share of Revenue Reserve [Ref: Step 3 (iii)]		800
			56,400
	(iv) Add: Share of Revenue Profit [Ref: Step 2 (iv)]		10,916
	(v) Minority Interest		67,316
Step 6:	Preparation of P&L A/c of A Ltd.:		
	(i) Balance as per Books		72,000
	(ii) Less: Dividend for 2009—Wrong Credit:		16,000
			56,000
	(iii) Less: Unrealized Profit in Stock (₹ 5,000×$\frac{20}{100}$)		1,000
			55,000
	(iv) Less: Proposed Dividend for 2010 @10% on ₹ 2,00,000		20,000
			35,000
	(v) Add: Share of Revenue Profit [Ref: Step 2 (iii)]		43,664
	(vi) P&L A/c Should Be Shown in Consolidated Balance Sheet		78,664

Step 7: Preparation of Consolidated Balance Sheet:

Consolidated Balance Sheet of
A Ltd. & and its Subsidiary B Ltd.
as at 31 December 2010.

Liabilities		₹	Assets		₹
Share Capital:			Fixed Asset:	₹	
Issued, Subscribed & Paid up:			A Ltd.	1,20,000	
20,000 Shares of ₹ 10 Each Fully Paid up		2,00,000	B Ltd.	2,40,000	
				3,60,000	
Minority Interest [Step 5 (v)]		67,316	Less: Depreciation	5,420	3,54,580
Reserves & Surplus:			Investments:		
Capital Reserve	₹	58,400	A Ltd.	20,000	
Reserve			B Ltd.	30,000	50,000
A Ltd.	80,000		Current Asset:		
Add: Share of B Ltd	3,200	83,200	Debtors		
[Step 3 (ii)]			A Ltd.	50,000	
Profit & Loss Account		78,664	B Ltd.	40,000	90,000
[Step 6 (vii)]			Stock		
Current Liabilities & Provisions:			A Ltd.	60,000	
Creditors			B Ltd.	80,000	
A Ltd.	1,42,000			14,000	
B Ltd.	96,000	2,38,000	Less: Unrealized Profit	1,000	1,39,000
Proposed Dividend		20,000	Bank		
			A Ltd.	64,000	
			B Ltd.	48,000	1,12,000
		7,45,580			7,45,580

Illustration 12.28

Model: Sale of investments

The summarized balance sheets of A Ltd. and B Ltd. are as follows:

Balance Sheets as at 31 December 2010

Particulars	A Ltd. ₹	B Ltd. ₹
Sources of Funds:		
Equity Shares of ₹ 10 Each	8,00,000	2,00,000
Reserves	80,000	20,000

Profit & Loss A/c as on 1 January 2010	1,20,000	40,000
Profit for the Year	32,000	32,000
Add: Dividends from B Ltd.	16,000	—
Less: Dividends Paid	—	(20,000)
Creditors	1,20,000	80,000
	11,68,000	3,52,000
Application of Funds:		
Fixed Assets	8,00,000	3,20,000
Current Assets	1,28,000	32,000
Shares in B Ltd. at Cost 12,000 Shares	2,40,000	—
	11,68,000	3,52,000

A Ltd. had acquired 16,000 shares in B Ltd. at ₹ 20 each on 1 January 2010 and sold 4,000 of them at the same price as on 1 October 2010. The sale is cum dividend. An interim dividend of 10% was paid by B Ltd. on 1 July 2010.

Draft the consolidated balance sheet as at 31 December 2010.

[C.A. (Final) Modified]

Solution

		₹
Step 1:	Determination of Share of Capital Profits:	
	(i) Reserves on 1 January 2010	20,000
	(ii) Add: Profit & Loss A/c on 1 January 2010	40,000
	(iii) Total Pre-acquisition (Capital Profit)	60,000
	(iv) Share of A Ltd.: ₹ 60,000× $\frac{60}{100}$	36,000
	(v) Minority Share: ₹ 60,000× $\frac{40}{100}$	24,000
Step 2:	Determination of Share of Revenue Profits:	
	(i) Profit for the Year (₹ 32,000 – ₹ 20,000)	12,000
	(ii) Share of A Ltd.: ₹ 12,000× $\frac{60}{100}$	7,200
	(iii) Minority Share: ₹ 12,000× $\frac{40}{100}$	4,800
Step 3:	Ascertainment of Minority Interest:	
	(i) Share Capital	80,000
	(ii) Add: Share of Capital Profit [Step 1 (v)]	24,000
		1,04,000
	(iii) Add: Share of Revenue Profit [Step 2 (iii)]	4,800
	(iv) Minority Interest	1,08,800
Step 4:	Calculation of Cost of Control/Goodwill:	
	(i) Cost of Investments	2,40,000
	(ii) Less: Paid-up Value of Shares	1,20,000

			1,20,000
	(iii) Less: Share of A Ltd. in Capital Profit [Step 1 (iv)]		36,000
	(iv) Goodwill (₹ 2,40,000 – ₹ 1,56,000)		84,000
Step 5:	Determination of P&L A/c for A Ltd.:	₹	
	(i) Balance on 1 January 2010		1,20,000
	(ii) Add: (a) Share of Profit in B Ltd. [Step 2 (ii)]	7,200	
	(b) Profit for the Year	32,000	
	(c) Dividends from B Ltd.	16,000	55,200
			1,75,200
	(iii) Add: Profit on Sale of Share (Investment)		—
	(iv) P&L A/c to Be Shown in Consolidated Balance Sheets		1,75,200

Step 6: Preparation of Consolidated Balance Sheet:

Consolidated Balance Sheet of
A Ltd. and Its Subsidiary S Ltd.
as at 31 December 2010

Liabilities	₹	Assets	₹
Share Capital:			
80,000 Equity Shares of ₹ 10 Each Fully Paid up	8,00,000	Goodwill [Step 4 (iv)]	84,000
Minority Interest [Ref: Step 3 (iv)]	1,08,800	Fixed Assets	11,20,000
Reserves	80,000	Current Assets	1,60,000
Profit & Loss Account [Ref: Step 5 (iv)]	1,75,200		
Creditors	2,00,000		
	13,64,000		13,64,000

Illustration 12.29

Model: More than one subsidiary companies' cross holdings

The following are the balance sheets of H Ltd., A Ltd. and B Ltd., as on 31 December 2010:

Particulars	H Ltd. ₹	A Ltd. ₹	B Ltd. ₹
Liabilities:			
Share Capital	30,00,000	6,00,000	3,00,000
Reserves	3,00,000	1,80,000	1,80,000
P&L A/c	12,00,000	3,60,000	1,80,000
Creditors	6,00,000	3,60,000	1,80,000
Bills Payable	—	90,000	—
	51,00,000	15,90,000	8,40,000

Assets:			
Sundry Assets	24,00,000	3,60,000	3,00,000
Stock	18,30,000	5,40,000	3,00,000
Debtors	3,90,000	5,10,000	2,40,000
Bills Receivable from A Ltd.	30,000	—	—
Shares in A Ltd.	4,50,000	—	—
Shares in B Ltd.	—	1,80,000	—
	51,00,000	15,90,000	8,40,000

H Ltd. purchased 80% of shares in A Ltd. when the latter's P&L A/c was ₹ 2,40,000 and reserve was ₹ 1,20,000. A Ltd. purchased 75% of shares in B Ltd. when the latter's P&L A/c was ₹ 1,20,000 and reserve was ₹ 60,000. Prepare consolidated balance sheets of H Ltd. and its subsidiaries A Ltd. and B Ltd. as on 31 December 2010 together units consolidation schedules.

[C.A. (Final). Modified]

Solution

A: Analysis of B Ltd.:

		₹
Step:1:	Determination of Share of Capital Profits:	
	(i) Reserve on the Date of Acquisition	60,000
	(ii) Add: P&L A/c on the Date of Acquisition	1,20,000
		1,80,000
	(iii) Share of A Ltd.: 75% of ₹ 1,80,000	1,35,000
	(iv) Minority Share: 25% of ₹ 1,80,000	45,000
Step 2:	Determination of Share of Revenue Profits:	
	(i) Increase in Profit After Acquisition	60,000
	(ii) Share of A Ltd: 75% of ₹ 60,000	45,000
	(iii) Minority Share: 25% of ₹ 60,000	15,000
Step 3:	Determination of Share of Revenue Reserve:	
	(i) Increase in Reserve After Acquisition	1,20,000
	(ii) Share of A Ltd.: 75% of ₹ 1,20,000	90,000
	(iii) Minority Share: 25% of ₹ 1,20,000	30,000
Step 4:	Ascertainment of Minority Interest of B Ltd:	
	(i) Share Capital	75,000
	(ii) Add: Share of Capital Profits [Step 1 (iv)]	45,000
		1,20,000
	(iii) Add: Share of Revenue Profits [Step 2 (iii)]	15,000
		1,35,000

(iv)	Add: Share of Revenue Profits [Step 3 (iii)]		30,000
(v)	Minority Interest		1,65,000

Step 5: Calculation of Cost of Control of Investment in B Ltd.'s Shares:

(i)	Cost of Investment		1,80,000
(ii)	Less: (a) Paid-up Value of Shares	2,25,000	
	(b) Share of Capital Profits in B Ltd. [Step 1 (iii)]	1,35,000	3,60,000
	Difference: Capital Reserve		1,80,000

B: Analysis of A Ltd.:

Step 6: Determination of Share of Capital Profits:

(i)	Reserve on the Date of Acquisition	1,20,000
(ii)	Add: P&L A/c on the Date of Acquisition	2,40,000
		3,60,000
(iii)	Share of H Ltd.: 80% of ₹ 3,60,000	2,88,000
(iv)	Minority Share: 20% of ₹ 3,60,000	72,000

Step 7: Determination of Share of Revenue Profits: 1,20,000

(i)	Increase in Profit After Acquisition	
(ii)	Add: Share of Revenue Profits of B Ltd. (Ref: Step 1–iv)	45,000
		1,65,000
(iii)	Share of H Ltd.: 80% of ₹ 1,65,000	1,32,000
(iv)	Minority Share: 20% of ₹ 1,65,000	33,000

Step 8: Determination of Share of Revenue Reserve:

(i)	Increase in Reserve After Acquisition:	60,000
(ii)	Add: Share of Revenue Profits of B Ltd.	90,000
		1,50,000
(iii)	Share of H Ltd.: 80% of ₹ 1,50,000	1,20,000
(iv)	Minority Share: 20% of ₹ 1,50,000	30,000

Step 9: Ascertainment of Minority Interest of A Ltd.

(i)	Share Capital	1,20,000
(ii)	Add: Share of Capital Profits [Step 1 (iv)]	72,000
		1,92,000

(iii) Add: Share of Revenue Profits [Step 2 (iv)]		33,000
(iv) Add: Share of Revenue Reserve [Step 3 (iv)]		2,25,000
		30,000
(v) Minority Interest		2,55,000

Step 10: Calculation of Control of Investments in A Ltd.'s Share:

(i) Cost of Investment		4,50,000
(ii) Less: (a) Paid-up Value of Shares	4,80,000	
(b) Share of Capital Profits in A Ltd.	2,88,000	7,68,000
(iii) Difference Capital Reserve		3,18,000

Step 11: Calculation of Total Capital Reserve (A Ltd. + B Ltd.)

(i) Add: Step 5 + Step 10:	
(₹ 1,80,000 + ₹ 3,18,000)	4,98,000

Step 12: Preparation of Consolidated Balance Sheet:

Consolidated Balance Sheet of H Ltd.
and Its Subsidiaries A Ltd. and B Ltd.
as at 31 December 2010

Liabilities		₹	**Assets**		₹
Share Capital:			Fixed Assets:		
Equity Shares		30,00,000	Sundry Assets	₹	
Minority Interest:	₹		H Ltd.	24,00,000	
A Ltd.	2,55,000		A Ltd.	3,60,000	
B Ltd.	1,65,000	4,20,000	B Ltd.	3,00,000	30,60,000
Reserves & Surplus:			Current Assets, Loans and Advances:		
Capital Reserve (Step 11)		4,98,000	Stock		
General Reserve		4,20,000	H Ltd.	18,30,000	
P&L A/c		13,32,000	A Ltd.	5,40,000	
Current Liabilities & Provisions Creditors			B Ltd.	3,00,000	26,70,000
H Ltd.	6,00,000		Debtors:		
A Ltd.	3,60,000		H Ltd.	3,90,000	
B Ltd.	1,80,000	11,40,000	A Ltd.	5,10,000	
Bills Payable			B Ltd.	2,40,000	11,40,000

A Ltd.	90,000		Bills Receivable:	30,000	
Less: Mutual Owning	30,000	60,000	H Ltd.		
			Less: Mutual Owing	30,000	NIL
		68,70,000			68,70,000

Illustration 12.30

Model: Consolidated P&L A/c

From the following trial balance of H Ltd. and its subsidiary S Ltd., you are required to prepare consolidated P&L A/c and balance sheet as on 31 March 2011.

Trial balance of H Ltd. and S Ltd.
as on 31 March 2011

Particulars	H Ltd.		S Ltd.	
	Dr. (₹)	Cr. (₹)	Dr. (₹)	Cr. (₹)
Fixed Assets	10,00,000	—	10,00,000	—
Closing Stock	2,00,000	—	1,00,000	—
Trade Debtors	2,80,000	—	1,60,000	—
Cash at Bank	1,20,000	—	60,000	—
Purchases & Sales	8,00,000	14,00,000	7,00,000	12,00,000
Wages & Salaries	1,60,000	—	1,20,00	—
Sundry Expenses	2,00,000	—	80,000	—
Debentures Interest	20,000	—	—	—
Preference Dividend	—	20,000	40,000	—
Investment in S Ltd.	8,00,000	—	—	—
Equity Share Capital	—	12,00,000	—	6,00,000
10% Preference Share Capital	—	—	—	4,00,000
10% Debentures	—	2,00,000	—	—
Trade Creditors	—	4,60,000	—	20,000
Profit & Loss A/c	—	3,00,000	—	40,000
	35,80,000	35,80,000	22,60,000	22,60,000

Additional information:

Investments in S Ltd. was acquired on 1 July 2010 and consisted of 80% of the equity capital and 50% of the preference capital the latter being at par.

Depreciation on fixed assets is as 10% p.a.

H Ltd. sold goods worth ₹ 1,20,000 at cost plus 25%; 50% of these goods are still in stock on 31 March 2011.

Solution

Consolidated P&L A/c of
H Ltd. and Its Subsidiary S Ltd.
for the Year Ended 31 March 2011

Dr. **Cr.**

Particulars	H Ltd.	S Ltd.	Adjustment ₹	Total ₹	Particulars	H Ltd. ₹	S Ltd. ₹	Adjustment ₹	Total ₹
To Purchases	8,00,000	7,00,000	1,20,000	13,80,000	By Sales	14,00,000	12,00,000	1,20,000	24,80,000
To Wages & Salaries	1,60,000	1,20,000	—	2,80,000	By Preference Dividend Received	20,000	—	20,000	—
To Debenture Interest	20,000	—	—	20,000					
So Sundry Expenses	2,00,000	80,000	—	2,80,000					
To Preference Dividend	—	40,000	20,000	20,000					
To Depreciation	1,00,000	1,00,000	—	2,00,000					
To Net Profit	1,40,000	1,60,000		3,00,000					
	14,20,000	12,00,000	1,40,000	24,80,000		14,20,000	12,00,000	1,40,000	24,80,000
To Minority Interest ₹1,60,000 × $\frac{20}{100}$	—	32,000	—	32,000	By Net Profit	1,40,000	1,60,000	—	3,00,000
To Capital Reserve ₹1,60,000 × $\frac{3}{12}$ × $\frac{80}{100}$		32,000	—	32,000					
To Stock Reserve ₹1,20,000 × $\frac{25}{125}$ × $\frac{4}{5}$ × $\frac{50}{100}$	9,600	—	—	9,600					
To Investment A/c Capital Dividend ₹ 20,000 × $\frac{3}{12}$	5,000	—	—	5,000					
To Balance Carried to Balance Sheet	1,25,400	96,000	—	2,21,400					
	1,40,000	1,60,000	—	3,00,000		1,40,000	1,60,000	—	3,00,000

CALCULATIONS:

Step 1:	Determination of Share of Capital Profit:		₹
	(i) P&L A/c on 31 March 2011		40,000
	(ii) Add: Current Year's Share of Capital Profit ₹1,60,000× $\frac{3}{12}$ (For 3 months):		40,000
	(iii) Total Capital Profits		80,000
	(iv) Share of H Ltd.: ₹80,000× $\frac{80}{100}$		64,000
	(v) Minority Share: ₹80,000× $\frac{20}{100}$		16,000
Step 2:	Determination of Share of Revenue Profits:		
	(i) Current Year's Profit		1,60,000
	(ii) Profit After Acquisition $\frac{9 \text{ months}}{12}$ × 1,60,000		1,20,000
	(iii) Share of H Ltd.: ₹1,20,000× $\frac{80}{100}$		96,000
	(iv) Minority Share: ₹1,20,000× $\frac{20}{100}$		24,000
Step 3:	Ascertainment of Minority Interest:		
	(i) Face Value of Equity Shares: 6,00,000 × $\frac{20}{100}$		1,20,000
	(ii) Add: Face Value of Preference Shares: 4,00,000× $\frac{50}{100}$		2,00,000
			3,20,000
	(iii) Add: Share of Capital Profits: [Step 1 (v)]		16,000
			3,36,000
	(iv) Add: Share of Revenue Profits [Step 2 (iv)]		24,000
	(v) Minority Interest		3,60,000
Step 4:	Calculation of Cost of Control/Goodwill:		
	(i) Share Capital (Shares in S Ltd.)		8,00,000
	(ii) Less:		
	(a) Face Value of Equity Shares Purchased		
	(b) Face Value of Pref. Shares 2,00,000 ₹4,00,000× $\frac{50}{100}$		
	(c) Share of H Ltd. in Capital Profit [Step 1 (iv)] 64,000		
	(d) Share of H Ltd. in Capital Dividend $\left(20{,}000\times \frac{3}{12}\right)$	5,000	7,49,000
	(iii) Goodwill		51,000
Step 5:	Preparation of Consolidated Balance Sheet:		

Consolidated Balance Sheet of
H Ltd. and Its Subsidiary S Ltd.
as at 31 March 2011

Liabilities		₹	Assets		₹
Shares Capital:			Goodwill [Step 4 (iii)]		51,000
Equity Share Capital	₹ 12,00,000		Fixed Assets	₹	
Minority Interest [Step 3 (v)]		3,60,000	H Ltd.	10,00,000	
Profit & Loss A/c	3,00,000		S Ltd.	10,00,000	
Add: Current Years'				20,00,000	
Profit from B/S	2,21,400	5,21,400	Less: Depreciation	2,00,000	18,00,000
			Debtors		
10% Debentures			H Ltd.	2,80,000	
Trade Creditors			S Ltd.	1,60,000	4,40,000
H Ltd.	4,60,000		Stock		
S Ltd.	20,000	4,80,000	H Ltd	2,00,000	
			S Ltd.	1,00,000	
				3,00,000	
			Less: Stock Reserve	9,600	2,90,400
			Cash		
			H Ltd.	1,20,000	
			S Ltd.	60,000	1,80,000
		27,61,400			27,61,400

Summary

Holding company: As per Section 4(4) of the Companies Act, "A company shall be deemed to be the holding company of another, if, but only if, that another is its subsidiary.

Subsidiary company: As per Section (1) of the Companies Act, a company is a subsidiary of another company, if, but only if:

1. The other company controls the composition of its board of directors

   or

2. The other company
   (a) Holds more than half in nominal value of its equity shares capital

   or

   (b) It is a subsidiary of any company which is that of other company's subsidiary

Consolidated P&L A/c and balance sheet means a single P&L A/c and balance sheet of a holding company and all its subsidiaries (Group).

Steps involved in the preparation of consolidated balance sheet and profit & Loss A/c (Ref: Main text).

Various factors to be considered for the preparation of consolidated balance sheet of a holding company and its subsidiaries:

(i) Holding–minority ratio
(ii) Elimination of investment A/c
(iii) Minority interest
(iv) Cost of control/goodwill
(v) Pre-acquisition profit (Capital profit)
(vi) Post-acquisition profit (Revenue profit)

(vii) Revaluation of assets and liabilities
(viii) Depreciation
(ix) Bonus shares issued by subsidiary company
(x) Dividends from subsidiary company
(xi) Preference shares in subsidiary company
(xii) Debentures in subsidiary company
(xiii) Mutual obligations
(xiv) Consignment liabilities
(xv) Unrealized profit in stock
(xvi) Post- and pre-acquisition losses—Abnormal losses
(xvii) Preliminary expenses

Each factor is explained (individually) in Illustrations 12.1 to 12.30 (Ref: Text)

Preparation of consolidated balance sheet of a holding company having more than one subsidiary company is explained in Illustration 12.29.

Key Terms

Holding Company: A company is said to be the holding company of another if that other company is its subsidiary.

Subsidiary Company: A company is said to be a subsidiary of another if that another company controls the composition of its Board of Directors (holding more than 50% of the nominal value of equity share capital).

Minority Interest: Holding of the general public (other than holding company) in a subsidiary company is termed as "minority interest".

Cost of Control: The "excess" amount paid (more than face value or book value of shares) by the holding company to acquire "controlling interest" in the subsidiary company.

Consolidated Balance Sheet: The balance sheet prepared by the holding company by incorporating all the assets and liabilities of its subsidiary company along with its own assets and liabilities.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. A holding company is one which controls the other company by way of holding 50% of its equity shares.
2. Holding company can become the subsidiary of another company.
3. It is not mandatory for a holding company to prepare and present "consolidated financial statements".
4. Minority interest is to be included in paid-up value of share capital.
5. The cost of control represents the amount paid by the holding company to acquire controlling interest in subsidiary company.
6. The minority share of revenue profit is to be added in computation of minority interest.
7. Pre-acquisition profits are revenue profits.
8. If shares are purchased by the holding company on the date of balance sheet, there will be no revenue profits.
9. Additional depreciation should be deducted from revenue profits.
10. Bonus issued out of capital profits will adversely affect the consolidated balance sheet.
11. Holding company's share of bonus (bonus issued out of revenue profits) should be added in computing minority interest.
12. Proposed dividend is to be added to revenue or capital profits as the case may be.
13. Minority share of the revenue dividend should be ignored.
14. Dividend due on the preference shares for the post-acquisition period should be treated as capital dividend.

15. In case, if a holding company purchases a part or all of the debentures, they should be eliminated from the consolidated balance sheet.
16. Mutual obligations should be included in the consolidated balance sheet.
17. "Investment in partly paid shares" should be shown on the assets side of the balance sheet.
18. The unrealized profit in stock should be deducted from stock.
19. If the holding company gets less than the amount of investment in shares of subsidiary, the excess is termed as "goodwill".
20. All inter-company transactions should be shown in the "Total Column" in consolidated profit and loss A/c.

Answers:

1. False	2. True	3. True
4. False	5. False	6. True
7. False	8. True	9. True
10. False	11. False	12. True
13. True	14. True	15. False
16. False	17. False	18. True
19. True	20. False	

II: Fill in the blanks with apt word(s)

1. A holding company is one which controls one or more other companies by means of holding _____ shares.
2. A holding company is one which controls one or more other companies by means of controlling the composition of _____.
3. A company is a subsidiary of another company if it is a subsidiary of any company which is that other company's _____.
4. Accounting Standard AS-21 deals with "_____".
5. "A group" represents a parent Company and all its _____.
6. The balance sheet depicting all items relating to a holding company and its subsidiaries is referred as _____.
7. Holding of the general public (after acquisition of major shares by the holding company) in the subsidiary company is known as "_____".
8. All the accumulated profits of the subsidiary company on the date of purchase of shares by the holding company are called: "_____" or "_____"
9. Profits earned by a subsidiary company after the date of acquisition of shares by the holding company are known as "_____" or "_____.
10. _____ is the excess amount paid for acquisition of shares in a subsidiary.
11. In case of appreciation on fixed assets on account of revaluation, _____ from the date of revaluation till the date of balance sheet should be provided.
12. Minority share of the bonus has to be _____to minority interest.
13. Dividend paid by subsidiary out of pre-acquisition profits is termed as _____.
14. Holding company's share of capital dividend which was to P&L A/c should be deducted from P&L A/c in the consolidated balance sheet.
15. Holding company's share of revenue dividend has to be _____ to P&L A/c.
16. Interim dividend relating to pre-acquisition period is adjusted units _____.
17. Cash in transit is to be shown on _____ side of the balance sheet as a separate item.
18. Any contingent liability involving a third party has to be shown as a _____ in the consolidated balance sheet.
19. The unrealized profit in stock should be _____ from "stock".
20. In case the holding company gets more than what it has invested in shares, the excess is treated as _____.

Answers:

1. more than 50% or majority
2. Board of Directors
3. subsidiary
4. consolidated financial statements
5. subsidiaries
6. consolidated balance sheet
7. minority interest
8. capital profit; pre-acquisition profit
9. revenue profit; post-acquisition profit
10. Cost of control/goodwill
11. additional depreciation
12. added
13. capital dividend
14. credited

15. credited
16. cost of control
17. assets
18. foot note
19. subtracted/deducted
20. capital reserve

III: Multiple choice questions—Choose the correct answer

1. A holding company is one which holds
   (a) 50% of share capital of subsidiary company
   (b) 75% of share capital of subsidiary company
   (c) more than two-thirds share capital of subsidiary company
   (d) more than 50% of share capital of subsidiary company
2. The Accounting Standard that is related to "consolidated financial statements" is
   (a) AS-21 (b) AS-14
   (c) AS-3 (d) none of the above
3. "Group accounts" constitute accounts of.
   (a) holding company
   (b) subsidiary companies
   (c) both of the above
   (d) none of the above
4. Profits earned by a subsidiary company till the date of acquisition are termed as
   (a) revaluation profits (b) capital profits
   (c) revenue profits (d) none of these
5. Profits earned after the date of acquisition by a subsidiary company are called
   (a) revenue profits (b) capital profits
   (c) revaluation profits (d) none of these
6. "Minority interest" is to be shown in consolidated balance sheet as
   (a) asset (b) liability
   (c) foot note (d) none of these
7. The "excess" paid by the holding company to acquire "controlling interest" in the subsidiary company is called
   (a) surplus (b) deficiency
   (c) cost of control (d) none of these
8. The excess of share in share capital of the subsidiary company above the amount spent on investment is called
   (a) goodwill
   (b) revenue reserve
   (c) cost of control
   (d) capital reserve
9. Revenue loss has to be
   (a) divided in holding–minority ratio
   (b) charged direct to holding company's P&L A/c
   (c) charged direct to subsidiary company's P&L A/c
   (d) none of the above
10. The holding company's share of revenue profits is
    (a) ignored
    (b) shown in consolidated balance sheet
    (c) shown in P&L A/c of holding company
    (d) added in computing minority interest
11. As per Section 212 of the Companies Act, the information to be attached to the balance sheet of a holding company with respect to subsidiary companies should
    (a) be on the same date as that of holding company
    (b) not be more than "year old"
    (c) not be more than 6 months old
    (d) be of any date
12. If the fall in the asset occurs in the post-acquisition period, the loss is treated as
    (a) capital loss (b) revenue loss
    (c) revaluation loss (d) none of these
13. Bonus issue is a capital profit when they are issued from
    (a) pre-acquisition profits
    (b) post-acquisition profits
    (c) both (a) & (b) above
    (d) none of the above
14. Interim dividend will
    (a) be shown as liability in consolidated balance sheet
    (b) be shown as asset in consolidated balance sheet
    (c) be shown in consolidated P&L A/c
    (d) not be shown in consolidated balance sheet
15. Any profit on revaluation of assets is

(a) treated as capital profit
(b) ignored
(c) shown as a separate item in the consolidated B/S
(d) treated as revenue profit

Answers:

1. (d)	4. (b)	7. (c)	10. (b)	13. (c)
2. (a)	5. (a)	8. (d)	11. (c)	14. (d)
3. (c)	6. (b)	9. (a)	12. (b)	15. (a)

Short Answer Questions

1. Define a "holding company".
2. What are the basic tenets of a "holding company"?
3. Define a "subsidiary company".
4. What do you mean by "deemed subsidiary"?
5. Mention the four important documents that a holding company has to attach with its balance sheet.
6. Enlist the main requirements of Schedule VI.
7. What do you mean by a consolidated balance sheet?
8. What is a "parent company"?
9. Explain "pre-acquisition profits".
10. Write a short note on "post-acquisition profits".
11. What do you understand by "minority interest".
12. Explain: Holding–minority ratio.
13. How will you ascertain "minority interest"?
14. What is meant by "cost of control"?
15. How will you determine "cost of control"?
16. What is "capital reserve"?
17. Explain: (a) Revenue loss (b) Capital loss.
18. Explain: "additional depreciation"
19. How will you deal with profit/loss on revaluation of the assets and the outside liabilities?
20. Explain the accounting treatment of bonus issue (i) out of capital profits (ii) out of revenue profits.
21. How will you treat "proposed dividend by the subsidiary company"?
22. Explain the accounting treatment for "interim dividend".
23. Write a note on: preference shares in subsidiary company.
24. What is meant by "capital dividend"? How it is treated?
25. What is the accounting treatment for "mutual obligations".
26. What is a contingent liability? How will a contingent liability involving a third party be shown in consolidated balance sheet?
27. Write a note on "unrealized profit in stock"

Essay Type Questions

1. What is a holding company? Explain the requirements that are to be fulfilled for a company to become a holding company? Explain with the help examples.
2. What is a consolidated balance sheet? Explain the methods of consolidating balance sheets of a holding company and its subsidiaries.
3. Explain the accounting treatment of the following while computing consolidated balance sheets of holding company and its subsidiary companies.
   (i) Elimination of investment A/c
   (ii) Minority interest
   (iii) Cost of control
   (iv) Pre-acquisition profits
   (v) Post-acquisition profits
   (vi) Pre- and post-acquisition losses
   (vii) Revaluation of assets and liabilities
   (viii) Bonus shares issued:
      (a) Out of capital profits
      (b) Revenue profits
   (ix) Dividends from a subsidiary company:
      (a) Proposed
      (b) Capital dividend
      (c) Revenue dividend

(x) Preference shares in subsidiary company
(xi) Debentures
(xii) Mutual obligations
(xiii) Contingent liabilities
(xiv) Unrealized profit in stock

4. Discuss the various steps involved in the preparation of consolidated profit and loss account.

Exercises

Part A—For Undergraduate Level

[Model: Capital and revenue profits]

1. H Ltd. acquired 15,000 equity shares in S Ltd. on 1 April 2010. On 31 December 2010, the balance sheet of S Ltd. was as follows:

Liabilities	₹	Assets	₹
Shares Capital:		Sundry Assets	32,00,000
20,000 Equity Shares of ₹100 Each R	20,00,000		
General Reserve on 1 January 2010	4,00,000		
P&L A/c ₹. Balance on 1 January 2010 1,00,000			
Profit for 2010	5,00,000		
4,00,000			
Sundry Creditors	3,00,000		
	32,00,000		32,00,000

Ascertain capital profits and revenue profits.

[B.Com Osmania University Modified]

[**Ans**:Capital profits: ₹6,00,000; Revenue profits: ₹3,00,000]

[Model: Minority interest]

2. Calculate minority interest from the balance sheet of Delhi Ltd.

Balance sheet of Delhi Ltd. as on 31 December 2010:

Liabilities	₹	Assets	₹
Share Capital:		Sundry Assets:	30,00,000
42,000 Shares of ₹100 Each	42,00,000	Plant & Machinery	21,00,000
General Reserve on 1 January 2010	18,00,000	Other Assets	4,50,000
Sundry Creditors	9,00,000	Investment (80% of Shares)	19,50,000
P&L A/c on 31 December 2010	6,00,000		
	75,00,000		75,00,000

Mumbai Ltd. acquired 80% of the shares at ₹19,50,000.

[**Ans**: Minority interest: ₹13,20,000]

[Model: Cost of control/capital reserve]

3. On 30 June 2010, two-third of the shares of S Ltd. (with a total capital of ₹48,00,000) was acquired by H Ltd. The balance sheet of S Ltd. showed a debit balance of ₹24,00,000 or 1 January 2010 and a credit balance of ₹14,40,000 on 31 December 2010. The investment by H Ltd. in shares of S Ltd. is ₹36,00,000. Calculate the cost of control or capital reserve.

[**Ans:** Cost of control/goodwill: ₹7,20,000]

[Model: Cost of control after the issue of bonus shares]

4. S Ltd. has a capital of ₹45,00,000 in shares of ₹100 each. Out of this, H Ltd. purchased 75% shares of ₹52,50,000. The profit of S Ltd. at the time of purchase of shares by H Ltd. were ₹22,50,000. S Ltd. decided to make a bonus issue out of capital profits of one share of ₹100 each fully paid for every three shares held. Calculate the cost of control after the issue of bonus shares.

[**Ans:** Cost of control/goodwill: ₹1,87,500]

[Model: Cost of control before and after the issue of bonus shares]

5. S Ltd. has a capital of ₹10,00,000 in shares of ₹100 each, out of which H Ltd. purchased 75% of the shares at ₹12,00,000. The profits of S Ltd. at the time of purchase of shares by H Ltd. were ₹5,50,000. S Ltd. decided to make a

bonus issue out of pre-acquisition profit of one share for every five shares held.

Calculate the cost of control of acquiring shares of S Ltd.:

(a) Before the issue of bonus shares

(b) After the issue of bonus shares

[**Ans**: Cost of control/goodwill:

(a) Before the issue of bonus shares— ₹37,500

(b) After the issue of bonus shares— ₹37,500]

[Model: Consolidated balance sheet—Simple problems

6. Prepare a consolidated balance sheet from the following balance sheets:

Liabilities	**H Ltd.** ₹	**S Ltd.** ₹	**Assets**	**H Ltd.** ₹	**S Ltd.** ₹
Capital:					
₹10 Shares	28,000	20,000	Sundry Assets	17,700	30,200
Creditors	7,000	3,800	Shares in S Ltd.		
P&L A/c	5,200	6,4000	18,000 Shares at Cost	22,500	—
	40,200	30,200		40,200	30,200

On the date of acquisition of shares by H Ltd. in S Ltd., the credit balance on latter's P&L A/c was ₹4,400. No dividends have been declared since that date.

[**Ans:** Capital profit: ₹4,400; Revenue profit: ₹2,000; Minority interest: ₹2,640; Goodwill: ₹540; B/S total: ₹48,440]

7. Consolidate the following balance sheets:

Liabilities	**H Ltd.** ₹	**S Ltd.** ₹	**Assets**	**H Ltd.** ₹	**S Ltd.** ₹
Capital: ₹1 Shares	7,000	5,000	4,500 Shares in S Ltd. at Cost	6,000	—
Creditors	—	2,500	Sundry Assets	1,000	9,000
P&L A/c	—	1,500			
	7,000	9,000		7,000	9,000

When H Ltd. acquired the shares in S Ltd. the P&L A/c of the latter had a credit balance of ₹1,000.

[**Ans:** Capital profit ₹1,000; Revenue profit: ₹500; Minority interest: ₹650; Goodwill: ₹600; Balance sheet total: ₹10,600]

8. From the following balance sheets, prepare a consolidated balance sheet of X Ltd. and its subsidiary Y Ltd. The interests of the minority shareholders of Y Ltd. are to be shown in the consolidated balance sheet.

Balance Sheet of
X Ltd. and Its Subsidiary Y Ltd.
as at 31 December 2010

(₹ in Lakhs)

Liabilities	**X** ₹	**Y** ₹	**Assets**	**X** ₹	**Y** ₹
Share Capital:					
4,00,000 Shares of ₹80	320	—	Land & Buildings	304	—
40,000 Shares of ₹80 Each	—	32	Plant & Machinery	44.80	6.40
General Reserve	160	—	Shares in Y Ltd. 36,000 Shares of ₹80 Each	57.60	—
Creditors	96	6.40	Stock	96	16
P&L A/c	32	48	Debtors	64	22.40
			Cash at Bank	41.60	41.60
	608	86.40		608	86.40

[**Ans**: Minority interest: ₹8,00,000; Capital reserve: ₹14,40,000; Balance sheet total: ₹6,36,80,000]

9. Balance sheets on 31 March 2010

Liabilities	**A Ltd.** ₹	**B Ltd.** ₹	**Assets**	**A Ltd.** ₹	**B Ltd.** ₹
Share Capital:			Sundry Assets:	11,15,000	7,60,000
₹10 Each	12,50,000	5,00,000	100% Shares in B Ltd.	5,85,000	
Reserves	2,50,000	1,25,000			
Creditors	2,00,000	1,50,000	Preliminary Expenses	—	15,000
	17,00,000	7,75,000		17,00,000	7,75,000

The shares of B Ltd. were acquired at ₹5,85,000 on 31 March 2010. Prepare consolidated balance sheet as on 31 March 2010.

[**Ans**: Capital profit: ₹1,10,000; Capital reserve: ₹25,000; Balance sheet total: ₹18,75,000]

10. On 31 March, 2010, the balance sheets of H Ltd. and S Ltd. stood as follows:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Sundry Assets	2,58,800	1,52,000
Shares of ₹10 Each Fully Paid	2,50,000	1,00,000	60% Shares in S Ltd. Acquired on 31 March 2010 at Cost	81,200	—
Reserves	50,000	25,000	Preliminary Expenses	—	3,000
Creditors	40,000	30,000			
	3,40,000	1,55000		3,40,000	1,55,000

Prepare the consolidated balance sheet as at 31 March 2010.

[**Ans**: Capital profit: ₹22,000; Minority interest: ₹48,800; Goodwill: ₹32,000; Balance sheet total: ₹4,18,800]

[Model: Revaluation of assets, unrealized profit in stock (Date of purchases of shares—Not given)]

11. From the balance sheets and information given below, prepare a consolidated balance sheet.

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Sundry Assets	4,00,000	60,000
₹10 per Share Fully Paid	5,00,000	1,00,000	Stock in Trade	3,05,000	1,20,000
Profit & Loss A/c	2,00,000	60,000	Debtors	65,000	85,000
Reserves	50,000	30,000	Bills Receivable	5,000	—
Creditors	1,00,000	60,000	Shares in S Ltd.		
Bills Payable	—	15,000	7,500 Shares at Cost	75,000	—
	8,50,000	2,65,000		8,50,000	2,65,000

Additional information:

1. All profits of S Ltd. have been earned since the shares were acquired by H Ltd. but the reserve of ₹30,000 was already there at the time.
2. Bills accepted by S Ltd. are all in favour of H Ltd., which has discounted ₹10,000 of them.
3. Sundry assets of S Ltd. were undervalued by ₹10,000.
4. The stock in trade of H Ltd. includes ₹25,000 bought from S Ltd. at a profit of 25% on cost to the latter.

[**Ans**: Capital profit: ₹40,000; Revenue profit: ₹60,000; Minority interest: ₹50,000; Capital reserve: ₹30,000; Provision for unrealized profit in stock: ₹5,000; Total of balance sheet: ₹10,40,000]

[Model: Mutual obligation (Date of acquisition of shares—Not given)]

12. From the following details, prepare a consolidated balance sheet of H Ltd. and its subsidiary S Ltd. as on 31 December 2010.

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Buildings	2,90,000	1,00,000
Shares of ₹10 Each	4,00,000	1,20,000	Plant	1,20,000	50,000
General Reserve	1,00,000	30,000	Stock	80,000	20,000

Profit & Loss A/c	50,000	42,000	Debtors	70,000	30,000
16% Debentures	1,40,000	—	Bills Receivable	30,000	20,000
Creditors	30,000	20,000	Bank	20,000	10,000
Bills Payable	10,000	18,000	Investment in S Ltd. (2,000 Shares)	1,20,000	—
	7,30,000	2,30,000		7,30,000	2,30,000

On the date of acquisition of shares by H Ltd. in S Ltd., the latter had undistributed profits of ₹18,000 and reserve of ₹12,000. The values of buildings and plant of S Ltd. were considered as ₹1,30,000 and ₹32,000, respectively. No purchase or sale of these assets after the acquisition of shares. Depreciation may be ignored. Debtors of H Ltd. include ₹10,000 due from S Ltd. and also bills payable of H Ltd. includes a bill of ₹6,000 accepted in favour of S Ltd.

[**Ans**: Capital profit: ₹42,000; Revenue profit:₹42,000; Minority interest: ₹68,000; Goodwill: ₹12,000; B/S total: ₹8,48,000]

[Model: Shares acquired at the beginning of accounting]

13. The following are the summarized balance sheets as on 31 December 2010:

Liabilities	**H Ltd.** ₹	**S Ltd.** ₹	**Assets**	**H Ltd.** ₹	**S Ltd.** ₹
Share of ₹10 Each	20,00,000	4,00,000	Fixed Assets	8,00,000	3,60,000
General Reserve	40,000	1,60,000	Stock	3,60,000	1,20,000
Creditors	80,000	1,20,000	Debtors	1,60,000	1,20,000
Bills Payable	—	20,000	Bills Receivable	20,000	—
			Bank Balance	4,60,000	1,00,000
			30,000 Shares in S Ltd. at Cost	3,20,000	—
	21,20,000	7,00,000		21,20,000	7,00,000

H Ltd. acquired shares in S Ltd. on 1 January 2010 when S Ltd. had ₹40,000 in general reserve. No dividend was declared by S Ltd. in 2010. All bills receivable of H Ltd. are drawn on S Ltd.

You are required to prepare a consolidated balance sheet on 31 December 2010.

[**Ans**: Capital profit: ₹40,000; Revenue profit: ₹1,20,000; Minority interest: ₹1,40,000; Capital reserve: ₹10,000; Balance sheet total: ₹24,80,000]

[Model: Unrealized profit in stock and mutual obligation]

14. X Ltd. acquired 10,000 shares of ₹10 each in Y Ltd. on 1 January 2010. The summarized balance sheets of both the companies on 31 December 2010 were as follows:

Liabilities	**X Ltd.** ₹	**Y Ltd.** ₹	**Assets**	**X Ltd.** ₹	**Y Ltd.** ₹
Shares of ₹10 Each	2,50,000	1,25,000	Fixed Assets	2,25,000	2,32,500
Reserves	1,00,000	75,000	Stock	37,500	50,000
Creditors	1,50,000	1,50,000	Debtors	75,000	1,00,000
Bills Payable	25,000	20,000	Shares in Y Ltd.	1,62,500	—
Bank Loan	—	25,000	Bills Receivable	37,500	25,000
Profit & Loss A/c	25,000	20,000	Cash	12,500	7,500
	5,50,000	4,15,000		5,50,000	4,15,000

On 1 January 2010, P&L A/c of Y Ltd. showed a debit balance of ₹25,000. Y Ltd. made a transfer of ₹15,000 to reserve on 31 December 2010.

Creditors of X Ltd include ₹25,000 for goods

supplied by Y on credit. Stock of ₹20,000 in X Ltd represents unsold goods purchased from Y Ltd. who charged profit on sale of 20%.

Bills payable of Y Ltd. included ₹15,000 accepted in favour of X Ltd. Bills receivable of X Ltd. included ₹12,500 received from Y Ltd.

Prepare a consolidated balance sheet.

[**Ans**: Capital profit: ₹35,000; Revenue profit: ₹60,000; Minority interest: ₹44,000; Goodwill: ₹34,500; Balance sheet total: ₹7,95,500]

15. From the following balance sheet of H Ltd and S Ltd., prepare a consolidated balance sheet of H Ltd. & S Ltd.

Balance Sheets as on 31 December 2010

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share of ₹1 Each	72,000	30,000	Sundry Assets	1,20,000	48,000
Reserve	30,000	6,000	Investment in Shares of S Ltd. (30,000 Shares)	39,000	—
P&L A/c	12,000	6,000			
Creditors	45,000	6,000			
	1,59,000	48,000		1,59,000	48,000

Shares were acquired by H Ltd. in S Ltd. on 30 June 2010. S Ltd. transferred ₹3,000 from profits to reserve on 31 December 2010.

[**Ans:** Capital profit: ₹7,500; Revenue profit: ₹4,500; Goodwill: ₹1,500; Balance sheet total: ₹1,69,500]

[Model: Shares acquired on a later date—Mutual obligations, unrealized profit in stock]

16. The following are the balance sheets of H Ltd. and S Ltd. on 31 December 2010:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:			Goodwill	15,000	10,000
Shares of ₹10 Each	3,00,000	1,25,000	Fixed Assets	2,90,000	1,00,000
General Reserve	80,000	47,500	Stock	80,000	40,000
Profit for the Year	1,10,000	60,000	Investments in 7,500 Shares of S Ltd.	1,00,000	—
Bills Payable	10,000	—	Bills Receivable	—	7,500
Sundry Creditors	50,000	17,500	Sundry Debtors	40,000	57,500
			Cash in Hand	25,000	35,000
	5,50,000	2,50,000		5,50,000	2,50,000

(i) H Ltd. acquired the shares of S Ltd. on 1 September 2010

(ii) Bills payable of H Ltd. was wholly in favour of S Ltd.

(iii) Debtors of S Ltd. include ₹7,500 owed by H Ltd.

(iv) Stock of H Ltd. includes ₹5,000 worth of goods bought from S Ltd. on which the latter company has made a profit of 25% on cost.

Prepare the consolidated balance sheet.

[**Ans**: Capital profit: ₹87,500; Revenue profit: ₹20,000; Minority interest: ₹93,000; Capital reserve: ₹27,500; Net capital reserve in B/S: ₹2,500; Provision for unrealized profit: ₹1,000; B/S total: ₹6,59,000]

[Model: Interim dividend]

17. A Ltd. acquired the whole of the shares in B Ltd. on 1 July 2010 at a total cost of ₹2,80,000. The balance sheets of both the companies as at 31 December 2010 were as follows:

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Shares of ₹ 50 Each	3,75,000	1,25,000	Land & Buildings	2,57,500	75,000
General Reserve on 1 January 2010	2,37,500	5,000	Plant & Machinery	75,000	67,750
Profit & Loss A/c	2,00,000	90,000	Debtors	70,000	39,500
Creditors	37,500	40,250	Stock	85,000	50,500
			Investments	2,80,000	—
			Cash at Bank	82,500	27,500
	8,50,000	2,60,250		8,50,000	2,60,250

(i) The balance of profit & loss A/c of B Ltd. on 1 January 2010 was ₹ 70,000. Included in the purchases from B Ltd. were goods for ₹ 15,000 on which B Ltd. made a profit of ₹ 3,750.

(ii) Stock of A Ltd. included ₹ 7,500 purchased from B Ltd. (part of ₹ 15,000)

(iii) Profit & Loss A/c of A Ltd. included interim dividend at the rate of 16% p.a. from B Ltd.

Make necessary adjustments and show a consolidated balance sheet as at 31 December 2010.

[**Ans**: Capital profit: ₹ 85,000; Revenue profit: ₹ 10,000; Goodwill: ₹ 60,000; B/S total: ₹ 8,88,375]

[Model: Revaluation of assets and depreciation]

18. A Ltd. acquired 8,000 shares in B Ltd. of ₹ 100 each on 1 July 2010, On 31 December 2010, the balance sheets of the two companies were as follows:

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Capital (₹ 100) Shares	25,00,000	10,00,000	Buildings	7,50,000	9,00,000
Reserve	12,00,000	5,00,000	Machinery	12,00,000	6,75,000
P&L A/c	2,86,000	4,10,000	Investment in B Ltd.	17,00,000	—
Bank Overdraft	4,00,000	—	Stock	6,00,000	1,82,000
Bills Payable	—	42,000	Debtors	2,20,000	2,00,000
Creditors	2,35,500	45,000	Bills Receivable	79,000	—
			Cash	72,500	40,000
	46,21,500	19,97,000		46,21,500	19,97,000

(i) P&L A/c of B Ltd. showed a balance of ₹1,50,000 on 1 January 2010 out of which 10% dividend was paid on 1 August. A Ltd. has credited the dividend to P&L A/c.

(ii) The machinery which stood at ₹ 7,50,000 on 1 January was revalued as ₹ 9,00,000 on 1 July 2010. This figure is to b\e adjusted.

(iii) B Ltd. has sold stocks worth ₹ 1,75,000 charging 25% on cost to A Ltd. Still half of the goods remain with A Ltd.

(iv) Of the debtors of A Ltd., ₹ 30,000 are from B Ltd.

Prepare the consolidated balance sheet in the books of A Ltd. as on 31 December 2010.

[**Ans**: Capital profit: ₹ 9,17,500; Revenue profit: ₹ 1,72,500; Minority interest: ₹ 4,18,000; Goodwill: ₹ 86,000; P&L A/c: ₹ 3,26,500; B/S total: ₹ 51,37,000]

[Model: Bonus issue of shares from general reserve]

19. H Ltd. acquired 15,000 equity shares of ₹ 10 each in S Ltd on 31 March 2010, on which date the balance sheets are as follows:

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Shares of ₹ 10 Each	5,00,000	2,00,000	Machinery	2,90,000	1,50,000
Shares Premium	1,00,000	—	Furniture	55,000	25,000
General Reserve	2,50,000	1,85,000	15,000 Shares in S Ltd	3,00,000	—
P&L A/c	19,000	80,000	Stock	2,21,500	1,90,000
Creditors	82,500	42,500	Debtors	60,000	85,000
Proposed Dividend	75,000	—	Cash	1,00,000	57,500
	10,26,500	5,07,500		10,26,500	5,07,500

On 31 March 2010, the directors of S Ltd. proposed a dividend of 10% on the shares capital of ₹ 2,00,000 and made a bonus issue of one equity share for every four equity shares held using general reserve.

Effect of bonus is to be incorporated in the above given balance sheets.

Prepare a consolidated balance sheet as at 31 March 2010.

[**Ans**: Capital profit (excluding dividend): ₹ 1,95,000;

Bonus: ₹ 50,000; Capital reserve: ₹ 48,750;

Balance sheet total: ₹ 12,34,000]

[Model: Consolidated profit and loss A/c]

20. X Ltd. purchased 54,000 equity shares and 1,800 preference shares in Y Ltd. on 1 January 2010. Both the companies make up their accounts on 30 June each year. The following figures are extracted from their records for the year ended 30 June 2010:

Particulars	X Ltd. ₹	Y Ltd. ₹
Sales	32,40,000	30,60,000
Purchases	18,00,000	17,40,000
Selling Expenses	1,60,000	2,40,000
Administration Expenses	4,00,000	1,80,000
Interim Divided: Paid on Reference Sheets	—	40,000
Stock on 1 July 2010	1,80,000	3,60,000
Paid-up Share Capital:		
Equity Shares of ₹ 10 Each	10,80,000	7,20,000
10% Preference Shares of 100 Each	—	4,00,000
P&L A/c Balance on 1 July 2010	1,00,000	1,20,000

The following additional information is relevant:

(i) Closing Stock X Ltd.: ₹ 3,00,000 and Y Ltd.: ₹ 3,40,000

(ii) Provision for tax to be made—X Ltd.: ₹ 5,40,000; Y Ltd.: ₹ 4,00,000

(iii) Y Ltd. sold goods worth ₹ 1,60,000 at cost plus 25% to X Ltd. which company had 50% of then as unsold stock.

Prepare consolidated P&L A/c.

[**Ans:** Consolidated profit: ₹ 18,58,000; Profit of X Ltd.: ₹ 10,18,000; Profit of Y Ltd.: ₹ 8,40,000; Minority interest in current year's profit:₹ 2,10,000; Capital reserve: ₹ 3,15,000: Provision for unrealized profits: ₹ 16,000]

Exercises

Part B—For Advanced Level

[Model: Revaluation of assets, dividend out of pre-acquisition profits, contingent liability]

21. Jupiter Ltd. purchased control of Neptune Ltd. on 1 October 2010. Following are the balance sheets of two companies as at 31 March 2011:

Liabilities	Jupiter ₹	Neptune ₹	Assets	Jupiter ₹	Neptune ₹
Equity Share Capital of ₹10 Each	10,80,000	5,40,000	Goodwill	18,000	72,000
General Reserve	1,08,000	90,000	Land & Building	1,80,000	1,80,000
P&L A/c	1,80,000	1,80,000	Plant & Machinery	3,60,000	3,24,000
Creditors	1,80,000	1,26,000	Stock in Trade	2,11,500	1,80,000
Bills Payable to Jupiter Ltd	—	18,000	Debtors	90,000	1,62,000
Contingent Liability of Jupiter Ltd for ₹27,000	—	—	Investment in 40,500 Shares of Neptune Ltd	6,07,500	—
For Bills Discounted	—	—	Cash at Bank	81,000	36,000
	15,48,000	9,54,000		15,48,000	9,54,000

Neptune Ltd. had on 1 April 2010 ₹90,000 in general reserve and ₹1,08,000 (Cr.) in P&L A/c. 10% dividend was received by Jupiter Ltd. in November for 2009–10 and this amount was credited to P&L A/c of holding company. Plant & machinery standing in the books of Neptune Ltd. as ₹3,60,000 on the date of purchase was revalued at ₹4,32,000. Stock of Neptune Ltd. includes ₹28,800 received from Jupiter Ltd. on which it made a profit of 25% on cost. Ignore corporate dividend tax. Prepare the consolidated balance sheet.

[B.Com (Hons) Calcutta University Modified]

[**Ans**: Goodwill: ₹29,250; Minority interest: ₹2,24,100; B/S total: ₹19,14,390; Contingent liability: ₹9,000]

[Model: Acquisition of shares during the current accounting year—Unrealized profit in stock]

22. The following are the balance sheets of VR Ltd. and its subsidiary RS Ltd. as at 31 March 2011:

Liabilities	V R Ltd ₹	R S Ltd ₹	Assets	V R Ltd ₹	R S Ltd ₹
Equity Share of ₹10 Each Fully Paid	24,00,000	8,00,000	Machinery	15,60,000	5,40,000
General Reserve	13,60,000	3,20,000	Furniture	3,20,000	1,60,000
Profit & Loss A/c	4,00,000	2,40,000	80% Shares in RS Ltd. at Cost	13,60,000	—
Creditors	2,80,000	1,40,000	Stock	7,20,000	4,80,000
			Debtors	2,00,000	1,20,000
			Cash at Bank	2,80,000	2,00,000
	44,40,000	15,00,000		44,40,000	15,00,000

The following additional information is provided to you:

(i) The P&L A/c of RS Ltd. stood at ₹1,20,000 on 1 April 2010 whereas general reserve has remained unchanged since that date

(ii) VR Ltd. acquired 80% of shares in RS Ltd. on 1 October 2010 for ₹13,60,000. As mentioned above.

(iii) Included in debtors of RS Ltd. is a sum of ₹40,000 due from VR Ltd. for goods sold at a profit of 25% on cost price. Till 31 March 2011, only one half of the goods had been sold while the remaining goods were laying tin warehouse of VR Ltd. as on that date.

Prepare the consolidated balance sheet as at 31 March 2011.

[B.Com (Hons) Delhi 1990, 1994 Modified]

[**Ans**: Minority interest ₹2,72,000, Cost of contiol ₹3,20, 000, B/S Total ₹48,56,000

[Model: Revaluation of assets and goods destroyed by fire]

23. The following are the balance sheets of B Ltd. and V Ltd. as on 31 December 2010:

Liabilities	B Ltd. ₹	V Ltd. ₹	Assets	B Ltd. ₹	V Ltd. ₹
Equity Shares of ₹100 Each Fully Paid	15,00,000	6,00,000	Fixed Assets	10,50,000	4,50,000
General Reserve	3,00,000	—	Stock	2,70,000	1,20,000
Profit & Loss A/c	2,40,000	—	Debtors	1,80,000	90,000
14% Debentures	—	3,00,000	14% Debentures in V Ltd. at par}	1,80,000	—
Creditors	2,25,000	1,35,000	Equity Shares in V Ltd. @ ₹80 per Share}	3,60,000	—
			Bank	2,25,000	75,000
			Profit & Loss A/c	—	3,00,000
	22,65,000	10,35,000		22,65,000	10,35,000

B Ltd. acquired these 4,500 shares on 1 May 2010. The profit & loss A/c of V Ltd. showed a debit balance of ₹4,50,000 on 1 January 2010. During March 2010, goods costing ₹18,000 were destroyed against which the insurance company paid only ₹6,000 to V Ltd. Creditors of V Ltd. include ₹60,000 for goods supplied by B Ltd. on which V Ltd. made a profit of ₹6,000. Half of the goods were sold out of this.

An item of plant (included in fixed assets) V Ltd. had book value of ₹45,000 was to be revalued at ₹60,000 on 1 January 2010 (ignore depreciation).

Prepare the consolidated balance sheet.

[B.Com (Hons) Delhi 2002 Modified]

[**Ans:** Goodwill; ₹2,04,750; Minority interest: ₹78,750 Balance sheet total: ₹26,16,750]

[Model: Bonus shares out of its reserves and dividend pair]

24. Balance sheets of two companies as on 31 March 2011 are given as follows:

(₹ in 000's)

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital:	4,000	2,000	Fixed Assets	1,920	1,000
Reserves	400	680	Stocks	1,680	1,600
Profit & Loss A/c	640	520	Debtors	1,200	1,400
Current Liabilities	1,760	800	Investments in Shares of S Ltd.	2,000	—
	6,800	4,000		6,800	4,000

Other information:

(i) H Ltd. acquired 60% shares of S Ltd. on 1 July 2010

(ii) Reserves and profit and loss A/c of S Ltd. on 1 April 2010 had balances of ₹10,00,000 and ₹4,80,000, respectively.

S Ltd. had issued bonus shares out of its reserves in the ratio of 1:4 on 1 October 2010.

(iii) No entry has been made in the books of H Ltd. for this.

(iv) S Ltd. also paid dividend @ 25% on its capital of ₹16,00,000 pre-acquisition profits on 1 October 2010 which were recorded by H Ltd.

Prepare consolidated balance sheet of H Ltd. and S Ltd.

[B.com (Hons) – Delhi – 2005 – Modified]

[**Ans:** Minority interest: ₹12,80,000; B/S total: ₹91,14,000]

[Model: Interim dividend—Paid]

25. H Ltd. acquired 80% shares in S Ltd. on 30 September 2010 as a total cost of ₹10,80,000. The balance sheets of both the companies as at 31 March 2011 were as follows:

Balance Sheet of H Ltd.
as at 31 March 2011

Liabilities	₹	Assets	₹
Equity Shares Capital	22,50,000	Land & Building	12,45,000
Security Premium	1,50,000	Plant & Machinery	6,75,000
General Reserve	12,00,000	Furniture & Fittings	4,50,000
Profit & Loss A/c	7,20,000	80% Shares in S Ltd.	10,80,000
Creditors	1,80,000	Stock	4,35,000
		Debtors	2,55,000
		Bank	3,60,000
	45,00,000		45,00,000

Profit & loss A/c balance includes interim dividend @ 10% per annum received from S Ltd.

Balance Sheet of S Ltd.
as on 31 March 2011

Liabilities	₹	Assets	₹
Equity Shares (75,000 of ₹10 Each Fully Paid)	7,50,000	Plant & Machinery	4,50,000
General Reserve on 1 April 2010	3,30,00	Furniture & Fittings	1,95,000
Profit & Loss A/c	2,40,000	Stock	4,83,000
Creditors	2,10,000	Debtors	2,37,000
		Bank	1,65,000
	15,30,000		15,30,000

On 1 April 2010, S Ltd.'s P&L A/c showed a credit balance of ₹1,20,000. S Ltd. declared interim dividend of 10% on 1 January 2010. Assume no taxation.

Prepare a consolidated balance sheet of H Ltd. and its subsidiary S Ltd. as at 31 March 2011.

[B.Com (Hons) Delhi 2004 Modified]

[**Ans:** Goodwill: ₹42,000; Minority interest: ₹2,64,000; Balance sheet total: ₹49,92,000]

[Model: Wholly owned subsidiary]

26. From the following balance sheets and additional information, prepare a consolidated balance sheet of X Ltd. and its subsidiary Y Ltd.:

Balance Sheets
as on 31 March 2011

Particulars	X Ltd. ₹	Y Ltd. ₹
Liabilities:		
Shares of ₹100 Each	25,00,000	5,00,000
Profit & Loss Account	10,00,000	3,00,000
Reserves	3,00,000	1,50,000
Bills Payable	—	75,000
Creditors	5,50,000	3,00,000
	43,50,000	13,25,000
Assets:		
Fixed Assets	20,00,000	3,00,000
Stock	15,00,000	6,00,000
Debtors	3,75,000	4,25,000
Bills Receivable	1,00,000	—
Shares in Y Ltd. at Cost	3,75,000	—
	43,50,000	13,25,000

Additional information:

(i) Bills accepted by Y Ltd. are all in favour of X Ltd.

(ii) The stock of X Ltd. includes ₹1,25,000 purchased from Y Ltd. at a profit to the latter of 20% on sales

(iii) All the profits of Y Ltd. have been earned since the shares were acquired by X Ltd. but there was already reserve of ₹1,50,000 at that date

[B.Com (Hons) Delhi 2006 Modified]

[**Ans:** Capital reserve: ₹2,75,000; Unrealized profit in stock: ₹2,500; Balance sheet total: ₹52,00,000]

[Model: Revaluation of assets, depreciation, dividend and interim dividend, unrealized profit in stock]

27. The following are the balance sheets of H Ltd. and S Ltd. as on 31 March 2011:

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Share Capital ₹250 Each Fully Paid	27,00,000	9,00,000	Land & Buildings	18,54,000	5,40,000
Reserve	17,10,000	36,000	Machinery	5,40,000	4,86,000
Profit & Loss A/c	14,40,000	6,48,000	Debtors	10,80,000	2,40,000
Loan from S Ltd.	34,200	—	Stock	6,12,000	3,60,000
Creditors	2,37,600	2,89,000	Investment in Shares of S Ltd.	14,40,000	—
			Bank	5,95,800	1,99,800
			Loan to H Ltd.	—	48,000
	61,21,800	18,73,800		61,21,800	18,73,800

Additional information:

(i) H Ltd. acquired 80% of Shares of S Ltd. on 1 April 2010, when the balances of Reserve and P&L A/c were ₹36,000 and ₹5,04,000, respectively.

(ii) Land and Buildings of S Ltd. whose book value on 1 April 2010 was ₹5,76,000 and ₹5,04,000, respectively.

(iii) Machines of S Ltd. whose book value was ₹5,40,000 on 1 April 2010 was revalued as ₹7,20,000 but no entry was made in this regard.

(iv) S Ltd. declared an interim dividend of 16% during the year ending 31 March 2011 and a final dividend of 6% an account of the year ended 31 March 2010. H Ltd. credited the entire amount of dividends received from S Ltd. to its profits & loss A/c.

(v) Stock of H Ltd. includes goods worth ₹54,000 supplied by S Ltd.

(vi) Sundry creditors of H Ltd. include ₹1,08,000 for purchases from S Ltd. on which H Ltd. made a profit of ₹27,000.

(vii) On 31 March 2011, H Ltd. remitted cash of ₹15,600 for loan received from S Ltd. Interest accrued ₹1,800 for loan to H Ltd. has not been provided by S Ltd.

Prepare consolidated balance sheet of H Ltd. and its subsidiary S Ltd. as on 31 March 2011.

[B.Com (Hons) Delhi 2007 Modified]

[**Ans:** Cost of Control/Goodwill: ₹2,01,600; Minority interest: ₹3,36,060; Unrealized profit in stock: ₹13,500; Balance sheet total: ₹66,97,800]

[Model: Revaluation of assets, dividends paid]

28. H Ltd. acquired 96,000 equity shares of ₹10 each in S Ltd. on 1 October 2010 for ₹19,36,800. The balance sheets of two companies as on 31 March 2011 were as follows:

Liabilities:	X Ltd. ₹	Y Ltd. ₹
Shares Capital of ₹100 Each	30,00,000	12,00,000
Reserves (1 April 2010)	14,40,000	6,00,000
Profit & Loss Account	3,43,200	4,92,000
Bank Overdraft	6,00,000	—
Bills Payable	—	78,000
Sundry Creditors	4,18,800	1,20,000
	58,02,000	24,90,000

Assets:	H Ltd. ₹	S Ltd. ₹
Land & Building	10,80,000	11,40,000
Plant & Machinery	14,40,000	8,10,000
Investments	21,60,000	—
Stock	6,84,000	2,52,000
Debtors	2,64,000	2,40,000
Bills Receivable	88,800	—
Cash	85,200	48,000
	58,02,000	24,90,000

(i) The P&L A/c of S Ltd. showed a balance of ₹1,80,000 on 1 April 2010 out of which a dividend of 10% was paid on 1 November 2010. The dividend was correctly recorded by H Ltd.

(ii) The plant & machinery of S Ltd. which stood at ₹9,00,000 on 1 April 2011 was considered worth ₹10,80,000 on the date of acquisition by H Ltd.

Prepare consolidated balance sheet together with work sheet.

[B.Com (Hons) Delhi 2008 Modified]

[**Ans:** Cost of control: NIL; Minority interest: ₹5,01,600; Balance sheet total: ₹66,67,200]

[Model: Contingent liability, dividend paid, unrealized profit in stock, Mutual obligations]

29. H Ltd. acquired 1,28,000 equity shares of ₹10 each in S Ltd. on 1 October 2010 for ₹24,00,000. The balance sheets of the two companies as at 31 March 2011 were as follows:

Liabilities	**H Ltd.** ₹	**S Ltd.** ₹
Equity Shares of ₹100 Each Fully Paid up	40,00,000	16,00,000
General Reserve (1 April 2010)	19,20,000	8,00,000
Profit & Loss A/c	4,80,000	7,20,000
Unclaimed Dividend	—	8,000
Bills Payable	—	1,20,000
Sundry Creditors	16,00,000	3,52,000
	80,00,000	36,00,000
Assets	**H Ltd.** ₹	**S Ltd.** ₹
Land and Building	16,00,000	17,60,000
Plant & Machinery	24,00,000	12,00,000
Investments	32,00,000	—
Stock	2,00,000	1,20,000
Debtors	1,60,000	2,00,000
Bills Receivable	40,000	80,000
Bank Balance	4,00,000	1,60,000
Preliminary Expenses	—	80,000
	80,00,000	36,00,000

Note: Contingent liability for bills discounted ₹80,000.

Additional information:

(i) On 1 April 2010, the P&L A/c of S Ltd. showed a credit balance of ₹2,80,000 out of which a dividend of 10% was paid on 1 November 2010. The dividend was credited by H Ltd. to its P&L A/c. Ignore corporate dividend tax.

(ii) Creditors of S Ltd. include an amount of ₹1,20,000 for purchases from H Ltd. The goods are still unsold on 31 March 2011. H Ltd. sells goods at cost plus 20%.

(iii) Bills payable of S Ltd. are all issued in favour of H Ltd. Of these bills, H Ltd. got discounted bills worth ₹80,000.

Prepare consolidated balance sheet.

[B.Com (Hons) 2009 Modified]

[**Ans:** Goodwill: ₹80,000; Unrealized profit in stock: ₹20,000; Minority interest: ₹6,16,000; B/S total: ₹90,20,000]

[Model: Dividend paid, mutual obligations, unrealized profit in stock, revaluation of assets]

30. Mili Ltd. took over the control of Noorie Ltd. on 1 July 2010 by acquiring 30,000 shares at a price of ₹4,80,000.

Balance Sheet as at 31 March 2011

Liabilities	**Mili Ltd.** ₹	**Noori Ltd.** ₹	**Assets**	**Mili Ltd.** ₹	**Noori Ltd.** ₹
Share of ₹10 Each	10,00,000	4,00,000	Goodwill	80,000	60,000
General Reserve	2,00,000	1,20,000	Buildings	4,00,000	2,60,000
P&L A/c	2,80,000	1,80,000	Plant	3,20,000	1,80,000
Creditors	1,60,000	1,00,000	Stock	2,00,000	1,80,000
Bills Payable	—	80,000	Debtors	40,000	1,50,000
			Investments: 30,000 Shares in Noorie Ltd.	4,80,000	—
			Bank	1,20,000	50,000
	16,40,000	8,80,000		16,40,000	8,80,000

The P&L A/c and general reserve of Noorie Ltd. showed a balance of ₹1,00,000 & ₹1,20,000, respectively, on 1 April 2010. A dividend was paid at the rate of 15% by Noorie Ltd. in the month of September 2010 for the year 2009–10. This dividend was credited to P&L A/c by Mili Ltd. The bills payable of Noorie Ltd. were all issued in favour of Mili Ltd. The receiving company got these bills discounted with the bank. Creditors of Noorie Ltd. included ₹40,000 due to Mili Ltd. for goods supplied by the latter company. Stock of Noorie Ltd. included ₹16,000 worth of stock purchased from Mili Ltd. at a profit of $33\frac{1}{3}$ % on cost. The plant of Noorie Ltd. with book value of ₹2,00,000 on 1 April 2010 was revalued at ₹3,00,000 at the time of taking the control of Noorie Ltd. The new value has not been incorporated in the books.

Prepare consolidated balance sheet as at 31 March 2011. Show clearly all the calculations and workings.

[B.Com (Hons) Delhi 2010 Modified]

[**Ans:** Goodwill: ₹50,000; Minority interest: ₹1,99,376; Balance sheet total: ₹20,02,500]

[Model: Bonus issue and corporate dividend tax]

31. On 31 March 2011, the balance sheets of H Ltd. and S Ltd. stood as follows:

(₹ in 000's)

Liabilities	H Ltd. ₹	S Ltd. ₹	Assets	H Ltd. ₹	S Ltd. ₹
Authorized Capital			Plant & Machinery	7,623	7,350
Equity Share Capital: Issued & SubscribXed:	15,000	9,000	Furniture & Fittings	1,845	894
Equity Shares of ₹10 Each Fully Paid	12,000	7,200	Investment in Equity shares of S Ltd	4,500	—
General Reserve	2,784	2,070	Stock	2,949	2,658
Profit & Loss A/c	3,915	2,430	Debtors	2,100	2,049
Bills Payable	372	240	Bills Receivable	360	285
Sundry Creditors	1,461	1,281	Cash & Bank Balances	1,230	306
Provision for Taxation	660	540	Sundry Advances	780	570
Other Provisions	195	51			
	21,387	13,812		21,387	13,812

Following additional information is available:

(i) H Ltd. purchased 270 thousands equity shares in S Ltd. on 1 April 2010 at which date the following balances stood in the books of S Ltd.:

General reserve: ₹4,500 thousands; P&L A/c: ₹1,989 thousands

(ii) On 14 July 2010, S Ltd. declared a dividend of 20% out of pre-acquisition profits and paid corporate dividend tax (including surcharge) as 11%. H Ltd. credited the dividend received to P&L A/c.

(iii) On 1 November 2010, S Ltd. issued three fully paid equity shares of ₹10 each for every five shares held as bonus shares out of pre-acquisition general reserve.

(iv) On 31 March 2011, the stock of S Ltd. included goods purchased for ₹150 thousands from H Ltd., which had made a profit of 25% on cost.

Prepare a consolidated balance sheet as on 31 March 2011. [C.A. (Final). 2002 Modified]

[**Ans:** Capital reserve: ₹19,80,000; Minority interest: ₹46,80,000; Balance sheet total: ₹3,06,69,000]

[Model: Bonus issued]

32. On 31 March 2010, P Ltd acquired 4,20,000 shares of Q Ltd for ₹48,00,000. The balance sheet of Q Ltd on that date was as follows:

Liabilities	₹	Assets	₹
6,00,000 Equity Shares of ₹10 Each Fully Paid	60,00,000	Fixed Assets	42,00,000
Pre-incorporation Profits	1,20,000	Current Assets	25,80,000
Profit & Loss A/c	2,40,000		
Creditors	4,20,000		
	67,80,000		67,80,000

On 31 March 2011, the balance sheets of two companies were as follows:

Liabilities	P Ltd ₹	Q Ltd ₹	Assets	P Ltd ₹	Q Ltd ₹
Equity Shares of ₹10 Each Fully Paid (Before Bonus Issue)	1,80,000	60,00,000	Fixed Assets	3,16,80,000	92,40,000
Securities Premium	36,00,000	—	4,20,000 Equity Shares in Q Ltd at Cost	48,00,000	—
Pre-incorporation Profits	—	1,20,000	Current Assets	1,76,40,000	70,20,000
General Reserve	2,40,00,000	76,20,000			
Profit & Loss A/c	63,00,000	16,80,000			
Creditors	22,20,000	8,40,000			
	5,41,20,000	1,62,60,000		5,41,20,000	1,62,60,000

Directors of Q Ltd made bonus issue on 31 March 2011 in the ratio of one equity share of ₹10 each fully paid for every two equity shares held on that date.

Calculate as on 31 March 2011:

(i) Cost of control/capital reserve

(ii) Minority interest

Prepare a consolidated balance sheet after the bonus issue. [C.A. (Final). 2003 Modified]

[**Ans:** Consolidated profits before bonus issue: ₹1,26,42,000; Consolidated profit after bonus issue: ₹1,05,40,000; Minority interest: ₹46, 26,000; Capital reserve: ₹17,52,000 Balance sheet total: ₹6,55,80,000]

[Model: Investment in different dates, dividend mutual obligation, unrealized profit in stock]

33. Following are the balance sheets of H Ltd and S Ltd as at 31 March 2011:

Liabilities	H Ltd ₹	S Ltd ₹	Assets	H Ltd ₹	S Ltd ₹
Equity Shares Capital of ₹10 Each Fully Paid	18,00,000	3,00,000	Land & Building	6,00,000	3,00,000
General Reserve	1,50,000	90,000	Machineries	8,40,000	1,50,000
Profit & Loss A/c	2,40,000	1,20,000	21,000 Shares of S Ltd	3,00,000	—
Sundry Creditors	3,00,000	1,20,000	Stock	2,10,000	1,20,000
Bills Payable	30,000	45,000	Debtors	4,50,000	60,000
			Bills Receivable	30,000	—
			Cash at Bank	90,000	45,000
	25,20,000	6,75,000		25,20,000	6,75,000

Additional information:

(i) All the bills receivable of H Ltd including those discounted were accepted by S Ltd

(ii) When 18,000 shares were acquired by H Ltd in S Ltd, it had ₹60,000 general reserve and ₹15,000 credit balance in P&L A/c

(iii) At the time of acquisition of further 3,000 shares by H Ltd, S Ltd had ₹75,000 general reserve and ₹84,000 credit balance in P&L A/c from which 20% dividend was paid by S Ltd and dividend received by H Ltd on these shares were credited to P&L A/c

(iv) Stock of S Ltd includes ₹60,000 purchased from H Ltd which has made 25% profit on cost

(v) Both companies have proposed dividend—H Ltd 10%; S Ltd 15% but no effect has been given in the above balance sheets

Prepare consolidated balance sheet as at 31 March 2011.

[C.A. (Final). Modified]

[**Ans:** Goodwill: ₹28,100; Minority interest: ₹1,53,000; P&L A/c of H Ltd: ₹42,000; Balance sheet total: ₹28,82,100]

[Model: Preference shares, proposed dividend, unrealized profit in stock, stock in transit, cash in transit]

34. H Ltd acquired 80% of the equity shares and 50% of the preference shares of S Ltd on 1 April 2010 at cost of ₹14,40,000 and ₹60,000, respectively. The balance sheets of the companies as at 31 March 2011 were as follows:

Balance Sheets

Particulars	H Ltd ₹	S Ltd ₹
Land & Building at Cost	6,00,000	8,00,000
Equipment at Cost	9,15,000	3,10,000
Investment in S Ltd	15,00,000	—
Stock	4,00,000	3,50,000
Debtors	8,00,000	4,50,000
Bank	50,000	60,000
Current Account	95,000	—
	43,60,000	19,70,000
Equity Shares (₹10 Each)	20,00,000	7,50,000
10% Cumulative Preference Shares	—	1,00,000
Reserves (1 April 2010)	11,00,000	4,50,000
Retained Profit for 2010–11	1,00,000	90,000
Sundry Creditors	8,00,000	3,50,000
Proposed Dividend	1,00,000	70,000
Provision for Depreciation:		
Land & Building	60,000	30,000
Equipment	2,00,000	60,000
Current Account	—	70,000
	43,60,000	19,70,000

Other information:

(1) A remittance of ₹10,000 from H Ltd to S Ltd in March 2011 was not received by S Ltd until April 2011.

(2) Goods with an invoice value of ₹15,000 were dispatched by H Ltd. in March 2011 but were not received by S Ltd until April 2011. The profit element included in this transaction is ₹2,500.

(3) Included in the stock of S Ltd at 31 March 2011 were goods purchased from H Ltd for ₹50,000. The profit element included in this amount was ₹4,000.

(4) Proposed dividend of S Ltd included a full year's preference dividend. No interim dividends were paid in the year by either company.

You are required to prepare a consolidated balance sheet of H Ltd and its subsidiary S Ltd as at 31 March 2011.

[I.C.W.A. (Final). Modified]

[**Ans:** Cost of control/Goodwill: ₹4,90,000; Minority interest: ₹3,08,000; Balance sheet total: ₹48,94,800]

[Model: Revaluation of assets, depreciation, unrealized profit in stock]

35. A Ltd. purchased control of B Ltd. on 1 July 2010. Following are the balance sheets of the two companies on 31 December 2010:

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Equity Share capital of ₹10 Each	10,80,000	5,40,000	Goodwill	18,000	72,000
General Reserve	1,08,000	90,000	Land & Buildings	1,80,000	1,80,000
Profit & Loss A/c	1,80,000	1,80,000	Plant & Machinery	3,60,000	3,24,000
Creditors	1,80,000	1,26,000	Stock in Trade	2,11,500	1,80,000
Bills Payable in A Ltd	—	18,000	Debtors	90,000	1,62,000
			Investments in 40,500 Shares in B Ltd	6,07,500	—
			Cash at Bank	81,000	36,000
	15,48,000	9,54,000		15,48,000	9,54,000

Note: Contingent liability of A Ltd. for ₹27,000 for bills discounted.

B Ltd. had on 1 January 2011 ₹90,000 in general reserve and ₹1,08,000 (Cr.) in P&L A/c. 10% dividend was received by A Ltd. in July 2010 from B Ltd. and this amount was credited to P&L A/c of holding company. Plant & machinery standing in the books of B Ltd. at ₹3,60,000 on the date of purchase was revalued at ₹4,32,000. Stock of B Ltd. includes ₹28,800 received from A Ltd. on which it made a profit of 25% on cost.

Prepare the consolidated balance sheet.

[I.C.W.A. (Final). Modified]

[**Ans:** Capital reserve: ₹67,500; Minority interest: ₹2,19,600; Unrealized profit in stock: ₹5,760; Consolidated P&L A/c: ₹1,58,040; B/S total: ₹18,89,640; Contingent liability: ₹9,000]

[Model: More than one subsidiary companies—gross holdings, dividends, unrealized profit in stocks]

36. The following is the balance Sheets of Red Ltd. and its two subsidiaries Yellow Ltd. and White Ltd. as at 31 March 2011:

Particulars	Red Ltd. ₹	Yellow Ltd. ₹	White Ltd. ₹
Equity Shares of ₹10 Each	12,50,000	7,50,000	5,00,000
Profit and Loss A/c	3,00,000	30,000	—
General Reserve	3,50,000	—	—
12% Debentures	—	—	2,50,000
11% Debentures	4,50,000	—	—
Sundry Creditors	3,00,000	1,50,000	2,00,000
Proposed Dividend	1,25,000	—	—
Bills Payable	25,000	20,000	50,000
	28,00,000	9,50,000	10,00,000
Fixed Assets:			
Investments	12,30,000	5,60,000	4,50,000
45,000 Shares in Yellow Ltd.	5,10,000	—	—
40,000 Shares in White Ltd.	4,50,000	—	—
Current Assets:			
Stock	3,00,000	1,50,000	2,70,000
Debtors	2,75,000	2,00,000	1,80,000
Cash and Bank	20,000	15,000	45,000
Bills Receivable	15,000	25,000	40,000
Profit & Loss A/c (Dr.)	—	—	15,000
	28,00,000	9,50,000	10,00,000

Addition information:

1. Red Ltd. acquired its shares in Yellow Ltd. and White Ltd. on 1 April 2010, on which date the P&L A/c balances of the latter companies showed the following position:

Yellow Ltd (Dr.): ₹25,000

White Ltd (Cr.): ₹45,000

2. In June 2010, Red Ltd. received equity dividends of ₹20,000 from White Ltd. for the year 2009–10 (out of the profits earned prior to 1 April 2010). The dividends were credited to its P&L A/c by Red Ltd.
3. The bills payable of Yellow Ltd. are all in favour of White Ltd
4. Stocks of Red Ltd. include goods of ₹15,000 and ₹20,000 representing purchases made from Yellow Ltd., and White Ltd. earns a margin of 33.33% on cost.

You are required to prepare a consolidated balance sheet as at 31 March 2011.

[I.C.W.A. (Final). 2000 Modified]

[**Ans:** Cost of control: Yellow Ltd.—₹75,000; White Ltd.—₹14,000; Minority interest Yellow—₹3,12,000; White—₹97,000; Consolidated profits: ₹6,29,200; B/S total: ₹38,38,200]

[Model: Purchase and sale of asset—Mutual obligations]

37. Following are the draft balance sheets of two companies A Ltd. and B Ltd. as at 31 March 2011:

(₹ in Lakhs)

Liabilities	A Ltd. ₹	B Ltd. ₹	Assets	A Ltd. ₹	B Ltd. ₹
Share Capital (₹100 Each)	30.00	15.00	Fixed Assets	25.00	7.50
Profits:			Investments:		
Capital profit	4.00	4.25	12,000 Shares in B Ltd.	15.00	—
Revenue profit	16.00	1.45	6,000 Shares in A Ltd.	—	10.00
Creditors	7.50	4.05	Current Assets:		
			Debtors	10.00	4.00
			Stock	2.00	1.50
			Cash & Bank	5.50	1.75
	57.50	24.75		57.50	24.75

The following adjustments were not yet made:

1. Stock worth ₹25,000 in B Ltd. was found to be obsolete with no value
2. A Ltd. acquired an asset costing ₹2,50,000 on 31 March 2011. No effect has been given for both the purchase and payment.
3. During the year, A Ltd. sold an asset for ₹3,00,000 (original cost ₹2,00,000). The profit was included in revenue profits.
4. Debtors of A Ltd. included a sum of ₹2,50,000 owed by B Ltd.

You are required to prepare a consolidated balance Sheet of both the companies as on 31 March 2011 after giving effect to the above transactions.

[C.A. (Final). Modified]

[**Ans:** Minority interest in revenue profits: ₹1,00,000; Minority interest in capital profits ₹1,25,000; Minority interest: ₹5,25,000; Goodwill: ₹2,00,000; Balance sheet total: ₹56,60,000]

[Model: More than one subsidiary companies—Consolidated P&L A/c]

38. The final sections of the profit & loss accounts of A Ltd, B Ltd and C Ltd for the year ended 31 December 2010 are as follows:

A Ltd

Particulars	₹	Particulars	₹
Proposed Dividend	1,00,000	Net Profit for 2010	1,23,000
Balance c/d	70,000	Balance on 31 December2009	47,000
	1,70,000		1,70,000

B Ltd

Particulars	₹	Particulars	₹
Balance Carried Forward	50,000	Net Profit for 2010	40,000
		Balance on 31 December 2009	10,000
	50,000		50,000

C Ltd

Particulars	₹	Particulars	₹
Net Loss for 2010	7,000	Balance on 31 December 2009	8,500
Balance Carried Forward	1,500		
	8,500		8,500

A Ltd acquired the whole share capital of C Ltd on 31 December 2009 and three-quarters of the share capital of B Ltd on 31 December 2008.

The balance of ₹10,000 on P&L A/c of B Ltd as on 31 December 2009 represents a credit balance of ₹6,000 brought forward from 2008 and a net profit of ₹4,000 in 2009.

No dividend has been paid by either B Ltd or C Ltd since the holding company acquired the shares.

You are required to prepare the final section of the consolidated profit & Loss account of A Ltd for the year ended 31 December 2010.

[C.S. Modified]

[**Ans:** Revenue profits: A Ltd—₹96,000; B Ltd—₹44,000; C Ltd—₹7,000; Capital Profits: B Ltd—₹6,000; C Ltd—₹8,500]

[Model: Consolidated P&L A/c]

39. Consolidated to prepare a consolidated profit & loss A/c for the year ended 31 December 2010, suitable for incorporation in the published accounts of A Ltd which will not include a separate P&L A/c for the holding company.

Particulars	A Ltd ₹	B Ltd ₹
P&L A/c Balance as 1 January 2010	7,20,000	3,00,000
Trading Profit	14,20,000	8,00,000
Dividends (Gross) from B Ltd (Preference)	1,08,000	—
Dividends (Gross) from B Ltd (Ordinary)	1,50,000	—
	23,98,000	11,00,000
Depreciation	2,40,000	80,000
Debentures Interest	2,00,000	—
Taxation	4,40,000	3,00,000
Director's Emoluments	1,40,000	60,000
Dividends Paid:	—	60,000
6% Preference:	—	60,000
On 30 June		
On 31 December		
Ordinary Shares:		
Interim on 30 June	2,40,000	1,00,000
Final on 31December	2,40,000	1,00,000
P&L A/c Balance as on 31 December 2010	8,98,000	3,40,000
	23,98,000	11,00,000
Information Relating to Share Capital:		
Ordinary Shares of ₹1 Each Fully Paid	80,00,000	40,00,000
6% Preference Shares of ₹1 Fully Paid	—	20,00,000
Shares in B Ltd Held by A Ltd:		
Ordinary Shares Acquired on 1 July 2010	—	30,00,000
Preference Shares Acquired on 1 January 2010	—	18,00,000

Income and expenditure are deemed to accrue evenly throughout the year. All dividends are payable out of the current year's profits. The directors of B Ltd. resigned on 1 July 2010 and were replaced on that day by directors of A Ltd who are to receive the same remuneration as the former directors.

[**Ans:** Balance carried forward: A Ltd—₹8,23,000; B Ltd—₹15,000; Total: ₹8,38,000]

[Model: Interim dividend, corporate dividend tax, mutual obligation, unrealized profit on stock]

40. The balance sheets of Ashish Ltd. and Anand Ltd. as on 31 March 2011 are as follows:

(₹ in 000's)

Liabilities	AshishLtd. ₹	Anand Ltd. ₹
Equity Share Capital:		
Fully Paid Shares of ₹10 Each	1,20,000	30,000
General Reserve as on 1 April 2010	84,000	1,200
Profit and Loss Account	51,000	21,600
Sundry Creditors	21,000	10,500
	2,76,000	63,300

Assets	₹	₹
Buildings	84,000	17,400
Plant & Machinery	60,000	15,600
Furniture & Fittings	4,500	2,100
Investments	60,000	—
Stock	60,000	—
Sundry Debtors	22,500	12,600
Cash at Bank	24,000	9,600
	21,000	6,000
	2,76,000	63,300

Prepare a consolidated balance sheet after considering the following:

(i) Ashish Ltd. acquired 24 lakh equity shares of Anand Ltd. on 1 July 2010 at ₹ 6 crore.

(ii) Stock of Ashish Ltd. includes ₹ 18 lakh relating to stock purchased from Anand Ltd. which sells goods at cost plus 25%.

(iii) Sundry creditors of Ashish Ltd. includes ₹ 30 lakh due to Anand Ltd.

(iv) P&L A/c of Ashish Ltd. includes interim dividend received from Anand Ltd. on 1 August 2010.

(v) On 1 April 2010, balance of P&L A/c in Anand Ltd.'s ledger stood at ₹ 1,71,30,000. Out of this balance, an interim dividend @ 10% was paid on 1 August 2010. Corporate dividend tax @ 11% was also paid on the amount of interim dividend.

Profits during the year 2010–11 have been earned by Anand Ltd. on a uniform basis throughout the year.

[C.S. (Inter). Modified]

[**Ans:** Goodwill: ₹ 20,040 thousand; Minority interest: ₹ 10,560 thousand; Balance sheet total ₹ 2,95,980 thousand]

Accounts of Banking Companies 13

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Define bank, banking company and scheduled bank.
2. Appraise business of banking companies.
3. Understand and interpret minimum paid-up capital and reserves.
4. Know the details of unclaimed deposits and liquidity requirements.
5. Enlist the principal books of accounts of a banking company, subsidiary ledgers, other books and registers and statistical books, and their usage.
6. Understand the salient features of banking accounting.
7. Know the meaning and significance of SLIP system of ledger posting.
8. Prepare and present final accounts of banking companies.
9. Know the usage of different formats of schedules to be furnished with balance sheet (Schedules 1–18).
10. Treat the following: Transactions relating to bills, demand drafts, travellers' cheques, letters of credit, branch adjustment income recognition, loans and advances including NPAs.
11. Explain certain key terms associated with banking.

Accounting procedure for banking companies differs from those of other joint stock companies. Despite the fact that banking companies are incorporated under the Companies Act, 1956, they have to strictly comply with the provisions of The Banking Regulations Act, 1949. In addition, the banking companies will have to adhere to the norms and guidelines issued by the Reserve Bank of India (RBI Act 1934). One has to understand all the important statutory provisions of these acts in order to prepare final accounts of banking companies. In this chapter, all such salient features have been discussed in detail and accounting procedure is explained in various illustrations.

13.1 DEFINITION AND MEANING OF BANK, BANKING AND BANKING COMPANY

Bank: In its broadest sense, the term "bank" is used to refer any institution, which is engaged in carrying on certain kinds of financial business. It may be defined as follows: "A bank is an organization that holds money, important documents and other valuables in safe keeping and the money being paid out on the customer's order/request." A bank deals with money. It acts in the same way as a trader buys and sells goods at a profit. It is involved in financial trading activities.

Banking: The Banking Regulation Act, 1949 [Section 5(b)] defines banking as, "accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawals by cheque, draft or otherwise".

Banking company: As per Section 5(c) of the Banking Regulation Act, banking company means any company, which transacts the business of banking in India.

13.2 FORMS OF BUSINESS OF BANKING COMPANIES

According to Section 6 of the Banking Regulation Act, a bank, in addition to banking business, may indulge in the forms of business, which are listed as follows:

(i) Borrowing, raising or taking up money.
(ii) Lending or advancing money.
(iii) Drawing, making, accepting, discounting, buying, selling, collecting and dealing with bills of exchange, hundis, promissory notes and other instruments.
(iv) Granting and issuing of letters of credit, travellers' cheques and circular notes.
(v) Buying, selling and dealing with bullion.
(vi) Buying and selling, on commission, and underwriting and dealing with stock, shares, debentures, bonds, etc.
(vii) Receiving all kinds of scripts or valuables on deposit for safe custody.
(viii) Providing safe deposit vaults.
(ix) Collecting and transmitting money and securities.
(x) Carrying on and transacting every kind of guarantee and indemnity business.
(xi) Undertaking and executing trusts.
(xii) Undertaking the administration of estates as executor, trustee or otherwise.
(xiii) Contracting for public and private loans and negotiating and issuing the same.
(xiv) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into accounts or otherwise dealing with all or any part of the property and rights of the company.
(xv) Doing all such things, which are incidental or conductive to the promotion or advancement of the business of the company.
(xvi) Any other form of business, which the Central Government may, by notification in the "Official Gazette", specify as a form of business in which it is for a banking company to engage.
(xvii) Acquiring and undertaking the whole or any part of the business of any person or a company when such business is of a nature enumerated or described in this sub-section.

No banking company shall engage in any form of business other than those mentioned above, as per Section 6(2) of the Banking Regulation Act, 1949.

13.3 CLASSIFICATION OF COMMERCIAL BANKS

Commercial banks are classified into two: (1) scheduled banks and (2) other banks.

Scheduled bank: A scheduled bank is one which is included in the second schedule of Reserve Bank of India Act, 1934. A scheduled bank should comply with the following terms:

(i) It must have paid-up capital and reserves as specified in the table below.
(ii) The activities to be carried out should not be detrimental to the interests of the depositors.

(iii) It should be incorporated under the Companies Act, 1956, that is, it should not be the sole trader for a partnership firm of business organization.

13.3.1 Minimum Paid-up Capital and Reserves

According to Section 11 of the Banking Regulations Act, the minimum limits of paid-up capital and reserve to be completed by a banking company are explained in the following table:

Type I:	Companies Incorporated in India	Aggregate Value of Paid-up Capital and Reserves (₹)
(A)	(i) For a banking company incorporated in india having places of business in more than one state	5,00,000
	(ii) If any such place or places of business is/are situated in the city of bombay (now, Mumbai) or Calcutta (now, Kolkata) or both	10,00,000
(B)	If all places of business in one state but none of them in bombay or calcutta:	
	(i) For principal place of business in one state except in the city of Bombay and Calcutta	1,00,000
	plus	
	(ii) For each other places of business in the same district	10,000
	plus	
	(iii) For each place of business situated outside that district (Subject to an overall limit of ₹ 5,00,000)	25,000
	(iv) For having only one place of business and that also not in Mumbai or Kolkata	50,000
(C)	If it has all places of business in one state or more:	
	(i) One or More of Which is/are in the city of Mumbai or Kolkata	5,00,000
	plus	
	(ii) In respect of each place of business situated outside the city of Mumbai or kolkata (Subject to an Overall Limit of ₹ 10,00,000)	25,000

Type II:	Companies Incorporated Outside India	Aggregate Amount of Paid-up Capital and Reserve
(i)	If It Has No Place of Business in Mumbai or Kolkata But Has Business Elsewhere	15,00,000
(ii)	If It Has Place or Places of Business in the City of Mumbai, Kolkata or Both.	20,00,000
[***Note:***	These will apply to those banks, which were established before 1962. The Banking Companies (Amendment) Act, 1962 raised the Minimum Amount of the Value of Paid-up Capital to ₹ 5,00,000, If it commences business after 1962]	

13.4 IMPORTANT LEGAL PROVISIONS OF BANKING REGULATION ACT 1949

Important legal provisions of Banking Regulation Act, 1949 are as follows:

1. **Trading restrictions:** As per Section 8, a banking company cannot directly or indirectly deal with the business of buying or selling or bartering of goods, except in connection with the realization of security given to or held by it or engage in any trade or buy, sell or barter goods for others otherwise than in connection with bills of exchange received for collection or negotiation or for the administration of estates as executor, trustee or otherwise.
2. **Non-banking assets:** In case of a failure of a debtor to repay the loan within the stipulated period, the bank can take possession of such assets mortgaged. As per Section 9, a banking company cannot hold any immovable property, however acquired, except for its own use, for any period exceeding 7 years from the date of acquisition there of. The gain or loss on the sale of such assets should be shown in the P & L A/c of the banking company separately.
3. **Authorized capital, subscribed capital and paid-up capital:**

   As per Section 12,

   (i) The subscribed capital of a banking company must not be less than half (50%) of its authorized capital.

   (ii) Its paid-up capital must not be less than half (50%) of its subscribed capital.

   (iii) The share capital of a banking company should comprise of only equity or ordinary shares and such preference shares, which have been issued prior to 1 July 1944.

   (iv) The voting right of a shareholder on poll in respect of any shares held by him is limited to 10% of the total voting rights of all the shareholders of the company (w.e.f. 31 January 1994).
4. **Payment of commission, brokerage, etc.:**

   According to Section 13, a banking company cannot pay out directly or indirectly any commission, brokerage, discount or remuneration in any form in respect of any shares issued by it, exceeding 2½% of the paid-up value of the shares.
5. **Charge on uncalled capital:** As per Section 14, a banking company cannot create any charge on unpaid capital. Any such charge is null and void.

   According Section 14A, a banking company cannot create a floating charge on the undertaking or any property of the bank except with the written permission of the RBI certifying that the charge will not be detrimental to the interest of the depositors.
6. **Payment of dividend:** According to Section 15, a banking company cannot make payment of dividend until all of its capitalized expenses are completely written off. Payment of dividend out of profits is not proper when capitalized expenses are outstanding. Preliminary expenses, organization expenses, share-selling commission, brokerage, amounts of losses incurred and any expenditure not represented by tangible assets are examples for capitalized expenses.

   A banking company, however, may pay dividends on its shares without writing off the following:

   (i) Depreciation in the value of its investments in approved securities where such depreciation has not been actually capitalized or otherwise accounted for as loss.

   (ii) Depreciation in the value of its investment in other than approved securities where adequate provision has been made to the satisfaction of the auditors of the company.

   (iii) Bad debts, if any, where adequate provision has been made.
7. **Statutory reserve fund:** According to Section 17, every banking company incorporated in India should create a reserve fund and transfer at least 20% of its profit to such reserve funds before any dividend is declared.

   According to RBI direction, every bank has to transfer 25% of the net profits to statutory reserve.

8. **Cash reserves:** Under Section 18, every non-scheduled bank shall maintain a cash reserve with itself or with RBI, a sum equivalent to at least 3% of its total time and demand liabilities in India on the last Friday of the second preceding fortnight and shall submit to the RBI before 20th day of every month a return showing the amount so held on alternate Fridays during a month with particulars of its demand and time liabilities in India on such Fridays or if any such Friday is a public holiday, at the close of the business on the preceding working day. From June 1994, banks are required to maintain with RBI a uniform average daily balance (cash reserve) of 15% of their entire net demand and time liabilities.

   It is important to note that from 22 June 2006 the RBI can prescribe the cash reserve ratio (CRR) for scheduled commercial banks without any ceiling rate. Hence, the statutory minimum CRR of 3% of the total demand and time liabilities no longer exist.

   At present CRR is 6% w.e.f. December 2010.

9. **Liquidity requirements:** As per the amendment envisaged to Section 24 by the Banking Regulation (Amendment) Act, 2007, effective from 2007, the RBI can prescribe the statutory liquidity ratio (SLR) for scheduled commercial banks in specified assets. The value of such assets of a scheduled commercial bank shall not be less than such a percentage not exceeding 40% of its total demand and time liabilities. The RBI can specify this norm from time to time. At present, the norm for SLR as per RBI is 24% from December 2010.

Any banking company, scheduled or non-scheduled, is required to maintain cash, gold or unencumbered approved securities, which is not less than 25% of the total of its time and demand liabilities in India. This is also referred to "statutory liquidity ratio" (SLR).

Prescribed form: Under Sections 29–33 of the Banking Regulation Act, every banking company is required to prepare a balance sheet in accordance with Form A set out in the Third Schedule of the said Act and a P & L A/c in conformity with Form 15 of the same schedule. The formats have been revised with effect from 1 April 1991.

Accounting year: A banking company has to close its account on 31 March every year, i.e. the accounting year commences on 1 April and closes on 31 March next year.

Loans and advances: There are certain restrictions on the loans granted by banks to persons associated with their management. As per Section 20, the restrictions are as follows:

1. A banking company cannot grant loans and advances on the security of its own shares.
2. It should not grant any loan or advance to:
   (i) Any of its directors.
   (ii) A firm in which any of its directors is interested as a partner, manager, or employee.
   (iii) Any company of which any of the directors of the banking company is a director, manager or guarantor.
   (iv) Any individual with whom any of its directors is a partner or a guarantor.

13.4.1 Unclaimed Deposits

Banking companies must submit the details regarding all the accounts, which could not be operated for 10 years. At the end of each calendar year, it should be submitted in the prescribed form to RBI. In case of fixed deposits, the said term of 10 years must be reckoned from the date of expiry (maturity) of such fixed deposit.

Limits as to investments in shares and debentures: RBI has removed the limits on investments made by the banks in the equity and debenture issues of 17 financial institutions such as LIC, UTI, IDBI, ICICI, IRBI and so on.

13.5 PRINCIPAL BOOKS OF ACCOUNTS

In order to understand the working of a bank, certain principal books of accounts have to be explained. The following are some of them:

13.5.1 Cash Book

The main activity of a bank is the transaction of money. Every transaction in cash should be entered in a book called cash book. Usually, a bank maintains two cash books: one is for receiving cash and the other is for paying cash. Receiving cashier records the following:

(a) Serial number
(b) Name of the depositor
(c) The amount received

When a client deposits money, he pays it along with the duly filled in paying-in-slip. The cashier (receiving cashier) receives money and returns the counterfoil of the paying-in-slip to the client after signing and stamping it.

When payment is made, the paying cashier receives a token from the client given to him by another bank staff to whom the client gives the cheque/withdrawal slip to withdrawl the amount from his account. The paying cashier records the following in the cash book maintained by him:

(a) Serial number
(b) Name of the payee
(c) Token number
(d) The amount

On the basis of paying-in-slips received by the receiving cashier and the cheques and withdrawal slips received by the paying cashier, these transactions are first entered in the accounts of the customers (clients) and then day books are written.

Cash book is the master book. It is used to verify all accounts. This type of procedure provides a good control over cash transactions. This is also known as "Slip system of posting".

Cash balance book, cash reserve book and day book are all important books of account with respect to cash transactions.

13.5.2 General Ledger

General ledger contains accounts of all personal ledgers, P & L A/c and accounts of all assets. From this, the trial balance and balance sheet may be prepared at ease. All transactions are first recorded in the books and then posted to ledger.

Accounts with respect to income items (revenue in nature) are entered in the general ledgers.

Some banks prepare P & L A/c in the general ledger and maintain separate books for revenue and expense items.

Some banks maintain summary of revenue accounts in the general ledger.

As the general ledger contains the total accounts of all ledgers it is an important book of accounts.

13.5.3 Subsidiary Ledgers

The following are the various types of ledgers for different purposes:

(i) Receiving cashier's (counter) cash book
(ii) Paying cashier's (counter) cash book
(iii) Savings bank accounts ledger
(iv) Current accounts ledger

(v) Recurring deposit accounts ledger
(vi) Fixed deposit accounts ledger
(vii) Fixed deposit interest ledger
(viii) Loan ledger and O/D register
(ix) Investment ledger
(x) Cash certificate ledger
(xi) Bills discounted and purchased ledgers
(xii) Inward and outward bills for collection ledgers
(xiii) Customers' acceptances, endorsements and guarantee ledgers

13.6 REGISTERS

In addition to books and ledgers, banks maintain the following registers and other books to record various other transactions. It is important to note that these books and registers are not based on double-entry system.

(i) Bills for collection register
(ii) Securities register (securities against loan granted)
(iii) Demand drafts, telegraphic transfers and mail transfers registers
(iv) Safe deposit vault register
(v) Jewellery register
(vi) Standing-order register
(vii) Cheques and dishonoured cheques
(viii) Document register
(ix) Letters of credit register
(x) Letter of guarantee register

13.7 SYSTEM OF BANKING ACCOUNTING

13.7.1 Salient Features

Procedure for banking accounting is entirely different from that of trading concerns. Salient features of banking accounting are as follows:

(i) **Slip system (or voucher system):** Considering the emergent exigencies of recording the transactions immediately, slip system of posting to ledger is adopted. (This system is explained in detail in the forthcoming pages.)
(ii) **Voucher summary sheets:** Transactions are entered in the accounts of customers straight from the vouchers. Then, they are summarized on summary sheets. After that total of these vouchers are posted to the control accounts in the general ledger.
(iii) **Self-balancing system:** Banking companies used to maintain the ledgers on the self-balancing system. The general ledger contains control accounts or total accounts relating to subsidiary ledgers. At regular intervals, the total balances of individual accounts are compared with the balances of control accounts.
(iv) **Daily trial balance:** The general ledger entries are extracted and got tallied every day.
(v) **Double voucher system:** Two different vouchers are used to record non-cash transactions: (1) Debt vouchers and (2) Credit vouchers.

13.7.1.1 Slip System (or) Voucher System of Ledger Posting

"Slip system of ledger posting" is defined as a method of instant posting of books of accounts on double-entry system.

In this system, entries are recorded in the accounts of the customers in the ledgers straight from different slips and not from subsidiary books or journals. After that, a day book is written up. Then, entries in the accounts of the customers are tallied with those in the day book.

Thus, the posting in the ledger accounts and writing of the day book are done simultaneously.

Slips are loose leaves of journals or cash books.

A slip is nothing but a voucher. Some of such slips are: pay-in-slips, cheques, withdrawal forms and dockets.

Slip system is essential for the following reasons:

1. It is essential for a bank to know at any time its position in relation to each individual customer, and the transactions have to be recorded immediately without loosing much time gap. This system is a boon to fulfil its aim.
2. This system facilitates the banks to keep their customers' accounts accurate and up to date—may be up to time.
3. It saves time and labour, as all the slips (except dockets) are filled in by the customers themselves.
4. It serves as objective evidence of records, as they are filled in by the customers.

Advantages of slip system: The following are the advantages of slip system:

1. **Reduction of work load:** The workload of the staff (mainly clerical) is reduced to a great extent, as all the slips (except dockets) are filled in by the customers themselves.
2. **Saves time:** Much time is saved as all transactions are recorded on the basis of slips.
3. **Division of labour:** This system paves the way of division of work among the bank staff.
4. **Responsibility with accountability:** The slip system fixes the responsibility of each employee and the errors made by any one can be easily accounted for.
5. **No interruption:** This type of procedure is carried out by the employees without any interruption.
6. **Eliminates subsidiary books:** As posting is done on the basis of slips, there is no need to maintain subsidiary books.
7. **Easy and early detection of errors:** Each transaction is entered in different books by different employees. At the end of the day, each book gets tallied. If it does not tally, the errors can be easily spotted on the same day and rectified immediately.
8. **Accurate and trustworthy:** All books are maintained on self-balancing system. Hence it is accurate and trustworthy.
9. **Facilitates auditing:** An important function of auditing is "vouching". Vouchers facilitate the task of auditing to a great extent.
10. **Objective evidence:** It serves as an objective evidence of record for transactions as slips are entered and signed by the customers themselves.

Disadvantages of slip system:

1. **Risk of loss:** As transactions are huge, and each such transaction is based on loose slip, there is a chance of loss of slips.
2. **Maintenance:** Maintaining a large number of slips is an arduous task. Keeping a date-wise record is not an easy affair.
3. **Easy to manipulate:** Dishonest employees can misuse by destroying the slips.
4. **No verification:** In case if a slip is lost or destroyed wilfully by a dishonest personnel, it will be very difficult to verify it.

5. **Customer's role:** As each customer may not be well versed in filling up the variety of forms, their role has become vital. Any negligence on their part will mar the entire accounting process.

13.8 PREPARATION AND PRESENTATION OF FINAL ACCOUNTS

A strange feature is that banking companies are not required to prepare their final accounts as per Schedule VI of the Companies Act, 1956. But according to Section 29 of the Banking Regulation Act, they have to prepare these accounts in accordance with Form A (for balance sheet) and Form B (for P & L A/c) of Schedule III annexed to Banking Regulation Act, 1949.

First, let us discuss the preparation of P & L A/c of the banking companies.

The Third Schedule
(Section 29)
From B
From of Profit and Loss Account
Profit and Loss Account
for the Year Ended on 31 March ……

(000's Omitted)

		Schedule No.	Year Ended on 31 March ….. (Current Year) ₹	Year Ended on 31 March …. (Previous Year) ₹
I.	Income:			
	Interest Earned	13	…	…
	Other Income	14	…	…
	Total:		…	…
II.	Expenditure:		…	…
	Interest Expended	15	…	…
	Operating Expenses	16	…	…
	Provisions & Contingencies		…	…
	Total:		…	…
III.	Profit/Loss:			
	Net Profit/Loss (–) for the Year			
	Profit/Loss (–) Brought Forward			
	Total:			
IV.	Appropriations:			
	Transfer to Statutory Reserves		…	…
	Transfer to Other Reserves		…	…
	Transfer to Govternment/Proposed Dividend		…	…
	Balance Carried Over to Balance Sheet		…	…
	Total:			

Note: 1. The total income includes income of foreign branches at ₹…….
2. The total expenditure includes expenditure of foreign branches at ₹…..
3. Surplus/deficit of foreign branches at ₹ ….

Schedules

Schedules to be Annexed to Profit and Loss Account

Schedule 13—Interest Earned

		Year Ended on 31 March ….. (Current Year) ₹	Year Ended on 31 March… (Previous Year) ₹
I.	Interest/Discount on Advances/Bills	…	…
II.	Income on Investments	…	…
III.	Interest or Balances with RBI and Other Inter-bank Funds	…	…
IV.	Others	…	…
	Total:	…	…

Schedule 14—Other Income

		As on 31 March…. (Current Year) ₹	As on 31 March…. (Previous Year) ₹
I.	Commission, Exchange & Brokerage	…	…
II.	Profit on Sales of Investments Less: Loss on Sale of Investments	…	…
II.	Profit on Revaluation of Investments Less: Loss on Revaluation of Investments	…	…
IV.	Profit on Sale of Land, Building and Other Assets Less: Loss on Sale of Land, Buildings & Other Assets	…	…
V.	Profit on Exchange Transactions Less: Loss on Exchange Transactions	…	…
VI.	Income Earned by Way of Dividends, etc. From Subsidiaries/ Companies and/or Joint Ventures Abroad/in India	…	…
VII.	Miscellaneous Income	…	…
	Total:	…	…
	Note: Under items II–V loss figures may be shown in brackets.		

Schedule 15—Interest Expended

		As on 31 March…. (Current Year) ₹	As on 31 March …. (Previous Year) ₹
I.	Interest of Deposits	…	…
II.	Interest on RBI/Inter-bank Borrowings	…	…
III.	Others	…	…
	Total:	…	…

Schedule 16—Operating Expenses

		As on 31 March…. (Current Year) ₹	As on 31 March …. (Previous Year) ₹
I.	Payments to and Provisions for Employees	…	…
II.	Rent, Taxes and Lighting	…	…
III.	Printing and Stationery	…	…
IV.	Advertisement and Publicity	…	…
V.	Depreciation on Bank's Property	…	…
VI.	Directors' Fees, Allowances and Expenses	…	…
VII.	Auditors' Fees and Expenses (Including Branch Auditors' Fees and Expenses)	…	…
VIII.	Law Charges	…	…
IX.	Postages, Telegrams, Telephone, etc.	…	…
X.	Repairs and Maintenance	…	…
XI.	Insurance	…	…
XII.	Other Expenditure	…	…
	Total:	…	…

13.9 GUIDELINES OF RBI FOR PROFIT AND LOSS ACCOUNT

1. Schedule 13—Interest earned:

(a) **Interest/discount on advances/bills:**

The following items are to be included under this head:

Interest and discount on all types of loans and advances such as (i) cash credits; (ii) demand loans; (iii) overdrafts, (iv) export loans, (v) loans, (vi) domestic and foreign bills purchased and discounted and rediscounted, (vii) overdue interest and (viii) interest subsidy with respect to such advances and/or bills.

(b) **Income on investments:** All types of income derived from investment portfolio by way of interest and dividend are to be included in this category.

(c) **Interest on balances with RBI and other bank funds:** It includes interest on balances with RBI and other banks, call loans, money market placements and so on.

(d) **Others:** It includes any other discount/interest income not included in the above three categories.

2. Schedule 14—Other income:

(a) **Commission, exchange and brokerage:** It includes all types of remuneration on services such as commission on collections, commission/exchange on remittances and transfers, commission on Govt. business, commission on other permitted agency business including consultancy and other services, brokerage, etc. on securities. It does not include foreign exchange income.

(b) **Profit on sale of investment:** Less—Loss on sale of investments.

(c) **Profit on revaluation of investments:** Less—Loss on revaluation of investments. Net profit/loss on revaluation of assets has to be shown.

(d) **Profit on sale of land, buildings and other assets:** Less—Loss on sale of land, buildings and other assets. It includes profit/loss on sale of securities, furniture, land and buildings, motor vehicles, gold, silver and so on. If the net position is a loss, it is to be shown as a deduction.

(e) **Profit on exchange transactions:** Less—Loss on exchange transactions. It includes profit/loss on dealing with foreign exchange; all income earned through foreign exchange and the commission and charges on foreign exchange transactions excluding interest. Only the net position should be shown.

(f) Income earned by way of dividends from subsidiary companies and joint ventures abroad and in India.

(g) **Miscellaneous income:** It includes recoveries from constituents for godown rents, income from bank's properties, security charges, insurance, etc. and any other miscellaneous income. In case, if any item under this head exceeds 1% of the total income, then such particulars may be given in the notes.

3. Schedule 15—Interest expended:

(a) **Interest on deposits:** It includes interest paid on all types of deposits from banks and other institutions.

(b) **Interest on RBI/Inter bank borrowings:** It includes discount/interest on all borrowings and refinance from RBI and other banks.

(c) **Others:** It includes discount/interest on all borrowings reference from financial institutions. All other payments like interest on participation certificate and panel interest paid may be included in this category.

4. Schedule 16—Operating expenses:

(a) **Payment to and provisions for employees:** It includes staff salaries/wages, allowances, bonus and other staff benefits like provided fund, pension, gratuity, leave fare concessions, staff welfare, medical allowances to staff and so on.

(b) **Rent, taxes and lighting:** It includes rent paid by the banks on buildings, municipal and other taxes paid (excluding income tax and interest tax), electricity and other similar charges and levies. House rent allowance and other similar payment to staff should appear under the head "payment to and provisions for employees".

(c) **Printing and stationery:** It includes expenditure on books and forms and stationery used by the bank and other printing charges, which are not incurred by way of publicity expenditure.

(d) **Advertisement and publicity:** It includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity matter.

(e) **Depreciation on bank's property:** It includes depreciation on bank's own property, motor cars and other vehicles, furniture, electric fittings, vaults, lifts, leasehold properties, non-banking assets and so on.

(f) **Directors' fees, allowances and expenses:** It includes sitting fees and all other items of expenditure incurred on behalf of directors. The daily allowance, total charges, conveyance charges, etc., which though in the nature of reimbursement of expenses incurred may be included under this head. Similar expenses of local committee members may also be included under this head.

(g) **Auditor's fees and expenses (including branch auditor's fees and expenses):** It includes the fees paid to the statutory auditors and branch auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspections and audits and other services the expenses incurred in that context including fees may not be included under this head but shown under "other expenditure".

(h) **Law charges:** It includes all legal expenses and reimbursement of expenses incurred with respect to legal service.

(i) **Postage, telegrams, telephone, etc.:** It includes all postal and courier charges, telegrams, telephones, fax, e-mail, internet expenses and so on.

(j) **Repairs and maintenance:** It includes repairs to bank property, their maintenance charges and so on.

(k) **Insurance:** It includes insurance charges on bank's property, insurance premia paid to deposit insurance and Credit Guarantee Corporation, etc. to the extent they are not recovered from the concerned parties.

(l) **Other expenditure:** All expenses other than those not included in any of the other heads like license fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. may be included under this head. If any particular item under this head exceeds 1% of the total income, particulars are made for bad and doubtful debts, provision for taxation and provision for diminution in the notes.

5. **Provisions and contingencies:** It includes all provisions made for bad and doubtful debts, provision for taxation, provision for diminution in the value of investments, transfers to contingencies and other similar items.

13.10 SPECIAL TRANSACTIONS

Some items require special treatment while preparing the final accounts of a banking company.

13.10.1 Interest on Doubtful Debts

When a loan is granted to a customer, the accounting treatment is

(a) The customer's loan account is debited (with amount of loan) in the accounts book of the bank. The interest accrued is to be entered in the debit side of his account. This is to be adopted till he returns the money on the maturity date. This holds good if the financial position of the customer is sound and the bank is in full confidence that the loan will be discharged on the maturity date. The accounting entry for such cases would be: Entry for interest will be :

Customer's Loan A/c	Dr	…	
Interest A/c			…

(b) When a loan is granted to a customer and uncertainty arises as to the settlement of the loan, such a debt becomes doubtful. Then in such cases, interest on doubtful debts cannot be treated as an income. The interest on the doubtful debts may be treated in the following ways:

(i) Interest suspense method

(ii) Cash basis

(iii) Accrual method

1. **Interest suspense method:** Under this method, interest on doubtful debts is credited to interest suspense A/c and debited to customer's loan A/c.

Entry:

Customer's Loan A/c	Dr.	…	
To Interest Suspense A/c			…

In the balance sheet, "interest suspense A/c" is to be shown on the liabilities side under "Schedule 5: Other Liabilities and Provisions". Customer's loan A/c with interest will be shown on the assets side.

After sometime, when the loan is repaid fully or partially with interest, then entry is:

(i)	Cash A/c	Dr.	…	
	To Customer's Loan A/c			…
	(Recovery of Loan)			
(ii)	Interest Suspense A/c	Dr.	…	
	To Interest A/c			…
	(Recovery of Interest Against Suspense A/c)			

To the extent, interest is received in cash and the amount is transferred to interest account and the balance to the loan account.

For closure:

(i)	For Unrealized Amount of Interest:			
	Interest Suspense A/c	Dr.	…	
	To Customer's Loan A/c			…
(ii)	For Loan (Principal Amount) Unrealized:			
	Customer's Loan A/c	Dr.	…	
	To Bad Debts A/c			…

Note: As doubtful debts fall under the category of non-performing assets (NPA), interest income on doubtful debts should not be taken to P&L A/c.

2. **Cash Basis:** Till the cash is received, no entry is to be passed.
3. **Accrual method:** Under this method, interest account is to be credited with full amount of interest due on doubtful debts. But, at the same, i.e. simultaneously an adequate provision for bad and doubtful debts is to be created and credited.

Entry:

Interest and Discount A/c	Dr.		
To Provision for Bad and Doubtful Debts			

When bad debt is recovered partially:

Cash A/c	Dr.	…		(Actually Received)
Bad Debts A/c	Dr.	…		(Balance of Loan)
To Customer's Loan A/c			…	(First Loan Amount)

Illustration 13.1

Model: Interest on doubt debts

While closing the books of a bank on 31 December 2010, you find in the loan ledger an unsecured balance of ₹ 5,00,000 in the account of one customer Mr. X whose financial condition is reported to you as bad. Interest on the same account amounted to ₹ 50,000 during the year. During the year 2011, the bank accepted 80 paise in the rupee on account of the debt up to 31 December 2010. Give journal and ledger to record these transactions under alternative accounting policies.

Solution

"Alternative accounting policies": Given in the question denotes the three different methods adopted to treat "interest on doubtful debts", as described above.

Method 1—Interest suspense method

Books of Bank
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
December 31 2010	X's Loan A/c	Dr.		50,000	
	To Interest Suspense A/c				50,000
	(Interest Due on Doubtful Debt)				
2011	Cash A/c	Dr.		4,40,000	
	To X's Loan A/c				4,40,000
	(Loan Recovered @ 80 Paise per Rupee on X's Loan) (₹ 4,00,000 Principal + ₹ 40,000 Interest)				
,,	Interest Suspense A/c	Dr.		50,000	
	To Interest A/c				40,000
	To X's Loan A/c				10,000
	(₹ 40,000 Collected From Interest Due and the Balance ₹ 10,000 Transferred to the Loan A/c)				
,,	Bad Debts A/c	Dr.		1,00,000	
	To X's Loan A/c				1,00,000
	(Uncollected Amount of X's Loan (₹ 5,00,000 – ₹ 4,00,000, i.e. ₹ 1,00,000 Written off as Bad)				

Ledger Accounts

Mr. X's Loan A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31 December 2010	To Balance b/d	5,00,000	31.12.10	By Balance c/d	5,50,000
	To Interest Suspense A/c	50,000			
		5,50,000			5,50,000
			2011	By Cash A/c	4,40,000
	To Balance b/d	5,50,000		By Interest Suspense	10,000
			,,	By Bad Debts A/c	1,00,000
		5,50,000			5,50,000

Interest Suspense A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31 December 2010	To Balance c/d	50,000	31.12.10	By X's Loan A/c	50,000
		50,000			50,000
2011	To Interest A/c	40,000	2011	By Balance c/d	50,000
	To X's Loan A/c	10,000			
		50,000			50,000

Method 2—Cash basis

Books of Bank
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 December 2010	— No Entry —			
2011	Cash A/c Dr.		4,40,000	
	To Interest A/c			40,000
	To X's Loan A/c			4,00,000
	(80 Paise per Rupee Received on Loan and Interest There on)			
	Bad Debts A/c Dr.		1,00,000	
	To X's Loan A/c			1,00,000
	(Unrecovered Amount on Loan Written off)			

Ledgers
X's Loan A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31 December 2010	To Balance b/d	5,00,000	31.12.10	By Balance c/d	5,00,000
		5,00,000			5,00,000
1 January 2011	To Balance b/d	5,00,000	,,	By Cash A/c	4,00,000
			,,	By Bad Debts A/c	1,00,000
		5,00,000			5,00,000

Interest A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2010	To Balance c/d	40,000	2010	By Cash	40,000
		40,000			40,000
				By Balance b/d	40,000

Bad Debts A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2010	To X's Loan A/c	1,00,000	2011	By Balance c/d	1,00,000
		1,00,000			1,00,000
	To Balance b/d	1,00,000			

Method 3—Accrual basis method

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2010	X's Loan A/c Dr.		50,000	
	To Interest A/c			50,000
	(Interest Due)			
,,	Interest and Discount A/c Dr.		5,50,000	
	To Provision for Bad and Doubtful A/c			5,50,000
	(Provision Created for Loan and Interest There on Considered Doubtful)			
2011	Cash A/c Dr.		4,40,000	
	Bad Debts A/c Dr.		1,10,000	
	To X's Loan Ac			5,50,000
	(Amount Received from X, the Balance Unrecovered Written off)			

[Bad debts provision has to be reduced to ₹4,40,000 for 2011.]

X's Loan A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31 December 2010	To Balance b/d	5,00,000	31.12.10	By Balance c/d	5,50,000
,,	To Interest A/c	50,000			
		5,50,000			5,50,000
1 January 2011	To Balance b/d	5,50,000	2011	By Cash	4,40,000
			,,	By Bad Debts A/c	1,10,000
		5,50,000			5,50,000

Provision for Bad and Doubtful Debts A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2010	To Balance c/d	5,50,000	31 December 2010	By Interest and Discount A/c	5,50,000
2011	To Bad Debts A/c	1,10,000			
	To Balance c/d	4,40,000	1 January 2011	By Balance b/d	5,50,000
		5,50,000			5,50,000
			2011	By Balance b/d	4,40,000

Bad Debts A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
2010	To X's Loan A/c	1,10,000	2010	By Provision for Bad and Doubtful Debts A/c	1,10,000
		1,10,000			1,10,000

13.10.2 Bills of Exchange

13.10.2.1 Bills for Collection

In buying and selling process, usually the sellers of the goods used to draw bills on their customers (buyers) for acceptance or bills are endorsed to the sellers.

These bills, also known as hundees, are sent to the banks for collection.

The banks hold these bills till their dates of maturity. When the banks realize the amount, the entry will be:

Cash A/c Dr. …

To Customer's Current A/c …

Cash A/c is debited with full amount mentioned in the bill and customer's current A/c is credited with the amount after deduction of bank's commission.

These are the outstanding bills for collection and are recorded in a subsidiary book known as "outstanding bills for collection register" and the entry is to be made only when bills are collected.

Treatment in final accounts:

Bills held for collection will be shown as a note to the balance sheet.

13.10.2.2 Discounting of Bills

Making payment for the bills before its maturity date is referred to as "discounting of bills". Sellers of the goods may discount these bills with the bankers or sell these to their bankers.

Accounting entry in the books of account of the banking company will be as follows:

Bills Discounted A/c Dr. …

To Customer A/c …

To Discount A/c …

In the final accounts, bills discounted account is to be shown in the balance sheet under the head: "Advances" and details should be given in Schedule 9 annexed to the balance sheet.

13.10.2.3 Rebate on Bills Discounted

This is also called "unexpired discount" or "discount received but not earned".

When a bank discounts or purchases a bill, it is credited to discount A/c, treating this as item of income of the accounting period. But at times, bills discounted may mature on a date beyond the relevant accounting period. This is the unearned amount received for such bills, which will mature after the date of preparation of final accounts. Hence, it cannot be treated as income of the current accounting period. The illustrate, if a bills is discounted on 1 December 2010 for 3 months at ₹ 9000 and accounts are closed on 31 December 2010, ₹ 6,000 is the unexpired discount as it is related to 2 months, i.e. January and February in 2011, the next accounting period.

Accounting Entry Is:

Bills Discounted A/c	Dr.	…	(With Full Amount of the Bill)
To Customer's A/c		…	(With Discounted Value of Bill)
To Discount A/c		…	(With Amount of Discount Earned in Current Accounting Period)
To Rebate on Bills Discounted A/c		…	(With the Amount of Unexpired Portion of Discount)

If the discount A/c is created with the full amount of discount (earned and unearned) and appears in trial balance, then the entry will be as follows:

Discount A/c	Dr.	…	
To Rebate on Bills Discounted		…	(With Unearned Amount Only)

In final accounts, rebate on bills discounted is shown on the liabilities side of the balance sheet under the head "Other Liabilities and Provisions". Details are given in Schedule 5.

In the next accounting period, it is transferred to discount A/c and closed thereby.

Note: In case, if rebate on bills discounted is given an adjustment outside the trial balance, then it has to be transferred to provisions account and deducted in P & L A/c.

Illustration 13.2

Model: Rebate on bills discounted.

On 31 March 2010, a bank held the followng bills discounted by it earlier:

Date of Bill	Term of Bill (Months)	Discounted @ % p.a.	Value of Bill ₹
17 January 2010	4	12	10,95,000
7 February 2010	3	18	25,55,000
9 March 2010	3	15	51,10,000

You are required to calculate the rebate on bills discounted. Also show the necessary journal entry for the rebate.

Solution

Stage I: Basic calculations

(A) Calculation of discount after 31 March 2010 for bill value of ₹ 10,95,000.

Step 1: No. of Days After 31 March 2010

Date of bill → 17 January 2010 → Term 4 Months → Maturity

Date → 20 May 2010

For April: 30 days +

For May: 20 days

50 days

Step 2: Discount Amount for 50 Days:

$$₹\,10,95,000 \times \frac{12}{100} \times \frac{50}{365} = ₹\,18,000$$

$(p \times r \times n)$

where p is the value of the bill, r is the rate of discount and n is the period.

(B) Calculation of Discount After 31 March 2010 for Bill Value of ₹ 25,55,000:

Step 1: No. of Days After 31 March 2010:

Date of Bill → 7 February 2010 → Term 3 Months → Maturity

Date →10 May 2010

For April	30 days +
For May	10 days
	40 days

Step 2: Discount Amount for 40 days:

$$₹\,25,55,000 \times \frac{18}{100} \times \frac{40}{365}$$

$= ₹\,50,400$

(C) Calculation of Discount After 31 March 2010 for Bill Value of ₹ 51,10,000.

Step 1: No. of Days After 31 March 2010:

Date of Bill → 9 March 2010 → Term 3 Months → Maturity

Date → 12 June 2010

For April	30 days +
For May	31 days +
For June	12 days
	73 days

Step 2: Discount Amount for 73 days:

$$₹\,51,10,000 \times \frac{15}{100} \times \frac{73}{365} = ₹\,1,53,300$$

These are transferred to the following table:

Date of Bill	Date of Maturity	No. of Days After 31 March 2010	Bill Value ₹	Rate of Discount (%)	Discount Amount After 31 March 2010
17 January 2010	20 May 2010	50	10,95,000	12	18,000
7 February 2010	10 May 2010	40	25,55,000	18	50,400
9 March 2010	12 June 2010	73	51,10,000	15	1,53,300
	Rebate on Bills Discounted			=	2,21,700

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 December 2010	Discount Received A/c Dr.		2,21,700	
	To Rebate on Bills Discounted A/c			2,21,700
	(Adjustment made for discount not earned on discounted Bills)			

Illustration 13.3

Model: Rebate on bills discounted

The following information is available in the books of AZ Bank Limited as on 31 March 2010.

	₹
Bills Discounted	1,20,11,350
Rebate on Bills Discounted (1 April 2009)	3,15,550
Discount Received	12,22,450

Details of bills discounted are as follows:

Value of Bill	Due Date	Rate of Discount (%)
15,00,000	12 June 2010	14
20,00,000	9 July 2010	12
50,00,000	29 July 2010	15
80,00,00	28 August 2010	18

Calculate the rebate on bills discounted as on 31 March 2010 and give necessary journal entries.

Solution

Step 1: No. of days after 31 March 2010 for each bill is calculated as explained in illustration 13.2. The amount for unexpired period is to be calculated and tabulated as follows:

Date of Maturity	No. of Days After 31 March 2010	Value of Bill ₹	Date of Interest (%)	Amount for Unexpired Period ₹
12 June 2010	April + May + June 30 + 31 + 12: 73	15,00,000	14	$15,00,000 \times \frac{73}{365} \times \frac{14}{100} = 42,000$
9 July 2010	30 + 31 + 30 + 9: 100	20,00,000	12	$20,00,000 \times \frac{100}{365} \times \frac{12}{100} = 65,753$
29 July 2010	30 + 31 + 30 + 29: 120	50,00,000	15	$50,00,000 \times \frac{120}{365} \times \frac{15}{100} = 2,46,575$
28 August 2010	30 + 31 + 30 + 31 + 28: 150	80,00,000	18	$80,00,000 \times \frac{150}{365} \times \frac{18}{100} = 5,91,781$
	*[1]Rebate on Bills Discounted:			9,46,109

Step 2:	Rebate on Bills Discounted (1 April 2009)	3,15,550
Step 3:	Add: Discount Received (Given)	12,22,450
		15,38,000
Step 4:	Less: Rebate on Bills Discounted (31 March 2010)	9,46,109
Step 5:	Amount on Rebate on Bills Discounted for the Year to Be Transferred to P & L A/c	5,91,891

Step 6: Journal entries

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Rebate on Bills Discounted A/c Dr.		3,15,550	
	To Discount on Bills A/c			3,15,550
	(Opening Balance of Rebate on Bills Discounted A/c Transferred to Discount on Bills A/c)			
	Discount on Bills A/c Dr.		9,46,109	
	To Rebate on Bills Discounted A/c			9,46,109
	(Provision created on 31 March 2010)			
	Discount on Bills A/c Dr		5,91,891	
	To Profit & Loss A/c			5,91,891
	(Discount on the Bills of the Year Transferred to P & L A/c)			

Illustration 13.4

Model: Rebate on bills discounted

The trial balance of BC Bank Ltd. as on 31 March 2011 shows the following balances:

	₹
Interest and Discount	37,27,170
Rebate on Bills Discounted (1 April 2010)	7,150
Bills Discounted and Purchased	2,27,500

The unexpired discount as on 31 March 2011 is estimated to be ₹24,125. Draft necessary adjusting entries and calculate the amount of interest and discount to be credited to P & L A/c.

Solution

Stage I: Ascertainment of interest and discount to be credited to Profit and Loss A/c:

		₹
Step 1:	Interest and Discount (Given in Trial Balance):	37,27,170
Step 2:	Add: Opening Balance (Balance as on 1 April 2010) of Bills Discounted (Given)	7,150
		37,34,320
Step 3:	Less: Closing Balance (Balance) as on 31 March 2010) of Bills Discounted (Given)	24,125
Step 4:	Interest and Discount to be Transferred (for the Year) to P & L A/c	37,09,195

Stage II: Journal entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Rebate on Bills Discounted A/c Dr.		7,150	
	To Discount A/c			7,150
	(Opening Balance of Unexpired Rebate on Bills Discounted Transferred to Discount			

	Discount A/c Dr.		24,125	
	To Rebate on Bills Discounted A/c			24,125
	(Closing Balance of Unexpired Discount)			
	Interest and Discount Received A/c Dr.		37,09,195	
	To Profit and Loss A/c			37,09,195
	(Transfer of Interest and Discount to P & L A/c) (Schedule 13)			

Illustration 13.5

Model: Rebate on bills discounted

As on 31 December 2010, the books of Giant Bank Ltd., include among others, the following balances:

	₹
Rebate on Bills Discounted (1 January 2010)	2,70,000
Discount Received	37,50,000
Bills Discounted and Purchased	3,65,00,000

Throughout the accounting year, the bank's rate for discounting has been 15%.

On Investigation and analysis, the average due date for the bills discounted and purchased is calculated as 14 March 2011.

Show the calculation of the amount to be credited to the Bank's P & L A/c under discount earned for the year 2010. Show also the journal entries required to adjust the above-mentioned accounts.

Solution

First, discount of the year to be transferred to P & L A/c has to be determined as follows:

		₹
Step 1:	Balance in Discount Received A/c (Given)	37,50,000
Step 2:	Add: Opening Balance (1 January 2010) (Given)	2,70,000
		40,20,000
Step 3:	Less: Closing Balance (as on 31 December 2010)	
	$₹\,3,65,00,000 \times \frac{73 \text{ days}}{365} \times \frac{15}{100}$	10,95,000
Step 4:	Amount of Discount of the Year to be Transferred to P & L A/c	29,25,000
Step 5:		

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 December 2010	Rebate on Bills Discounted A/c Dr.		2,70,000	
	To Discount Received A/c			2,70,000
	(Opening Balance of Rebate on Bills Discounted A/c Transferred)			
31 December 2010	Discount Received A/c Dr.		10,95,000	
	To Rebate on Bills Discounted A/c			10,95,000
	(Provision Made on Unexpired Discount as on 31 December 2010)			

31 December 2010	Discount Received A/c Dr. To Profit and Loss A/c (Transfer of Discount to Profit and Loss A/c)		29,25,000	 29,25,000

13.11 PROVISION FOR NON-PERFORMING ASSETS

Loans, advances, discounting of bills, purchasing of bills and the like are the main source of income for any bank. Some of such assets may not bring in any income to the banks. In accordance with International Accounting Standards, a distribution is made on the treatment of income on different advances by classifying into "performing assets" and "non-performing assets" (NPA).

13.11.1 Meaning of Non-performing Assets

An asset is said to be a non-performing asset, when it ceases to generate income for a bank. The RBI has given certain guidelines for treating an asset as NPA. Some of them are provided as follows:

(i) **Term loans:** When interest or instalment on loans is overdue for more than 90 days, the account is to be treated as NPA.

(ii) **Cash credits and overdrafts:** When a cash credit or O/D account remains out of order for more than 90 days, it will be considered as NPA.

An account is treated as "out of order", if any one of the following conditions is satisfied:

(a) The outstanding balance remains continuously in excess of the sanctioned limit and or drawing power.

(b) Even if the outstanding balance is well within the sanctioned limit/drawing power, if there are no credits in the account continuously for 90 days as on the date of the balance sheet.

(c) If the credits in such accounts are not sufficient enough to meet the interest debited during the same period.

(iii) **Bills purchased and discounted:** When the bill remains overdue for a period of more than 90 days from its due date, it is to be treated as NPA.

(iv) **Agricultural advances:** Loan granted for short-duration crops is to be treated as NPA, if interest or principal remains overdue for two crop seasons. Loan granted for long-duration crops is to be treated as NPA, if the instalment of principal or interest remains overdue for one crop season.

(v) **Other advances:** Any other credit facility is to be treated as NPA, if the amount to be received remains overdue for a period of more than 90 days.

13.11.2 Provisions for Non-performing Assets

To create provision for NPAs, the advances of a bank are classified into four categories, with variable provisions explained as follows:

Category I: Standard assets or performing assets: Dues are required to make a provision of a minimum of 0.40% on standard assets also on global loan portfolio basis and not on domestic advances alone.

Category II: Sub-standard assets:

(i) A general provision of 10% on total outstanding has to be created without making any allowance for Export Credit Guarantee Corporation (ECGC).

(ii) However, the "unsecured exposures", which are categorized as sub-standard assets will attract additional provision of 10%. That means 10% + 10% = 20% on the outstanding balance. (When the realizable value of the security is not more than 10% of the outstanding exposure, it is known as unsecured exposure.)

(iii) When loans are classified as NPAs and also as sub-standard, a provision of 20% is required.

(iv) W.e.f. the year ending on 31 March 2005, the banks are permitted to spread the additional provision consequent upon the reduction in the transition period from sub-standard to doubtful asset from 18 to 12 months over a 4-year period, with a minimum of 20% each year.

Category III: Doubtful assets:

(i) If the debt is not covered by realizable value of the security, 100% provision should be created.

(ii) If the debt is secured, then provision is to be made as follows:

Provisions	Percentage
Up to 1 Year	20
1–3 Years	30
More than 3 Years	100

Category IV: Loss assets: This category has been identified as assets, which have lost value but not written off. The entire assets are to be written off completely. However, if the assets are to be retained in the books of accounts for any specific reason, then 10% provision is required to be created.

Illustration 13.6

Model: NPA—Provisions to be created

On 31 March 2011, Indian Inland Bank Ltd. finds its advances classified as follows:

	₹
Standard Assets	20,60,500
Sub-standard Assets	1,10,000
Doubtful Assets : (Secured)	
: Doubtful for 1 Year	40,000
: Doubtful for 1–3 Years	25,000
: Doubtful for More Than 3 Years	10,500
Doubtful Assets: (Unsecured)	22,000
Loss of Assets	15,500

Calculate the amount of provision to be made by the Bank against the above-mentioned advances.

Solution

Advances	Amount ₹	% for Provision	Provision to Be Made ₹
Standard Assets	20,60,500	0.40	8,242
Sub-standard Assets	1,10,000	20	22,000
Doubtful Assets (Secured):			
Up to 1 Year	40,000	20	8,000
1–3 Years	25,000	30	7,500
More Than 3 Years	10,500	100	10,500
Doubtful Assets (Unsecured)	22,000	100	22,000
Loss Assets	15,550	100	15,550
Total Provision to Be Made			93,792

Note: If "unsecured exposures" are included in sub-standard assets, then additional 10% provision has to be made.

Illustration 13.7

Model: Provisions to be created

From the following information, find out the amount of provisions required to be made in the profit and loss A/c of a commercial bank for the year ended on 31 March 2011:

(i) Packing credit outstanding from food processors is ₹80,00,000 against which the bank holds securities worth ₹20,00,000. Forty per cent of the above advance is covered by ECGC. The above advances have remained doubtful for more than 3 years.

(ii) Other Advances:

Assets Classification:	(₹ in Lakhs)
Standard	5,000
Sub-standard	4,200
Doubtful:	
For 1 Year	1,200
For 2 Years	800
For 3 Years	600
For More Than 3 Years	400
Loss Assets	800

Solution

(i) Calculation of required provision (packing credit):

		₹ (in Lakhs)
Step 1:	Amount Outstanding (Given)	80
Step 2:	Less: Realizable value of securities (Given)	20
		60
Step 3:	Less: ECGC Cover 40% $\left(\frac{40}{10} \times ₹60 \text{ Lakhs}\right)$	24
Step 4:	Balance	36
Step 5:	Required Provision:	
	(a) Provision for Unsecured Part @ 100%	36
	(b) Provision for Secured Part @ 100%	20
Step 6:	Total Required Provision (a + b)	56

(ii) Calculation of required provision for other advances:

Note: Doubtful advances are assumed to be fully secured and provision is made accordingly.

Solution

Assets	Amount (₹ in Lakhs)	Percentage Provision	Provision to Be Made (₹ in Lakhs)
Standard	5000	0.40	20
Sub-standard	4200	10	420
Doubtful:			
For 1 Year	120	20	240
For 2 Years	800	30	240
For 3 Years	600	30	180

For More Than 3 Years	400	100	400
Loss Assets	800	100	800
Total Required Provision:			2300

Illustration 13.8

Model: Provision to be created

Best Bank Ltd. had extended the following credit lines to a small-scale industry, which had paid any interest since March 2009:

Particulars	Term Loan	Export Credit
Balance Outstanding on 31 March 2011	₹ 90,00,000	₹ 70,00,000
DICGC/ECGC Cover	50%	40%
Securities Held	₹ 40,00,000	₹ 30,00,000
Realizable Value of Securities	₹ 30,00,000	₹ 20,00,000

Compute the necessary provisions to be made for the year ended on 31 March 2011.

Solution

Particulars		Term Loan (₹ in Lakhs)	Export Credit (₹ in Lakhs)
Step 1:	Balance Outstanding	90.00	70.00
Step 2:	Less: Realizable Value of Securities	30.00	20.00
		60.00	50.00
Step 3:	Less: DICGC/ECGC Cover	30.00	20.00
		30.00	30.00
Step 4:	Provision With Respect to Secured Part 100%	30.00	20.00
Step 5:	Provision With Respect to Unsecured Part 100%	30.00	30.00
Step 6:	Total Provision Required	60.00	50.00

13.12 INCOME RECOGNITION

For the purpose of income recognition, the banks are required to classify their assets into two main categories: performing and non-performing assets (NPAs). The banks should ensure that interest on non-performing assets should not be recognized as income. Such income should not be taken to P & L A/c.

Banks should strictly adhere to the guidelines issued by RBI. Accordingly, banks should recognize their income on "accrual basis" with respect to income on performing assets and on "cash basis" with respect to income on non-performing assets.

Interest on non-performing assets is not recognized unless it is actually realized in cash. But, interest on advances against term deposits is treated as income on due date (even though not actually received in cash) provided if the value of deposit is more than the balance outstanding.

Fees and commission earned by the banks due to re-negotiation or rescheduling of outstanding debts are to be recognized on an accrual basis.

Similarly, the interest on government-guaranteed advances are not to be taken to income account until the same has been realized in cash.

The guidelines of RBI relating to income recovered from NPAs are as follows:

(i) Interest realized on NPAs is to be credited to P & L A/c only if the credits in the accounts to interest are not out of fresh or additional credit facilities sanctioned to the borrower.

(ii) The banks should appropriate recoveries in NPAs property.

(iii) Although the banks do not recognize income until it is realized, banks are permitted to debit interest to NPA account if it is credited to interest suspense account.

The banks are required to classify the assets of NPA into the following categories:

(i) (a) Sub-standard assets, (b) doubtful assets and (c) loss assets for the purpose of ascertaining provisions to be made for each category. The RBI, in its Master Circular issued on 1 July 2008, has mentioned the following clarifications in respect of assets classification inter alia.

(ii) Assets are to be classified on the basis of borrower and not facility wise.

(iii) Advances on consortium should be based on the record of recovery of individual member banks.

(iv) Exemption from classification of government-guaranteed advances as non-performing assets is not intended to income recognition.

(v) When arrears of interest and principle are paid by the borrower in loan accounts classified as NPAs, such accounts should no longer be treated as NPAs but are to be upgraded as "standard accounts".

(vi) The asset classification of borrowal accounts must be done objectively. When the account reflects any unreliability, it is to be considered as non-performing asset only.

Illustration 13.9

Model: Income recognition

Following are the information provided by ABZ Ltd. regarding the interest on advance along with the measure of assets.

Types of (Classification of) Assets	Interest Earned (₹ in Lakhs)	Interest Received (₹ in Lakhs)
(A) Performing Assets:		
Term Loans	250	150
Cash Credits & Overdrafts	900	550
Bills Purchased & Discounted	400	260
(B) Non-performing Assets:		
Terms Loans	150	40
Cash Credits & Overdrafts	560	55
Bills Purchased & Discounted	200	20

You are required to calculate the income to be recognized for the year ending on 31 March 2011.

Solution

In compliance with the guidelines of the RBI,

(a) Interest on *performing assets* should be recognized on "accrual basis".

(b) Interest on *non-performing assets* (NPAs) should be recognized on "cash basis".

Determination of Interest Income

	₹ (in Lakhs)
(i) Interest on Term Loans: Performing Assets + NPAs (Accrual) (Cash) (₹ 250 + ₹ 40) Lakhs	295
(ii) Interest on Cash Credits & O/Ds P.A. (Accrual) + NPA (Cash) (₹ 900 + ₹ 55) Lakhs	955
(iii) Bills Purchased & Discounted P.A. (Account) + NPA (Cash) (₹ 400 + ₹ 20) Lakhs	420
Total:	1,670

Illustration 13.10

Model: Preparation of profit and loss A/c

From the following particulars, prepare a profits and loss A/c of Fancy Bank Ltd. for the year ended on 31 December 2010:

Particulars	₹ (in Lakhs)	Particulars	₹ (in Lakhs)
Interest on Loans	130	Interest on Cash Credits	112.5
Interest on Fixed Deposits	140	Rent and Taxes	10
Rebate on Bills Discounted	25	Interest on Overdrafts	28
Commission Charged to Customers	4.5	Director's and Auditor's Fees	2
Establishment Expenses	28	Interest on Savings Bank A/c	35
Discount on Bills Discounted	100	Postage & Email	1
Interest on Current A/c	22.5	Sunday Charges	1
Printing & Advertisements	1.5		

Solution

Note: Even though the proper procedure is to provide all the schedules only after showing P & L A/c, here in one or more illustrations, schedules with workings are shown first so as to make the students to understand at ease.

Step 1: Schedule 13 is to be prepared as follows:

In this schedule, interest earned is to be shown in detail as interest on loans. Discount on bills discounted, interest on cash credits and O/DS have to be shown and added.

Schedule 13—Interest Earned

	₹(in Lakhs)
Interest on Loans	130
Discount on Bills Discounted	100

Interest on Cash Credits	112.5
Interest on Overdrafts	28
Total	370.5

Note: Rebate on bills is not to be included here. It is to be shown in Schedule 5 annexed to balance sheet, as it is the closing rebate.

Step 2: Schedule 14 is to be prepared. Under this head, i.e., "Other Income", only one item is to be shown in this problem, i.e., commission charged to customers.

Schedule 14—Other Income

	₹ (in Lakhs)
Commission Charged to Customers	4.5
	4.5

Step 3: Schedule 15 is to be prepared under the head "Interest Expended". Interests on fixed deposits, current accounts and SB accounts have to be shown and get aggregated value.

Schedule 15—Interest Expended

	₹ (in Lakhs)
Interest on Fixed Deposits	140
Interest on Current Account	22.5
Interest on SB A/c	35
Total	197.5

Step 4: Schedule 16—"Operating expenses" is prepared as follows:

Schedule 16—Operating Expenses

	₹ (in Lakhs)
Establishment Expenses	28
Printing & Advertisement Expenses	1.5
Rents and Taxes	10
Director's Auditor's Fees	2
Postage & Email	1
Sundry Charges	1
Total	43.5

Note: In this problem no data relating to provisions and contingencies are given.

Hence, no need to show under separate head in this question.

Step 5: Preparation of P & L A/c:

Fancy Bank Ltd.
Profit and Loss Account
for the Year Ended on 31 December 2010

	Schedule No.	Year Ended on 31 December 2010 (Current Year) (₹ in Lakhs)	Year Ended on 31 December 2009 (Previous Year) (₹ in Lakhs)
I. Income:			
Interest Earned	13	370.5	—
Other Income	14	4.5	—
Total		375.0	
II. Expenditure:			
Interest Expended	15	197.5	—
Operating Expenses	16	43.5	—
Total		241.0	
III. Profit/Loss:			
Net Profit for the Year (I – II)		134	—
Profit Brought Forward		—	—
Total		134	
IV. Appropriation:			
Transfer to Statutory Reserve:		33.5	—
(25/100 × 1,34,00,000)			
Transfer to Other Reserves		—	—
Transfer to Govternment/Proposed Dividend		—	—
Balance Carried Over to Balance Sheet		100.5	—
Total		134.0	

Illustration 13.11

Model: Preparation of P & L A/c

From the following information, prepare the profit and loss A/c of Merchant Bank Ltd. for the year ended on 31 March 2011 in the prescribed form:

	₹
Interest on Loan	5,18,000
Interest on Fixed Deposits	5,50,000
Rebate on Bills Discounted Required	98,000
Commission	16,400
Establishment	1,08,000

Discount on Bills Discounted	3,90,000
Interest on Cash Credit	4,46,000
Interest on Current Account	84,000
Rent and Taxes	36,000
Interest on Overdraft	3,08,000
Director's Fees	6,000
Auditor's Fees	2,400
Interest on Savings Bank Deposits	1,36,000
Postage, Phone, Internet Expenses	2,800
Printing and Stationery	5,800
Sundry Charges	3,400

Bad debts to be written off amounted to ₹ 80,000. Provision for taxation may be made @ 50%.

Balance of profit from last year was ₹ 2,40,000. The Directors have recommended a dividend of ₹ 40,000 for the shareholders.

[CA (Inter) and ICWA (Final)—Modified]

Solution

First, required schedules are prepared as follows:

Step 1: Schedule 13—Interest Earned

Year Ended on 31 March 2011

	₹
Interest on Loan	5,18,000
Discount on Bills Discounted	3,90,000
Interest on Cash Credits	4,46,000
Interest on Overdrafts	3,08,000
	16,62,000
Less: Rebate on Bills Discounted Required	98,000
	15,64,000

Step 2: Schedule 14—Other Income

	₹
Commission	16,400
	16,400

Step 3: Schedule 15—Interest Expended

	₹
Interest on Fixed Deposits	5,50,000
Interest on Current Accounts	84,000
Interest on Savings Bank Deposits	1,36,000
	7,70,000

Step 4: **Schedule 16—Operating Expenses**

	₹
Establishment	1,08,000
Rent and Taxes	36,000
Directors Fees	6,000
Auditor's Fees	2,400
Postage, Phone & Interest	2,800
Printing and Stationery	5,800
Sundry Charges	3,400
	1,64,4000

Step 5: **Provision and Contingencies**

	₹
Bad Debts Written off	80,000
Provision for Taxation:	
(₹ 15,64,000 + ₹ 16,400) – (₹ 7,70,000 + ₹ 1,64,400 + ₹ 80,000) = ₹ 5,66,000	
50% of ₹ 5,66,000 = ₹ 2,83,000	2,83,000
	3,63,000

Step 6: **Preparation of P & L A/c**

Merchant Bank Ltd.

Profit and Loss Account

for the Year Ended on 31 March 2011

	Schedule No.	Year Ended on 31 December 2011 (Current Year) ₹	Year Ended on 31 December 2010 (Previous Year) ₹
I. Income:			
Interest Earned	13	15,64,000	—
Other Income	14	16,400	
		15,80,400	
II. Expenditure:			
Interest Expended	15	7,70,000	
Operating Expenses	16	1,64,400	
Provision & Contingencies		3,63,000	
		12,97,400	
III. Profit/Loss:			
Net Profit for the Year (I – II)		2,83,000	
Profit Brought Forward		2,40,000	
		5,23,000	

IV. Appropriation:			
Transfer to Statutory Reserve:		70,750	
25% of ₹ 2,83,000			
Transfer to Other Reserves		—	
Transfer to Govt./Proposed Dividend		40,000	
Balance Carried Over to Balance Sheet		4,12,250	
		5,23,000	

Important note:

According to Section 17 of the Banking Regulation Act, 20% of the current year's profit is to be transferred to statutory reserve.

However, as per the latest RBI guidelines, 25% of the current year's profit has to be transferred to statutory reserve. Hence, 25% is transferred to statutory reserve.

Illustration 13.12

Model: Preparation of P & L A/c

The following figures are extracted from the books of Lucky Bank Ltd. for the year ending on 31 March 2011:

	₹
Interest and Discount Received	60,90,000
Interest Paid on Deposits	36,06,000
Issued and Subscribed Capital	15,00,000
Reserve under Section 17	10,50,000
Commission, Exchange and Brokerage	2,70,000
Rent Received	90,000
Profit on Sale of Investments	2,85,000
Salaries and Allowances	3,15,000
Director's Fees and Allowances	36,000
Rent and Taxes Paid	1,62,000
Stationery and Printing	36,000
Postage and Phone	75,000
Other Expenses	36,000
Audit Fees	12,000
Depreciation on Bank Properties	37,500

Other information:

(i) A customer, to whom a sum of ₹ 7,50,000 has been advanced, has become insolvent and it is expected that 40% can be recovered from his estate. Interest due at 15% on his debt has not been provided in the books.

(ii) Provision for bad and doubtful debts on other debts necessary is ₹ 1,50,000.

(iii) Rebate on bills discounted as on 1 April 2010 is ₹ 22,500

(iv) Provide ₹ 5,00,000 for income tax.

(v) The directors decide to declare 10% dividend.

Prepare the profit and loss A/c in accordance with law. Make necessary assumptions, wherever necessary.

Solution

Note:

1. Reserve is given in the problem as "reserve under Section 17". Hence, as per Section 17 of the Banking Regulation Act, 20% of the current year's profit is to be transferred to statutory reserve.
2. The debt of insolvent customer is NPA. Hence, interest on it is to be recorded only on cash basis and not on accrual basics. As such, interest due is not to be provided.

Lucky Bank Ltd.

Profit and Loss Account

for the Year Ended on 31 March 2011

	Schedule No.	Year Ended 31 March 2011 (Current Year) ₹	Year Ended 31 March 2010 (Previous Year) ₹
I. Income:			
Interest Earned	13	61,12,500	—
Other Income	14	6,45,000	—
		67,57,500	
II. Expenditure:			
Interest Expended	15	36,06,000	
Operating Expenses	16	7,09,500	
Provision and Contingencies		11,00,000	
(60% of ₹ 7,50,000 + ₹ 1,50,000 + ₹ 5,00,000)			
		54,15,500	
III. Profit/Loss:			
Net Profit for the Year (I – II)		13,42,000	
IV. Appropriation:			
Transfer to Statutory Reserve:		2,68,400	
(20% of ₹ 13,42,000)			
Transfer to Proposed Dividend		1,50,000	
[10% of ₹ 15,00,000 (Share Capital)]			
Balance Carried Over to Balance Sheet		9,23,600	
		13,42,000	

Schedule 13—Interest Earned

	₹
Interest and Discount Received	61,12,500
(₹ 60,90,000 + ₹ 21,500)	

Schedule 14–Other Income

	₹
Commission on Exchange and Brokerage	2,70,000
Profit on Sale of Investment	2,85,000
Rent Received (Miscellaneous Income)	90,000
	6,45,000

Schedule 15—Interest Expended

	₹
Interest on Deposits	36,06,000

Schedule 16—Operating Expenses

	₹
Payment & Provisions for Employees	3,15,000
Rent & Taxes	1,62,000
Printing & Stationery	36,000
Depreciation on Bank Properties	37,500
Directors Fees and Allowances	36,000
Auditor's Fees and Allowances	12,000
Postage, Phone, etc.	75,000
Other Expenses	36,000
	7,09,500

Provisions and Contingencies

	₹
Provision for Doubtful Debts of Insolvent Customer (60% of ₹ 7,50,000)	4,50,000
Provision for Doubtful Debts	1,50,000
Provision for Income Tax	5,00,000
	11,00,000

Illustration 13.13

Model: P & L A/c—preparation

Some of the items in the trial balance of Delhi Bank Ltd. as on 31 December 2010 were as follows:

Particulars	₹	**Particulars**	₹
Loan & Advances	35,75,000	Interest on Cash Credits	52,500
Current Accounts (Including O/D of ₹ 7,50,000)	33,00,000	Commission Earned	23,250
Bills Discounted and Purchased	9,60,000	Loss on Sale of Investments	17,000
Interest on Fixed Deposits	77,500	Salaries and Allowances	41,000

Interest on Loans	1,12,500	Printing and Stationery	2,250
Discount (Subject to Unexpired Discounts ₹ 15,000)	1,00,500	Interest on SB Deposits	37,500
		Auditor's Fees	2,500
Provision for Bad Debts (1 January 2010)	21,000	Director's Fees	1,250
		Interest on O/D	47,500
Bad Debts	10,500	Provision for Income Tax (1 January 2010)	33,000
		Income Tax Paid for the Year 2010	27,000

You are required to prepare the P & L A/c of the bank, maintaining the provision for income tax at ₹ 42,000 and provision for bad debts at ₹ 26,000 for the year ended on 31 December 2010.

All workings should form part of your answer.

Solution

Delhi Bank Ltd.
Profit and Loss Account
for the Year Ended on 31 December 2010

	Schedule No.	Year Ended on 31 December 2010 (Current Year) ₹	Year Ended on 31 December 2009 (Previous Year) ₹
I. Income:			
Interest Earned	13	2,98,000	—
Other Income	14	6,250	—
		3,04,250	
II. Expenditure:			
Interest Expended	15	1,15,000	—
Operating Expenses	16	47,000	—
Provision & Contingencies		51,500	—
		2,13,500	
III. Profit/Loss:			
Net Profit for the Year (I – II)		90,750	—
Profit Brought Forward		—	—
		90,750	
IV. Appropriation:			
Transfer to Statutory Reserve: (25% of ₹ 90,750)		22,687.50	—
Transfer to Other Reserves		—	—
Balance Carried Over to Balance Sheet		68,062.50	—
		90,750.00	

Schedule 13—Interest Earned

	₹
Interest on Loans	1,12,500
Discount (₹ 1,00,500 – ₹ 15,000)	85,500
Interest on Cash Credit	52,500
Interest on Overdrafts	47,500
	2,98,000

Schedule 14—Other Income

	₹
Commission Earned	23,250
Less: Loss on Sale of Investment	17,000
	6,250

Schedule 15—Interest Expended

	₹
Interest on Fixed Deposits	77,500
Interest on SB Deposits	37,500
	1,15,000

Schedule 16—Operating Expenses

	₹
Salaries & Allowances	41,000
Printing & Stationery	2,250
Auditor's Fees	2,500
Director's Fees	1,250
	47,000

Provision for Taxation A/c

Particulars	₹	**Particulars**	₹
To Bank A/c (Tax Paid)	27,000	By Balance b/d	33,000
To Balance c/d	42,000	*[1]By P & L A/c (Bal Fig) Current Year's Provision	36,000
	69,000		69,000

Provision for Bad Debts A/c

Particulars	₹	**Particulars**	₹
To Bad Debts	10,500	By Balance b/d	21,000
To Balance c/d	26,000	*[2]By P & L A/c (Bal Fig)	15,500
	36,500		36,500

Provision for Contingencies

	₹
*[1] Provision for Taxation	36,000
*[2] Provision for Bad debts	15,500
	*[3] 51,500

Illustration 13.14

Model: Preparation of P & L A/c

The following figures are extracted from the books of Modern Bank Ltd. as on 31 March 2011.

	₹
Interest and Discount Received	18,47,869
Interest Paid on Deposits	10,16,226
Commission, Exchange & Brokerage	1,00,000
Rent Received	27,500
Profit on Sale of Investments	1,00,000
Salaries and Allowances to Staff	1,00,000
Director Fees and Allowances	15,000
Rent and Taxes Paid	50,000
Postage and Internet Expenses	25,143
Depreciation on Bank's Property	15,000
Stationery	25,000
Preliminary Expenses	7,500
Audit Fees	2,500

The following further information are also given:

(i) A consumer to whom ₹ 5,00,000 has been advanced has become insolvent and it is expected that only 50% can be recovered from his estate.

(ii) There were also other debts for which a provision of ₹ 75,000 was found necessary by the auditors.

(iii) Rebate on bills discounted as on 31 March 2010 was ₹ 6,000 and rebate on bills discounted as on 31 March 2011 was ₹ 8,000.

(iv) Provide ₹ 3,00,000 for income tax.

(v) Write off all preliminary expenses.

Solution

Working notes:

(A) Calculation of interest earned:

Interest and Discount Received	18,47,869
Add: Rebate on Bills Discounted on 1 April 2011	6,000
	18,53,869
Less: Rebate on Bills Discounted on 31 March 2011	8,000
∴ Interest Earned	18,45,869

Preparation of Profit and Loss A/c
Modern Bank Ltd.
Profit and Loss Account
for the Year Ended on 31 March 2011

	Schedule No.	As on 31 March 2011 (Current Year) ₹	As on 31 March 2010 (Current Year) ₹
I. Income:			
Interest Earned	13	18,45,869	—
Other Income	14	2,27,500	—
		20,73,369	—
II. Expenditure:			
Interest Expended	15	10,16,226	—
Operating Expenses	16	2,40,143	—
Provisions & Contingencies [₹ 2,50,000 + ₹ 75,000 + ₹ 3,00,000]		6,25,000	
		18,81,369	—
III. Profit/Loss:			
Profit for the Year (I – II)		1,92,000	—
Profit Brought Forward		—	—
		1,92,000	—
IV. Appropriations:			
Transfer to Statutory Reserve (25% on ₹ 1,92,000)		48,000	—
Balance Carried Over to Balance Sheet		1,44,000	—
		1,92,000	

Schedule 13—Interest Earned

	₹
Interest and Discount (Ref: Working note 1)	18,45,869

Schedule 14—Other Income

	₹
Commission, Exchange and Brokerage	1,00,000
Profit on Sale of Investments	1,00,000
Rent Received	27,500
	2,27,500

Schedule 15—Interest Expended

	₹
Interest on Deposits	10,16,226

Schedule 16—Operation Expenses

	₹
Staff Salaries & Allowances	10,00,000
Rent, Rates & Taxes	50,000
Printing & Stationery	25,000
Depreciation on Bank's Property	15,000
Directors' Fees & Allowances	15,000
Auditor's Fees	2,500
Postage, Internet, etc.	25,143
Preliminary Expenses	7,500
	12,40,143

Provisions and Contingencies

	₹
Provision for Bad & Doubtful Debts (₹ 2,50,000 + ₹ 75,000)	3,25,000
Provision for Taxation (Given)	3,00,000
	6,25,000

The Third Schedule
(Section 29)
Form A
Form of Balance Sheet
Balance Sheet of …Ltd.
as on 31 March

(000's omitted)

	Schedule No.	As on 31 March … (Current Year) ₹	As on 31 March… (Current Year) ₹
Capital and Liabilities:			
Capital	1	—	—
Reserves and Surplus	2	—	—
Deposits	3	—	—
Borrowings	4	—	—
Other Liabilities & Provisions	5	—	—
Total		xx	xx
Assets:			
Cash & Balances with Reserve Bank of India	6	—	—
Balances with Banks and Money at Call and Short Notices	7	—	—

Investments	8	—	—
Advances	9	—	—
Fixed Assets	10	—	—
Other Assets	11	—	—
Total		xx	xx
Contingent Liabilities:			
Bills for Collection	12	—	—

The following schedules are required to be furnished with the balance sheet:

Schedule 1—Capital

I.	For Nationalized Banks:		
	Capital	—	—
	(Fully Owned by Central Government)		
II.	For Banks Incorporated Outside India:		
	Capital	—	—
	(The Amount brought in by Banks by way of Start-up Capital as prescribed by RBI Should Be Shown Under This Head)		
	Total	xx	xx
III.	For Other Banks:		
	Authorized Capital		
	(… Shares of ₹ …. Each)	—	—
	Issued Capital		
	(… Shares of ₹ …. Each)	—	—
	Subscribed Capital		
	(… Shares of ₹ … Each)	—	—
	Called-up Capital		
	(…. Shares of ₹ …. Each)	—	—
	Less: Calls Un-paid		
	Add: Forfeited Shares		
	Total	xx	xx

Schedule 2—Reserves and Surplus

	As on 31 March… (Current Year) ₹	**As on 31 March … (Previous Year) ₹**
I. *Statutory Reserves:*		
Opening Balance	—	—
Additions During the Year	—	—
Deductions During the Year	—	—

II.	*Capital Reserves:*		
	Opening Balance	—	—
	Additions During the Year	—	—
	Deductions During the Year	—	—
III.	*Securities Premium:*		
	Opening Balance	—	—
	Additions During the Year	—	—
	Deductions During the Year	—	—
IV.	*Revenue and Other Reserves:*		
	Opening Balance	—	—
	Additions During the Year	—	—
	Deductions During the Year	—	—
V.	*Balance in Profit and Loss Account:*	—	—
	Total (I, II, III, IV and V)	xx	xx

Schedule 3–Deposits

		As on 31 March… (Current Year) ₹	As on 31 March… (Previous Year) ₹
A: I.	*Demand Deposits:*		
	(i) From Banks	—	—
	(ii) From Others	—	—
II.	*Savings Bank Deposits:*	—	—
III.	*Capital Reserves:*		
	(i) From Banks	—	—
	(ii) From Others	—	—
	Total (I, II and III)	xx	xx
B: I.	Deposits of Branches in India		
II.	Deposits of Branches Outside India	—	—
	Total (B I, and II)	xx	xx

Schedule 4—Borrowings

		As on 31 March… (Current Year) ₹	As on 31 March… (Previous Year) ₹
I.	Borrowings in India		
	(i) Reserve Bank of India	—	—
	(ii) Other Banks	—	—
	(iii) Other Institutions and Agencies	—	—

II.	Borrowings Outside India		xx
	Total (I and II)	xx	xx
	Secured Borrowings in I and II	—	—

Schedule 5—Other Liabilities and Provisions

		As on 31 March… (Current Year) ₹	As on 31 March… (Previous Year) ₹
I.	Bills Payable	—	—
II.	Inter-office Adjustments (Net)	—	—
III.	Interest Accrued	—	—
IV.	Others (Including Provisions)	—	—
	Total	xx	xx

Schedule 6—Cash and Balance

		As on 31 March… (Current Year) ₹	As on 31 March… (Previous Year) ₹
I.	Cash in Hand (Including Foreign Currency Notes)	—	—
II.	Balance with Reserve Bank of India		
	(i) In Current Accounts	—	—
	(ii) In Other Accounts	—	—
	Total (I and II)		

Schedule 7—Balances with Banks and Money at Call and Short Notice

		As on 31 March… (Current Year) ₹	As on 31 March… (Previous Year) ₹
I.	In India		
	(i) Balance with Banks		
	(a) In Current Accounts	—	—
	(b) In Other Deposit Accounts	—	—
	(ii) Money at Call & Short Notice		
	(a) With Banks		
	(b) With Other Institutions		
	Total	xx	xx

II.	Outside India		
	(i) In Current Accounts	—	—
	(ii) In Other Deposit Accounts	—	—
	(iii) Money at Call and Short Notice	—	—
	Total	xx	xx
	Grand Total (I and II)	xx	xx

Schedule 8—Investments

		As on 31 March… (Current Year) ₹	As on 31 March… (Previous Year) ₹
I.	Investments in India in:		
	(i) Government Securities	—	—
	(ii) Other Approved Securities	—	—
	(iii) Shares	—	—
	(iv) Debentures and Bonds	—	—
	(v) Subsidiaries and/or Joint Ventures	—	—
	(vi) Other (to Be Specified)	—	—
	Total	xx	xx
	Grand Total (I and II)	xx	xx
II.	Investments Outside India in:		
	(i) Government Securities (Including Local Authorities)	—	—
	(ii) Subsidiaries and/or Joint Ventures Abroad	—	—
	(iii) Other Investments (to Be Specified)	—	—
	Total	xx	Xx
	Grand Total (I and II)	xx	xx

Schedule 9—Advances

		As on 31 March… (Current Year) ₹	As on 31 March … (Previous Year) ₹
(A)	(i) Bills Purchased and Discounted	—	—
	(ii) Cash Credits, Overdrafts, and Loans Repayable on Demand	—	—
	(iii) Term Loans	—	—
	Total		
(B)	(i) Secured by Tangible Assets	—	—
	(ii) Covered by Bank/Govternment Guarantees		

	(iii) Unsecured		
	Total		
(C)	I. Advances in India		
	(i) Priority Sectors	—	—
	(ii) Public Sector	—	—
	(iii) Banks	—	—
	(iv) Others	—	—
	Total		
	II. Advances Outside India		
	(i) Due from Banks	—	—
	(ii) Due from Others	—	—
	(a) Bills Purchased and Discounted	—	—
	(b) Syndicated Loans	—	—
	(c) Others	—	—
	Total	xx	xx
	Grand Total (C.I and C.II)	xx	xx

Schedule 10—Fixed Assets

		As on 31 March… (Current Year) ₹	**As on 31 March … (Previous Year)** ₹
I.	Premises		
	At Cost as on 31 March of Preceding Year	—	—
	Additions During the Year	—	—
	Deductions During the Year	—	—
	Depreciation to Date	—	—
II.	Other Fixed Assets (Including Furniture and Fixtures)	—	—
	At Cost as on 31 March of the Preceding Year	—	—
	Additions During the Year	—	—
	Deductions During the Year	—	—
	Depreciation to Date	—	—
	Total (I and II)	—	—

Schedule 11—Other Assets

		As on 31 March … (Current Year) ₹	**As on 31 March … (Previous Year)** ₹
I.	Inter-office Adjustments (Net)	—	—
II.	Interest Accrued	—	—

III.	Tax Paid in Advance/Tax Deducted at Source	—	—
IV.	Stationery and Stamps	—	—
V.	Non-banking Assets Acquired in Satisfaction of Claims	—	—
VI.	Others*		
	Total	xx	xx

* In case there is any unadjusted balance of loss the same may be shown under this item with appropriate footnote

Schedule 12—Contingent Liabilities

		As on 31 March ... (Current Year) ₹	As on 31 March ... (Previous Year) ₹
I.	Claims Against the Bank not Acknowledged as Debts	—	—
II.	Liability for Partly Paid Investments	—	—
III.	Liability on Account of Outstanding Forward Exchange Contracts	—	—
IV.	Guarantees Given on Behalf of Customers		
	(a) In India	—	—
	(b) Outside India	—	—
V.	Acceptances, Endorsements and Other Obligations	—	—
VI.	Other Items for Which the Bank Is Contingently Liable	—	—
	Total	xx	xx

13.13 GUIDELINES OF RBI FOR PREPARING BALANCE SHEET

The following are the guidelines of RBI for preparing the balance sheet:

1. **Capital—Schedule 1**

   The changes in the items shown in this schedule, if any, during the year, say for instance, fresh contribution made by Govt., fresh issue of capital, capitalization of reserves, etc. may be explained in the "Notes".

2. **Reserves and surplus—Schedule 2**

   Statutory Reserves: Reserves created under any of the sections of the Banking Regulation Act should be disclosed separately.

   Capital reserves: Surplus on revaluation is a capital reserve. Surplus on translation of the financial statements of foreign branches (including fixed assets) should not be treated as revaluation reserve. The capital reserve should not include any amount regarded as free distribution through P & L A/c.

   Revenue and other reserves: The expression "reserve" should not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability.

   Balance of profit: It includes balance of profit after appropriations. In case of any loss, the balance is to be shown by way of deduction.

3. **Deposits—Schedule 3**

   A.I. Demand deposits:

   (i) From banks: It includes all bank deposits repayable on demand.

   (ii) From others: It includes all demand deposits of non-bank sectors.

Credit balance in O/D, cash credit A/c, deposits payable at call, over due deposits, inoperative current accounts, matured time deposits and cash certificates, and certificates of deposits are to be included under this category.

A.III. Term deposits:

(i) From banks: It includes all types of bank deposits repayable after a specified term.

(ii) From others: All types of deposits of non-banking sector repayable after a specified term are to be included under this category. It includes fixed deposits, cumulative and recurring deposits, cash certificates, certificates of deposits, annuity deposits, deposits mobilized under various schemes, ordinary staff deposits, foreign currency non-resident deposit A/c and so on.

Explanatory notes:

(i) Interests payable on deposits, which are accrued but not due should not be included. It should be shown under "other liabilities".

(ii) Matured time deposits and cash certificates should be treated as demand deposits.

(iii) Deposits under special schemes should be included under "term deposits". If they are not payable at maturity, they should be shown under "demand deposits".

(iv) Deposits from banks will include deposits from the banking system in India, Co-operative banks, foreign banks which may or may not have a presence in India.

4. **Borrowings—Schedule 4**

Explanatory notes:

(i) Inter-office transactions should not be shown as borrowings.

(ii) Funds raised by foreign branches by way of certificates of deposits, notes, bonds, etc. should be classified upon documentation as "deposits", "borrowings", etc.

(iii) Refinance obtained by the banks from RBI and various institutions are being brought under the head "borrowings". Hence, advances will be shown at the gross amount on the asset side.

5. **Other liabilities and provisions—Schedule 5**

Inter-office adjustments: These are mostly related to the transactions of a head office with its branches. Only net balance will be shown.

Credit balance of branch adjustment A/c will be shown in the liabilities side of the balance sheet under the head "other liabilities and provisions" (Schedule 5).

Debit balance will be shown on the assets side of the balance sheet under the head "other assets" (Schedule 11).

Interests accruing on all deposits, whether the payment is due or not, should be treated as liability.

6. **Balance with banks and money at call and short notice—Schedule 7**

Money at call and short notice: These represent loans related to inter-bank transactions. It includes deposits repayable within or less than 15 days notice lents in inter-bank call money market. This should be shown on the assets side of the balance sheet and details in this schedule.

7. **Advances—Schedule 9**

(i) The gross amount of advances including refinance and rediscounts, but excluding provisions made to the satisfaction of the auditors should be shown as advances on the assets side.

(ii) Term loans are the loans that are not repayable on demand.

(iii) Consortium advances should be shown as net of shares from other participating banks /institutions.

Details of advances in India and outside India are to be given separately in this schedule.

8. Acceptances, endorsements and other obligations are not shown in the balance sheet. However, these are included in Schedule 12.

Illustration 13.15

Model: Preparation of balance sheet.

On 31 December 2010, the following balances stood in the books of ABC Bank Ltd., after preparation of its P & L A/c:

	₹ (in '000)
Share Capital: Issued and Subscribed	8,000
Reserve Fund (U/S 17)	12,400
Fixed Deposits	85,200
Savings Bank Deposits	38,000
Current Accounts	46,400
Money at Call & Short Notice	3,600
Investments	50,000
Profit and Loss A/c (Cr.) 1 January 2010	2,700
Dividend for 2009	800
Premises	5,900
Cash in Hand	760
Cash with RBI	20,000
Cash with Other Banks	12,000
Bills Discounted and Purchased	7,600
Loans, Cash Credits and Overdrafts	1,02,000
Bills Payable	140
Unclaimed Dividend	120
Rebate on Bills Discounted	100
Short Loans (Borrowing from Other Banks)	9,500
Furniture	2,328
Other Assets	672
Net Profit for 2010	3,100

Prepare the balance sheet of the bank as on 31 December 2010.

Solution

Working notes:

Calculation of reserves and surplus to be included in the balance sheet.

		(₹ '000)	(₹ '000)
(i)	Reserve Fund (Given)	—	1,24,00
(ii)	P & L A/c as on 1 January 2010	2,700	
	Less: Dividend for 2009	8,00	
		1,900	
	Add: Net Profit After Deducting Statutory Reserve (₹ 31,00,000 – 25% of ₹ 31,00,000)	2,325	42,25
(iii)	Statutory Reserve		7,75
(iv)	Total to Be Shown in the Balance Sheet		17,400

ABC Bank Ltd.

Balance Sheet as on 31 December 2010

	Schedule No.	As on 31 December 2010 ₹('000)
Capital and Liabilities:		
Capital	1	8,000
Reserves & Surplus (Ref: Working)…	2	17,400
Deposits	3	1,69,600
Borrowings	4	9,500
Other Liabilities and Provisions	5	360
		2,04,860
Assets:		
Cash and Balance with RBI	6	20,760
Balance with Banks and Money at Call & Short Notice	7	15,600
Investments	8	50,000
Advances	9	1,09,600
Fixed Assets	10	8,228
Other Assets	11	672
		2,04,860
Contingent Liabilities	12	NIL
Bills for Collection	—	NIL

Schedule 1—Capital

	As on 31 December 2010 ₹('000)	At on 31 December 2009 ₹('000)
Issued and Subscribed Share Capital	8,000	
	8,000	

Schedule 2—Reserves and Surplus

(₹ '000)

		As on 31 December 2010 ₹	As on 31 December 2009 ₹
Reserve Fund		12,400	
Profit & Loss A/c	2,700		
Less: Dividend for 2009	800		
	1,900		
Add: Net Profit for 2010 After Deducting	2,325	4,225	
Statutory Reserve (₹ 31,00,000 – 25% of ₹ 31,00,000)		775	
Statutory Reserve		17,400	

Schedule 3—Deposits

(₹ '000)

	As on 31 December 2010	As on 31 December 2009
Fixed Deposits	55,200	
Savings Bank Deposit	38,000	
Current Accounts	46,400	
	1,69,600	

Schedule 4—Borrowings

(₹ '000)

	As on 31 December 2010	As on 31 December 2009
Short Loans	9,500	

Schedule 5—Other Liabilities and Provisions

	As on 31 December 2010	As on 31 December 2009
Bill's Payable	140	
Unclaimed Dividend	120	
Rebate on Bills Discounted	100	
	360	

Schedule 6—Cash and Balances with RBI

	As on 31 December 2010	As on 31 December 2009
Cash in Hand	760	
Cash with RBI	20,000	
	20,760	

Schedule 7—Balance with Banks and Money at Call and Short Notice

	As on 31 December 2010	As on 31 December 2009
Money at Call and Short Notice	3,600	
Cash with Other Banks	12,000	
	15,600	

Schedule 8—Investments

	As on 31 December 2010	As on 31 December 2009
Investments	50,000	

Schedule 9—Advances

	As on 31 December 2010	As on 31 December 2009
Bills Discounted & Purchased	7,600	
Loans, Cash Credits & Overdrafts	1,02,000	
	1,09,600	

Schedule 10—Fixed Assets

	As on 31 December 2010	As on 31 December 2009
Premises	5,900	
Furniture	2,328	
	8,228	

Schedule 11—Other Assets

	As on 31 December 2010	As on 31 December 2009
Other Assets	672	

Schedule 12—Contingent Liabilities

	As on 31 December 2010	As on 31 December 2009
	Nil	

Bills for Collection → Nil

Illustration 13.16

Model: Preparation of trial balance and balance sheet

From the following particulars of MN Bank Ltd., having its own premises, prepare the balance sheet in the prescribed form as on 31 December 2010.

	₹ (in '000)
Authorized Capital	20,000
Subscribed Capital:	
20,00,000 Shares of ₹ 10 Each ₹ 5 Paid	10,000

Investments	35,000
Bills Discounted (in India)	75,000
Profit & Loss (Cr.)	4,250
Endorsement on Bills for Collection	500
Liability of Customers for Acceptances	25,000
Money at Call and Short Notice	45,000
Cash in Hand	10,000
Cash with RBI	20,000
Reserve	15,000
Cash with State Bank	20,000
Letters of Credit Issued	2,500
Telegraphic Transfer Payable	4,000
Bonus Drafts Payable	6,000
Short Loans	200
Rebate on Bills Discounted	50
Acceptances for Customers	25,000
Loans and Advances	50,000
Cash/Credits	50,000
Overdrafts	5,000
Bills Purchased (Payable Outside India)	5,000
Current and Deposit Accounts	2,80,000
Investment Fluctuation Fund	500
Bills for Collection	500

Note: Prepare a trial balance and determine the balancing figure which constitutes the value of premises.

[CS (Inter)—Modified]

Solution

Step 1: As per the direction in the question, value of premises is determined by preparing the trial balance as follows:

Trial Balance (₹ in '000)

Trial Balances	₹	Credit Balances	₹
Investments	35,000	Subscribed Capital	10,000
Bills Discounted	75,000	P & L A/c	4,250
Endorsement on Bills for Collection	500	Endorsement on Bills for Collection	500
Liability of Customers for Acceptance	25,000	Acceptances for Customers	25,000
Money at Call & Short Notice	45,000	Reserves	15,000
Cash in Hand	10,000	Letters of Credit Issued	2,500
Cash with RBI	20,000	Telegraphic Transfers Payable	4,000
Cash with State Bank	20,000	Bank Drafts Payable	6,000
Letters of Credit Issued	2,500	Short Loans	200
Loans & Advances	50,000	Rebate on Bills Discounted	50
Cash Credits	50,000	Current Deposit A/c	2,80,000

Over Drafts	5,000		
Bills Purchased	5,000	Investment Fluctuation Fund	500
Premises (Balancing Figure)	5,000		
	3,48,000		3,48,000

Step 2: Preparation of balance sheet:

(All figures are transferred from the respective schedules. For details, refer the schedules shown beneath the balance sheet one by one).

MN Bank Ltd.

Balance Sheet as on 31 December 2010

(₹ in '000)

	Scheduled No.	As on 31 December 2010 (Current Year) ₹	As on 31 December 2009 (Previous Year) ₹
Capital and Liabilities:			
Capital	1	10,000	
Reserves and Surplus	2	19,750	
Deposits	3	2,80,000	
Borrowings	4	200	
Other Liabilities and Provisions	5	10,050	
		3,20,000	
Assets:			
Cash and Balance with RBI	6	30,000	
Balance with Banks & Money at Call and Short Notice	7	65,000	
Investments	8	35,000	
Advances	9	1,85,000	
Fixed Assets	10	5,000	
Other Assets	11	Nil	
		3,20,000	
Contingent Liabilities	12	28,000	
Bills for Collection	—	Nil	

WORKING NOTES:

Schedule 1—Capital (₹ in '000)

	As on 31 December 2010	As on 31 December 2009
Authorized, Issued & Subscribed Capital:		
20,00,000 Shares of ₹ 10 Each	20,000	
Called-up and Paid-up Capital:		
20,00,000 Shares of ₹ 10 Each, ₹ 5 Called, Paid	10,000	

Schedule 2—Reserves and Surplus

Reserves	15,000	
Profit & Loss A/c	4,250	
Investment Fluctuation Fund	500	
	19,750	

Schedule 3—Deposits

Current and Deposit Accounts	2,80,000	

Schedule 4—Borrowings

Short Loans	200	

Schedule 5—Other Liabilities and Provisions

Telegraphic Transfers Payable	4,000	
Bank Drafts Payable	6,000	
Rebate on Bills Discounted	50	
	10,050	

Schedule 6—Cash and Balance with RBI

Cash with RBI	20,000	
Cash in Hand	10,000	
	30,000	

Schedule 7—Balance with Banks and Money at Call

Money at Call & Short Notice	45,000	
Cash with State Bank	20,000	
	65,000	

Schedule 8—Investments

Investments	35,000	

Schedule 9—Advances

Loans & Advances	50,000	
Bills Discounted	75,000	
Cash Credits	50,000	
Overdrafts	5,000	
Bills Purchased	5,000	
	1,85,000	

Schedule 10—Fixed Assets

Premises	5,000	

Schedule 11—Other Assets

Nil	Nil	

Schedule 12—Contingent Liabilities

Endorsement on Bills for Collection	500	
Liability for Customers Acceptances	25,000	
Letters of Credit Issued	2,500	
	28,000	
Bills for Collection	Nil	

Illustration 13.17

Model: P & L A/c and balance sheet

From the following figures taken from the books of Inland Bank Ltd., you are required to draft a balance sheet and a profit and loss account as on 31 March 2011:

	₹ (in '000)
20,000 Shares of ₹ 100 Each ₹ 50 Paid	1,000
Reserve Fund	700
Fixed Deposit Accounts	1,900
Saving Bank Accounts	6,000
Current Accounts	16,000
Money as Call and Short Notice	600
Investment at Cost	6,000
Interest Accrued and Paid	400
Salaries (Including Salary to General Manager 48,000 and Director Fees ₹ 10,000)	160
Rent	40
P & L A/c (Cr.) 1 April 2009	420
General Expenses (Including Stationery ₹ 10,000 and Auditor's Fees ₹ 4,000)	20
Dividend for 2009–10	100
Premises (After Depreciation up to 31 March 2010 ₹ 2,00,000)	2,400
Cash in Hand	120
Cash with RBI	3,000
Cash with Other Banks	2,600
Borrowed from Banks	1,400
Interest and Discounts	1,500
Bills Discounted and Purchased	1,200
Bills Payable	1,600
Loans, Overdrafts and Cash Credits	14,000
Unclaimed Dividends	60
Bills for Collection	280
Sunday Creditors	60
Acceptances and Endorsements on Behalf of Customers	400

(i) Rebate on bills discounted and purchased for unexpected term amounted to ₹ 10,000.
(ii) Allow 5% depreciation on premises on original cost.
(iii) A provision for doubtful debts amounting to ₹ 60,000 is required.
(iv) Create a provision of ₹ 2,00,000 for taxation.

The bank has no business outside India.

Solution

Inland Bank Ltd.
Profit and Loss Account
for the Year Ended on 31 March 2011

	Schedule No.	Year Ended on 31 March 2011 (₹ in '000)
I: Income		
Interest Earned	13	1,490
Other Income	14	—
		1,490
II: Expenditure		
Interest Expended	15	400
Operating Expenses	16	350
Provisions and Contingencies		260
		1,010
III: Profit/Loss		
Net Profit for the Year (I – II)		480
Profit Brought Forward From Last Year After Deducting Last Year Dividend		320
		800
IV: Appropriations:		
Transfer to Statutory Reserve		120
25% of ₹ 4,80,000 = ₹ 1,20,000		
Balance Carried Forward to Balance Sheet		680
		800

Inland Bank Ltd.
Balance Sheet as on 31 March 2011

	Schedule No.	Year Ended on 31 March 2011 (₹ in '000)
Capital and Liabilities:		
Capital	1	1,000
Reserves and Surplus	2	1,500
Deposits	3	23,900

Borrowings	4	1,400
Other Liabilities & Provisions	5	1,930
Assets:		29,730
Cash and Balance with RBI	6	3,120
Balance with Banks & Money at Call and Short Notice	7	3,200
Investments	8	6,000
Advances	9	15,140
Fixed Assets	10	2,270
Other Assets	11	NIL
		29,730
Contingent Liabilities	12	400

Working notes:

Schedules:

As on 31 March 2011
(₹ in '000)

Schedule 1: Capital		
20,000 Equity Shares of ₹ 100 Each, ₹ 50 Paid		1,000
Schedule 2: Reserves & Surplus:		
Statutory Reserves: Opening Balance		700
Additions During the Year		120
		820
Balance of P & L A/c		680
		1500
Schedule 3: Deposits		
Current Account Deposits		16,000
Saving Bank Deposits		6,000
Fixed Deposits		1,900
		23,900
Schedule 4: Borrowings:		1,400
Schedule 5: Other Liabilities and Provisions:		
Bills Payable		1,600
Others (Including Provisions)		
Sundry Creditors	60	
Unclaimed Dividends	60	
Provision for Tax	200	
Rebate on Bills Discounted	10	330
		1,930

Schedule 6: Cash and Balances with RBI:	
Cash in Hand	120
Balance with RBI	3,000
	3,120
Schedule 7: Balances with Banks and Money at Call and Short Notice	
Balance with Banks	2,600
Money at Call and Short Notice	600
	3,200
Schedule 8: Investments	
Investments in India	600
Schedule 9: Advances	
Bills Discounted and Purchased	1,200
Loans, Cash Credits and Overdrafts	13,940
	15,140
Schedule 10: Fixed Assets	
Premises at Cost	2,600
Depreciation	(330)
	2,270
Schedule 11: Other Assets	NIL
Schedule 12: Contingent Liabilities	
Acceptance, Endorsements & Other obligations	400
Schedule 13: Interest Earned	
Interest, Discount on Advances & Bills	1,500
(Less: Rebate on Bills Discounted)	10
	1,440
Schedule 14: Other Income	NIL
Schedule 15: Interest Expended	
Interest on Deposits	400
Schedule 16: Operating Expenses:	
Salaries	150
Printing & Stationery	10
Rent, Rates & Listing	40
Auditor's Fees	4
General Expenses	6
Directors' Fees	10
Depreciation on Bank Property	130
	350

Provisions and Contingencies:	
Provision for Bad Debts	60
Provision for Taxation	200
	260

Illustration 13.18

Model: Cash reserves and statutory reserves balance sheet

From the following information, prepare a balance sheet with necessary schedules of the New India Bank Ltd. as on 31 March .... and ascertain cash reserves and statutory liquid reserves required:

(₹ in Lakhs)

	Debit ₹	**Credit** ₹
Share Capital: 6,00,000 Shares of ₹ 100 Each	—	600
Statutory Reserves	—	690
Net Profit Before Appropriation	—	450
Profit and Loss Account	—	1,230
Fixed Deposit Account	—	1,560
Saving Deposit Account	—	1,350
Current Accounts	90	1,560
Bills Payable	—	3
Cash Credit	2,439	—
Borrowing from Other Banks	—	330
Cash in Hand	480	—
Cash with RBI	120	—
Cash with Other Banks	468	—
Money at Call and Short Notice	630	—
Gold	165	
Government Securities	330	—
Premises	468	—
Furniture	210	—
Term Loan	2373	—
	7,773	7,773

Additional Information:

Bills for Collection	60,00,000
Acceptances and Endorsements	45,00,000
Claims Against the Bank not Acknowledged as Debits	1,80,000

Depreciation Charges:

Premises	3,00,000
Furniture	2,40,000

50% of the Term Loans Are Secured by Govt. Guarantees

10% of the Cash Credit Is Unsecured

Note: Cash reserves required 3% of the total demand and time liabilities and stationary liquidity ratios require 30% of the total demand and time liabilities. Statutory reserves: 20% of the net profit.

Solution

Note: Here, the calculations are based on the percentage given in the question (Note)

1. 20% of the Net Profit is to be Transferred to Statutory Reserve:

(i)	Net Profit Before Appropriation (Given)	=	₹ 450 Lakhs
(ii)	Amount to be Transferred to Statutory Reserve	=	20% of Net Profit
	(as per Note in the Question 20%)	=	$\frac{20}{100} \times$ ₹ 450 Lakhs
		=	₹ 90 Lakhs
(iii)	Balance of P & L A/c which was Transferred to be Balance Sheet	=	Opening Balance + Net Profit – Statutory Reserve
		=	₹ 1,230 + ₹ 450 – ₹ 90 Lakhs
		=	₹ 1,590 Lakhs

2. Calculation of Reserves and Surplus:

(a) Statutory Reserves	₹ (in Lakhs)
Opening Balance	690
Add: Additions During the Year (20% of ₹ 4,50,00,000)	90
	780
Less: Dedications During the Year	Nil
	780
Add: Balance in P & L A/c (Ref: 1) Above	15,90
	23,70

3. Calculation of Cash Reserve:

Cash Reserve to be Maintained at 3% on Deposits (Demand Deposit + SB + FD ₹ 1,560 1,350 1,560 = ₹ 44,70,00,000) $\frac{3}{100} \times$ ₹ 44,70,00,000	=	134.10
Less: Existing Cash Reserve with RBI	=	120.00
Shortage of Cash Reserve	=	14.10

4. Calculation of Statutory Liquid Reserve: (SLR)

SLR to be Maintained at 30% $\frac{30}{100} \times$ ₹ 44,70,00,000	1341.00

Cash in Hand		480.00	
Less: Shortage of Cash Reserve		14.10	
		465.90	
Add:	Gold	165.00	
	Govt. Securities	330.00	960.90
Shortage of Statutory Liquid Ratio:			380.10

Balance Sheet of New India Bank Ltd.
As on 31 March.....

	Schedule No.	As on 31 March... Current Year (₹ in Lakhs)	As on 31 March... (Previous Year (₹ in Lakhs)
Capital and Liabilities:			
Capital	1	600	—
Reserves and Surplus	2	2,370	—
Deposits	3	4,470	—
Borrowings	4	330	—
Other Liabilities and Provisions	5	3	—
		7,773	—
Assets:			
Cash and Balance with RBI	6	600	
Balance with Bank and Money at Call and Short Notice	7	1,098	
Investments	8	495	
Advances	9	4,902	
Fixed Assets	10	678	
Other Assets	11	—	
		7,773	
Contingent Liabilities	12	46.80	
	—	60.00	

Schedules

(₹ in Lakhs)

	As on 31 March..... Current Year	As on 31 March.... (Previous Year
Schedule 1: Capital		
Subscribed, Called-up and Paid-up Capital:		
6,00,000 Shares of ₹ 100 Each	600	
Schedule 2: Reserve and Surplus:		

I. Statutory Reserves:		
Opening Balance	690	
Add: Additions During the Year (20% × ₹ 4,50,00,000)	90	
	780	
Less: Deductions During the Year	Nil	
	780	
II. Capital Reserve	Nil	
III. Share Premium	Nil	
IV. Reserve and Other Reserves	Nil	
V. Balance in P & L A/c (1230 + 360)	1,590	
	2,370	
Schedule 3: Deposits:		
I. Demand Deposits—Current A/c	1,560	
II. Saving Bank Deposits	1,350	
III. Term Deposits—Fixed Deposit A/c	1,560	
	4,470	
Schedule 4: Borrowings:		
I. Borrowings in India:		
(i) RBI	—	
(ii) Other Banks	330	
(iii) Other Institutions and Agencies	—	
II. Borrowings Outside India	—	
	330	
Schedule 5: Other Liabilities and Provisions:		
I. Bills Payable	3	
II. Inter-office Adjustments (Net)	—	
III. Interest Accrued	—	
IV. Other Liabilities (Including Provisions)	—	
	3	
Schedule 6: Cash and Balance with RBI:		
I. Cash in Hand	480	
II. Cash Balance with RBI	120	
	600	
Schedule 7: Balance with Banks and Money at Call and Short Notice:		
I. In India:		
(i) Balance with Bank	468	
(ii) Money at Call and Short Notice	630	
	1,098	

Schedule 8: Investments:		
I. Investment in India in:		
(i) Govt. Securities	330	
(ii) Other (Gold)	165	
	495	
Schedule 9: Advances		
I. (i) Bills Discounted and Purchased		
(ii) Cash Credit, Overdrafts and Loans:		
Payable on Demand:		
Cash Creditors	2,439	
Overdraft	90	
(iii) Term Loans	2,373	
	4,902	
II. (i) Secured by Tangible Assets		
(90% of 2,439 + 50% of 2373)	3,381.60	
(ii) Covered by Bank/Govt. Guarantors (50% of 2373)	1,186.50	
(iii) Unsecured (10% of 2439 + 100% of 90)	333.90	
	4,902.00	
Schedule 10: Fixed Assets		
(i) Premises	468	
(ii) Other Fixed Assets (Including Furniture)	210	
	678	
Schedule 11: Other Assets	Nil	
Schedule 12: Contingent Liabilities		
(i) Claims Against the Bank Not Acknowledge as Debts	1.80	
(ii) Acceptance and Endorsements	45.00	
	46.80	

Illustration 13.19

Model: P & L A/c and balance sheet.

From the following figures taken from the books of Asian Bank Ltd., prepare profit and loss account and balance sheet as on 31 March 2011:

	₹ (in '000)
5,00,000 Shares of ₹ 10 Each, ₹ Paid up	2,500
Reserve Fund Investments	1,750
Fixed Deposits	4,750
Savings Bank Deposits	15,000

Current Deposits	40,000
Money at Call and Short Notice	2,250
Investments	12,500
Interest Accrued and Paid	1,000
Rent	100
Salaries (Including GM's Salary 1,20,000)	345
Directors Fees	30
Provident Funds Contribution	25
General Expenses	50
Profit and Loss Account (1 April 2010)	1,000
Bank Drafts	1,550
Unclaimed Dividends	100
Premises (After Depreciation up to 31 March 2010 ₹ 5,00,000)	6,000
Cash	750
Stock of Stationery	50
Cash with RBI	7,000
Traveller's Cheques	2,500
Balance Writs Other Banks	8,000
Letters of Credit	1,500
Borrowed from Banks	4,000
Owing by Foreign Correspondents	500
Interest and Discounts	3,500
Commission	250
Bill Discounted	3,000
Loans	15,000
Cash Credits and Overdrafts	20,000
Bills for Collection	700
Acceptances on Behalf of Customers	1,000
Dividend for 2009–10	250
Branch Adjustments (Cr.)	50

Rebate on Bills Discounted for Unexpired Term is ₹ 25,000

A provision for doubtful debts amounting to ₹ 1,50,000 is required. Create provision for taxation to the extent of ₹ 5,00,000. Charge 5% depreciation on premises on original cost. Travellers' cheques paid amounted to ₹ 1,00,000.

Solution

Asian Bank Ltd.
Profit and Loss Account
for the Year Ended on 31 March 2011

		Schedule No.	Year Ended on 31 March 2011 (₹ in '000)
I.	Income:		
	Interest Earned	13	3,475
	Other Income	14	250
			3,725
II.	Expenditure:		
	Interest Expended	15	1,000
	Operating Expenses	16	875
	Provisions and Contingencies		650
			2,525
III.	Profit/Loss:		
	Net Profit for the year (I – II)		1,200
	Profit Brought Forwarded		1,000
			2,200
IV.	Appropriations:		
	Transfer to Statutory Reserve		300
	(₹ 12,00,000 × 25/100)		
	Transfer to Other Reserves	—	
	Transfer to Government/Proposed Dividend		250
	Balance Carried to Balance Sheet		1,650
			2,200

Schedules to P & L A/c

(₹ '000)

Schedule 13: Interest Earned:	
Interest and Discount	3,500
Less: Closing Rebate on Bills Discounted	25
	3,475
Schedule 14: Other Income:	
Commission	250
Schedule 15: Interest Expended	
Interest Accrued and Paid	1,000

Schedule 16: Operating Expenses:	
Rent	100
Salaries (Including GM's Salary)	345
Directors Fees	30
Provident Fund Contribution	25
Central Expenses	50
Depreciation on Premises	325
(₹ 60,00,000 + ₹ 5,00,000) × 5/100)	
	875
Provisions and Contingencies	150
Provision for Taxation	500
	650

Now, trial balance has to be prepared and the difference in trial balance is to be taken to other liabilities and provisions.

Trial Balance

Debit Balances	₹ **(in '000)**	**Credit Balances**	₹ **(in '000)**
Reserve Fund Investments	1,750	Share Capital	2,500
Money at Call & Short Notice	2,250	Reserve Fund	1,750
Investments	12,500	Fixed Deposits	4,750
Interest Accrued & Paid	1,000	SB Deposits	15,000
Rent	100	Current A/c Deposits	40,000
Salaries	345	P & L A/c (1 April 2010)	1,000
Directors Fees	30	Bank Draft	1,550
PF Contribution	25	Unclaimed Dividends	100
General Expenses	50	Traveller's Cheques	2,500
Premises	6,000	Borrowed from Banks	4,000
Cash	750	Interest and Discounts	3,500
Stock of Stationery	50	Commission	250
Cash with RBI	7,000	Branch Adjustments	50
Balance with Other Banks	8,000	*Difference in Trial Balance	1,650
Owing by Foreign Correspondents	500	(Balancing figure)	
Bills Discounted	3,000		
Loans	15,000		
Cash Credit & Overdraft	20,000		
Dividend	250		
	78,600		78,600

Important note:

As reserve fund investment is shown in the question, then obviously "reserve fund" also should exist.

Calculation of other liabilities and provisions:

	(₹ in '000)
Bank Drafts	1,500
Unclaimed Dividends	100
Traveller's Cheques (₹ 25,00,000 – ₹ 1,00,000)	2,400
Branch Adjustment (₹ 50,000 + ₹ 1,00,000)	150
Rebate on Bills Discounted	25
Provision for Taxation	500
Difference in Trial Balance (Ref: T/B)	1,650
	6,375

Asian Bank Ltd.

Balance Sheet as on 31 March 2011

	Schedule No.	As on 31 March 2011 (₹ in '000)
Capital and Liabilities:		
Capital	1	2,500
Reserve & Surplus	2	3,700
Deposits	3	59,750
Borrowings	4	4,000
Other Liabilities & Provisions	5	6,375
		76,325
Assets:		
Cash & Balance with RBI	6	7,750
Balance with Banks and Money at Call and Short Notice	7	10,200
Investments	8	14,250
Advances	9	38,350
Fixed Assets	10	5,675
Other Assets	11	50
Contingent Liabilities	12	2,500
Bills for Collection	—	700

Schedules to be attached to the balance sheet are prepared as follows:

	As on 31 March 2011 (₹ in '000)
Schedule 1: Capital	
Authorized, Issued and Subscribed Capital:	

5,00,000 Shares of ₹ 10 Each	5,000
Called-up and Paid-up Capital	
5,00,000 Shares of ₹ 10 Each, ₹ 5 Paid	2,500
Schedule 2: Reserve and Surplus:	
Reserve Fund	1,750
Statutory Reserve	300
P & L A/c Balance	1,650
	3,700
Schedule 3: Deposits	
Fixed Deposits	4,750
Saving Bank Deposits	15,000
Current A/c Deposits	40,000
	59,750
Schedule 4: Borrowings	
Borrowed from Banks	4,000
Schedule 5: Other Liabilities and Provisions	
Bank Drafts	1,550
Unclaimed Dividends	100
Traveller's Cheques	2,400
Branch Adjustments	150
Rebate on Bills Discounted	25
Provision for Taxation	500
Difference in Trial Balance	1,650
	6,375
Schedule 6: Cash and Balances with RBI	
Cash	750
Balance with RBI	7,000
	7,750
Schedule 7: Balance with Banks and Money at Calls and Short Notice	
Balance with Other Banks	8,000
Money at Call and Short Notice	2,250
	10,250
Schedule 8: Investments	
Reserve Fund Investments	1,750
Investments	12,500
	14,250

Schedule 9: Advances		
Owing by Foreign Correspondents		500
Bills Discounted		3,000
Loans		15,000
Cash Credits and Overdrafts		20,000
		38,500
Less: Provision for Doubtful Debts		150
		38,350
Schedule 10: Fixed Assets		
Premises	60,00,000	
Less: Depreciation (65,00,000 × 5/100)	3,25,000	5,675
Schedule 11: Other Assets		
Stock of Stationery		50
Schedule 12: Contingent Liabilities		
Acceptances on Behalf of Customers		1,000
Letter of Credit		1,500
		2,500
Bills for Collection		700

Summary

A bank is an organization, which may involve a number of financial trading activities, regulated by the Banking Regulations Act, 1949.

Banking means accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawals by cheque, draft or otherwise. A company that transacts the business of banking is called a bank company.

A bank which is included in the second schedule of RBI Act, 1934 is referred as "Scheduled Bank".

Business of banking companies involves the following activities:

1. Borrow or raise money.
2. Carry on and transact guarantee and indemnity business.
3. Undertake and execute trusts.
4. Acquire and undertake the whole or any part of the banking business of any person or company.
5. Contract for public and private loans, negotiate and issue them.
6. To engage in any business, which is authorized by the Govt. No banking company is permitted to carry on business other than those specified in Section 5(2) of the Act.

Banking Regulation Act stipulates certain minimum amount of paid-up capital and reserve (for details refer the text).

For important provisions of the Banking Regulation Act, 1949 refer the main part of the text.

Main features of banking accounting: (i) slip system of posting, (ii) voucher summary sheets, (iii) self-balancing system of ledgers, (iv) daily trial balance and (v) double voucher system.

Preparation of final accounts of banking companies: Third schedule—Form A and B—Formats of P & L A/c and balance sheet along with necessary schedules to be prepared and are explained with illustrations (Ref. Illustrations 13.1–13.18).

Key Terms

Statutory Reserve Fund: A statutory requirement for banking companies to create and transfer a specified percentage of its profit. Section 17 requires 20% of the profit. RBI stipulates 25% of the net profits to be transferred to statutory reserve.

Cash Reserve: A sum equivalent to 3% of is total time and demand liabilities is to be created and amounted with RBI banking companies. This cash reserve ratio varies from time to time. At present it is 6 %.

Slip System: A system of ledger posting under which entries are made in the personal accounts of the customers in the ledger directly from the slips and not from the subsidiary books or journals.

Slip: Loose leaf of journals or cash books on which transactions are recorded when they incur, for example, pay-in-slip, cheque or withdrawal form.

Rebate on Bills Discounted: A technical term that refers to unearned portion of the discount income received by the bank. This occurs when the bills discounted/purchased by the bank will mature after the closing date of the final accounts.

Non-performing Asset: Asset that ceases to generate income.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. Regulations regarding appointment of directors, disposal of profits and the like with respect to nationalized banks are not applicable.
2. A banking company can do any form of business other than those mentioned in Section 6 of the Banking Regulation Act.
3. Energy banking company is required to prepare final accounts in accordance with Schedule VI of Companies Act, 1956.
4. A banking company closes its accounts on 31 March every year.
5. A banking company can directly or indirectly deal with the business of buying or selling or bartering of goods.
6. A banking company cannot hold any immovable property for any period exceeding 7 years.
7. The minimum limit of paid-up capital and reserve to be complied with by a banking company varies from place to place.
8. When capitalized expenses are outstanding, payment of dividend out of the profits is permitted for banking companies.
9. A banking company cannot create a floating charge on unpaid capital.
10. A scheduled bank is not required to maintain cash reserves.
11. The RBI has been empowered to alter SLR.
12. A banking company can grant loans and advances on security of its own shares.
13. Profit on sale of investments is an income and should be shown under the head "other income".
14. Surplus on transaction of the financial statements of foreign branches is a revaluation reserve.
15. Interest payable on deposits, which is accrued but not due should be included under the head "deposits"—Schedule 3.
16. Inter-office transactions should not be shown as borrowings.
17. Income from non-performing assets (NPAs) is recorded on accrual basis.
18. For all sub-standard assets, a general provision of 10% is to be made on total outstanding amount.
19. Provision is required to be made depending upon the period for which the asset has remained doubtful.
20. The contingent liabilities are to be shown in Schedule 12.

Answers:

1. True	6. True	11. True	16. True
2. False	7. True	12. False	17. False
3. False	8. False	13. True	18. False
4. True	9. True	14. False	19. True
5. False	10. False	15. False	20. True

II: Fill in the blanks with apt word(s)

1. In India, the business of banking is governed by the _____Act, 1949.
2. In addition to this 1949 Act, corporate entities carrying on the business of banking are governed by the _____Act.
3. The_____ controls and supervises the activities of banking companies in India.
4. Section ____ of the Banking Regulation Act provides a detailed list of the form of business a banking company can do, in addition to banking business.
5. The minimum paid-up capital and reserves to be complied with by a banking company, which is incorporated in India and if it has place of business in more than one state but not in Mumbai or Kolkata is ₹_____.
6. U/S 17 of the Banking Regulation Act, a banking company incorporated in India is required to create _____of its net profit and transfer to statutory reserve.
7. According to Section 13 of the Banking Regulation Act, a bank cannot pay more than _____ of the paid-up value of shares by way of commission, brokerage, etc.
8. A sum of at least _____ of its time and demand liabilities has to be maintained as cash reserve as per Section 18.
9. At present, the norm for statutory liquidity ratio (SLR) as per Reserve Bank of India is _____.
10. The balance sheet of a banking company should be prepared in Form _____ of Schedule III of the Act.
11. The P & L A/c of a banking company has to be prepared in Form _____ of Schedule III of the Act.
12. _____ are the basis for recording transactions in banking.
13. At present, as per the regulations of RBI, cash reserve is _____.
14. All appropriations of profit are to be shown in _____ part of P & L A/c.
15. "Interest earned" is shown in Schedule _____.
16. Schedule 14 is related to _____.
17. "Interest expended" is shown in Schedule ____.
18. Depreciation on bank's property is to be included under the head "_____".
19. Income from "performing assets' is recorded on "_____".
20. At present, banks are required to create a provision of_____ on standard assets on global loan portfolio basis.

Answers:

1. banking regulation
2. companies
3. Reserve Bank of India
4. 6
5. ₹ 5 Lakhs
6. 20%
7. 2½%
8. 3%
9. 25%
10. A
11. B
12. Slips
13. 5%
14. IV
15. 13
16. other income
17. 15
18. operating expenses
19. accrual
20. 0.40%

III: Multiple choice questions—Choose the correct answer

1. A banking company in India is regulated by
   (a) The Companies Act
   (b) Reserve Bank of India
   (c) Banking Regulation Act
   (d) all of these
2. Which of the following forms of business is not permitted to carry out by banking companies, as per Section 6 of the Banking Regulation Act?
   (a) buying, selling and dealing with bullion
   (b) providing of safe deposit values
   (c) buying, selling or bartering of goods
   (d) undertaking and executing trusts
3. Every banking company is required to prepare final accounts in conformity with
   (a) third schedule of the Banking Regulation Act, 1949
   (b) sixth schedule of the Companies Act, 1956

(c) guidelines of RBI
(d) none of these

4. As per RBI guidelines, the percentage of profit to be transferred to statutory reserve is
   (a) 20 (b) 25
   (c) 10 (d) 12.5
5. Which of the following is not classified as "Capitalized expenses"?
   (a) preliminary expenses
   (b) brokerage
   (c) share-selling commission
   (d) depreciation on assets
6. Which of the following is not the permissible factor to form a subsidiary company?
   (a) the undertaking and executing of trust
   (b) the undertaking of the administration of estates as execute
   (c) the undertaking of another sick banking company
   (d) the carrying-on business of banking exclusively outside India, with prior permission of the RBI
7. The inter-office adjustment balance (net) should be shown under the head
   (a) other Liabilities and provisions
   (b) borrowings
   (c) interest expended
   (d) (d) none of the above
8. "Provision for income tax" is to be shown under the head
   (a) other assets
   (b) other liabilities
   (c) operating expenses
   (d) loans and advances
9. Which of the following is not a contingent liability?
   (a) guarantees given on behalf of customers
   (b) acceptances, endorsements and other obligations
   (c) claims against the bank, not acknowledged as debts
   (d) traveller's cheques, gift cheques and the like
10. Which of the following is not included under the head "advances"—Schedule 9:
    (a) cash credit
    (b) overdrafts
    (c) Money as call
    (d) purchasing and discounting of bills

Answers

1. (d)	4. (b)	7. (a)	10. (c)
2. (c)	5. (d)	8. (b)	
3. (a)	6. (c)	9. (d)	

Short Answer Questions

1. Define Bank.
2. Define Banking.
3. What do you mean by a "banking company"?
4. Mention some forms of business that a banking company can carry on.
5. How can the final accounts of a banking company be presented?
6. What is the accounting year for banking companies?
7. Explain the provisions of Section 8 of the Banking Regulation Act relating to "trading".
8. What is "statutory reserve"?
9. Explain the main provisions of Section 15 with respect to payment of dividend.
10. What is the maximum limit for payment of commission, brokerage, etc.?
11. What are the major considerations in forming a subsidiary company?
12. Write short notes on "cash reserves".
13. What is meant by "statutory liquidity ratio"?
14. Enlist the items to be included under "Schedule 13".
15. Explain non-performing assets.
16. Enlist the items to be included in "Schedule 14".
17. Mention the items to be shown under the head "interest expended".
18. Mention the important items to be shown under the head "provisions and contingencies".
19. How will you treat "rebate on bills discounted" in a bank account?
20. What is the accounting treatment for "money at call and short notice"?
21. How bank accounts are classified?

22. Explain "doubtful debts".
23. How will you create provision for doubtful debts?
24. How will you treat "inter-office adjustments" in bank accounts?
25. Mention the items to be shown under the head "contingent liabilities".
26. Write short notes on "non-banking assets".
27. How banks advances are classified for the purpose of "provisioning"?
28. Write short notes on "money at call and short notice".
29. Explain "interest suspense account".
30. Write short notes on "standard assets".

Essay Type Questions

1. Define banking and banking company. Explain in detail the forms of business a banking company may carry on as per Section 6 of the Banking Regulation Act.
2. Explain in detail the important legal provisions with special reference to final accounts of a banking company.
3. Draw the proforma of P & L A/c in conformity with Form B of Schedule III of Banking Regulation Act and the schedules to be annexed to it.
4. Draw the proforma of balance sheet in conformity with Form A of Schedule III and the schedules to be attached to it.
5. Enumerate the important guidelines issued by the RBI in the preparation of P & L A/c of banking companies.
6. What are the different types of provisions for NPAs as on date?
7. How are the following treated in bank final accounts? (i) Rebate on bills discounted, (ii) bad debts and provision for doubtful debts, (iii) provision for taxation, (iv) interest on doubtful debts, (v) money at call and short notice, (vi) advances and (vii) investments.

Exercises

Part A—For Undergraduate Level

1. Calculate rebate on bills discounted as on 31 March 2011:

Date of Bill	Amount (₹)	Period (Months)	Rate of Discount (%)
15 January 2011	1,25,000	5	8
10 February 2011	75,000	4	7
25 February 2011	1,00,000	4	7
20 March 2011	1,50,000	3	9

[**Ans.:** Rebate: ₹ 8,020.45 (₹ 2,158.45 + ₹ 1,061.45 + ₹ 1,702.20 + ₹ 3,098.95)]

2. The following accounts are extracted from trial balance of Konark Bank Ltd. on 31 March 2011:

	Dr.	Cr.
	₹	₹
Interest and Discounted	—	52,26,000
Rebate on Bills Discounted	—	37,500
Bills Discounted and Purchased	15,36,000	—

It is ascertained that proportionate discount not earned on the balance of bills discounted, which will mature in 2011–12 amounts to ₹ 68,100.

Pass the necessary adjustment entries.

[**Ans.:** Amount of interest and discount to be shown in P & L A/c: ₹ 51,95,400]

3. From the following information, find out the amount of provision to be shown in the P & L A/c of a Commercial Bank:

Assets:	₹ in Lakhs
Standard	32,000
Substandard	24,000
Doubtful:	
For 1 Year	4,000

For 3 Years	6,400
For More Than 3 Years	1,600
Loss Assets	4,800

[**Ans.:** Total provision: ₹ 10,800 Lakhs]

4. While closing the books of a commercial bank on 31 December 2010, you find in the loan ledger an unsecured balance of ₹ 3,00,000 in the account of a merchant, whose financial condition is reported to you as doubtful. Interest on the same account amounted to ₹ 30,000 during the year.

   During the year 2011, the bank accepted 60 paise in the rupee on account of the total debt up to 31 December 2010.

   Show the merchant's loan account.

   [**Ans.:** Amount written off as bad debts: ₹ 1,20,000 Interest taken into account: ₹ 18,000]

5. From the following particulars relating to Himachal Bank Ltd., ascertain the profit balance carried over to the balance sheet:

	₹
Net Profit for the Year	5,12,000
Profit Brought Forward from Previous Year	4,80,000
Transfer to Statutory Reserve	25%
Transfer to Other Reserves	10%
Transfer to Proposed Dividend	80,000

   [**Ans.:** ₹ 7,32,800]

6. From the following balances, prepare P & L A/c of New Bank Ltd., in the revised format:

	₹
Interest Received	16,26,780
Discount Received	7,31,280
Commission Received	1,32,720
Interest on Deposits	4,81,560
General Expenses	5,47,260
Bad Debts	3,86,130

   Note: Rebate on bills discounted: ₹ 1,93,140

   [**Ans.:** Net profit: ₹ 8,82,690 Transfer to statutory reserve: ₹ 2,20,674]

7. On 31 December 2010, the loan ledger in the books of a bank showed a debit balance of ₹ 5,00,000 including ₹ 1,00,000 due from a merchant, which is doubtful. The interest accrued on the loans up to 31 December 2010 was ₹ 25,000 including ₹ 5,000 on doubtful debt. The merchant became insolvent and the official reserve paid a dividend of ₹ 0.25 in the rupee on 31 January 2011.

   Pass the necessary journal entries in the books of the bank on 31 December 2010 and 31 January 2011 and prepare the loan account.

   [**Ans.:** Amount written off as bad debts: ₹ 75,000 Interest taken into account: ₹ 1,250]

8. The following is an extract from trial balance of a bank as on 31 December 2010:

	₹	₹
Bills Discounted and Purchased	7,45,400	—
Interest and Discount	—	1,93,24,800
Rebate on Bill Discounted	—	21,680

   It is ascertained that proportionate discount not yet earned on the balance of bills discounted, which will mature in 2011 amounts to ₹ 30,920.

   You are required to show the rebate on bills discounted A/c and interest and discount A/c. How will these items appear in the bank's balance sheet?

   [**Ans.:** Amount of interest and discount to be shown in the P & L A/c: ₹ 1,93,15,560 Rebate on bills—₹ 30,920 is a liability. Bills discounted ₹ 7,45,400 is as asset]

9. From the following particulars, prepare the P & L A/c of Noida Bank Ltd. for the year ending on 31 March 2011.

	(₹ in '000)
Interest on Deposits	16,000
Commission (Cr.)	500
Interest on Loans	12,450
Sundry Charges (Cr.)	500
Rent and Taxes	1,000
Establishment	2,500
Discount on Bills Discounted	7,450
Interest on Overdrafts	8,000
Interest on Cash Credits	11,600
Auditors' Fees	175
Directors Fees	80
Bad Debts to be Written off	1,500

   [**Ans.:** Net profit for the year: ₹ 1,82,45,000 Balance carried to B/s: ₹ 1,36,83,750]

10. Prepare the profit and loss A/c for the year ended on 31 December 2010 of Rajasekaran Bank Ltd., from the following particulars:

	(₹ in '000)
Interest on Loans	3,000
Interest on Savings Accounts	1,800
Interest on Credit Cards	1,920
Interest on Fixed Deposits	2,280
Interest on Overdraft	600
Amount Charged Against Current Accounts	240
Rebate on Bills Discounted	228
Salaries and Allowances	1,440
Discount	480
Rent, Tax, Insurance, etc.	60
Dearness Allowance	420
Commission, Brokerage and Exchange	180
Managing Director's Salary	180
Contribution to Provident Fund	120

[**Ans.:** Net profit for the year: ₹ 1,20,000; Balance carried to B/s: ₹ 90,000]

11. The following are the balances of Khan Bank Ltd. for the year ended on 31 March 2011:

	(₹ in '000)
Interest on Loans	1,554
Interest on Fixed Deposit	1,650
Commission Received	48
Salaries & Allowances	324
Discount on Bills Discounted	876
Rebate on Bills Discounted	294
Interest on Cash Credits	1,338
Interest on Current Accounts	252
Rent & Taxes	108
Interest on Overdrafts	924
Director's Fees	18
Auditors Fees	6
Interest on Savings Bank Deposits	408
Postage & Phone	9
Printing & Stationery	18
Locker Rent	6
Transfer Fees	3
Depreciation on Bank's Properties	30
Sundry Changes	12

Other information:

(i) Provision for bad debts to be made: ₹ 2,40,000

(ii) Provision for income tax required: ₹ 9,00,000

Prepare P & L A/c of the bank for the year ended on 31 March 2011.

[**Ans.:** P & L A/c balance carried to B/s: ₹ 5,80,500]

12. From the following ledger balances of Overseas Bank Ltd. prepare P & L A/c:

	(₹ in '000)
Interest Paid on Deposits	16,052
Commissions Exchange & Brokerage	4,424
Interest Received	53,226
Discount on Bills Discounted	24,376
Salary & Provident Fund	4,000
Profit on Sale of Fixed Assets	3,000
Printing & Stationery	1,000
Postage & Telephones	2,000

Note: Provide for taxation: ₹ 20,00,000; rebate on bills discounted: ₹ 14,38,000.

[**Ans.:** Net profit for the year: ₹ 58,53,600 Balance carried to B/s: ₹ 4,39,02,000]

13. Form the following information, prepare P & L A/c of Poone Bank Ltd. for the year ended on 31 December 2010.

	(₹ in '000)
Interest on Loans	5,180
Interest on Fixed Deposits	5,500
Relate on Bills Discounted	980
Commission	164
Establishment	1,080
Discount on Bills Discounted (Net)	2,920
Interest on Cash Credits	4,460
Interest on Current Accounts	840
Rent and Taxes	360
Interest on Overdrafts	3,080
Director's Fees	60
Auditor's Fees	24
Interest on Saving Bank Deposits	1,360
Postage & Phone	28
Printing & Stationery	58
Sundry Charges	34

Bad debts to be written off amounted to ₹8,00,000. Provision for taxation may be made @ 55%.

[**Ans.:** Provision for taxation: ₹31,13,000 Net profit: ₹25,47,000 Balance to B/s: ₹19,10,250]

14. From the following information prepare P & L A/c of Mumbai Bank Ltd. as on 31 March 2011:

	(₹ in '000)
Interest and Discount	6,090
Income from Investments	230
Interest on Balance with RBI	360
Commission, Exchange and Brokerage	1,640
Profit on Sale of Investments	220
Interest on Deposits	2,450
Interest Paid to RBI	322
Payment to and Provision for Employees	2,088
Rent, Taxes and Lighting	420
Printing and Stationery	360
Advertisement and Publicity	190
Depreciation	184
Director's Fees	440
Auditor's Fees	240
Law Charges	460
Postage & Telephone	140
Insurance	112
Repairs & Maintenance	96

Other information:

(a) Interest and discount mentioned above is after adjustment for the following:

	(₹ in '000)
Tax Provision for the Year	400
Provision During the Year for Doubtful Debts	204
Loss on Sale of Investments	24
Rebate on Bills Discounted	116

(b) 25% of the profit is to be transferred to statutory reserves and 5% of the profit is to be transferred to revenue reserve. Profit brought forward from last year is ₹32,000.

[**Ans.:** Net profit for the year: ₹10,38,000; Balance carried to B/s: ₹7,58,600]

15. From the following particulars of AZ Bank Ltd., prepare a balance sheet as on 31 March 2011 in the revised format:

	(₹ in Lakhs)
Authorised Capital	80
Subscribed Capital	40
Investments	140
Bills Discounted	300
P & L A/c (Cr.)	17
Endorsement on Bills for Collection	2
Liability of Customers for Acceptances	100
Money at Call and Short Notice	180
Cash in Hand	40
Cash with RBI	80
Statutory Reserve	60
Cash with SBI	80
Letters of Credit Issued	10
Telegraphic Transfers Payable	16
Bank Drafts Payable	24
Short Loans	0.8
Rebate on Bills Discounted	0.2
Acceptances for Customers	100
Loans & Advances	200
Cash Credit	200
Overdraft	20
Bills Purchased	20
Current and Deposit Accounts	1,120
Investment Fluctuation Fund	2
Bills for Collection	2
Buildings	20

[**Ans.:** Balance sheet total: ₹1,280 Lakhs]

16. From the following balances of Swasthik Bank Ltd., as on 31 March 20…., prepare its balance sheet in the prescribed form:

	(₹ in '000)
Paid-up Share Capital (Shares of ₹50 each) Fully Paid	4,000
Bills Discounted	3,600
Reserve Fund	1,540
Cash Credits	4,000
Overdrafts	1,600
Unclaimed Dividends	20
Loans	9,200
Current Deposits	7,600
Furniture	80
P & L A/c (Cr.)	440

Stamps and Stationery	20
Cash in Hand	1,000
Cash with RBI	2600
Branch Adjustment (Dr.)	340
Investments	1,900
Loans (Cr.)	2,400
Recurring Deposits	2,000
Fixed Deposits	4,000
Cash Certificates	2,000
Contingency Reserve	340

Adjustments:

(a) Rebate on bills discounted: ₹20,000

(b) Provide ₹1,60,000 for doubtful debts

(c) Bank acceptance on behalf of customers is ₹13 lakhs

[**Ans.:** P & L balance taken to B/s: ₹2,60,000 Balance sheet total: ₹2,43,40,000]

17. The following ledger balances of Bank of Triplicane Ltd. as on 31 December 2010 are furnished to you. Prepare P & L A/c and balance sheet as per requirement of law.

	(₹ in '000)
Reserve Fund	3,600
Bad Debts Written off	384
General Expenses	546
Current Accounts	60,735
Interest Paid	480
Deposit Accounts	20,760
P & L A/c b/fd	687
Bills Receivable for Customers	4,500
Discounts	732
Endorsements and Guarantees	1,725
Commission	135
Cash	675
Interest Earned	1,650
Balance with RBI	6,090
Endorsements and Guarantees (Constituent Liabilities)	1,725
Balance with Foreign Correspondents	3,618
Bills for Collection	4,500
Borrowings from Banks	19,446
Cash Credit and Overdrafts	46,371
Bills Discounted	18,684
Premises	6,651
Share Capital	6,000

The following information is furnished:

(a) Rebate on bills discounted to provide ₹1,92,000

(b) The bank has paid an interim dividend of ₹6,00,000 during the year.

[**Ans.:** Net profit: ₹9,15,000 B/s total: ₹11,17,35,000 Trial balance difference: ₹6,00,000 Interim dividend given in adjustments in a part of trial balance]

18. The following is the trial balance of a banking company as on 31 December 2010:

Particulars	Debit (₹ in '000)	Particulars	Credit (₹ in '000)
Loans and Advances	11,925	Share Capital:	
Premises	300	1,25,000 Shares of ₹20,00,000	2,500
Reserve Fund Investments	1,000	Reserve Fund	1,000
Investment in Govt. Securities	800	Current and Other Deposits	10,400
Salaries	300	P & L A/c as on 1 January 2010	175
General Expenses	160	Interest and Discounts	1,560
Rent, Rates and Taxes	15		
Directors' Fees	100		
Money at Call and Short Notice	400		
Income Tax Paid	130		
Bills Discounted	1,810		
Interim Dividend Paid	125		
Cash in Hand and with RBI	200		
	15,635		15,635

Adjustments:

(a) Interest accrued on investments: ₹1,10,000.

(b) The market value of Govt. securities is ₹7,50,000 and provision is to be made.

(c) Endorsements on behalf of customers: ₹10,50,000.

(d) Authorized capital: 2,50,000 shares of ₹20 each.

Prepare P & L A/c and balance sheet as on 31 December 2010.

[**Ans.:** Net profit: ₹9,15,000 Balance taken to B/s: ₹7,36,250 B/s total: ₹1,49,15,000]

19. From the following balances of Hope Bank Ltd. as on 31 March 2011, prepare a profit and loss A/c and a balance sheet for the relevant year:

Balances as on 31 March 2011

	(₹ in '000)
Share Capital (Equity Shares of ₹100 Each Fully Paid	9,900
Reserve Fund	1,920
Current Accounts	30,000
Savings Bank Accounts	15,000
Fixed Deposit Accounts	7,500
P & L A/c	2,400
Money at Call and Short Notice	1,800
Salaries (Including ₹3,60,000 to GM)	9,600
Directors' Fees	150
Investment (at Cost)	22,500
General Expenses	210
Audit Fees	120
Building (Net of Depreciation up to 31 March 2010) ₹16,80,000	6,720
Borrowing from Banks	6,300
Cash with Other Banks	5,400
Cash with RBI	9,000
Cash in Hand	750
Interest and Discount Received	30,240
Bills Payable	12,600
Bills Discounted & Purchased	9,000
Term Loans	13,500
Cash Credits	35,010
Sundry Creditors	1,500
Bills for Collection	2,940
Acceptances on Behalf of Customers	7,500
Interest Accrued and Paid	3,600

Depreciation has to be provided at 5% on the original cost of the building. A provision of ₹7,50,000 for bad debts and ₹60,00,000 for taxation needs to be made.

[**Ans.:** Net profit: ₹93,90,000; Balance sheet total: ₹10,25,10,000]

20. The following is the trial balance of Victory Bank Ltd. as on 31 December 2010.

Debit Balances	₹	Credit Balances	₹
Loans, Cash Credits and Overdrafts	1,42,500	Subscribed Capital:	
Premises	25,000	25,000 Equity	2,50,000
Indian Govt. Securities	2,00,000	Shares of ₹10 Each Fully Paid	
Salaries	14,000	Reserve Fund	1,25,000
General Expenses	13,700	Current Deposits	50,000
		(Including Cash	
Rent, Rates & Taxes	1,150	Deposits at Demand)	
Stock of Stationery	4,250	Fixed Deposits	62,500
		(Including Cash	
Directors' Fees	900	Certificates)	
Bills Purchased and Discounted	23,000	SB Deposits	25,000
Interim Dividend Paid	8,500	P & L A/c (1 January 2010)	8,000
Shares	25,000	Interest and Discount	64,000
Cash in Hand & with RBI	96,500	Recurring Deposits	10,000
Money as Call & Short Notice	40,000		
	5,94,500		5,94,500

The following information should be considered:

(a) Provision for bad and doubtful debts required is ₹2,500.

(b) Accrued interest on investments was ₹4,0000.

(c) Unexpired discounts amount to ₹190.

(d) Interim dividend declared at 4% actual.

(e) Endorsement made on behalf of the customers totalled ₹ 57,500.

(f) Authorized capital was 40,000 equity shares of ₹ 10 each.

(g) ₹ 5,000 was added to the premises during the year. Depreciation at 5% on the opening balance was required.

(h) Market value of Indian Govt. securities was ₹ 1,95,000.

Prepare P & L A/c for the year ended on 31 December 2010 and the balance sheet as on that date.

[**Ans.:** Net profit for the year: ₹ 34,560 Balance carried to B/s: ₹ 23,920 B/s total: ₹ 5,59,250]

Exercises

Part B—For Advanced Level

21. (a) The following particulars are extracted from the (trial balance) books of M/s Sound Bank Ltd. for the year ending on 31 March 2011:

Details	₹
1. Interest and Discount	98,31,200
2. Rebate on Bills Discounted (1 April 2010)	32,520
3. Bills Discounted and Purchased	33,72,700

It is ascertained that proportionate discount not yet earned on the bills discounted, which will mature during 2011–12 amounted to ₹ 46,380.

Pass the necessary journal entries adjusting the above and show in the ledger of the bank:

(i) Rebate on bills discounted account

(ii) Interest and discount account.

(b) Calculate the provision required to be made in respect of advance:

Details	Amount ₹
Term Loan	1,00,000
ECGC Cover	30%
Security	24,00,000

Period for which advance had remained doubtful is 2 years.

[B.Com. (Hons.) Delhi, 2007—Modified]

[**Ans.:** (a) Transfer of net interest and discount to P & L A/c: ₹ 98,17,340.

(b) ₹ 58,24,000]

22. From the following information, prepare P & L A/c of New Bank of India Ltd. as on 31 March 2011:

	(₹ in '000)
Interest and Discount	1,82,70
Income from Investments	6,90
Interest on Balances with RBI	10,80
Commission, Exchange and Brokerage	49,20
Profit on Sale of Investments	6,60
Interest on Deposits	73,50
Interest to RBI	9,66
Payment to and Provision for Employees	62,64
Rent, Taxes and Lighting	12,60
Printing and Stationery	10,80
Advertisement and Publicity	5,70
Depreciation	5,62
Directors' Fees	13,20
Auditor's Fees	7,20
Law Charges	13,80
Postage & Telephone	4,20
Insurance	3,36
Repairs & Maintenance	2,88

Other information:

(i) Interest and discount mentioned above is after adjustment for the following:

	(₹ in '000)
Tax Provision for the Year	13,20
Provision During the Year for Doubtful Debts	6,12
Loss on Sale of Investment	72
Rebate on Bills Discounted	3,48

(ii) 20% of profit is transferred to statutory reserve.

5% of profit is transferred to revenue reserve.

Profit brought forward from last year is ₹ 96,000.

[B.Com. (Hons.) Delhi, 2008—Modified]

[**Ans.:** Net profit: ₹ 31,14,000 Transfer to statutory reserve: ₹ 6,22,800; Transfer to statutory reserve: ₹ 1,55,700; Balance carried to B/s: ₹ 24,31,500

23. From the following trial balance and the additional information, prepare a balance sheet of Kuber Bank Ltd. as on 31 March 2011:

Debit Balance:	**₹ (in Lakhs)**
Cash Credits	1,218.15
Cash in Hand	240.23
Cash with RBI	67.82
Cash with Other Banks	132.81
Money at Call & Short Notice	315.18
Gold	82.84
Government Securities	365.25
Current Accounts	42.00
Premises	133.55
Furniture	95.18
Term Loans	1189.32
	3882.33
Credit Balances:	
Share Capital:	
(29,70,000 Equity Shares of ₹ 10	
Each Fully Paid up)	297.00
Statutory Reserve	346.50
Net Profit for the Year	
(Before Appropriations)	225.00
P & L A/c (Opening Balance)	618.00
Fixed Deposit Accounts	775.50
Saving Deposit Accounts	675.00
Current Accounts	780.18
Bills Payable	0.15
Borrowings from Other Banks	165.00
	3,882.33

Additional Information:

(i) Bills for collection: ₹ 18,10,000

(ii) Acceptances & endorsements: ₹ 14,12,000

(iii) Claims against the bank not acknowledged as debts: ₹ 55,000.

(iv) Depreciation charged on premises: ₹ 1,10,000 and furniture: ₹ 78,000.

[B.Com. (Hons.) Delhi, 2009]

[**Ans.:** Balance in P & L A/c carried to B/s: ₹ 798 Lakhs B/s total: ₹ 3882.33 Lakhs]

24. From the following balances of Saraswati Bank Ltd. as on 31 December 2010, prepare the balance sheet in the prescribed form:

	(₹ in '000)
Paid-up Share Capital	
(of ₹ 10 Each Fully Paid)	1,000
Bills Discounted	900
Reserve Fund	385
Cash Credits	1,000
Overdrafts	400
Unclaimed Dividends	5
Loans	2,300
Current Deposits	1900
Furniture	20
P & L A/c (Cr.)	110
Cash in Hand	5
Cash with Reserve Bank	650
Branch Adjustments (Dr.)	85
Investments	475
Loans (Cr.)	600
Recurring Deposits	500
Fixed Deposits	1,000
Cash Certificates	500
Contingency Reserve	85

Adjustments:

(a) Rebate on bills discounted: ₹ 5,000.

(b) Provide ₹ 40,000 for doubtful debts

(c) Banks acceptances on behalf of customers: ₹ 3,25,000.

[M.Com., Madras—Modified]

[**Ans.:** Balance carried to B/s: ₹ 65,000 Balance sheet total: ₹ 60,85,000

25. Following are some of the balances as on 31 March 2011 of Sindh Bank Ltd.:

	(₹ in '000)
Interest on Advances	2,400
Commission, Exchange and Brokerage	600
Cash Balance	600
Balance with Other Banks	1,200
Cash with RBI	300
Profits on Sale of Investments	60

Other Revenue Receipts	240
Share Capital	6,000
20% Investment in Govt. Securities (Purchased at 60% of Face Value)	900
Other Securities @ 25% (Purchased at Par)	300
Borrowing from Other Banks	900
Printing and Stationery	105
Repairs	75
Statutory Reserves	2,700
P & L A/c (Cr.)	1,950
Bills Purchased and Discounted	750
Cash Credit, Overdrafts & Demand Drafts	4,275
Term Loans	3,825
Fixed Deposits	825
Savings Deposits	975
Current Deposits	375
Premises (Net)	4,125
Furniture	750
Interest (Includes Paid 135)	360
Salary	225
Bills Payable (Net)	75
Postage etc.	60

The following additional information is furnished:

(i) Advances have been classified as under with given details:

	Cash Credit Overdrafts Demand Loans	**Term Loans (₹ in '000)**
Standard Assets	3,000	2,925
Sub Standard Assets	?	?
Doubtful—Up to 1 Year	300	60
- 1–3 Years	360	150
- More than 3 Years	150	240
Less Assets	90	?

(ii) Standard and sub-standard assets in bills portfolio are in the ratio of 9:1.

(iii) Term loans comprise loss assets, which are half of its sub-standard.

(iv) No provision has been made so far against these assets.

(v) Doubtful assets are secured to the extent of 50% of the dues.

(vi) Forty per cent of the total interest on investments has been accrued

(vii) Bills for collection ₹ 705 (in thousands)

Prepare final accounts of Sindh Bank Ltd.

[M.Com., Mumbai—Modified)

[**Ans.:** Difference in trial balance: ₹ 5,25,000; Current year profit: ₹ 12,52,686; Balance carried to B/s: ₹ 29,52,150; Provision for bad debts: ₹ 13,72,314; Balance sheet total: ₹ 1,71,75,000]

26. From the following information, prepare profit and loss A/c of Vishali Bank Ltd. for the period ended on 31 March 2010 (working should form part of your answer):

	(₹ in '000)
Interest on Loans	1,200
Interest on Fixed Deposits	1,100
Commission	40
Exchange and Brokerage	80
Salaries and Allowances	600
Discount on Bills (Gross)	608
Interest on Cash Credits	960
Interest on Temporary Overdrafts in Current A/c	120
Interest on Savings Bank Deposits	348
Postage, Telegram and Stamps	40
Printing and Stationery	80
Sundry Expenses	40
Rent	60
Taxes and Licenses	40
Audit Fee	40
Additional information:	
(i) Rebate on Bills Discounted	120
(ii) Salary of Managing Director	120

(iii) Bad Debts 160

(iv) Provision for Income Tax Is to Be Made at 55% (Round off to Nearest Thousand)

(v) Interest of ₹16,000 on Doubtful Debts Was Wrongly Credited to Interest on Loans Account

[CS (Inter)—Modified]

[**Ans.:** Net profit: ₹1,08,000]

27. Following facts have been taken out from the records of Akash Bank Ltd. in respect of the year ending on 31 December 2010:

(a) On 1 January 2010 bills for collection were ₹14,00,000. During 2010, bills received for collection amounted to ₹1,29,00,000, bills collected were ₹94,00,000 and bills discounted and returned were ₹11,00,000. Prepare bills for collection (asset) A/c and bills for collection (liability) A/c.

(b) On 1 January 2010, acceptances, endorsements, etc., not satisfied, amounted to ₹29,00,000. During the year under question, acceptances, endorsements, guarantee, etc. amounted to ₹88,00,000. Bank honoured acceptances to the extent of ₹50,00,000 and clients paid off ₹20,00,000 against the guaranteed liability. Clients failed to pay ₹2,00,000, which the Bank had to pay. Prepare the acceptances, endorsements and other obligations A/c as it would appear in the general ledger.

(c) It is found from the books that a loan of ₹12,00,000 was advanced on 30 June 2010 at an interest of 10% p.a. payable half-yearly; but the loan was outstanding as on 31 December 2010 without any payment recorded either towards principal or interest. The security for the loan was 20,000 fully paid shares of ₹100 each (market value was ₹98 as per the Stock Exchange Information as on 31 June 2010. But due to fluctuation, the price has fallen to ₹60 per share in October 2010. On 31 December 2010, the price as per Stock Exchange rate was ₹82 per share). State how would you classify the loan as secured/unsecured in the balance sheet of the company.

(d) The following balances are extracted from the trial balance as on 31 March 1997:

	Dr. ₹	**Dr.** ₹
Interest & Discount	—	1,96,00,000
Rebate for Bills Discounted	—	40,000
Bills Discounted & Purchased	8,00,000	—

It is ascertained that the proportionate discounts not yet earned for bills to mature in 1998 amount to ₹28,000. Prepare ledger accounts.

[CA —Modified]

[**Ans.:** (a) Bills for collection: ₹37,99,000

(b) Acceptances and endorsements: ₹45,00,000

(c) Secured loan, interest and discounts: ₹1,96,12,000]

28. The following are the figures extracted from the book of Golden Bank Ltd. as on 31 March 2010:

	₹
Interest and Discount Received	74,11,476
Interest Paid on Deposits	40,74,904
Issued & Subscribed Capital	20,00,000
Salaries & Allowances	4,00,000
Directors Fees & Allowances	60,000
Rent & Taxes Paid	1,80,000
Postage & Phone	1,20,572
Statutory Reserve Fund	16,00,000
Commission, Exchange & Brokerage	3,80,000
Rent Received	1,30,000
Profit on Sale of Investments	4,00,000
Depreciation on Bank's Properties	60,000
Stationery Expenses	80,000
Preliminary Expenses	50,000
Auditor's Fees	10,000

The following further information is given:

(a) A customer to whom a sum of ₹ 20 lakhs has been advanced has become insolvent and it is expected only 50% can be recovered from his estate.

(b) There were also other debts for which a provision of ₹ 3,00,000 was found necessary by the auditors.

(c) Rebate on bills discounted on 31 March 2009 was ₹ 24,000 and on 31 March 2010 was ₹ 32,000.

(d) Provide ₹ 13,00,000 for income tax.

(e) The Directors desire to declare 10% dividend.

Prepare the P & L A/c of Golden Bank Ltd. for the year ended on 31 March 2010 and also show how the P & L A/c will appear in the balance sheet of the P & L A/c. Opening balance was nil as on 31 March 2009.

[CA (Inter)—Modified]

[**Ans.:** Profit: ₹ 6,78,000 Balance to B/s: ₹ 3,42,400]

29. The following is the trial balance of NO SCAM Bank Ltd. as on 31 March 2011:

(₹ in '000)

Debits	₹	**Credits**	₹
Loans, Cash Credits and Overdrafts	1,284	Share Capital: 45,000 Shares of ₹ 50 Each	1,125
Bank Premises	225	Reserve Fund	1,110
Development Loan (Reserve Fund Investment)	1,110	Savings Deposits	582
		Demand Deposits	750
Indian Govt. Securities	690	Term Deposits	1,050
Interest Paid	60	P & L A/c Balance as on 1 April 2010	87
Salaries	96		
General Expenses	93	Interest and Discount	540
Rent, Rates & Taxes	12	Brokerage, Commission and Exchange	126
Directors Fees	9		
Money at Call & Short Notice	360		
Income Tax Paid	39		
Bills Discounted	210		
Interim Dividend (up to 30.9.2010)	90		
Shares in Other Companies	225		
Cash in Hand	267		
Cash with RBI	300		
Balance with Other Banks	300		
	5,370		5,370

Prepare profit and loss A/c for the year ending on 31 March 2011 and a balance sheet as on that date after taking into account the following information:

1. Interest accrued on investments: ₹ 30,000.
2. Rebate on bills discounted: ₹ 6,000.
3. Interim dividend was declared @ 12%.
4. ₹ 45,000 was added to the premises during the year. Depreciation @ 5% on opening balance is to be provided.
5. Endorsements on behalf of customers were ₹ 3,45,000.
6. The provision for taxation at 1 April 2010 was ₹ 36,000. It is to be maintained at ₹ 93,000.
7. Authorized capital was 90,00,000, shares of ₹ 50 each.

[ICWA (Final)—Modified]

[**Ans.:** Net profit: ₹ 3,15,000 B/s total: ₹ 49,92,000]

30. From the following information and balances extracted from the books of accounts of Asia Bank Ltd. as on 31 December 2010, prepare a P & L A/c for the year ended on 31 December 2010 and balance sheet as on that date as per the Banking Companies Act:

Authorized capital in equity shares of ₹ 100 each is ₹ 750 lakhs issued, subscribed and called-up ₹ 50 per share by application and allotment equal amount 3,75,000. Equity shares were subscribed out of which allotment moneys for 20,000 shares were not received.

	(₹ in Lakhs)	
Reserve Fund	70.00	
Reserve for Doubtful Debts	30.00	
Loans Advanced Secured	243.50	
Loans Unsecured	114.00	
Fixed Deposits	257.00	
Current Account Deposits	378.00	
Saving Deposits	241.00	
Recurring Deposits	95.50	
LC Account Deposit (Cr.)	7.50	
Advances on Govt. Scheme	105.00	
Non-banking Assets	65.00	
Provision for Income Tax	4.45	
Balance of P & L A/c (Cr.)	16.00	
Bills Discounted	154.50	
Cash with RBI	205	
Cash with Other Banks	213.75	
Investments in Government Bonds	50.00	
Building (Written-down Value)	10.00	Depn. 5%
Furniture (Written-down Value)	2.50	Depn. 10%
Office Equipment (Written-down Value)	3.00	Depn. 15%
Vehicles (Written-down Value)	12.50	Depn. 30%
Interest Paid	39.00	
Interest Received	84.80	
Exchange & Commission (Cr.)	25.00	
Salaries and Wages Benefits	16.00	
Rent and Rates, Lighting, Insurance	4.00	
Travelling Expenses	8.00	
Postage & Telephone	1.75	
Stationery & Printing	1.00	
Directors' Fees	0.75	
Sundry Expenses	3.50	
Legal Expenses	3.75	
Cash on Hand	15.25	
Bills for Collection from Customers	150.00	

Additional Information:

(i) Treat any difference in balances as inter-branch adjustment A/c.

(ii) Provide depreciation at rates indicated on WDV method.

(iii) Provide for loss on sale of non-banking assets: ₹ 8 lakhs.

(iv) Bad debts to be written off in Govt. scheme advances is 5 lakhs and provide for doubtful debts at 5% on unsecured loans and Govt. scheme advance.

(v) Interest receivable is ₹ 8 lakhs and payable is 2.25 lakhs.

(vi) Interest accrued on investment for half year @ 6% from 1 July 2010.

(vii) Provide for taxation @ 55% and 10% surcharge per rupee.

(viii) There is claim for salaries to staff for past 2 years, in dispute as ₹ 16 lakhs.

(ix) Estimated discount taken into account on bills discounted is ₹ 100 lakhs.

[ICWA (Final)—Modified]

[**Ans.:** Net profit: ₹ 3,72,500 B/s total: ₹ 12,88,55,000]

Insurance Company Accounts 14

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. Understand the meaning and types of insurance business (policies)
2. Know the principles of insurance
3. Distinguish between life and non-life insurance
4. Learn the legal provisions relating to insurance business
5. Know the books of account maintained for insurance business
6. Explain certain special terms associated with insurance business such as claims, premiums, reinsurance and reserve for unexpired risk.
7. Prepare Valuation balance sheet and final accounts of life insurance business
8. Prepare final accounts of general insurance business

Insurance business differs from other business entities. The terms used in insurance business are new and very peculiar. Although several types of insurance policies exist, they are grouped into two categories namely life insurance and non-life insurance. The accounting treatment differs with respect to each category. Even the final accounts have to be prepared in accordance with the statutory provisions of the IRDA Act and Regulations. All intricacies involved in the preparation of accounts of insurance companies are explained in a lucid manner in this chapter.

14.1 MEANING OF INSURANCE

Life is replete with risk and uncertainty, which may occur due to accident, death, destruction of property by fire or other natural calamities. Losses arising due to such risk may be minimized by way of insurance.

Insurance is an agreement between two parties under which the insurer undertakes to indemnify by the risk of the insured by getting a small sum for a specified period under regular instalments. This sum is called 'premium'. The person or any form of organization, which agrees to indemnify such losses for a sum of money, i.e. premium is known as 'insurer'. The person for whom such a risk is to be borne is known as 'insured'. The document by which the contract to be entered is known as 'insurance policy'.

Insurance is a contract through which the insurer agrees to pay a stipulated amount to the insured on the occurrence of an eventuality in lieu of a sum of premium. One important factor is that the insured must show that one has pecuniary interest in it. Hence, 'insurable interest' is an inevitable element in all insurance contracts.

14.2 PRINCIPLES OF INSURANCE

Following are the important underlying principles that govern insurance business:

(i) **Principle of indemnity:** Insurance is a contract to protect against risk. It is a contract of indemnity, which is the fundamental principle of insurance. The insured is called the indemnified.

(ii) **Principle of utmost good faith:** All contracts of insurance are contract of '*uberrimae fidei*', i.e. contract of utmost good faith. This necessitates the proposers to disclose all the material facts known to them in the insurance proposal form. Only on the basis of such frank disclosure the assessment of risk is taken into account by the insurer.

(iii) **Insurable interest:** Another important principle is 'insurable interest'. As insurance is a contract between the insurer and the insured, this principle is an important ingredient in such contracts.

14.3 TYPES OF INSURANCE

Although there are several types of insurance policies (business), they may be broadly divided into two categories:

1. Life insurance
2. General insurance

14.3.1 Life Insurance

It is a contract under which the insurer (life insurance company) agrees to pay a certain amount on the death of the insured (assured) or upon the expiry of predetermined fixed period, whichever is earlier. Under this insurance, 'risk of life' is covered. Life insurance policies may further be classified into the following:

(a) **Whole life policy:** Under this policy, premium has to be paid continuously till the death of the insured. The policy amount will be payable only after the death of the insured by the insurer.

(b) **Endowment policy:** Under this, the insured gets a specified sum on completion of certain years of age or to a nominee of the insured on the event of death, whichever is earlier. Premium for this type of policies will be higher than those for whole life policies.

(c) **With profit policy:** Under this type, the insured, i.e. the policy holders are entitled to participate in the profits of the insurance company besides getting a guaranteed sum of money on maturity of policies.

(d) **Without profits policy:** Under this type of policies, the insured are not entitled to participate in the profits of the company. They will get a fixed sum of money.

(e) **Annuity:** Under this, the insurer either pays a lump sum or a premium in regular instalment for a specified period. At the end of the period, the insurer will pay back the sum in regular instalments.

14.3.2 General Insurance

All insurance other than life will be grouped under this category. A contract under which the insurer (the company), in consideration of a fixed premium, undertakes to reimburse the insured (policy holder) for the loss due to an uncertain event is called general insurance. Various types of general insurance are as follows:

(a) **Fire insurance:** This policy covers risks of fire.

(b) **Marine insurance:** Under this type of policy, goods vehicle and freight exposed to marine risks are covered. Here, vehicle means cargo or the ship.

(c) **Burglary insurance:** Losses of theft are covered under this insurance.

(d) **Other type:** In addition to the above, there are various other policies to insure accidents, fidelity of employees, third party, workmen compensation, consequential loss and so on.

14.3.3 Difference Between Life Insurance and Non-life (General) Insurance

One has to understand the fundamental differences between these two broad categories of insurance, which are tabulated as follows:

Basis of Distinction	Life Insurance	Non-life Insurance (General Insurance)
1. Period	Life insurance contracts are of long-term, covering number of years.	These are of short term, generally, one year only.
2. Determination of actual loss	As human life cannot be valued precisely, the exact quantum of loss cannot be estimated. It depends entirely on the financial capacity of the individuals to pay premium.	These policies are contracts of indemnity. Actual loss can be ascertained. Hence, what ever may be the amount of policy, the insurer will reimburse the actual loss only.
3. Determination of profit	A valuation balance sheet is prepared on the basis of estimate by actuaries to determine the profit. The liability under existing policies are estimated by actuaries, which is a complicated mathematical process.	A portion of premium is carried forward as a provision for unexpired liability and the net balance of claims and expenses is treated as profit/loss.
4. Nomenclature	Life 'insurance' is also called as life 'assurance', as the insured gets an assured sum	These policies are called 'insurance' only and non-assurance.

14.4 INSURANCE BUSINESS IN INDIA

The following are the legislations enacted to govern the insurance business in India:

1. The Insurance Act, 1938; Insurance (Amendment) Act, 2000
2. Insurance Rules, 1939
3. The Companies Act, 1956
4. The General Insurance Business (Nationalization) Act, 1972
5. The Marine Insurance Act, 1963
6. The Insurance Regulatory and Development Authority Act, 1999 (IRDA)
7. The Insurance Regulatory and Development Authority Regulations, 2002

The IRDA Act was passed with the following objectives:

(i) To protect the interests of policyholders

(ii) To regulate and promote the orderly growth of insurance business

(iii) To further amend the Insurance Act and other related acts

14.4.1 The IRDA Regulations, 2002

IRDA has issued, through a notification, regulations, which govern the preparation of financial statements and auditors report of the insurance companies.

1. An insurer carrying on life insurance business shall comply with the requirements of Schedule A (Refer Page 1073).
2. An insurer carrying on general insurance business shall comply with the requirements of Schedule B (Refer Page 1079).
3. The report of the auditors of the financial statements of every insurer and reinsurer shall be in conformity with the requirements of Schedule C (Refer Page 1085).

14.5 ACCOUNTS OF INSURANCE COMPANIES

Accounts of insurance companies shall be maintained according to the provisions of the Insurance Act, 1938, as amended in Insurance (Amendment) Act, 2000. The accounts shall comply with the requirements of Schedule A of the IRDA Regulations, 2002 (Refer Page 48)

14.5.1 Books of Accounts

It is obligatory on the part of all insurance companies to maintain the following books, which are called '**statutory books**'.

They are as follows:

1. **Register of policies:** This book contains the following particulars relating to each policy:
   (a) The name and address of the policyholder
   (b) The date on which the policy was effected
   (c) A record of any assignment of the policy
2. **Register of claims:** This contains the following particulars in respect of each claim:
   (a) The date of claim
   (b) The name and address of the claimant
   (c) The date on which the claim was discharged
   (d) In the case of claim, which is rejected, the date of rejection and the ground for rejection
3. **Register of licensed insurance agents:** This book contains the following particulars in respect of each agent:
   (a) Name and address of every insurance agent appointed
   (b) The date of appointment
   (c) The date on which appointment was ceased, if any

Besides the above-mentioned statutory books, the insurance companies should maintain the following **subsidiary books** also for proper accounting:

(i) Register of proposals and proposal advance cash book
(ii) First year's premium cash book
(iii) Renewal premium cash book
(iv) Agency and branch cash book
(v) Petty cash book
(vi) Claims cash book
(vii) General cash book
(viii) Bank cash book
(ix) Agency credit journal

(x) Agency debit journal
(xi) Commission book
(xii) Lapsed and cancelled policies book
(xiii) Chief journal
(xiv) Agency ledger
(xv) Policy loan ledger
(xvi) General loan ledger
(xvii) Investment ledger

14.5.2 Preparation of Final Accounts—Life Insurance Business

The final accounts of a life insurance company consist of: (i) revenue accounts, (ii) profit and loss account and (iii) balance sheet.

14.5.2.1 Revenue Account

Procedure:

Revenue Account is prepared in Form A—RA as per IRDA Regulations, 2002.

First, the following four Schedules should be prepared:

Schedule 1—under the caption 'Premiums Earned (Net)'

Schedule 2—under the caption 'Commission'

Schedule 3—under the caption 'Operating expenses'

Schedule 4—under the caption 'Claims'

The following are the next procedure in preparation of revenue account:

(i) Add: Premiums earned, income from investments and other income.

(ii) From the aggregate of the above,
Deduct: Commission expenses, operating expenses, benefits paid and provisions for debts and taxes.

(iii) The net result will be Surplus or deficit.

(iv) Transfer to shareholders' account and other reserves shall be made from the surplus.

(v) Balance of surplus is to be transferred to funds for future appropriations, represented by 'life assurance fund'.

14.5.2.2 Profit and Loss Account

Procedure:

(i) Profit is transferred from revenue A/c. Opening balance is shown at the beginning of the P & L A/c.

(ii) Deduct: Dividends declared and dividend distribution tax.

(iii) Transfer to specified reserves as per the provisions of IRDA.

(iv) Remaining balance → to be carried to balance sheet.

14.5.2.3 Balance Sheet

The balance sheet comprises two parts:

Part I: Sources of funds:

This includes:

(a) Shareholders' funds
(b) Borrowings
(c) Policyholders' funds
(d) Funds for future appropriations

Part II: Application of funds:

This includes:

(a) Investments
(b) Loans

(c) Fixed assets (d) Net current assets

(e) Miscellaneous expenditure

This should be accompanied by schedules, i.e. Schedules 5–15.

With respect to life insurance business, Revenue Account (Policy holder's A/c), P & L A/c (Shareholders' A/c) & Balance Sheet should be prepared as per Form A–RA, Form A–PL & Form A–BS–which are reproduced in the following pages:

FORM A-RA

Name of Insurer: **Registration No. and Date of Registration with the IRDA**

Revenue Account for the Year Ended on 31 March 20…

Policyholder's Account (Technical Account)

Particulars	**Schedule**	**Current Year (₹'000)**	**Previous Year (₹'000)**
Premiums Earned (Net)			
(a) Premium			
(b) Reinsurance Ceded	1		
(c) Reinsurance Accepted			
Income from Investments			
(a) Interest, Dividends and Rent (Gross)			
(b) Profit on Sale/Redemption of Investments			
(c) (Loss on Sale/Redemption of Investments)			
(d) Transfer/Gain on Revaluation/Change in Fair Value*			
Other Income (to be Specified)			
Total (A)			
Commission	2		
Operating Expenses Related to Insurance Business	3		
Provision for Doubtful Debts			
Bad debts Written off			
Provision for Tax			
Provisions (other than Taxation)			
(a) For Diminution in the Value of Investments (Net)			
(b) Others (to be Specified)			
Total (B)			
Benefits Paid (Net)	4		
Interim Bonuses Paid			
Change in Valuation of Liability in Respect of Life Policies			
(a) Gross**			
(b) Amount Ceded in Reinsurance			
(c) Amount Accepted in Reinsurance			
Total (C)			

Surplus/(Deficit) (D) = (A) – (B) – (C)			
Appropriations			
Transfer to Shareholders' Account			
Transfer to Other Reserve (to be Specified)			
Balance Being Funds for Future Appropriations			
Total (D)			

Notes: *Represents the deemed realized gain as per norms specified by the authority.

**Represents mathematical reserves after allocation of bonus.

The total surplus shall be disclosed separately with the following details:

(a) Interim bonuses paid

(b) Allocation of bonus to the policyholders

(c) Surplus shown in the revenue account

(d) Total surplus: [(a) + (b) + (c)]

See notes appended at the end of Form A-PL

FORM A-PL

Name of Insurer:
Registration No. and Date of Registration with the IRDA

Profit and Loss Account

for the Year Ended on 31 March 20…

Shareholder's Account (Non-technical Account)

Particulars	**Schedule**	**Current Year (₹'000)**	**Previous Year (₹'000)**
Amounts Transferred from/to the Policyholders Account (Technical Account)			
Income From Investments			
(a) Interest, Dividends and Rent (Gross)			
(b) Profit on Sale/Redemption of Investments			
(c) (Loss on Sale/Redemption of Investments)			
Other Income (to be Specified)			
Total (A)			
Expenses Other than Those Directly Related to the Insurance Business			
Bad Debts Written off			
Provisions (Other than Taxation)			
(a) For Diminution in the Value of Investments (Net)			
(b) Provisions for Doubtful Debts			
(c) Others (to be Specified)			
Total (B)			

Profit/(Loss) Before Tax			
Provision for Taxation			
Profit/(Loss) After Tax			
Appropriations			
(a) Balance at the Beginning of the Year			
(b) Interim Dividends Paid During the Year			
(c) Proposed Final Dividend			
(d) Dividend Distribution Tax			
(e) Transfer to Reserves/Other Accounts (to be Specified)			
Profit Carried to the Balance Sheet			

Notes to Form A-RA and A-PL:

(a) Premium income received from business concluded in and outside India shall be separately disclosed.

(b) Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e. before deducting commissions) under the head 'reinsurance premiums'.

(c) Claims incurred shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year-end.

(d) Items of expenses and income more than 1% of the total premium (less reinsurance) or ₹ 5,00,000, whichever is higher, shall be shown as a separate line item.

(e) Fees and expenses connected with claims shall be included in claims.

(f) Under the subhead 'others' shall be included items like foreign exchange gains or losses and other similar items.

(g) Interest, dividends and rentals receivable in connection with an investment should be stated as gross amount. The amount of income tax deducted at source being included under 'advance taxes paid and taxes deducted at source'.

(h) Income from the rest should include only the realized rent. It should not include any national rent.

FORM A-BS

Name of Insurer:
Registration No. and Date of Registration with the IRDA

Balance Sheet as at on 31 March 20…

Particulars	**Schedule**	**Current Year (₹'000)**	**Previous Year (₹'000)**
Sources of Funds			
Shareholders' Funds			
Share Capital	5		
Reserves and Surplus	6		
Credit/(Debit) Fair Value Change Account			
Sub-total			

Borrowings	7		
Policyholders' Funds			
Credit/(Debit) Fair Value Change Account			
Policy Liabilities			
Insurance Reserves			
Provision for Linked Liabilities			
Sub-total			
Funds for Future Appropriations			
Total			
Application of Funds			
Investments			
Shareholders'	8		
Policyholders'	8A		
Assets Held to Cover Linked Liabilities	8B		
Loans	9		
Fixed Assets	10		
Current Assets			
Cash and Bank Balances	11		
Advances and Other Assets	12		
Sub-total (A)			
Current Liabilities	13		
Provisions	14		
Sub-total (B)			
Net Current Assets (C) = (A) – (B)			
Miscellaneous Expenditure (to the Extent not Written off or Adjusted)	15		
Debit Balance Profit and Loss Account (Shareholder's Account)			
Total			

Contingent Liabilities

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Partly Paid-up Investments		
2.	Claims, Other than Against Policies, not Acknowledged as Debts by the Company		
3.	Underwriting Commitments Outstanding (in Respect of Shares and Securities)		

4.	Guarantees Given by or on Behalf of the Company		
5.	Statutory Demands/Liabilities in Dispute, not Provided for		
6.	Reinsurance Obligations to the Extent not Provided for in Accounts		
7.	Others (to Be Specified)		
	Total		

Schedules Forming Part of Financial Statements

Schedule 1

Premium

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	First Year Premiums		
2.	Renewal Premiums		
3.	Single Premiums		
	Total Premium		

Schedule 2

Commission Expenses

Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
Commission Paid		
Direct: – First Year Premiums – Renewal Premiums – Single Premiums Add: Commission on Reinsurance Accepted Less: Commission on Reinsurance Ceded **Net Commission**		

Schedule 3

Operating Expenses Related to Insurance Business

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Employees' Remuneration and Welfare Benefits		
2.	Travel, Conveyance and Vehicle Running Expenses		
3.	Training Expenses		
4.	Rents, Rates and Taxes		

5.	Repairs		
6.	Printing and Stationery		
7.	Communication Expenses		
8.	Legal and Professional Charges		
9.	Medical Fees		
10.	Auditors' Fees, Expenses, etc.		
	(a) As Auditor		
	(b) As Adviser or in any Other Capacity, in Respect of		
	(i) Taxation Matters		
	(ii) Insurance Matters		
	(iii) Management Services; and		
	(c) In any Other Capacity		
11.	Advertisement and Publicity		
12.	Interest and Bank Charges		
13.	Others (to Be Specified)		
14.	Depreciation		
	Total		

Schedule 4

Benefits Paid (Net)

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Insurance Claims		
	(a) Claims by Death		
	(b) Claims by Maturity		
	(c) Annuities/Pension Payment		
	(d) Other Benefits, Specify		
2.	(Amount Ceded in Reinsurance):		
	(a) Claims by Death		
	(b) Claims by Maturity		
	(c) Annuities/Pension Payment		
	(d) Other Benefits, Specify		
3.	Amount Accepted in Reinsurance:		
	(a) Claims by Death		
	(b) Claims by Maturity		
	(c) Annuities/Pension Payment		
	(d) Other Benefits, Specify		
	Total		

Notes:

(a) Claims include specific claims settlement costs, wherever applicable.

(b) Legal and other fees and expenses shall also form part of the claims cost, wherever applicable.

Schedule 5

Share Capital

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Authorized Capital		
	…Equity Shares of ₹…Each		
2.	Issued Capital		
	…Equity Shares of ₹…Each		
3.	Subscribed Capital		
	…Equity Shares of ₹…Each		
4.	Called-up Capital		
	Equity Shares of ₹…Each		
	Less: Calls Unpaid		
	Add: Shares Forfeited (Amount Originally Paid up)		
	Less: Par Value of Equity Shares Bought Back		
	Less: Preliminary Expenses		
	Expenses Including Commission or Brokerage on		
	Underwriting or Subscription of Shares		
	Total		

Notes:

(a) Particulars of the different classes of capital should be separately stated.

(b) The amount capitalized on account of issue of bonus shares should be disclosed.

(c) In case, any part of the capital is held by a holding company, the same should be separately disclosed.

Schedule 5A

Pattern of Shareholding

(As Certified by the Management)

Shareholders	Current Year		Previous Year	
	Number of shares	% of Holding	Number of Shares	% of Holding
Promoters				
(a) Indian				
(b) Foreign				
Others				
Total				

Schedule 6

Reserves and Surplus

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Capital Reserve		
2.	Capital Redemption Reserve		
3.	Securities Premium		
4.	Revaluation Reserve		
5.	General Reserves		
	Less: Debit Balance in Profit and Loss Account, if any		
	Less: Amount utilized for Buy-back		
6.	Catastrophe Reserve		
7.	Other Reserves (to be Specified)		
8.	Balance of Profit in Profit and Loss Account		
	Total		

Note: Additions to and deductions from the reserves shall be disclosed under each of the specified heads.

Schedule 7

Borrowings

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Debentures/Bonds		
2.	Banks		
3.	Financial Institutions		
4.	Others (to be Specified)		
	Total		

Notes:

(a) The extent to which the borrowings are secured shall be separately disclosed, stating the nature of the security under each subhead.

(b) Amounts due within 12 months from the date of balance sheet should be shown separately.

Schedule 8

Investments Shareholders

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
	Long-term Investments		
1.	Government Securities and Government Guaranteed Bonds Including Treasury Bills		

2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares		
	(i) Equity		
	(ii) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/Bonds		
	(e) Other Securities (to be Specified)		
	(f) Subsidiaries		
	Investments Properties—Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	Short-term Investments		
1.	Governments Securities and Government Guaranteed Bonds Including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares		
	(i) Equity		
	(ii) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/Bonds		
	(e) Other Securities (to be Specified)		
	(f) Subsidiaries		
	(g) Investments Properties—Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	Total		

Note: See appended at the end of Schedule 8B.

Schedule 8A

Investments Policyholders

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
	Long-term Investments		
1.	Government Securities and Government Guaranteed Bonds Including Treasury Bills		

2.	Other Approved Securities		
3.	(a) Shares		
	(i) Equity		
	(ii) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/Bonds		
	(e) Other Securities (to be Specified)		
	(f) Subsidiaries		
	(g) Investments Properties—Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	Short-term Investments		
1.	Governments Securities and Government Guaranteed Bonds Including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares		
	(i) Equity		
	(ii) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/Bonds		
	(e) Other Securities (to be Specified)		
	(f) Subsidiaries		
	(g) Investments Properties—Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	Total		

Note: See Notes appended at the end of Schedule 8B.

Schedule 8B

Assets Held to Cover Linked Liabilities

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
	Long-term Investments		
1.	Government Securities and Government Guaranteed Bonds Including Treasury Bills		
2.	Other Approved Securities		

3.	(a) Shares		
	(i) Equity		
	(ii) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/Bonds		
	(e) Other Securities (to be Specified)		
	(f) Subsidiaries		
	(g) Investments Properties—Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	Short-term Investments		
1.	Governments Securities and Government Guaranteed Bonds Including Treasury Bills		
2.	Other Approved securities		
3.	(a) Shares		
	(i) Equity		
	(ii) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/Bonds		
	(e) Other Securities (to be Specified)		
	(f) Subsidiaries		
	(g) Investments Properties—Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	Total		

Notes: (applicable to Schedule 8 and 8A and 8B):

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) Holding company and subsidiary shall be construed as defined in the Companies Act, 1956.

(ii) Joint venture is a contractual arrangement, whereby two or more parties undertake an economic activity, which is subject to joint control.

(iii) Joint control is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(iv) Associates is an enterprise in which the company has significant influence and which is neither a subsidiary nor a joint venture of the company.

(v) Significant influence (for the purpose of this schedule)—means participation in the financial and operating policy decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policy-making process, material intercompany transactions, interchange of

managerial personnel or dependence on technical information. Significant influence may be gained by share ownership statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence. Unless such influence is clearly demonstrated, a substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

(b) Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.

(c) Investment made out of catastrophe reserve should be shown separately.

(d) Debt securities will be considered as 'held to maturity' securities and will be measured at historical costs subject to amortization.

(e) Investment property means a property (land, building, part of a building or both) held to earn rental income, for capital appreciation or for both, rather than for use in services or for administrative purposes.

(f) Investments maturing within 12 months from balance sheet date and investments made with the specific intention to dispose them of within 12 months from balance sheet date shall be classified as short-term investments.

Schedule 9

Loans

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Security-wise Classification		
	Secured		
	(a) On Mortgage of Property		
	(i) In India		
	(ii) Outside India		
	(b) On Shares, Bonds, Govt. Securities, etc.		
	(c) Loans Against Policies		
	(d) Others (to be Specified)		
	Unsecured		
	Total		
2.	Borrower-wise Classification		
	(a) Central and State Governments		
	(b) Banks and Financial Institutions		
	(c) Subsidiaries		
	(d) Companies		
	(e) Loans Against Policies		
	(f) Others (to be Specified)		
	Total		

3.	Performance-wise Classification		
	(a) Loans Classified as Standard		
	(i) In India		
	(ii) Outside India		
	(b) Non-standard Loans Less Provisions		
	(i) In India		
	(ii) Outside India		
	Total		
4.	Maturity-wise Classification		
	(a) Short Term		
	(b) Long Term		
	Total		

Notes:

(a) Short-term loans should include those, which are repayable within 12 months from the date of balance sheet. Loans other than short-term loans are long-term loans.

(b) Provisions against non-performing loans shall be shown separately.

(c) The nature of the security in case of all long-term secured loans shall be specified in each case. Secured loans for the purpose of this schedule means secured wholly or partly against an asset of the company.

(d) Loans considered doubtful and the amount of provision created against such loans should be disclosed.

Schedule 10

Fixed Assets

Particulars	Cost/Gross Block				Depreciation			Net Block		
	Opening	Additions	Deductions	Closing	Up to Last Year	For the Year	On Sales/ Adjustment	To Date	As at Year-end	Previous Year
Goodwill										
Intangibles (Specify)										
Land-Freehold										
Leasehold Property										
Buildings										
Furniture and Fittings										
Information Technology										
Equipment										

Vehicles										
Office Equipment										
Others (Specify Nature)										
Total										
Work in Progress										
Grand Total										
Previous Year										

Note: Assets included in land property and building above exclude investments properties as defined in Note (e) to Schedule 8.

Schedule 11

Cash and Bank Balances

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Cash (Including Cheques, Drafts and Stamps)		
2.	Bank Balances		
	(a) Deposit Accounts		
	(i) Short-term (Due Within 12 Months of the Date of Balance Sheet)		
	(ii) Others		
	(b) Current Accounts		
	(c) Others (to be Specified)		
3.	Money at Call and Short Notice		
	(a) With Banks		
	(b) With Other Institutions		
4.	Others (to be Specified)		
	Total		
	Balances with Non-scheduled Banks Included in 2 and 3 Above		
	Cash and Bank Balances		
1.	In India		
2.	Outside India		
	Total		

Note: Bank balance may include remittances in transit. If so, the nature and amount shall be separately stated.

Schedule 12

Advances and Other Assets

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
	Advances		
1.	Reserve Deposits with Ceding Companies		
2.	Application Money for Investments		
3.	Prepayments		
4.	Advances to Directors/Officers		
5.	Advance Tax Paid and Taxes Deducted at Source (Net of Provision for Taxation)		
6.	Others (to be Specified)		
	Total (A)		
	Other Assets		
1.	Income Accrued on Investments		
2.	Outstanding Premiums		
3.	Agent's Balances		
4.	Foreign Agencies Balances		
5.	Due From Other Entities Carrying on Insurance Business (Including Reinsures)		
6.	Due from Subsidiaries/Holding Company		
7.	Deposit with Reserve Bank of India (Pursuant to Section 7 of Insurance Act, 1938)		
8.	Others (to be Specified)		
	Total (B)		
	Total (A) + (B)		

Notes:

(a) The items under the above heads will not show net provisions for doubtful amounts. The amount of provision against each head should be shown separately.

(b) The term 'officer' should conform to the definition of that term as given under the Companies Act, 1956.

(c) Sundry debtors will be shown under item 8 (Others)

Schedule 13

Current Liabilities

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Agent's Balances		
2.	Balances due to Other Insurance Companies		
3.	Deposits Held on Reinsurance Ceded		

4.	Premiums Received in Advance		
5.	Unallocated Premium		
6.	Sundry Creditors		
7.	Due to Subsidiaries/Holding Company		
8.	Claims Outstanding		
9.	Annuities Due		
10.	Due to Officers/Directors		
11.	Others (to be Specified)		
	Total		

Schedule 14

Provisions

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	For Taxation (Less Payments and Taxes Deducted at Source)		
2.	For Proposed Dividends		
3.	For Dividend Distribution Tax		
4.	Others (to be Specified)		
	Total		

Schedule 15

Miscellaneous Expenditure
(To the Extent not Written off or Adjusted)

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Discount Allowed in Issue of Shares/Debentures		
2.	Others (to be Specified)		
	Total		

Notes:

(a) No item shall be included under the head 'miscellaneous expenditure' and carried forward unless:
   1. Some benefit from the expenditure can reasonably be expected to be received in future.
   2. The amount of such benefit is reasonably determinable.

(b) The amount to be carried forward in respect of any item included under the head 'miscellaneous expenditure' should not exceed the expected future revenue/other benefits related to the expenditure.

14.5.3 Final Accounts of General Insurance Companies

The final accounts of a general insurance company consist of: (1) revenue account, (2) profit and loss account and (3) balance sheet.

14.5.3.1 Revenue Account

This account is a summarized in forms of Schedules 1–4.

When the same company is doing various types of insurance businesses such as fire, marine, accident and the like, for each business separate account is prepared and shown in separate column in FORM B-RA as per the IRDA norms.

1. The following items are to be added and shown as Total (A):
   (a) Premiums
   (b) Income and profit from investments
   (c) Other incomes
2. The following items are to be added and shown as Total (B):
   (a) Expenditure on claims (net)
   (b) Commission
   (c) Operating expenses
3. The different (A) – (B) gives the operating profit of the business.
4. After appropriations, operating profit is to be transferred to P & L A/c.

14.5.3.2 Profit and Loss Account

If a general insurance company is indulged in doing more than one business, a combined P & L A/c is to be prepared.

As stared earlier, the operating profit or loss is to be transferred from revenue account to P & L A/c.

Income not related to specific business is to be added with operating profit and shown as 'Total (A)'.

Similarly, expenses not related to specific business are to be added and shown as 'Total (B)'.

Total (A) – total (B) – profit before tax

Provision for tax and appropriations has to be made.

Finally, balance of profit is to be added to the balance brought forward from the previous year.

Net balance of profit is to be carried forward to the balance sheet.

14.5.3.3 Balance Sheet

This consists of two parts.

Part I: Sources of funds:

This is a summarized presentation of Schedules 5–7, which reveals share capital, reserves and surplus and borrowings.

Part II: Application of funds:

This is a summarized presentation of Schedules 8–15, which depicts

investments, loans, fixed assets, net depicts investments, loans, fixed assets, net current assets, current liabilities, provisions and miscellaneous expenditure.

14.6 SPECIAL TERMS RELATING TO INSURANCE ACCOUNTS

Insurance business differs from other business undertakings. Even the terms used in insurance business are new and peculiar. Some of such new terms are explained here.

Claims: The risk of the insured covered for a consideration is referred to as premium. When the risk falls on the insured, one makes a claim on the insurer, i.e. on the insurance company.

Claim is to be shown after deducting the reinsurance claim in the revenue account. It is pertinent to note here that the actual loss borne is to be taken into account and 'not' the actual amount paid.

Accounting treatment:

Adjustment entry will be:

Claims A/c	Dr.	…	
To Claims intimated and accepted but not paid A/c			…
To Claims intimated but not accepted and paid A/c			…

At the commencement of the next accounting year, a reverse entry should be passed. The reason is that the claims intimated are paid, generally. However, when the company rejects any claim, the amount is to be transferred to the insurance fund account and 'not' to the claims account.

While determining the loss on account of claim, the claim outstanding at the end should be added and the claim outstanding at the beginning should be deducted. Further, while determining the claim outstanding at the end, (i) the claim intimated and (ii) the claim intimated and accepted should be added.

This can be best understood with the help of the following illustration:

Illustration 14.1

From the following, one is required to calculate the loss on account of claim to be shown in the revenue account for the year ending on 31 March 2010:

Intimated in	Admitted in	Paid in	₹
2008–09	2008–09	2009–10	40,000
2009–10	2009–10	2010-11	25,000
2007–08	2008–09	2008–09	15,000
2007–08	2008–09	2009–10	35,000
2009–10	2010–11	2010–11	20,000
2009–10	2009–10	2009–10	2,50,000

Claims on account of Reinsurance: ₹ 30,000.

Solution

Notes:

1. While determining loss on account of claim, the 'column admitted in' has to be ignored.
2. Items relating to 2007–08 (intimated in), admitted in 2008–09 and paid in 2008–09, ₹ 15,000 are to be ignored. The reason is that the amount paid in 2008–09 is not included in the amount paid in 2009–10.

Schedule 2

Claims Incurred (Net)
As on 31 March 2010

Particulars		Current Year ₹	Previous Year ₹
Step 1:	Total Claims Paid in 2009–10:		
	(₹ 40,000 + ₹ 35,000 + ₹ 2,50,000)	3,25,000	

Step 2:	Less: Claims Outstanding at the Beginning of 2009–10:	₹.		
	(i) Intimated in 2008–09 Paid in 2009–10:	40,000		
	(ii) Intimated in 2007–08 Paid in 2009–10:	35,000	75,000	
			2,50,000	
Step 3:	ADD: Claims Outstanding at the End of 2009–10:			
	(i) Intimated in 2009–10, Paid in 2010–11:	25,000		
	(ii) Intimated in 2009–10, Paid in 2010–11:	20,000	45,000	
			2,95,000	
Step 4:	Less: Reinsurance Claim		30,000	
Step 5:	Claims Paid and Outstanding in 2009–10 to be Shown in Revenue Account		2,65,000	

14.6.1 Bonus in Reduction of Premium

This term is widely used in general insurance. The common practice is that general insurance policy is taken for 1 year. It is renewed after the expiry of the insured period. In case if the insured did not make any claim during the year, the company grants a reduction in premium at prescribed rates. The rate of reduction will increase year after year when no claim is made. Such a type of reduction is referred to as 'bonus in reduction of premium'.

Accounting treatment:

Total premium (without reduction) is to be treated as income and bonus, which is deducted is to be treated as expense.

Entry is:

Bonus in Reduction of Premium A/c Dr. …

To Premium A/c …

Example:

Net premium received is ₹ 292. Bonus in reduction of premium is ₹ 28.

This will be treated. Thus:

Income → ₹ (292 + 28) = 320 is to be shown on the credit side of revenue A/c and

Expense → ₹ 28 is to be shown on the debit side of Revenue A/c.

14.6.2 Reversionary Bonus

This term is generally used in life insurance business. If the life policies with profits are opted, policyholders will be given the right to participate in the profits of the company. In general, profit is paid on the maturity of the policy. Such a type of bonus paid at the expiry of the policy with the policy amount is known as 'reversionary bonus'. Policyholders are awarded 95% of profits of LIC by way of bonus.

14.6.3 Reinsurance

When an insurer thinks that a specific risk is so high that he cannot shoulder in his individual capacity, he may reinsure that part of the risk with some other insurer. This is known as reinsurance. In such a situation, proportionate premium has to be ceded by the first insurer. On maturity, both the insurers will share the claim in the ratio agreed by them.

Accounting treatment:

In the books of the first insurer, amount of claim recovered from the second insurer will be subtracted from the total claim payable by him. Premium ceded is to be deducted from the total premium received.

In the books of the second insurer, claims paid include claims paid on account of reinsurance and premium received include premium received on reinsurance business.

14.6.3.1 Commission on Reinsurance (Ceded and Accepted)

These are two types:

(i) Commission on reinsurance accepted: When a company gets reinsurance business, it has to pay commission to other company. This commission is known as 'commission on reinsurance accepted'.

This should be shown as an expense, on the debit side in revenue account.

(ii) Commission on reinsurance ceded: When a company passes one part of business to some other company, then such a company gets commission, which is referred to as 'commission on reinsurance ceded'.

This should be shown on the credit side of the revenue account as it is treated as 'income'.

Note: Under Schedule 2: Commission expenses.

Commissions on direct business and reinsurance accepted should be added and commission on reinsurance should be deducted. The net balance should be shown in the revenue account.

14.6.4 Annuities and Consideration for Annuity Granted

'Annuity' is an annual payment guaranteed and paid by an insurance company regularly till the life of an insurer or for a specified period in consideration of a 'lump sum' received at the beginning. Instead of a lump sum payment, it may be paid over a certain period in regular instalments.

Treatment:

Annuity is shown under Schedule 4: It is an expenditure for the insurance company.

On the other hand, consideration for annuities granted is an income for the company. It is shown in revenue A/c

14.6.5 Surrender Value and Surrenders

When an insured is not in a position to pay premiums for the agreed period, he may surrender the policy to the company. The company will pay an amount, which is only a portion of the total premium paid. The surrender value usually will be of small amount and that too only a part of premium, which the insured has remitted to the company. If only one annual premium is paid, then such policyholders will not be eligible to surrender their policies. Surrender value includes the present value of bonus.

Under schedule 4: Surrenders is shown as an expenditure along with claims, annuities, etc.

14.6.6 Paid-up Value

A policy holder may opt to get the policy paid up, if he will not be able to continue paying premiums. It is calculated as:

$$\text{Paid up value} = \frac{\text{Sum Assured} \times \text{Total No. of Premiums Paid}}{\text{Total No. of Premiums Payable}}$$

This is shown like claims.

14.6.7 Life Assurance Fund

This fund is maintained by life insurance company, which represents the excess of revenue income over revenue expenditure. The object of maintaining this fund is to meet the aggregate liability of all policies.

This is depicted under Schedule 6.

Any amount that exceeds the liability is called 'valuation surplus'. This is a profit to the company.

Illustration 14.2

Model: calculation of true or correct life assurance fund.

A life assurance company prepared its revenue A/c for the year ended on 31 March 2011 and ascertained its life assurance fund to be ₹ 35,00,000. It was found that the following had been omitted from the accounts.

	₹
(a) Interest Accrued on Investments:	45,000
Income Tax Liable to be Deducted There on is Estimated to be	10,500
(b) Outstanding Premiums:	37,500
(c) Bonus Utilized for Reduction of Premium:	8,500
(d) Claims Intimated but not Admitted:	18,750
(e) Claims Covered under Reinsurance:	7,250

What is the true life assurance fund?

Solution

Note: Bonus in reduction of premium will reduce both premiums and bonus. Hence, it should be added to and subtracted from the fund.

Statement Showing Correct Life Assurance Fund

		₹	₹
Step 1:	Balance of life assurance fund as on 31 March 2011		35,00,000
Step 2:	Add:		
	(i) Interest Accrued (before Deduction of IT)	45,000	
	(ii) Bonus Utilized on Reduction of Premium	8,500	
	(iii) Outstanding Premium	37,500	
	(iv) Claims Covered under Reinsurance	7,250	98,250
Step 3:	Sub-total [Step 1 + Step 2 (i–iv)]		35,98,250
Step 4:	Less :		
	(i) Bonus Utilized in Reduction of Premium	8,500	
	(ii) Claims Intimated but not Admitted	18,750	
	(iii) Income Tax on Interest Accrued	10,500	37,750
Step 5:	Correct Life Assurance Fund		35,60,500
	[Step 3 – Step 4 (i–iii)]		

Illustration 14.3

Model: Correct assurance fund and Journal entries.

The revenue A/c of a life insurance company showed the life fund as ₹ 65,65,000 on 31 March 2011 before taking into account the following items:

	₹
(a) Claims Intimated but not Admitted	74,250
(b) Bonus Utilized in Reduction of Premium	11,750
(c) Interest Accrued on Investments	23,250
(d) Outstanding Premiums	21,500
(e) Claims Covered under Reinsurance	39,000
(f) Provision for Taxation	29,500

Pass journal entries giving effect to the above adjustments and show the adjusted life fund.

Solution

Journal Entries

Date	Particulars		LF	Dr. ₹	Cr. ₹
	Claims A/c	Dr.		74,520	
	To Outstanding Claims A/c				74,250
	(Claims Admitted but not Admitted Recorded)				
	Bonus in Reduction of Premium A/c	Dr.		11,750	
	To Premium A/c				11,750
	(Bonus in reduction of premium)				
	Accrued Interest A/c	Dr.		23,250	
	To Interest A/c				23,250
	(Bonus in Reduction of Premium)				
	(Accrued Interest—Adjusted)				
	Outstanding Premium A/c	Dr.		21,500	
	To Premium A/c				21,500
	(Outstanding Premium Taken into Account)				
	Reinsurance Claims A/c	Dr.		39,000	
	To Claims A/c				39,000
	(Claims Covered under Reinsurance—Adjusted)				
	Revenue A/c	Dr.		29,500	
	To Provision for Taxes A/c				29,500
	(Provision for Taxation—Adjusted)				

Statement Showing Correct Life Assurance Fund

Particulars		₹	₹
Step 1:	Life Assurance Fund as on 31 March 2011		65,65,000
Step 2:	Add:		
	(i) Bonus in Reduction of Premium	11,750	
	(ii) Accrued Interest	23,250	
	(iii) Outstanding Premium	21,500	
	(iv) Reinsurance Claims	39,000	95,500
Step 3:	Sub-total [Add Step 1 + Step 2 (i–iv)]		64,69,500

Step 4:	Less :		
	(i) Bonus in Reduction of Premium	11,750	
	(ii) Claims Outstanding	74,250	
	(iii) Provision for Taxation	29,500	1,15,500
Step 5:	Correct Life Assurance Fund (after Adjustments)		63,54,000

14.7 SOME SPECIAL TERMS RELATING TO INSURANCE BUSINESS

14.7.1 Net Liability

14.7.1.1 Determination of Net Liability

In general, life policies are taken for a longer period. The premium by insurance companies cannot be taken as income for computation of profit for that year. The balance in life assurance fund cannot be taken as profit. Hence, in order to determine the profit, net liability on all outstanding policies is to be calculated. The difference between the present value of future liability and the present value of future premium is known as 'net liability'. The method of calculation is done by highly technical experts called 'actuaries'. It is a highly complicated mathematical calculation. The process by which net liability is ascertained by actuaries is called 'actuarial valuation'.

14.7.1.2 Computation of Profit

To ascertain profit of the life insurance companies, the life assurance fund on a particulars date is to be determined. Then, net liability on all policies has to be determined, which is done by actuaries. These two values are to be compared.

If the amount of life assurance fund is more than net liability, the excess is treated as surplus (profit).

It net liability is more than life assurance fund, the excess is treated as deficiency (loss).

The surplus or deficiency is ascertained by preparing a statement known as 'valuation balance sheet'. The former of which is shown as follows:

Valuation Balance Sheet

As on …

Particulars	₹	**Particulars**	₹
To Net Liability		By Life Assurance Fund	…
As per Actuary's Valuation	…	As per Balance Sheet	
To Surplus (Net Profit)	…	By Deficiency (Net Loss)	…
(Balancing Figure)		(Balance Figure)	
	xx		xx

Note:

1. The result will be either surplus or deficiency, which is arrived as balancing the ledger account.
2. Only surplus will be shown in the final balance sheet.

Distribution of profits:

(i) Ninety-five per cent of the surplus (profit) as disclosed in valuation balance sheet should be declared as share of (bonus) policyholders.

(ii) Interim bonus paid to policyholders is an advance. Payment of bonus should be adjusted with net profit.

(iii) Any dividend payable, provision for loss on revaluation of investments should be subtracted from surplus.

(iv) From the adjusted amount, 95% is calculated. Then the interim bonus is deducted. The resultant will be the amount due to policyholders.

(v) The balance of 5% is payable to the shareholders.

Illustration 14.4

Model: Valuation balance sheet and distribution of profits.

The life insurance fund of Himalayan Life Insurance Co. Ltd. was ₹ 36,00,000 on 31 March 2011. Its actuarial valuation on 31 March 2011 disclosed a net liability of ₹ 28,00,000. An interim bonus of ₹ 50,000 was paid to the policyholders during the previous 2 years. It is now proposed to carry forward ₹ 1,50,000 and to divide the balance between the policyholders and shareholders.

Show

(a) The valuation balance sheet

(b) The net profit for the 2-year period

(c) The distribution of profits

Solution

Stage (a):

In the Books of Himalayan Life Insurance Co. Ltd.
Valuation Balance Sheet
As on 31 March 2011

Particulars	₹	Particulars	₹
To Net Liability (As per Actuarial Valuation)	28,00,000	By Life Insurance Fund (As per Valuation B/S)	36,00,000
To Surplus (Profit) (Bal. Fig.)	8,00,000		
	36,00,000		36,00,000

Stage (b): Net profit for the 2-year period:

		₹
Step 1:	Profit (Surplus) as per Valuation Balance Sheet	8,00,000
Step 2:	Add: Interim Bonus Paid during the Previous 2 Years	50,000
Step 3:	Net Profit (for the 2-year Period):	8,50,000

Stage (c): Distribution of Profits:

		₹
Step 1:	Net Profit (Ref Stage (b)	8,50,000
Step 2:	Less: Amount Proposed to be Carried Forward	1,50,000
Step 3:	Balance (Step 1 – Step 2):	7,00,000
Step 4:	Share of Policyholders (95% of ₹ 7,00,000):	6,65,000
Step 5:	Less: Interim Bonus Paid:	50,000
Step 6:	Amount Due to Policyholders:	6,15,000
Step 7:	Share of Shareholders 5% of ₹ 7,00,000:	35,000

Illustration 14.5

Model: True life assurance fund.

The life assurance fund of an insurance company as on 31 March 2011 showed a balance of ₹ 65,65,650. It was later found that the following were not taken into account:

	₹
(i) Dividend from Investments	2,22,250
(ii) Income Tax on above	22,220
(iii) Bonus in Reduction of Premium	6,66,660
(iv) Claims Covered under Reinsurance	3,33,330
(v) Claims Indicated but not Accepted by Company	5,55,550
(vi) Interest Accrued on Securities	44,440

Ascertain Correct Balance of Fund.

Solution

Statement Showing Life Assurance Fund
(Correct Balance of Fund)

		₹	₹
Step 1:	Balance of Life Assurance Fund as on 31 March 2011	…	65,65,650
Step 2:	Add:		
	(i) Dividend from Investments	2,22,250	
	(ii) Bonus in Reduction of Premium	6,66,660	
	(iii) Reinsurance Recovers	3,33,330	
	(iv) Interest on Securities	44,440	12,66,680
Step 3:	Sub-total [Step 1 + Step 2 (i to iv)]		78,32,330
Step 4:	Less:		
	(i) Bonus in Reduction of Premium	6,66,660	
	(ii) Income Tax	22,220	
	(iii) Claims Indicated	5,55,550	12,44,430
Step 5:	Correct Balance of Fund (Life Assurance Fund)		63,87,900

Illustration 14.6

Model: Valuation balance sheet distribution of surplus.

A life insurance company gets its valuation made once in every 2 years. Its life assurance fund on 31 March 2011 stood at ₹ 58,55,000. Before providing for ₹ 55,000 being the shareholders' dividend for 2011, its actual valuation on 31 March 2011 disclosed a net liability of ₹ 46,00,000. An interim bonus of ₹ 1,00,000 was paid to the policyholders during the previous 2 years.

Prepare a statement showing the amount now available as bonus to policyholders, assuming that the policyholders are entitled to 95% of surplus as under LIC Act.

Solution

Stage I: In this problem, an adjustment has to be made to arrive as life insurance fund balance as in the balance sheet:

	₹
Life Assurance Fund as on 31 March 2011 (Give)	58,55,000
Less: Dividends for the Year 2011	55,000
Balance of Fund (as per B/S)	58,00,000

Stage II:

Valuation Balance Sheet
As on 31 March 2011

Particulars	₹	Particulars	₹
To Net Liability As per Actuary's valuation	46,00,000	By Life Assurance Fund As per Balance Sheet	58,00,000
To Surplus (Profit) (Balancing Figure)	12,00,000		
	58,00,000		58,00,000

Stage III: Calculation of Net Profit:

	₹
Surplus as per Valuation Balance Sheet	12,00,000
Add: Interim Bonus	1,00,000
Net Profit for the Period	13,00,000

Stage IV: Distribution of Profits:

Net Profit (Ref: Stage III)	13,00,000
(i) Policy Holder's Share as per LIC Act @ 95%	12,35,000
(95% of ₹13,00,000)	12,35,000
(ii) Less: Interim Bonus Paid	1,00,000
(iii) Revisionary Bonus to be Declared	11,35,000
(iv) Shareholders Share of Profit @ 5% 5% of ₹13,00,000	65,000

Illustration 14.7

Model: Valuation balance sheet and journal.

Life assurance fund of a company on 31 March 2011 was ₹5,00,00,000. Its net liability on that date amounted to ₹4,60,000 as per actuarial valuation. Investments held by the company on that date amounted to ₹4,00,00,000. Against which the investment reserve stood as ₹6,20,000. The investments have to be written down by ₹10,00,000. The company declared a reversionary bonus of ₹60 per ₹1,000 with the option of cash bonus at the rate of ₹24 per ₹1000. Out of the total of ₹6 crore policies in force, one-third of the policyholders (in value) opted for cash bonus. The company estimated that its liability for income tax would be ₹4,00,000. Draft the journal entries to record the above. Also show the valuation balance sheet as on 31 March 2011 [CS—Modified].

Solution

Valuation Balance Sheet
As on 31 March 2011

Particulars	₹	Particulars	₹
Net Liability As per Actuary's Valuation	4,60,00,000	Life Assurance Fund As per Balance Sheet	5,00,00,000

Surplus (Profit) (Balancing Figure)	40,00,000		
	5,00,00,000		5,00,00,000

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2011	Life Assurance Fund A/c Dr.		3,80,000	
	To Investment Reserve A/c			3,80,000
	(Increase in Investment Reserve)			
	Investment Reserve A/c Dr.		10,00,000	
	To Investments A/c			10,00,000
	(Transfer of Investment Reserve to Investment A/c)			
	Life Assurance Fund A/c Dr.		4,80,000	
	To Bonus Payable in Cash			4,80,000
	(Bonus in Cash Payable @ ₹ 24 per ₹ 1,000 on Policies of the Value of 1/3 of ₹ 6 crore ₹ 2 crores)			
31 March 2011	Life Assurance Fund A/c Dr.		4,00,000	
	To Provisions for Income Tax			4,00,000
	(Provisions Created for Income Tax)			
	Life Assurance Fund A/c Dr.		40,00,000	
	To Profit and Loss A/c			40,00,000
	(Profit as per Valuation Balance Sheet Transferee to P & L A/c)			
	Profit and Loss A/c Dr.		3,80,000	
	To Investment Reserve A/c			3,80,000
	(Increase in Investment Reserve Transferred)			
	Investments Reserve A/c Dr.		10,00,000	
	To Investments A/c			10,00,000
	(Writing Down the Value of Investments)			
	Profit and Loss A/c Dr.		14,40,000	
	To Bonus Payable in Cash A/c			4,80,000
	To Life Assurance Fund A/c			9,60,000
	(Bonus @ ₹ 24 per 1,000 on Policies Valued as ₹ 2 Crores Credited to Bonus Payable in Cash and A/c and the Remaining Policies (₹ 6 Crores – ₹ 2 Crores): ₹ 4 Crores Reaccredited to Life Assurance Fund.) (i.e. ₹ 4 Cr ÷ ₹ 1000 × ₹ 24)			
	Profit and Loss A/c Dr.		4,00,000	
	To Provision for Income Tax			4,00,000
	(Provision Made for Income Tax)			

Illustration 14.8

Model: Revenue account.

The following balances are abstracted from the books of New Life Insurance Co. Ltd. as on 31 March 2011:

(₹ in '000)

	₹		₹
Life Assurance Fund (1 April 2010)	20,00,000	Bonus in Reduction of Premiums	2,500
Premiums	7,00,000	Medical Fees	2,800
Consideration for Annuities Granted	20,000	Surrenders	5,000
Interest and Dividends	1,20,000	Commission	20,000
Fines for Revival of Policies	800	Management Expenses	30,000
Reinsurance Premium	22,200	Income Tax on Dividends	10,000
Claims Outstanding (1 April 2010)	5,800		
Claims Paid during the year	90,200		
Annuities	2,500		

Prepare Revenue Account after Making the Following Adjustments:

	₹ '000
(i) Outstanding Balances: Claims	18,000
Premiums	6,000
(ii) Further Bonus for Premium	2,800
(iii) Claims under Reinsurance	10,000

Solution

New Life Insurance Co Ltd.
Revenue Account
For the Year Ended on 31 March 2011

Particulars	Schedule No.	Current Year (₹ '000)	Previous Year (₹ '000)
Premiums Earned (Net)			
(a) Premium	1	7,08,800	—
(b) Reinsurance Ceded (Given)		–(22,200)	—
(c) Reinsurance Accepted		—	—
Income from Investments:			
(a) Interest and Dividends (Gross) Other Income (to be Specified)		1,20,000	—
Consideration for Annuities Granted		20,000	—
Fines for Revival of Policies		800	—
Total (A)		8,27,400	—
Commission	2	20,000	—
Operating Expenses Related to Insurance Business	3	32,800	—
Total (B)		52,800	

Benefits Paid	4	1,05,200	—
Total (C)		1,05,200	
Surplus (D) = (A) – (B) – (C)		6,69,400	

Important note:

As per IRDA norms, income tax on dividends, which is TDS, appears in Schedule 12.

Schedules Forming Part of Revenue Account Follow

Schedules Forming Part of Revenue Account

Schedule 1

Premium

No.	Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
	Premiums Received	7,00,000	—
	Add: Outstanding Premiums	6,000	—
	Add: Further Bonus in Reduction of Premium	2,800	—
		7,08,800	—

Schedule 2

Commission Expenses

No.	Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
	Commission Paid	20,000	—
		20,000	—

Schedule 3

Operating Expenses Related to Insurance Business

No.	Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
	Management Expenses	30,000	—
	Medical Fees	2,800	—
		32,800	—

Schedule 4

Benefits Paid (Net)

No.	Particulars	Current Year (₹ '000)	Previous Year (₹ '000)
	Claims Paid	90,200	
	Add: Outstanding Claims on 31 March 2011	18,000	
		1,08,200	

	Less: Outstanding Claims on 1 April 2010	5,800	
		1,02,400	
	Less: Claims under Reinsurance	10,000	
		92,400	
	Add: Annuities	2,500	
	Surrenders	5,000	
	Bonus in Reduction of Premium ₹(2500 + 2800)	5,300	
		1,05,200	

Illustration 14.9

Model: Revenue A/c and balance sheet.

From the following prepare a life insurance revenue A/c and balance sheet as on 31 March 2011:

	₹('000)		₹('000)
Claims by Death	33,780	Bonus Paid with Claims	5,400
Agent's Allowances	12,840	Endowment Assurance Matured	48,830
Surrender Values Paid	5,620	Annuities Paid	2,700
Actuarial Expenses	3,040	Interest Revenue	38,120
Premiums	1,89,672	Rent, Rates and Taxes	10,950
Commission to Agents	17,800	General Charges	3,720
Salaries	27,000	Fees Received	344
Medical Fees	2,400	Bonus Paid in Cash	5,650
Travelling Expenses	3,600	Advertisement	1,452
Director's Fees	1,800	Consideration for Annuities Granted	25,706
Agents Balances	1,500	Printing and Stationery	1,300
Claim Expenses	2,864	Claims Outstanding 1 April 2010	4,752
Premium Outstanding 1 April 2010	4,268	Claims Outstanding 31 March 2011	7,470
Premium Outstanding 31 March 2011	6,286	Loans on Policies	76,600
Investments	2,93,400	Loans on Mortgages	5,81,120
Share Capital	4,00,000	Freehold Premises	2,45,200
Life Assurance Fund 1 April 2010	7,07,344	Furniture and Fittings	1,28,200
Outstanding Interest On Advances 31 March 2011	3,888	Cash on Hand and Deposits	1,52,600
Reserve Fund	2,92,000		

Solution

Revenue Account

For the Year Ended on 31 March 2011

Particulars	**Schedule No.**	**Current Year (₹'000)**	**Previous Year (₹'000)**
Premiums Earned–Net	1	1,85,404	
Interest Revenue		38,120	

Other Incomes (to be Specified):			
Consideration for Annuities Granted	1	25,706	
Fees Received		344	
Total (A)		2,49,574	
Commission	2	17,800	—
Operating Expenses Related to Insurance Business	3	68,102	—
Total (B)		85,902	—
Benefits Paid – Net	4	1,00,092	—
Total (C)		1,00,092	—
Surplus (D) = (B) – (C)		63,580	—
Appropriations:		—	—
Transfer to Share Holders Account		—	—
Transfer to Other Reserves		—	—
Balance Being Funds for Future Appropriations		63,580	
Total (D)		63,580	

Balance Sheet
as on 31 March 2011

Particulars	**Schedule No.**	**Current Year (₹'000)**	**Previous Year (₹'000)**
Sources of Funds:			
Share Capital	5	4,00,000	—
Reserves and Surplus	6	10,62,924	—
Borrowings	7	—	—
Total		14,62,924	
Application of Funds:			
Investments	8	2,93,400	
Loans	9	6,57,720	
Fixed Assets	10	3,73,400	
Total		12,24,520	
Current Assets:			
Cash and Bank Balances	11	1,52,600	
Advances and Other Assets	12	11,674	
Sub-total (A)		1,64,274	

Current Liabilities:			
Current Liabilities	13	25,870	
Provisions	14	—	
Sub-total (B)		25,870	—
Net Current Assets (A – B)		1,38,404	
Total		14,62,924	
(Total of Schedules 8, 9, 10 and Net Current Assets)			

Schedules forming part of financial statements:

Schedule 1

Premiums

No.	Particulars	Current Year (₹'000)	Previous Year (₹'000)
			(₹'000)
	Premiums Received	1,89,672	
	Less: Outstanding Premiums on 1 April 2010	4,268	
		1,85,404	

Premium O/S on 31 March 2011 will come under Schedule 12 as assets.

Schedule 2

Commission Expenses

No.	Particulars	Current Year (₹'000)	Previous Year (₹'000)
	Commission to Agents	17,800	
		17,800	

Schedule 3

Operating Expenses Related to Insurance Business

No.	Particulars	Current Year (₹'000)	Previous Year (₹'000)
	Agent's Allowances	12,840	
	Actuarial Expenses	3,040	
	Salaries	27,000	
	Medical Fees	2,400	
	Travelling Expenses	3,600	
	Director's Fees	1,800	

	Rent, Rates and Taxes	10,950	
	General Charges	3,720	
	Advertisement	1,452	
	Printing and Stationery	1,300	
		64,102	-

Schedule 4

Benefits Paid (Net)

Particulars		Current Year	Previous Year
		(₹'000)	(₹'000)
Claims Paid:			—
By Death		33,780	—
By Maturity		48,830	—
Add: Claim Expenses		82,610	—
		2,864	—
Less: Outstanding Claims on 1 April 2010		85,474	—
		4,752	—
Net Claims		80,722	—
Annuities		2,700	—
Surrenders		5,620	—
Bonus Paid Is Cash		5,650	—
Bonus Paid with Claims		5,400	—
		1,00,092	—

Claims O/s on 31 March 2011 will appear under Schedule 13 as liability

Schedule 5

Share Capital

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Share Capital	4,00,000	—
	4,00,000	

Schedule 6

Reserves and Surplus

Particulars		Current Year	Previous Year
Reserve Fund		2,92,000	—
Life Assurance Fund on 1 April 2010:	7,07,344		
Add: Surplus Transferred to Funds			
For Future Appropriations	63,580	7,70,924	
		10,62,924	

Schedule 7

Borrowings—Nil

Schedule 8

Investments

Particulars	Current Year	Previous Year
Investments	2,93,400	—
	2,93,400	

Schedule 9

Loans

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Loans on Mortgages	5,81,120	—
Loans on Policies	76,600	—
	6,57,720	—

Schedule 10

Fixed Assets

Particulars	Current Year ₹	Previous Year ₹
Freehold Premises	2,45,200	—
Furniture and Fittings	1,28,200	—
	3,73,400	—

Schedule 11

Cash and Bank Balances

Particulars	Current Year	Previous Year
Cash on Hand and Deposits	1,52,600	—
	1,52,600	—

Schedule 12

Advances and Other Assets

Particulars	Current Year	Previous Year
Advances	—	—
Other Assets:		
Outstanding Premiums	6,286	—
Outstanding Interest and Dividend	3,888	—

Agents' Balances	1,500	—
	11,674	—

Schedule 13

Current Liabilities

Particulars	Current Year	Previous Year
Sundry Creditors	18,400	—
Outstanding Claims	7,470	—
	25,870	—

Schedule 14

Provision (Nil)

Schedule 15

Miscellaneous Expenditure (Nil)

Illustration 14.10

Model: Net revenue A/c, P & L A/c and valuation balance sheet.

The valuation of Federal Life Assurance Company Ltd., having a paid-up capital of ₹2,50,000 disclosed a net liability of ₹33,25,000 on all their policies and contracts in force on 31 March 2011. From the figures set out below prepare the revenue account for the year ended on 31 March 2011 and a valuation balance sheet as on that date showing the surplus for the shareholders and policyholders (on the pattern of distribution prescribed in the LIC Act, 1950).

	₹
Life Assurance Fund as on 1 April 2010	25,00,000
Premiums Received	13,00,000
Interest and Dividends Received	7,50,000
Bonus in Cash	56,000
Bonus in Reduction of Premium	2,025
Claims Paid	1,30,000
Surrenders	95,000
Annuities Paid	57,000
Expenses of Management	1,10,000
Commission Paid to Agents	62,500
Reassurance Balance Irrecoverable	1,000
Income Tax	1,20,000
Surplus on Revaluation of Reversion Purchased	4,500
Consideration for Annuities Granted	42,500
Fines for Revival of Lapsed Policies	625

[ICWA (Final)—Modified]

Solution

Federal Life Insurance Co. Ltd
Revenue Account
For the Year Ended on 31 March 2011

Particulars	**Schedule**	₹
1. Premiums and Earned (Net)	**1**	13,00,000
2. (i) Consideration for Annuities Granted		42,500
(ii) Fine for Revival of Lapsed Policies		625
(iii) Surplus on Revaluation of Reversion Purchased		4,500
3. Interest, Dividend and Rent (Gross)		7,50,000
Total (A)		20,97,625
Commission	2	62,500
Operating Expenses Related to Insurance Business	3	1,10,000
Reassurance Balance Irrecoverable		1,000
Total (B)		1,73,500
Benefits Paid (Net)	4	2,82,000
Bonus Paid		56,000
Bonus in Reduction of Premium		2,025
Total (C)		3,40,025
Surplus (D) = (A) – (B) – (C)		15,84,100

Profit and Loss Account
For the Year Ended on 31 March 2011

Particulars	**Schedule**	₹
Operating Profit (Ref: Revenue A/c)		15,84,100
Income from Investments		—
Other Income		—
Total (A)		15,84,100
Expenses Other than Those Directly Related to the Insurance Business}		—
Provision (Other than Taxation)		—
Total (B)		Nil
Profit Before Tax		15,84,100
Less: Provision for Taxation		1,20,000
Profit After Tax		14,64,100
Appropriations:		
Brought Forward form the Balance Sheet		25,00,000
Profit Carried Forward to the Balance Sheet		39,64,100

Valuation Balance Sheet
As on 31 March 2011

Liabilities	₹	Assets	₹
Net Liability		Life Insurance Fund	
As per Actuaries Revaluation as on 31 March 2010	33,25,000	As per Balance Sheet	39,64,100
Surplus: (Profit)			
Policyholders—95%	6,07,145		
Shareholders—5%	31,955		
	39,64,100		39,64,100

Schedule 1

Premium

Particulars	₹
Renewal Premium	13,00,000
	13,00,000

Schedule 2

Commission

Particulars	₹
Commission Paid	62,500
	62,500

Schedule 3

Operating Expenses Related to Insurance Business

Particulars	₹
Employee's Remuneration and Welfare Benefits	1,10,000
	1,10,000

Schedule 4

Benefits Paid (Net)

Particulars	₹
Insurance Claims:	
Claims Paid	1,30,000
Annuities	57,000
Surrenders	95 ,000
	2,82,000

Illustration 14.11

Model: Revenue A/c, P & L A/c and balance sheet with schedules.

The following were the balances disclosed by the trial balance of the Indian Life Insurance Society as on 31 March 2011:

	₹
Balance of Account at the Beginning of the Year	1,00,00,000

Government Securities	50,00,000
Profit on Realization of Assets	10,000
Investment Fluctuation Account	50,000
Claims under Policies by Death	3,00,000
Claims under Policies at Maturity	5,00,000
Loans on Mortgage	28,00,000
Loans on Policies	15,00,000
Freehold Property and Furniture	4,15,000
Foreclosed Properties	18,000
Agent's Balances Owing	18,000
Sundry Creditors	10,000
Outstanding Premiums	1,20,000
Commission Paid	1,20,000
Interest Accrued Not Due	15,000
Premiums (Other than Single)	10,00,000
Claims Admitted But Not Paid	30,000
Surrenders	1,00,000
Single Premiums	4,00,000
Consideration for Annuities Granted	2,50,000
Interest, Dividends and Rents Received	3,50,000
Depreciation on Furniture	15,000
Administration Expenses	1,80,000
Salaries	15,000
Auditors Fees	7,500
Director's Fees	1,500
Legal Expenses	5,000
Advertising	7,000
Printing and Stationery	54,000
Cash as Bank	8,42,000
Provision for Depreciation	15,000

Prepare a Revenue A/c and Balance Sheet

[ICWA (Final)—Modified]

***Solution*:**

Stage I: Preparation of revenue A/c:

Indian Life Insurance Society

Revenue A/c

For the Year Ended on 31 March 2011

Particulars	**Schedule**	₹
Premiums Earned (Net):		
Premium	1	14,00,000

Income from Investments		
Interest, Dividends and Rent (Gross)		3,50,000
Consideration for Annuities Granted		2,50,000
Profit on Realization of Assets		10,000
Total (A)		20,10,000
Commission	2	1,20,000
Operating Expenses Related to Insurance Business	3	2,85,000
Total (B)		4,05,000
Benefits Paid (Net)	4	9,00,000
Total (C)		9,00,000
Surplus (D) = (A) – (B) – (C)		7,05,000

Stage II:

Profit and Loss Account
for the Year Ended on 31 March 2011

Particulars	**Amount** ₹
Operating Profit	7,05,000
Other Income	—
Total (A)	7,05,000
Provisions Other than Tax	—
Other Expenses	—
Total (B)	Nil
Profit Before Tax	7,05,000
Provision for Taxation	—
Profit After Tax	7,05,000
Balance of Profit Brought Forward from Last Year	1,00,00,000
Balance Carried Forward to Balance Sheet	1,07,05,000

Balance Sheet
As on 31 March 2011

Particulars	**Schedule**	₹
Sources of Funds:		
Reserves and Surplus	6	1,07,55,000
Total		1,07,55,000
Application of Funds:		
Investments	8A	50,00,000
Loans	9	43,00,000
Fixed Assets	10	4,00,000

Current Assets: Cash and Bank Balances	11	8,42,000
Advances and Other Assets	12	2,53,000
Sub-total (A)		10,95,000
Current Liabilities:	13	40,000
Sub-total (B)		40,000
Net Current Assets C = (A) – (B)		10,55,000
Total		1,07,55,000

Schedule 1

Premium

Particulars	₹
Renewal Premiums	10,00,000
Single Premiums	4,00,000
Total	14,00,000

Schedule 2

Commission Expenses

Particulars	₹
Commission Paid—Direct	1,20,000
	1,20,000

Schedule 3

Operating Expenses Related to Insurance Business

Particulars	₹
Employee's Remuneration and Welfare Benefits	1,95,000
Printing and Stationery	54,000
Legal Expenses	5,000
Audit Fee	7,500
Advertisement and Publicity	7,000
Director's Fee	1,500
Depreciation	15,000
	2,85,000

Schedule 4

Benefits Paid (Net)

Particulars	₹
Claims by Death	3,00,000
Claims by Maturity	5,00,000
Surrenders	1,00,000
Total Benefits paid:	9,00,000

Schedule 6

Reserves and Surplus

Particulars	₹
Investment Fluctuation A/c	50,000
Balance of P & L A/c	1,07,05,000
Total	1,07,55,000

Schedule 8A

Investments—Policyholders

Particulars	₹
Govt. Securities	50,00,000
Total	50,00,000

Schedule 9

Loans

Particulars	₹
Secured:	
On Mortgage of Property in India	28,00,000
Unsecured:	
Loans Against Policies	15,00,000
Total	43,00,000

Schedule 10

Fixed Assets

Particulars	Gross Block			Depreciation			Net Block	
	Opening	Additions	Closing	Up to Last Year	For the Year	To Date	As on Year-end	Previous Year
Freehold Property and Furniture	4,15,000	—	4,15,000	—	15,000	15,000	4,00,000	4,15,000
	4,15,000	—	4,15,000	—	15,000	15,000	4,00,000	4,15,000

Schedule 11

Cash and Bank Balances

Particulars	₹
Cash as Bank	8,42,000
Total	8,42,000

Schedule 12

Advance and Other Assets

Particulars	₹
Other Assets:	
Interest Accrued on Investments	15,000

Outstanding Premium	1,20,000
Agents Balances	18,000
Foreclosed Properties	1,00,000
	2,53,000

Schedule 13

Current Liabilities

Particulars	₹
Balances Due to Other Insurance Companies	10,000
Claims Outstanding	30,000
Total	40,000

NOTE :

1. 'Previous year' column is not drawn, as there are no figures to transfer into that column.
2. While preparing all the accounts, including schedules, only the items which are shown in the problem are taken into account. Other items are not shown in the prescribed formats.

14.8 GENERAL INSURANCE

14.8.1 Some Special Terms

14.8.1.1 Claims

Claims paid should be added with all expenses directly incurred in connection with assessment of claims. Claims should include expenses such as survey fees, legal fees and court expenses. It should not include expenses relating to establishment. If they are related to an employee, then it has to be included under the head claims. Expenses relating to reissuance should also be taken into account.

Illustration 14.12

Model: Claims—computation.

From the following particulars appearing in the books of fire insurance division of general insurance company, show the amount of claim as it would appear in the revenue A/c for the year ended on 31 March 2011:

	Direct Business	**Reinsurance**
	₹ ('000)	(₹ '000)
Claims Paid during the Year	9,340	1,400
Claims Payable—1 April 2010	1,526	174
31 March 2011	1,624	106
Claims Received	—	460
Claims Receivable—1 April 2010	—	130
31 March 2011	—	226
Expenses of Management	460	—
Includes ₹ 70,000 Surveyor's Fees and ₹ 90,000 Legal Expenses For Settlement of Claim)		

[CA (Inter)—Modified]

Solution

Note: With claims outstanding, on direct business reinsurance accepted should be added and reinsurance ceded should be subtracted.

Claims incurred (net) is shown under Schedule 2 as follows:

Schedule 2

Claims Incurred (Net) (₹'000)

Particulars			₹
	Claims Paid		9,340
Add:	Surveyors Fees		70
	Legal Expenses		90
	Claims Paid on Reissuance Accepted		1,400
	Claims Payable on Direct Business on 31 March 2011		1,624
	Claims Payable on Reissuance Accepted on 31 March 2011		106
	Claims Available on Reissuance on 1 February 2010		130
		₹	12,760
Less:	Claims Received from Reinsurance	460	
	Claims Receivable from Reinsurance on 31 March 2011:	226	
	Claims Payable on Direct Business on 31 March 2010:	1,526	
	Claims Payable on Reinsurance Accepted on 1 April 2010:	174	2,386
	Claims Incurred (Net)		10,374

14.8.2 Final Accounts of Insurance Companies

The final accounts have to be prepared in accordance with the provisions of IRDA Act. The 'forms' and 'schedules' for the preparation of final accounts of insurance as stipulated in the Act are reproduced in the following pages:

14.9 ACCOUNTING PRINCIPLES FOR PREPARATION OF FINANCIAL STATEMENTS

For Life Insurance Business

Schedule A

(See Regulation 3)

Part I

14.9.1 Applicability of Accounting Standards

Every balance sheet, revenue account (policyholder's account), receipts and payments account (cash flow statement) and profit and loss account (shareholders' account) of an insurer shall be in conformity with the accounting standards (AS) issued by the ICAI, to the extent applicable to insurers carrying on life insurance business, except that:

(i) Accounting Standard-3 (AS-3)—Cash flow statements—cash flow statement shall be prepared only under the direct method.

(ii) Accounting Standard-17 (AS-17)—Segment reporting—shall apply to all insurers irrespective of the requirement regarding listing and turnover mentioned therein.

14.9.2 Premium

Premium shall *be recognized as income when due*. For linked business the due date for payment may be taken as the date when the associated units are created.

14.9.3 Acquisition Costs

Acquisition costs, if any, shall be expensed in the period in which they are incurred.

Acquisition costs vary with and are primarily related to the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e. commencement of risk).

14.9.4 Claims Cost

The ultimate cost of claims shall comprise the policy benefit amount and specific claims settlement costs, wherever applicable.

14.9.5 Actuarial Valuation—Liability for Life Policies

The estimation of liability against life policies shall be determined by the appointed actuary of the insurer pursuant to his annual investigation of the life insurance business. Actuarial assumptions are to be disclosed by way of notes to the account.

The liability shall be so calculated that together with future premium payments and investments income, the insurer can meet all future claims (including bonus entitlements to policyholders) and expenses.

14.9.6 Procedure to Determine Value of Investments

An insurer shall determine the values of investments in the following manner:

14.9.6.1 Real Estate—Investment Property

The value of investment property shall be determined at historical cost, subject to revaluation at least once in every 3 years. The change in the carrying amount of the investment property shall be taken to revaluation reserve.

The insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred. Gains/losses arising due to changes in the carrying amount of real estate shall be taken to equity under 'revaluation reserve'. The 'profit on sale of investments' or 'loss on sale of investments', as the case may be, shall include accumulated changes in the carrying amount previously recognized in equity under the heading 'revaluation reserve' in respect of a particular property and being recycled to the relevant revenue account or profit and loss account on sale of that property.

The bases for revaluation should be disclosed in the notes to accounts. The Authority may issue directions specifying the amount to be released from the revaluation reserve for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except for the amount that is released to policyholders as per the authority's direction, no other amount shall be distributed to shareholders out of revaluation reserve account.

An impairment loss shall be recognized as an expense in the revenue/profit and loss account immediately. Unless the asset is carried at revalued amount, any impairment loss of a revalued asset shall be treated as a revaluation decrease of that asset and if the impairment loss exceeds the corresponding revaluation reserve, such excess shall be recognized as an expense in the revenue/profit and loss account.

14.9.6.2 Debt Securities

Debt securities, including government securities and redeemable preference shares, shall be considered as 'held to maturity' securities and shall be measured at historical cost subject to amortization.

14.9.6.3 Equity Securities and Derivative Instruments That Are Traded in Active Markets

Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value on the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price at the stock exchanges where the securities are listed shall be taken.

The insurer shall assess on each balance sheet date whether any impairment of listed equity security(ies)/ derivatives) instruments has occurred.

An active market means a market, where the securities traded are homogeneous, availability of willing buyers and willing sellers is normal and the prices are publicly available.

Unrealized gains/losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'fair value change account'. The 'profit on sale of investments' or 'loss on sale of investments, as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading 'fair value change account' in respect of a particular security and being recycled to the relevant revenue account or profit and loss account on actual sale of that listed security.

The authority may issue directions specifying the amount to be released from the fair value change account for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except for the amount that is released to policyholders as per the authority's prescription, no other amount shall be distributed to shareholders out of fair value change account. Also, any debit balance in fair value change account shall be reduced from profit/free reserves while declaring dividends.

The insurer shall assess, on each balance sheet date, whether any impairment has occurred. An impairment loss shall be recognized as an expense in revenue/profit and loss account to the extent of the difference between the remeasured fair value of the security/investment and its acquisition cost as reduced by any previous impairment loss recognized as expense in revenue/profit and loss account. Any reversal of impairment loss, earlier recognized in revenue/profit and loss account, shall be recognized in revenue/profit and loss account.

14.9.6.4 Unlisted and Other than Actively Traded Equity Securities and Derivative

Instruments: Unlisted equity securities and derivative instruments and listed equity securities and derivative instruments that are not regularly traded in active markets shall be measured at historical cost. Provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of the investment over its carrying amount. The increased carrying amount of the investment due to the reversal of the provision shall not exceed the historical cost.

For the purpose of this regulation, a security shall be considered as being not actively traded, if as per guidelines governing mutual funds laid down from time to time by SEBI, such a security is classified as 'thinly traded'.

14.9.7 Loans

Loans shall be measured at historical cost subject to impairment provisions. The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be lower than the amounts derived on the basis of guidelines prescribed from time to time by the Reserve Bank of India that apply to companies and financial institutions.

14.9.8 Linked Business

The accounting principles used for valuation of investments are to be consistent with principles enumerated above. A separate set of financial statements, for each segregated fund of the linked businesses, shall be

annexed. Segregated funds represent funds maintained in accounts to meet specific investment objectives of policyholders who bear the investment risk. Investment income/gains and losses generally accrue directly to the policyholders. The assets of each account are segregated and are not subject to claims that arise out of any other business of the insurer.

14.9.9 Funds for Future Appropriation

The funds for future appropriation should be presented separately. These funds represent all funds, the allocation of which, either to the policyholders or to the shareholder, has not been determined by the end of the financial year.

Part II

14.10 DISCLOSURES FORMING PART OF FINANCIAL STATEMENTS

A. The following shall be disclosed by way of notes to the balance sheet

1. Contingent liabilities:
   (a) Partly paid-up investments.
   (b) Underwriting commitments outstanding.
   (c) Claims, other than those under policies, not acknowledged as debts.
   (d) Guarantees given by or on behalf of the company.
   (e) Statutory demands/liabilities in dispute, not provided.
   (f) Reinsurance obligations to the extent not provided for accounts.
   (g) Others (to be specified).
2. Actuarial assumptions for valuation of liabilities for life policies in force.
3. Encumbrances to assets of the company in and outside India.
4. Commitments made and outstanding for loans, investments and fixed assets.
5. Basis of amortization of debt securities.
6. Claims settled and remaining unpaid for a period of more than 6 months as on the balance sheet date.
7. Value of contracts in relations to investments, for the following:
   (a) Purchases where deliveries are pending.
   (b) Sales where payments are overdue.
8. Operating expenses relating to insurance business: basis of allocation of expenditure of various segments of business.
9. Computation of managerial remuneration.
10. Historical costs of those investments valued on fair value basis.
11. Basis of revaluation of investment property.

B. The following accounting policies shall form an integral part of the financial statements:

1. All significant accounting policies in terms of the accounting standards issued by the ICAI and significant principles and policies given in Part I of accounting any other accounting policies, followed by the insurer, shall be stated in the manner required under accounting standard-1 (AS-1) issued by the ICAI.
2. Any departure from the accounting policies shall be separately disclosed with reasons for such departure.

C. The following information shall also be disclosed:

1. Investments made in accordance with any statutory requirements should be disclosed separately together with its amount, nature, security and any special rights in and outside India.
2. Segregation into performing/non-performing investments for the purpose of income recognition as per the directions, if any, issued by the authority.
3. Assets to the extent required to be deposited under local laws or otherwise encumbered in or outside India.
4. Percentage of business sector wise.
5. A summary of financial statements for the last 5 years, in the manner as may be prescribed by the authority.
6. Bases of allocation of investments and income thereon between policyholders' account and shareholders' account.
7. Accounting ratios as may prescribed by the authority.

Part III

14.11 GENERAL INSTRUCTIONS FOR PREPARATION OF FINANCIAL STATEMENTS

1. The corresponding amounts for the immediately preceding financial year for all items shown in the balance sheet, revenue account, profit and loss account and receipts and payments accounts shall be given.
2. The figures in the financial statements may be rounded off to the nearest thousands.
3. Interest, dividends and rentals receivable in connection with an investment should be stated at gross amount. The amount or income tax deducted at source should be included under 'advance taxes paid' and taxes deducted at source.
4. (I) For the purposes of financial statement, unless the context otherwise requires:
   (a) The expression 'provision' shall, subject to (II) below mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy.
   (b) The expression 'reserve' shall not subject to as aforesaid include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability or loss.
   (c) The expression 'capital reserve' shall not include any amount regarded as fee for distribution through the profit and loss account and the expression 'revenue reserve' shall mean any reserve other than a capital reserve.
   (d) The expression 'liability' shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

   (II) Where:

   (a) Any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or
   (b) Any amount retained by way of providing for any known liability or loss is more than the amount which in the opinion of the directors is reasonably necessary for the purpose. The excess shall be treated as a reserve and not as provision.

5. The company shall make provisions for damages under lawsuits where the managements is of the opinion that the award may go against the insurer.
6. Extent of risk retained and reinsured shall be separately disclosed.
7. Any debit balance of the profit and loss account shall be shown as deduction from uncommitted reserves and the balance, if any, shall be shown separately.

Part IV

14.12 CONTENTS OF MANAGEMENT REPORT

There shall be attached to the financial statements, a management report containing, inter alia, the following duly authenticated by the management.

1. Confirmation regarding the continued validity of the registration granted by the authority.
2. Certification that all the dues payable to the statutory authorities have been duly paid.
3. Confirmation to the effect that the shareholding pattern and any transfer of shares during the year are in accordance with the statutory or regulatory requirements.
4. Declaration that the management has not directly or indirectly invested outside India the funds of the holders of policies issued in India.
5. Confirmation that the required solvency margins have been maintained.
6. Certification to the effect that the values of all the assets have been reviewed on the date of the balance sheet and that in his (insurer's) belief the assets set forth in the balance sheets are shown in the aggregate at amounts not exceeding their realizable or market value under several headings:
   (i) 'Loans' (ii) 'Investments'
   (iii) 'Agents balances' (iv) 'Outstanding premiums'
   (v) 'Interest, dividends and rents outstanding' (vi) 'Interest, dividends and rents accruing but not due'
   (vii) 'Amounts due from other persons or bodies carrying on insurance business' (viii) 'sundry debtors'
   (ix) 'Bills receivable' (x) 'Cash' and
   (xi) The several items specified under 'other accounts'
7. Certification to the effect that no part of the life insurance fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 (4 of 1938) relating to the application and investment of the life insurance funds.
8. Disclosure with regard to the overall risk exposure and strategy adopted to mitigate the same.
9. Operations in other countries, if any, with a separate statement giving the management's estimate of country risk and exposure risk and the hedging strategy adopted.
10. Ageing of claims indicating the trends in average claim settlement time during the preceding 5 years.
11. Certification to the effect as to how the values, as shown in the balance sheet, of the investments and stocks and shares have been arrived at, and how the market value thereof has been ascertained for the purpose of comparison with the values so shown.
12. Review of asset quality and performance of investment in terms of portfolios, i.e. separately in terms of real estate, loans, investments, etc.
13. A responsibility statement indicating therein that:
    (a) In the preparation of financial statements, the applicable accounting standard, principles and policies have been followed along with proper explanations relating to material departures, if any.

(b) The management has adopted accounting policies and applied them consistently and made judgments and estimated that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the operating profit or loss and or the profit or loss of the company for the year.

(c) The management has taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the applicable provisions of the Insurance Act 1938 (4 of 1938)/ Companies Act, 1956 (1 of 1956), for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

(d) The management has prepared the financial statements on a going concern basis.

(e) The management has ensured that an internal audit system commensurate with the size and nature of the business exists and is operating effectively.

14. A schedule of payments, which has been made to individuals, firms, companies and organizations in which directors of the insurer are interested.

Part V

14.13 PREPARATION OF FINANCIAL STATEMENTS

1. An insurer shall prepare the revenue account (policyholder's account), profit and loss account (shareholders' account) and the balance sheet in Form A-RA, Form A-PL and Form A-BS, as prescribed in this Part, or as near thereto as the circumstances permit (see Pages 13.9 to 13.29).

   Provided that an insurer shall prepare revenue account and balance sheet for the undermentioned business separately and to that extent the application of AS 17 shall modified:

   (a) Participating policies and non-participating policies.

   (b) (i) Linked business [As defined in regulation 2(i) of the IRDA (Registration of Indian Insurance Companies) Regulations, 2000]

   (ii) Non-linked business separately for ordinary life, general annuity, pensions and health insurance.

   (c) Business within India and outside India.

2. An insurer shall prepare separate receipts and payments account in accordance with the direct method prescribed in AS-3—'Cash Flow Statement' issued by the ICAI.

14.14 ACCOUNTING PRINCIPLES FOR PREPARATION OF FINANCIAL STATEMENTS

For General Insurance Business

Schedule B

(See Regulation 3)

Part I

14.14.1 Applicability of Accounting Standards

Every balance sheet, receipts and payments account (cash flow statement)] and profit and loss account (shareholders' account) of the insurer shall be in conformity with the accounting standards (AS) issued by the ICAI, to the extent applicable to the insurers carrying on general insurance business, except that:

(i) Accounting standard-3 (AS-3)—Cash flow statements—shall be prepared only under the direct method.

(ii) Accounting standard-13 (AS-13)—Accounting for investments, shall not be applicable.

(iii) Accounting standard-17 (AS-17)—Segment reporting—shall apply to all insurers irrespective of the requirements regarding listing and turnover mentioned therein.

14.14.2 Premium

Premium shall be recognized as income over the contract period of risk, whichever is appropriate. Premium received in advance, which represents premium income not relating to the current accounting period, shall be disclosed separately in the financial statements.

A reserve for unexpired risks shall be created as the amount representing that part of the premium written, which is attributable to, and to be allocated to the succeeding accounting periods and shall not be less than as required under Section 64 V (i) (ii) (b) of the IRDA Act.

14.14.3 Premium Deficiency

Premium deficiency shall be recognized if the sum of expected claim costs, related expenses and maintenance costs exceeds related reserve for unexpired risks.

14.14.4 Acquisition Costs

Acquisition costs, if any, shall be expensed in the period in which they are incurred. Acquisition costs vary with, and are primarily related to, the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e. commencement of risk).

14.14.5 Claims

The components of the ultimate cost of claims to an insurer comprise the claims under policies and specific claims settlement costs. Claims under policies comprise the claims made for losses incurred, and those estimated or anticipated under the policies following a loss occurrence.

The liability shall include the following:

(a) Future payments in relation to unpaid reported claims.

(b) Claims incurred but not reported (IBNR) including inadequate reserves (sometimes referred to as claims incurred but not enough reported (IBNER), which will result in future cash/asset outgo for settling liabilities against those claims. Change in estimated liability represents the difference between the estimated liability for outstanding claims at the beginning and at the end of the financial period.

The accounting estimate shall also include claims cost adjusted for estimated salvage value if there is sufficient degree of certainty of its realization. Claims made in respect of contracts where the claims payment period exceeds 4 years shall be recognized on an actuarial basis, subject to regulations that may be prescribed by the authority. In such cases, certificate from a recognized actuary as to the fairness of liability assessment must be obtained. Actuarial assumptions shall be suitably disclosed by way of notes to the account.

14.14.6 Procedure to Determine the Value of Investments

An insurer shall determine the values of investments in the following manner:

(a) Real estate—investment property: Investment property shall be measured at historical cost, less accumulated depreciation and impairment loss, residual value being considered zero and no revaluation being permissible.

The insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred.

An impairment loss shall be recognized as an expense in the revenue/profit and loss account immediately.

Fair value as at the balance sheet date and the basis of its determination shall be disclosed in the financial statements as additional information.

(b) ***Debt securities:*** Debt securities including government securities and redeemable preference shares shall be considered as 'held to maturity' securities and shall be measured at historical cost subject to amortization.

(c) ***Equity securities and derivative instruments that are traded in active markets:*** Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value as at the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price of the stock exchanges where the securities are listed shall be taken.

The insurer shall asses on each balance sheet date whether any impairment of listed equity security(ies)/ derivative(s) instruments has occurred.

An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and willing sellers is normal and the prices are publicly available.

Unrealized gains/losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'fair value change account'. The 'profit on sale of investments' or 'loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognized in equity under the heading fair value change account in respect of a particular security and being recycled to profit and loss account on actual sale of that listed security.

For the removal of doubt, it is clarified that balance or any part thereof shall not be available for distribution as dividends. In addition, any debit balance in said fair value change account shall be reduced from the profits/free reserves while declaring dividends.

The insurer shall asses, at each balance sheet date, whether any impairment has occurred. An impairment loss shall be recognized as an expense in revenue/profit and loss account to the extent of the different between the remeasured fair value of the security/investment and its acquisition cost as reduced by any previous impairment loss, recognized as expense in revenue/profit and loss account. Any reversal of impairment loss, earlier recognized in revenue/profit and loss account shall be recognized in revenue/ profit and loss account.

(d) ***Unlisted and other than actively traded equity securities and derivative instruments:*** Unlisted equity securities and derivative instruments and listed equity securities and derivative instruments that are not regularly traded in active market will be measured at historical cost. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of the investment over its carrying amount. The increased carrying amount of the investment due to the reversal of the provision shall not exceed the historical cost. For the purposes of this regulation, a security shall be considered as being not actively traded, if as per guidelines governing mutual funds laid down form time to time by SEBI, such a security is classified as 'thinly traded'.

14.14.7 Loans

Loans shall be measured at historical cost subject to impairment provisions. The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be lower than the amounts derived on the basis of guidelines prescribed from time to time by the Reserve Bank of India that apply to companies and financial institutions.

14.14.8 Catastrophe Reserve

Catastrophe reserve shall be created in accordance with norms, if any, prescribed by the authority. Investment of funds of catastrophe reserve shall be made in accordance with prescription of the authority.

Part II

14.15 DISCLOSURES FORMING PART OF FINANCIAL STATEMENTS

A. The following shall be disclosed by way of notes to the balance sheet

1. Contingent liabilities:
   (a) Partly-paid up investments.
   (b) Underwriting commitments outstanding.
   (c) Claims, other than those under policies, not acknowledged as debts.
   (d) Guarantees gives by or on behalf of the company.
   (e) Statutory demands/liabilities in dispute, not provided for.
   (f) Reinsurance obligations to the extent not provided for in accounts.
   (g) Other (to be specified).
2. Encumbrances to assets of the company in and outside India.
3. Commitments made and outstanding for loans, investments and fixed assets.
4. Claims, less reinsurance, paid to claimants in/outside India.
5. Actuarial assumptions for determination of claim liabilities in the case of claims where the claims payment period exceeds 4 years.
6. Ageing of claims—distinguishing between claims outstanding for more than 6 months and other claims.
7. Premiums, less reinsurance, written from business in/outside India.
8. Extent of premium income recognized, based on varying risk pattern, category wise, with basis and justification therefore, including whether reliance has been placed on external evidence.
9. Value of contracts in relation to investments, for:
   (a) Purchases where deliveries are pending.
   (b) Sales where payments are overdue.
10. Operating expenses relating to insurance business; basis of allocation of expenditure to various classes of business.
11. Historical costs of those investments valued on fair value basis.
12. Computation of managerial remuneration.
13. Basis of amortization of debt securities.
14. (a) Unrealized gain/losses arising due to changes in the fair value of listed equity shares and derivative instruments are to be taken to equity under the head 'fair value change account' and on realization reported in profit and loss account.
    (b) Pending realization, the credit balance in the 'fair value change account' is not available for distribution.
15. Fair value of investment property and the basis therefore.
16. Claims settled and remaining unpaid for a period of more than 6 months as on the balance sheet date.

B. The following accounting policies shall form an integral part of the financial statements

All significant accounting in terms of the accounting standards issued by the ICAI, and

1. Significant principles and policies given in Part I of accounting principles. Any other accounting policies, followed by the insurer, shall be stated in the manner required under accounting standard-1 (AS-1) issued by the ICAI.
2. Any departure from the accounting policies as aforesaid shall be separately disclosed with reasons for such departure.

C. The following information shall also be disclosed:

1. Investments made in accordance with any statutory requirement should be disclosed separately together with its amount, nature, security and any special rights in and outside India.
2. Segregation into performing/non-performing investments for the purpose of income recognition as per the directions, if any, issued by the authority.
3. Percentage of business sector wise.
4. A summary of financial statements for the last 5 years, in the manner as may be prescribed by the authority.
5. Accounting ratios as may be prescribed by the authority.
6. Basis of allocation of interest, dividends and rent between revenue account and profit and loss account.

Part III

14.16 GENERAL INSTRUCTIONS FOR PREPARATION OF FINANCIAL STATEMENTS

1. The corresponding amounts for the immediately preceding financial year for all items shown in the balance sheet, revenue account, profit and loss account shall be given.
2. The figures in the financial statements may be rounded off to the nearest thousands.
3. Interest, dividends and rentals receivable in connection with an investment should be stated at gross value; the amount of income tax deducted at source being included under 'advance taxes paid'.
4. Income from rent shall not include any national rent.
5. (I) For the purposes of financial statement, unless the context otherwise requires:
   (a) The expression 'provision shall, subject to note (II) below mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy.
   (b) The expression 'reserve' shall not, subject to as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability.
   (c) The expression 'capital reserve' shall not include any amount regarded as free for distribution through the profit and loss account; and the expression 'revenue reserve' shall mean any reserve other than a capital reserve.
   (d) The expression 'liability' shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

   (II) Where:

   (a) Any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or
   (b) Any amount retained by way of providing for any known liability is more than the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purpose of these accounts as a reserve and not provision.

6. The company should make provision for damages under lawsuits where the management is of the opinion that the award may go against the insurer.
7. Extent of risk retained and reinsured shall be separately disclosed.
8. Any debit balance of the profit and loss account shall be shown as deduction from uncommitted reserves and the balance, if any, shall be shown separately.

Part IV

14.17 CONTENTS OF MANAGEMENT REPORT

There shall be attached to the financial statements, a management report containing, inter alia, the following duly authenticated by the management:

1. Confirmation regarding the continued validity of the registration granted by the Authority.
2. Certification that all the dues payable to the statutory authorities have been duly paid.
3. Confirmation to the effect that the shareholding pattern and any transfer of shares during the year are in accordance with the statutory or regulatory requirements.
4. Declaration that the management has not directly or indirectly invested outside India the funds of the holders of policies issued in India.
5. Confirmation that the required solvency margins have been maintained.
6. Certification to the effect that the values of all the assets have been reviewed on the date of the balance sheet and that in his (insurer's) belief the assets set forth in the balance sheets are shown in the aggregate at amounts not exceeding their realizable or market value under the several headings:
   (i) 'Loans'
   (ii) 'Investments'
   (iii) 'Agents balances'
   (iv) 'Outstanding premiums'
   (v) 'Interest, dividends and rents outstanding'
   (vi) 'Interest, dividends and rents accruing but not due'
   (vii) 'Amounts due from other persons or bodies carrying on insurance business'
   (viii) 'Sundry debtors'
   (ix) 'Bills deceivable'
   (x) 'Cash' and
   (xi) The several items specified under 'other accounts'
7. Disclosure with regard to the overall risk exposure and strategy adopted to mitigate the same.
8. Operations in other countries, if any, with a separate statement giving the management's estimate of country risk and exposure risk and the hedging strategy adopted.
9. Ageing of claims indicating the trends in average claim settlement time during the preceding 5 years.
10. Certification to the effect as to how the values, as shown in the balance sheet, of the investments and stocks and shares have been arrived at, and how the market value thereof has been ascertained for the purpose of comparison with the values so shown.
11. Review of asset quality and performance of investment in terms of portfolios, i.e. separately in terms of real estate, loans, investments, etc.
12. A responsibility statement indicating therein that:
    (a) In the preparation of financial statements, the applicable accounting standards, principles and policies have been followed along with proper explanations relating to material departures, if any.

(b) The management has adopted accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and the operating profit or loss and of the profit or loss of the company for the year.

(c) The management has taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the applicable provisions of the Insurance Act, 1938 (4 of 1938)/ Companies Act 1956 (1 of 1956), for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

(d) The management has prepared the financial statements on a going concern basis.

(e) The management has ensured that an internal audit system commensurate with the size and nature of the business exists and is operating effectively.

13. A schedule of payments, which has been made to individuals, firms companies and organizations in which directors of the insurer are interested.

Part V

14.18 PREPARATION OF FINANCIAL STATEMENTS

1. An insurer shall prepare the revenue account, profit and loss account (shareholders' account) and the balance sheet in Form B-RA, Form B-PL and Form B-BS, or as there to as the circumstances permit (see Pages 13.29 to 13.55 for the forms).

Provided that an insurer shall prepare revenue account and balance sheet for fire, marine and miscellaneous insurance business and separate schedules shall be prepared for marine cargo, marine other than marine cargo and the following classes of miscellaneous insurance business under miscellaneous insurance and accordingly application of AS 17 segment reporting shall stand modified.

(a) (i) Motor, (ii) workmen's compensation/employers' liability, (iii) public/product liability, (iv) engineering, (v) aviation, (vi) personal accident, (vii) health insurance, (viii) others.

(b) An insurer shall prepare separate receipts and payments account in accordance with the direct method prescribed in AS-3—'cash flow statement' issued by the ICAI.

Schedule C

(See Regulation 3)

Auditor's Report

1. **The report of the auditors on the financial statements of every insurer shall deal with the matters specified herein:**

(a) That they have obtained all the information and explanations which, to the best of their knowledge and belief were necessary for the purpose of their audit and whether they have found them satisfactory.

(b) Whether proper books of account have been maintained by the insurer so far as appears from an examination of those books.

(c) Whether proper returns, audited or unaudited, from branches and other offices have been received and whether they were adequate for the purpose of audit.

(d) Whether the balance sheet, revenue account, profit and loss account and the receipts and payments account dealt with the report are in agreement with the books of account and returns.

(e) Whether the actuarial valuation of liabilities is duly certified by the appointed actuary including to the effect that the assumptions for such valuation are in accordance with the guidelines and norms, if any, issued by the authority, and/or the Actuarial Society of India in concurrence with the authority.

2. The auditors shall express their opinion on:
   (a) (i) Whether the balance sheet gives a true and fair view of the insurer's affairs as at the end of the financial year/period.
   (ii) Whether the revenue account gives a true and fair view of the surplus or the deficit for the financial year/period.
   (iii) Whether the profit and loss account gives a true and fair view of the profit or loss for the financial year/period.
   (iv) Whether the receipts and payments account gives a true and fair view of the receipts and payments for the financial year/period.
   (b) The financial statements stated at (a) above are prepared in accordance with the requirements of the Insurance Act, 1938 (4 of 1938), the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999) and the Companies Act, 1956 (1 of 1956), to the extent applicable and in the manner so required.
   (c) Investments have been valued in accordance with the provision of the act and these regulations.
   (d) The accounting policies selected by the insurer are appropriate and are in compliance with the applicable accounting standards and with the accounting principles, as prescribed in these regulations or any order or direction issued by the authority in this behalf.
3. The auditors shall further certify that:
   (a) They have reviewed the management report and there is no apparent mistake or material inconsistencies with the financial statements.
   (b) The insurer has complied with the terms and conditions of the registration stipulated by the authority.
4. A certificate signed by the auditors (which shall be in addition to any other certificate or report which is required by law to be given with respect to the balance sheet) certifying that:
   (a) They have verified the cash balances and the securities relating to the insurer's loans, reversions and life interest (in the case of life insurers) and investments.
   (b) To what extent, if any, they have verified the investments and transactions relating to any trusts undertaken by the insurer as trustee; and
   (c) No part of the assets of the policyholders' funds has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 (4 of 1938) relating to the application and investments of the policyholders' funds.

General Insurance Business:

FORM B-RA

In case of general insurance, Revenue A/c, P & L A/c & Balance sheet should be prepared in the prescribed forms B–RA, B–PL & B–BS respectively as per IRDA Act, which are reproduced in the following pages:

Name of the Insurer:
Registration No. and Date of Registration with the IRDA

Revenue Accounts for the Year Ended on 31 March 20…

	Particulars	**Schedule**	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Premiums Earned (Net)	1		
2.	Profit/Loss on Sale/Redemption of Investments			
3.	Others (to be Specified)			

4.	Interest, Dividend and Rent (Gross)			
	Total (A)			
1.	Claims Incurred (Net)	2		
2.	Commission	3		
3.	Operating Expenses Related to Insurance Business	4		
	Total (B)			
	Operating Profit/(Loss) from Fire/Marine/Miscellaneous Business (C) = (A) – (B)			
	Appropriations			
	Transfer to Shareholders' Account			
	Transfer to Catastrophe Reserve			
	Transfer to Other Reserves (to be Specified)			
	Total (C)			

Note: See notes appended at the end of Form B-PL.

FORM B-PL

Name of the Insurer:
Registration No. and Date of Registration with the IRDA

Profit and Loss Accounts for the Year Ended on 31 March 20…

	Particulars	**Schedule**	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Operating Profit/(Loss)			
	(a) Fire Insurance			
	(b) Marine Insurance			
	(c) Miscellaneous Insurance			
2.	Income from Investments			
	(a) Interest Dividend and Rent (Gross)			
	(b) Profit on Sale of Investments			
	Less: Loss on Sale of Investments			
3.	Other Income (to be Specified)			
	Total (A)			
4.	Provisions (other than Taxation)			
	(a) For Diminution in the Value of Investments			
	(b) For Doubtful Debts			
	(c) Others (to Be Specified)			
5.	Other Expenses			
	(a) Expenses Other than Those Related to Insurance Business			
	(b) Bad Debts Written off			
	(c) Others (to Be Specified)			
	Total (B)			

	Profit Before Tax			
	Provision for Taxation			
	Appropriations			
	(a) Interim Dividend Paid During the year			
	(b) Proposed Final Dividend			
	(c) Dividend Distribution Tax			
	(d) Transfer to Any Reserves or Other Accounts (to Be Specified)			
	Balance of Profit/Loss Brought Forward From Last Year			
	Balance Carried Forward to Balance Sheet			

Notes: To forms B-RA and B-PL.

(a) Premium income received form business concluded in and outside India shall be separately disclosed.

(b) Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e. before deducting commission) under the head 'reinsurance premiums'.

(c) Claims incurred shall comprise claims paid, specific claims settlement costs, wherever applicable, and change in the outstanding provision for claims at the year-end.

(d) Items of expenses and income more than 1% of the total premiums (less reinsurance) or ₹ 5,00,000, whichever is higher, shall be shown as a separate line item.

(e) Fees and expenses connected with claims shall be included in claims.

(f) Under the subhead 'others' shall be included items like foreign exchange gains or losses and other items.

(g) Interest dividends and rentals receivable in connection with an investment should be stated as gross amount, the amount of income tax deducted at source being included under 'advance taxes paid and taxes deducted at source'.

(h) Income from rest shall include only the realized rent. It shall not include any notional rent.

FORM B-BS

Name of the Insurer:
Registration No. and Date of Registration with the IRDA

Balance Sheet As on 31 March 20…

Particulars	**Schedule**	**Current Year (₹'000)**	**Previous Year (₹'000)**
Sources of Funds			
Share Capital	5		
Reserves and Surplus	6		
Fair Value Change Account			
Borrowings	7		
Total			
Application of Funds			
Investments	8		

Loans	9		
Fixed Assets	10		
Current Assets			
Cash and Bank Balances	11		
Advances and Other Assets	12		
Sub-total (A)			
Current Liabilities	13		
Provision	14		
Sub-total (B)			
Net Current Assets (C) = (A) – (B)			
Miscellaneous Expenditure (to the Extent Not Written off or Adjusted)	15		
Debit Balance in Profit and Loss Account			
Total			

Contingent Liabilities

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Partly Paid-up Investments		
2.	Claims, Other Than Against Policies, Not Acknowledged as Debts by the Company		
3.	Underwriting Commitments Outstanding (in Respect of Shares and Securities)		
4.	Guarantees Given by or on Behalf of the Company		
5.	Statutory Demands/Liabilities in Dispute, not Provided for		
6.	Reinsurance Obligations to the Extent not Provided for in Accounts		
7.	Others (to be Specified)		
	Total		

Schedules Forming Part of Financial Statements

Schedule 1

Premium Earned (Net)

Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
Premium from Direct Business		
Add: Premium on Reinsurance Accepted		
Less: Premium on Reinsurance Ceded		
Net Premium		

Adjustments for Change in Reserve for Unexpired Risks		
Total Premium Earned (Net)		

Note: Reinsurance premiums whether on business, ceded or accepted are to be brought into account, before deducting commission, under the head 'reinsurance premiums'.

Schedule 2

Claims Incurred (Net)

Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
Claims Paid		
Direct		
Add: Reinsurance Accepted		
Less: Reinsurance Ceded		
Net Claims Paid		
Add: Claims Outstanding at the End of the Year		
Less: Claims Outstanding at the Beginning		
Total Claims Incurred		

Notes:

(a) Incurred but not reported (IBNR), incurred but not enough reported (IBNER) claims should be included in the amount for outstanding claims.

(b) Claims include specific claims settlement cost but not expenses of management.

(c) The surveyor fees, legal and other expenses shall also form part of claims cost.

(d) Claims cost should be adjusted for estimated salvage value if there is a sufficient certainty of its realization.

Schedule 3

Commission

Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
Commission Paid		
Direct		
Add: Reinsurance Accepted		
Less: Commission on Reinsurance Ceded		
Net Commission		

Note: The profit/commission, if any, are to be combined with the reinsurance accepted or reinsurance ceded figures.

Schedule 4

Operating Expenses Related to Insurance Business

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Employees' Remuneration and Welfare Benefits		
2.	Travel, Conveyance and Vehicle Running Expenses		
3.	Training Expenses		
4.	Rents, Rates and Taxes		
5.	Repairs		
6.	Printing and Stationery		
7.	Communication		
8.	Legal and Professional Charges		
9.	Auditor's Fees, Expenses, etc.		
	(a) As Auditor		
	(b) As Adviser or in Any Other Capacity, in Respect of		
	(i) Taxation Matters		
	(ii) Insurance Matters		
	(iii) Management Services; and		
	(c) In Any Other Capacity		
10.	Advertisement and Publicity		
11.	Interest and Bank Charges		
12.	Others (to Be Specified)		
13.	Depreciation		
	Total		

Note: Items of expenses and income more than 1% of the total premiums (less reinsurance) or ₹ 5,00,000, whichever is higher, shall be shown as a separate line item.

Schedule 5

Share Capital

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Authorized Capital		
	…Equity Shares of ₹ …Each		
2.	Issued Capital		
	…Equity Shares of ₹ …Each		
3.	Subscribed Capital		
	…Equity Shares of ₹ …Each		
4.	Called-up Capital		
	…Equity Shares of ₹ …Each		
	Less: Calles Unpaid		

	Add: Equity Shares Forfeited (Amount Originally Paid up) Less: Preliminary Expenses Expenses Including Commission or Brokerage on Underwriting or Subscription of Shares **Total**		

Notes:

(a) Particulars of the different classes of capital should be separately stated.

(b) The amount capitalized on account of issue of bonus shares should be disclosed.

(c) In case any part of the capital is held by a holding company, the same should be separately disclosed.

Schedule 5A

Share Capital
Pattern of Shareholding
(As Certified by the Management)

Shareholders	**Current Year**		**Previous Year**	
	Number of Shares	**% of Holding**	**Number of Shares**	**% of Holding**
Promoters • Indian • Foreign Others **Total**				

Schedule 6

Reserves and Surplus

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Capital Reserve		
2.	Capital Redemption Reserve		
3.	Securities Premium		
4.	General Reserve		
	Less: Debit Balance in Profit and Loss Account		
	Less: Amount Utilized for Buy-back		
5.	Catastrophe Reserve		
6.	Other Reserves (to Be Specified)		
7.	Balance of Profit in Profit and Loss Account		
	Total		

Note: Additions to and deduction from the reserves should be disclosed under each of the specified heads.

Schedule 7

Borrowings

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Debentures/Bonds		
2.	Banks		
3.	Financial Institutions		
4.	Others (to Be Specified)		
	Total		

Notes:

(a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each subhead.

(b) Amounts due within 12 months from the date of balance sheet should be shown separately.

Schedule 8

Investments

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
	Long-term Investments		
1.	Government Securities and Government Guaranteed Bonds Including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares		
	(i) Equity		
	(ii) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/Bonds		
	(e) Other Securities (to Be Specified)		
	(f) Subsidiaries		
	(g) Investments Properties—Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	Short-term Investments		
1.	Government Securities and Government Guaranteed Bonds Including Treasury Bills		

2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares		
	(i) Equity		
	(ii) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/Bonds		
	(e) Other Securities (to Be Specified)		
	(f) Subsidiaries		
	(g) Investments Properties—Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	Total		

NOTES:

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) Holding company and subsidiary shall be construed as defined in the Companies Act, 1956.

(ii) Joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

(iii) Joint control is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(iv) Associate is an enterprise in which the company has significant influence and which is neither a subsidiary nor a joint venture of the company.

(v) Significant influence (for the purpose of this schedule) means participation in the financial and operating policy decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policy-making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee, it is presumed that the investor does have significant influence unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor for having significant influence.

(b) Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value there of shall be disclosed.

(c) Investments made out of catastrophe reserve should be shown separately.

(d) Debt securities will be considered as 'held to maturity' securities and will be measured at historical cost subject to amortization.

(e) Investment property means a property (land, building, part of a building or both) held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.

(f) Investments maturing within 12 months from balance sheet date and investments made with the specific intention to dispose of within 12 months from balance sheet date shall be classified as short-term investments.

Schedule 9

Loans

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Security-wise Classification		
	Secured		
	(a) On Mortgage of Property		
	(i) In India		
	(ii) Outside India		
	(b) On Shares, Bonds, Government Securities		
	(c) Others (to Be Specified)		
	Unsecured		
	Total		
2.	Borrower-wise Classification		
	(a) Central and State Government		
	(b) Banks and Financial Institutions		
	(c) Subsidiaries		
	(d) Industrial Undertakings		
	(e) Others (to Be Specified)		
	Total		
3.	Performance-wise Classification		
	(a) Loans Classified as Standard		
	(i) In India		
	(ii) Outside India		
	(b) Non-performing Loans Less Provisions		
	(i) In India		
	(ii) Outside India		
	Total		
4.	Maturity-wise Classification		
	(a) Short Term		
	(b) Long Term		
	Total		

Notes:

(a) Short-term loans include those, which are repayable within 12 months from the date of balance sheet. Loans other than short-term loans are long-term loans.

(b) Provisions against non-performing loans shall be shown separately.

(c) The nature of the security in case of all long-term secured loans shall be specified in each case. Secured loans for the purposes of this schedule means loans secured wholly or partly against an asset of the company.

(d) Loans considered doubtful and the amount of provisions created against such loans shall be disclosed.

Schedule 10

Fixed Assets

Particulars	Cost/Gross Block				Depreciation			Net Block		
	Opening	Additions	Deductions	Closing	Up to Last Year	For the Year	On Sales/ Adjustment	To Date	As at Year-end	Previous Year
Goodwill										
Intangibles (Specify)										
Land—Freehold										
Leasehold Property										
Buildings										
Furniture and Fittings										
Information										
Technology										
Equipment										
Vehicles										
Office Equipment										
Others (Specify Nature)										
Total										
Work in Progress										
Grand Total										
Previous Year										

Note: Assets included in land property and building above exclude investments properties as defined in Note (e) to Schedule 8.

Schedule 11

Cash and Bank Balances

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Cash (Including Cheques, Drafts and Stamps)		
2.	Bank Balances		
	(a) Deposit Accounts		
	(i) Short-term (Due Within 12 Months)		
	(ii) Others		
	(b) Current Accounts		
	(c) Others (to Be Specified)		
3.	Money at Call and Short Notice		
	(a) With Banks		
	(b) With Other Institutions		
4.	Others (to Be Specified)		
	Total		
	Balances With Non-scheduled Banks Included in 2 and 3 Above		

Note: Bank balance may include remittances in transit. If so, the nature and amount shall be separately stated.

Schedule 12

Advances and Other Assets

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
	Advances		
1.	Reserve Deposits with Ceding Companies		
2.	Application Money for Investments		
3.	Prepayments		
4.	Advances to Directors/Officers		
5.	Advance Tax Paid and Taxes Deducted at Source (Net of Provision for Taxation)		
6.	Others (to Be Specified)		
	Total (A)		
	Other Assets		
1.	Income Accrued on Investments		
2.	Outstanding Premiums		

3.	Agent's Balances		
4.	Foreign Agencies Balances		
5.	Due from Other Entities Carrying on Insurance Business (Including Reinsures)		
6.	Due from Subsidiaries/Holding Company		
7.	Deposit with Reserve Bank of India (Pursuant to Section 7 of Insurance Act, 1938)		
8.	Others (to Be Specified)		
	Total (B)		
	Total (A) + (B)		

Notes:

(a) The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.

(b) The term 'officer' should conform to the definition of that term as given under the Companies Act, 1956.

(c) Sundry debtors will be shown under item 9 (Others)

Schedule 13

Current Liabilities

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Agent's Balances		
2.	Balances Due to Other Insurance Companies		
3.	Deposits Held on Reinsurance Ceded		
4.	Premiums Received in Advance		
5.	Unallocated Premium		
6.	Sundry Creditors		
7.	Due to Subsidiaries/Holding Company		
8.	Claims Outstanding		
9.	Due to Officers/Directors		
10.	Others (to be Specified)		
	Total		

Schedule 14

Provisions

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Reserve for Unexpired Risk		
2.	For Taxation (Less Advances Tax Deducted at Source)		
3.	For Proposed Dividends		

4.	For Dividend Distribution Tax		
5.	Others (to Be Specified)		
	Total		

Schedule 15

Miscellaneous Expenditure (To the Extent not Written off or Adjusted)

	Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
1.	Discount Allowed in Issue of Shares/Debentures		
2.	Others (to Be Specified)		
	Total		

Notes:

(a) No item shall be included under the head 'miscellaneous expenditure' and carried forward unless:
   1. Some benefit from the expenditure can reasonably be expected to be received in future, and
   2. The amount to be carried forward in respect of any item included under the head 'miscellaneous expenditure' shall not exceed the expected future revenue/other benefits related to the expenditure.

(b) The amount to be carried forward in respect of any item included under the head 'miscellaneous expenditure' shall not exceed the expected future revenue/other benefits related to the expenditure.

14.19 RESERVE FOR UNEXPIRED RISK

This refers the income received in advance by the insurance company as premium relating to general insurance business. In general insurance business, policies are restricted for 1 year. Every year it has to be renewed as if it were a new policy. Strictly speaking liability does not arise after the expiry of 1 year until and otherwise is gets renewed. In general insurance, it is the practice that policies are issued throughout the year. As such, most of the policies will be 'in force' even after the end of the accounting year, usually financial year. Risk may occur on any day, before the expiry of 1 year. Hence, a provision has to be created to meet claims that may arise after the end of the accounting year. Such a provision is referred to as 'reserve for unexpired risk'.

According to Section 64 v (i) (ii) (b) of IRDA Act, the reserve for unexpired risk should be 100% of the net premium in the case of marine insurance and in the case of other business such as fine, theft accident and the like, the provision should be 50% of the net premium.

Accounting treatment:

Adjustment for change in reserve for unexpired risk should be shown in Schedule 1—Premiums Earned (Net).

Net premium has to be arrived as through adjustments as follows:

(i) The difference between closing reserve for unexpired risk and additional reserve and opening reserve for unexpired risk and additional reserve should be determined.

(ii) When closing reserves are more than opening reserves, the amount of change has to be deducted, from the premium earned.

(iii) When opening reserves are more than closing reserves, the amount of change has to be added to the premium earned.

After the above adjustment, net premium has to be shown in revenue A/c as 'premium earned (Net)'.

The closing reserve for unexpired risk should appear under Schedule 14—Provision for Balance Sheet Purpose.

It is important to note that the balance of provision appears on the liabilities side of the balance sheet under the head 'balance of funds and accounts'.

Illustration 14.13

Model: Unexpired risk reserve.

The Bharath Insurance Co. Ltd. furnishes you the following information.

(i) On 31 March 2010 it had reserve for unexpired risks to the tune of ₹ 80 crores. It comprised of ₹ 30 crores in respect of marine insurance business, ₹ 40 crores in respect of fire insurance business and ₹ 10 crores in respect of miscellaneous insurance business.

(ii) It is the practice of the company to crease reserves as 100% of the net premium income in respect of marine insurance policies and as 50% of the net premium income in respect of fire and miscellaneous insurance policies.

(iii) During 2010–11, the following business was conducted:

Particulars	Figure in Crores (₹)		
	Marine	Fire	Miscella-neous
Premia Collected from:			
(a) Insurance in Respect of Policies Issued	36	86	24
(b) Other Insurance Companies in Respect of Risks Undertaken	14	10	8
Premia Paid/Payable to Other Insurance Companies on Business Ceded	13.4	8.6	14

The Bharath Insurance Co. asks you to:

(a) Pass journal entries relating to 'unexpired RISKS reserve'

(b) Show in columnar form 'unexpired risks reserve account' for 2010–11.

[CA (Inter)—Modified]

Solution

First, closing reserve for unexpired risk is to be ascertained as follows:

Closing reserve for unexpired risk:

(₹ in Crores)

Particulars	Marine	Fire	Miscellaneous
Premia Collected on Direct Business	36	86	24
Add: Premia Collected on Reinsurance Accepted	14	10	8
	50	96	32
Less: Premia Paid/Payable on Reinsurance Ceded	13.4	8.6	14
Net Premia Received	36.6	87.4	18
Percentage of Premia Required for Net Premia	100%	50%	50%
Amount of Reserve for Unexpired Risks	36.6	43.7	9

In the Books of the Bharath Insurance Co. Ltd.

Journal Entries

(₹ in Crores)

Date	Particulars	LF	Dr. ₹	Cr. ₹
31 March 2011	Unexpired Risk Reserve A/c Dr.		80	
	To Marine Revenue A/c			30
	To Fire Revenue A/c			40
	To Miscellaneous Revenue A/c			10
	(Transfer of Opening Unexpired Risks Reserve to Revenue A/c)			
"	Marine Revenue A/c Dr.		36.6	
	Fire Revenue A/c Dr.		43.7	
	Miscellaneous Revenue A/c Dr.		9.0	
	To Unexpired Risks Reserve A/c			88.30
	(Reserve for Unexpired Risk to Be Maintained at the End of the Year to Be Debited to Respective Revenue Account)			

Unexpired Risk Reserve A/c

For 2010–11

(in Columnar Form)

(₹ in Crores)

Date	Particulars	Marine	Fire	Miscellaneous	Date	Particulars	Marine	Fire	Miscellaneous
2011	To Revenue A/c (Transfer)	30	40	10	1 April 2010	By Balance b/d	30	40	10
"	To Balance c/d	36.6	43.7	9	31 March 2011	By Revenue A/c	36.6	43.7	9
		66.6	83.7	19			66.6	83.7	19
					1 April 2011	By Balance b/d	36.6	43.7	9

Illustration 14.14

Model: Fire revenue A/c and schedules.

From the following particulars relating to Extinct Insurance Co. Ltd., prepare fire revenue A/c for the year ending on 31 March 2011:

	(₹ in '000s)		(₹ in '000s).
Claims Paid	2,40,000	Reinsurance Premium Paid	60,000
Claims Outstanding on 1 April 2010	20,000	Commission	1,00,000

Claims Intimated but not Accepted and Paid on 31 March 2011	5,000	Commission on Reinsurance Ceded	5,000
Claims Intimated and Accepted But not Paid on 31 March 2011	30,000	Provision for Unexpired Risk on 1 April 2010	2,00,000
Commission on Reinsurance Accepted	2,500	Additional Provision for Unexpired Risk on 1 April 2010	10,000
Expenses of Management	1,52,500		
Bonus in Reduction of Premium	6,000		
Premium Received	6,00,000		

You are required to provide for additional reserve for unexpired risk at 1% of the net premium in addition to the opening balance.

Solution

This question relates to general insurance business. Hence, form prescribed by IRDA, i.e. Form B-RA is to be used for the preparation of revenue A/c and schedules forming part of it as follows:

Extinct Insurance Co. Ltd.
Revenue Account For the Year Ended on 31 March 2011
In Respect of Fire Insurance Business

No.	Particulars	Schedule	Current Year (₹'000)	Previous Year (₹'000)
1.	Premiums Earned (Net)	1	4,64,600	—
2.	Profit on Sale/Redemption of Investments		—	—
3.	Other Incomes:		—	—
4.	Interest, Dividends and Rent (Gross)		—	—
	Total (A)		4,64,600	
1.	Claims Incurred (Net)	2	2,55,000	—
2.	Commission	3	97,500	—
3.	Operating Expenses Related to Insurance Business	4	1,58,500	—
	Total (B)		5,11,000	
	Operating Loss for Fire Insurance Business (C) = (A) – (B)		46,400	

Schedules Forming
Part of Revenue Account
Schedule 1

Premium Earned (Net)

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Premiums Received	6,00,000	—
Less: Reinsurance Premiums Paid	60,000	

Net Premium			5,40,000	
Adjustment for change in Reserve for Unexpired Risk				
Reserve for Unexpired Risk (31 March 2011)		₹		
50% of ₹ 5,40,000	2,70,000			
Additional Reserve:				
$\left(₹\,5,40,000 \times \frac{1}{100}\right) + ₹\,10,000$:		15,400		
		2,85,400		
Less: Reserve for Unexpired Risk	₹			
(1.4.2010)	2,00,000			
Additional Reserve (1 April 2010)	10,000	2,10,000		
Change in Reserve for Unexpired Risk			75,400	
Total Premiums Earned (Net)			4,64,600	

Note:

(a) Any increase in reserve for unexpired risk and additional reserve should be deducted from the premium.

(b) Any decrease in reserve for unexpired risk and additional reserve should be added to the premium.

Schedule 2

Claims Incurred (Net)

Particulars	**Current Year ₹'000**	**Previous Year ₹'000**
Claims Paid	2,40,000	—
Add: Claims Intimated and Accepted but not Paid on 31 March 2011	30,000	—
Claims Intimated but not Accepted and Paid on 31 March 2011	5,000	—
	2,75,000	—
Less: Claims Outstanding on 1 April 2010	20,000	—
Total Claims Incurred (Net)	2,55,000	—

Schedule 3

Commission

Particulars	**Current Year ₹'000**	**Previous Year ₹'000**
Commission on Direct Business	1,00,000	—
Add: Commission on Reinsurance Accepted	2,500	—
	1,02,500	
Less: Commission on Reinsurance Ceded	5,000	
Net Commission	97,500	

Schedule 4

Operating Expenses Related to Insurance Business

Particulars	Current Year ₹'000	Previous Year ₹'000
Expenses of Management	1,52,500	—
Bonus in Reduction of Premium	6,000	—
Total	1,58,500	

Note: Bonus in reduction of premium is an operating expense.

Illustration 14.15

Model: Marine insurance—revenue A/c and schedules forming part of it

From the following information as on 31 March 2011, prepare the revenue account of Seven Seas Co. Ltd., engaged in marine Insurance business:

Particulars		Direct Business (₹'000)	Reinsurance (₹'000)
I: Premium:			
Received		7,200	1,080
Receivable:	1 April 2010	360	63
	31 March 2011	540	84
Payable:	1 April 2010	—	720
	31 March 2011		
II: Claims			
Paid		4,950	375
Payable:	1 April 2010	285	39
	31 March 2011	525	66
Received		—	300
Receivable	1 April 2010	—	27
	31 March 2011	—	36
III: Commission			
On Insurance Accepted		450	33
On Insurance Ceded		—	42

Other expenses are incomes:

	₹ in '000		₹ in '000
Salaries	780	Legal Expenses (Inclusive of ₹ 60,000 in Connection with Settlement of Claims)	180
Income Tax Paid	720	Income Tax Deducted as Source	73.5

Rent, Rates and Taxes	54	Bad Debts	15
Printing and Stationery	69	Double Income Tax Refund	36
Interest Dividend and Rent Received (Net)	3,46.5	Profit on Sale of Motor Car	15

Balance on 1 April 2010 was 79,50,000 including additional reserve of 9,75,000. Additional reserve has to be maintained at 5% of the net premium of the year.

[CA (Final)—Modified]

Solution

Seven Seas Co., Ltd.

Revenue Account for the Year Ended on 31 March 2011

in Respect of Marine Business

No.	Particulars	Schedule No.	Current Year (₹'000)	Previous Year (₹'000)
1.	Premiums Earned (Net)	1	7,565.25	—
2.	Profit on Sale/Redemption of Investments		—	—
3.	Other Incomes:			
	Double Income Tax Refund		36	—
	Profit on Sale of Motor Car		15	—
4.	Interest Dividends and Rents (Gross) (346.5 + 73.5)		420	—
	Total (A)		8,036.25	—
1.	Claims Incurred (Net)	2	5,343	—
2.	Commission	3	441	—
3.	Operating Expenses Related to Insurance Business	4	1.038	—
	Total (B)		6,822	—
	Operating Profit from Marine Insurance Business (C) = (A) – (B)		1,214.25	—

Income tax paid and TDS should be shown in the balance sheet under Schedule 12.

Schedules Forming Part of Revenue Account

Schedule 1

Premiums Earned (Net)

Particulars			Current Year (₹'000)	Previous Year (₹'000)
	Direct	Reinsurance		
	₹	₹		
Premiums Received	7,200	1,080		
Add: Premium Receivable: 31 March 2011	540	84		
	7,740	1,164		
Less: Premiums Receivable: 1 April 2010	360	63		
	7,380	1,101		

Total Premiums Received (₹ 7,380 + 1,101)		8,481	
Less: Premiums Paid	720		
Premiums Payable on 31 March 2011	126		
	846		
Premiums Payable on 1 April 2010	60	786	
Net Premium		7,695	
Adjustment for Change in Reserve for Unexpired Risk:			
Reserve for Unexpired Risk on 31 March 2011			
7.695 × 100%	7,695		
Additional Reserve 7,695 × 5%	384.75		
	8,079.75		
Less: Reserve for Unexpired Risk and Additional Reserve on 1 April 2010	7,950.00		
Change in Reserve for Unexpired Risk		129.75	
Total Premiums Earned (Net)		7,565,25	

Schedule 2

Claims Incurred (Net)

Particulars		**Current Year (₹'000)**	**P revious Year (₹'000)**
Claims Paid		4,950	
Add: Claims on Reinsurance Accepted		375	
Legal Expenses Regarding Claims		60	
		5,385	
Less: Reinsurance Claims Received		300	
Net Claims Paid		5,085	
Add: Claims Outstanding on 31 March 2011:			
Direct		525	
Reinsurance		66	
Claims Recoverable from Insurance on 1 April 2010		27	
		5,703	
Less: Claims Outstanding on 1 April 2010:			
Direct	285		
Reinsurance	39		
Claims Recoverable from Reinsurance on 31 March 2011	36	360	
Total Claims Incurred:		5,343	

Schedule 3

Commission

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Commission on Direct Business	450	—
Add: Commission on Reinsurance Accepted	33	—
	483	—
Less: Commission on Reinsurance Ceded	42	—
Net Commission	441	—

Schedule 4

Operating Expenses Related to Insurance Business

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Salaries	780	—
Rent, Rates and Taxes	54	—
Printing and Stationery	69	—
Legal Charges (not Connected with Claims)	120	—
Bad Debts	15	—
Total	1,038	—

Illustration 14.16

Model: Technical and non-technical account.

A Generous Insurance Co. Ltd. has furnished the following information for the preparation of revenue A/c for fire insurance business for the year ended on 31 March 2011 and its profit and loss A/c for the year:

	(₹'000)		(₹'000)
Claims Admitted but not Paid	84,752	Expenses of Management	1,56,000
Commission Paid	1,00,000	Claims Outstanding as on 1 April 2010	54,000
Commission on Reinsurance Received	10,000	Dividend on Share Capital	37,000
Bad Debts	5,000	Reserve for Unexpired Risk as on 1 April 2010	4,60,000
Claims Paid	30,000	Additional Reserve on 1 April 2010	80,000
Premium Received Less Insurance	11,04,000		

The following further information have also to be considered:

(i) Premium outstanding at the end of the year: ₹ 8,00,00,000

(ii) Additional reserve @ 10% of net premium to be maintained.

(iii) It is the policy of the company to maintain 50% of the premium towards reserves for unexpired risks.

[CA (Inter)—Modified]

Solution

Form B-RA (IRDA Norm)
Technical Account (Policyholders' Account)
Generous Insurance Co. Ltd.
Fire Revenue Account for the Year Ended on 31 March 2011

No.	Particulars	Schedule No.	Current Year (₹'000)	Previous Year (₹'000)
1.	Premiums Earned (Net)	1	10,13,600	—
2.	Profit on Sale/Redemption of Investments		—	—
3.	Other Incomes		—	—
4.	Interest, Dividend and Rent (Gross)		—	—
	Total (A)		10,13,600	
1.	Claims Incurred (Net)	2	60,752	—
2.	Commission	3	76,000	—
3.	Operating Expenses Related to Insurance Business	4	1,61,000	—
	Total (B)		2,97,752	—
	Operating Profit from Fire Business (C) = (A) – (B)		7,15,848	—

Form B-PL (IRDA Prescription)
Non-technical Account (Shareholder's Account)
Profit and Loss Account
For the Year Ended on 31 March 2011

No.	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Operating Profit/Loss:		
	Operating Profit from Fire Business	7,15,848	—
2.	Income from Investments	—	—
3.	Other Income:		
	Share Transfer Fees	10,000	—
4.	Provision Other than Taxation	7,25,848	—
5.	Other Expenses	—	—
	Total (B)	Nil	—
	Profit Before Tax (A) – (B)	7,25,848	—
	Less: Provision for Taxation	—	—
	Profit After Tax	7,25,848	—

	Appropriations:			
	Dividend on Share Capital	37,000		
	Dividend Distribution Tax	3,700		
	(10% on ₹ 37,000)		40,700	—
	Transfer to Reserve		—	—
			6,85,148	—
	Balance of Profit Brought Forward from Last Year		20,000	
	Balance of Profit Carried Forward to Balance Sheet		7,05,148	—

Schedules Forming Part of Financial Statements

Schedule 1

Premiums Earned (Net)

Particulars		**Current Year (₹'000)**	**Previous Year (₹'000)**
Premium Received Less Reinsurance		11,04,00	—
Add: Premium Outstanding on 31 March 2011		80,000	—
Net Premium		11,84,000	—
Adjustment for Change in Reserve for Unexpired Risk:			
Reserve for Unexpired Risk on 31 March 2011			
50% on ₹ 11,84,000	5,92,000		
Additional reserve on 31 March 2011			
10% of ₹ 1,18,400	1,18,400		
	7,10,400		
Less: Reserve for Unexpired Risk on 1 April 20104,	60,000		
Additional Reserve on 1 April 2010:	80,000		
	5,40,000		
Change in Reserve for Unexpired Risk		1,70,400	—
Total Premiums Earned (Net)		11,13,600	—

Schedule 2

Claims Incurred (Net)

Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
Claims Paid	30,000	—
Add: Claims Admitted but not Paid on 31 March 2011	84,752	—
	1,14,752	
Less: Claims Outstanding on 1 April 2010	54,000	—
Claims Incurred (Net)	60,752	—

Schedule 3

Commission

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Commission Paid	1,00,000	—
Less: Commission on Reinsurance Received	24,000	—
Net Commission	76,000	—

Schedule 4

Operating Expenses Related to Insurance Business

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Expenses of Management	1,56,000	—
Bad Debts	5,000	—
Total	1,61,000	—

Illustration 14.17

Model: Fire revenue and marine revenue accounts and profit and loss account.

From the following balances of universal General Insurance Co. Ltd. as on 31 March 2011 prepare: (a) fire revenue account, (b) marine revenue account and (c) profit and loss account:

	(₹'000)		(₹'000)
Provision for Unexpired Risk on 1 April 2010:		Commission Paid:	
Fire	2,500	Fire	900
Marine	8,200	Marine	1,080
Additional Reserve on 1 April 2010:		Depreciation	350
Fire	500	Interest, Dividends, etc.	140
Bad Debts:		Difference in Exchange (Cr.)	3
Fire	50	Miscellaneous Receipts	50
Marine	120	Profit on Sale of Land	600
Auditor's Fees	120	Premium Received:	
Director's Fees	50	Fire	6,000
Share Transfer Fees	8	Marine	10,800
Bad Debts Recovered	12	Expenses of Management:	
Claims Paid and Outstanding:		Fire	1,450
		Marine	4,000

Claims Paid and Outstanding:		Commission Earned on Reinsurances Ceded:	
Fire	1900	Fire	300
Marine	3800	Marine	600

Provision for unexpired risk is to be kept at 50% of the premium for fire and 100% for marine departments. The additional reserve in case of fire insurance is to be increased by 5% of the net premium.

Solution

Note: The figures are given for marine and fire business. Revenue A/c is to be prepared by providing separate columns, for each, as shown below:

Universal General Insurance Co. Ltd.
Revenue Account for the Year Ended on 31 March 2011

No.	Particulars	Schedule No.	Fire (₹'000)	Marine (₹'000)
1.	Premiums Earned	1	5,200	8,200
	Total (A)		5,200	8,200
1.	Claims Incurred (Net)	2	1,900	3,800
2.	Commission	3	600	480
3.	Operating Expenses Related to Insurance Business	4	1,500	4,120
	Total (B)		4,000	8,400
	Operating Profit/Loss (C) = (A) – (B)		1,200	(200)

Profit and Loss Account
For the Year Ended on 31 March 2011

No.	Particulars	Schedule No.	(₹ in '000)
1.	Operating Profit/Loss:		
	(a) Operating Profit from Fire Business		1,200
	(b) Operating Loss from Marine Business		(200)
	Net Operating Profit		1,000
2.	Income from Investments:		
	(a) Interest, Dividends and Rents (Gross)		140
	(b) Profit on Sale of Investments:		
	Profit on Sale of Land		600
	Less: Loss on Sale of Investments		—
3.	Other Income:		
	Share Transfer Fees		8
	Bad Debts Recovered		12

	Miscellaneous Receipts		50
	Difference in Exchange (Cr.)		3
	Total (A)		1,813
4.	Provision		—
5.	Other Expenses:		50
	Directors' Fees		12
	Auditor's Fees		350
	Total (B)		412
	Profit Before Tax (A) – (B)		1,401

Schedules Forming Part of Financial Statements

Schedule 1

Premiums Earned (Net)

Particulars	**Fire (₹'000)**	**Marine (₹'000)**
Premium Received	6,000	10,800
Adjustment for Change in Reserve for Unexpired Risk:		
Add: Provision for Unexpired Risk on 1 April 2010	2,500	8,200
Add: Additional Reserve on 1 April 2010	500	—
	9,000	19,000
Less: Provision for Unexpired Risk on 31 March 2011 50% of ₹6,000 and 100% of ₹10,800	3,000	10,800
	6,000	8,200
Less: Additional Reserve on 31 March 2011 for Fire (₹6,000 × 5%) + 500	800	—
Total Premiums Earned	5,200	8,200

Schedule 2

Claims Incurred (Net)

Particulars	**Fire (₹'000)**	**Marine (₹'000)**
Claims Paid and Outstanding	1,900	3,800
Claims Incurred (Net)	1,900	3,800

Schedule 3

Commission

Particulars	**Fire (₹'000)**	**Marine (₹'000)**
Commission Paid	900	1,080
Less: Commission on Reinsurance Ceded	300	600
Net Commission	600	480

Schedule 4

Operating Expenses Related to Insurance Business

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Management Expenses	1,450	4,000
Bad Debts	50	120
Total	1,500	4,120

Illustration 14.18

Model: Revenue A/c; P and L A/c and balance sheet of general insurance company.

From the following details, prepare the revenue A/c, profit and loss A/c and the balance sheet of Deep Ocean Co. Ltd. carrying on marine insurance for 15 Months Ended on 31 March 2011:

	(₹'000)		(₹'000)
Agents Balances (Dr.)	73,200	Shares in Limited Companies	1,80,000
Interest Accrued but not Due	4,100	State Government Securities	4,40,000
Furniture and Fixtures (Cost ₹ 6,300)	4,200	Claims Less Reinsurance	5,30,000
Share Capital	7,50,000	Commission Paid	31,200
Balance of Marine Fund (1 April 2010)	3,80,000	Cash and Bank Balances	47,200
Stock of Stationery	1,250	Unclaimed Dividends	1,200
Expenses of Management	1,10,000	P & L A/c (Cr.)	1,20,000
Foreign Taxes and Insurance	6,150	Sundry Creditors	6,300
Outstanding Premium	10,600	Due to Reinsurance	30,000
Donations Paid	4,300	Premium Less Reinsurance	6,20,000
Advance Income Tax Payments	31,000	Interest and Dividends	1,20,000
Sundry Debtors	4,600	Transfer Fees Received	300
Govt of India Securities	4,60,000		
Debentures of Public bodies	90,000		

Outstanding claims on 31 March 2011 were ₹ 7,00,00,000 depreciation on furniture to be provided @ 20% p.a.

[CA (Inter)—Modified]

Solution

Deep Ocean Insurance Co. Ltd.

Marine Revenue A/c for 15 Months Ended on 31 March 2011

No.	Particulars	Schedule No.	Current Year (₹'000)	Previous Year (₹'000)
1.	Premiums Earned (Net)	1	3,80,000	—
2.	Profit on Sale of Investments		—	—

3.	Other Incomes		—	—
4.	Interest Dividends and Rents (Gross)		1,20,000	—
	Total (A)		5,00,000	—
1.	Claims Incurred (Net)	2	6,00,000	—
2.	Commission	3	31,200	—
3.	Operating Expenses Related to Insurance Business	4	1,16,150	—
	Total (B)		7,47,350	—
	Operating Loss (C) = (A) – (B)		2,47,350	—

Profit and Loss Account
For the year Ended on 31 March 2011

No.	Particulars	Schedule No.	Current Year (₹'000)	Previous Year (₹'000)
1.	Operating Loss from Marine Insurance Business		(2,47,350)	—
2.	Income from Investments		—	—
3.	Other Income:			
	Transfer Fees		300	—
	Total (A)		(2,47,050)	
4.	Provision (Other than Taxation)		—	—
5.	Other Expenses:		—	—
	Depreciation on Furniture		1,050	—
	Donation		4,300	
	Total (B)		5,350	
	Profit/Loss Before Tax (A) – (B)		(2,52,400)	—
	Provision for Taxation		—	—
	Appropriations		—	—
			2,52,400	—
	Balance of Profit Brought Forward from Last Year		1,20,000	—
	Balance of Loss Carried Forward to Balance Sheet		1,32,400	—

Balance Sheet of Deep Ocean Insurance Co. Ltd.
As on 31 March 2011

Particulars	Schedule No.	Current Year (₹'000)	Previous Year (₹'000)
Sources of Funds:			
Share Capital	5	7,50,000	—
Reserves and Surplus	6	—	—
Fair Value Change Account	–	—	—
Borrowings	7	—	—
Total		7,50,000	—

Application of Funds:			
Investments	8	11,70,000	—
Loans	9	—	—
Fixed Assets	10	3,500	—
Current Assets:			
Cash and Bank Balances	11	47,200	—
Advances and Other Assets	12	1,24,750	
Sub-total (A)		1,71,950	
Current Liabilities	13	1,07,500	—
Provisions	14	6,20,000	—
Sub-total (B)		7,27,500	—
Net Current Assets (A) – (B)		(5,55,550)	—
Miscellaneous Expenditure	15	1,32,400	—
Total		7,50,000	—

Note:

1. Net current asset is a negative figure.
2. Miscellaneous expenditure, even if it is a loss, is to be treated as a positive figure for the purpose of balance sheet.

Schedules Forming Part of Financial Statements

Schedule 1

Premiums Earned (Net)

Particulars		**Current Year (₹'000)**	**Previous Year (₹'000)**
Premium Less Reinsurance		6,20,000	—
Adjustment for Change in Reserve for Unexpired Risk:			
Reserve for Unexpired Risk on 31 March 2011	₹		
(₹ 6,20,000 × 100%)	6,20,000		
Less: Reserve for Unexpired Risk on 1 April 2010	3,80,000	2,40,000	
Change in Reserve for Unexpired Risk:			
Total Premiums Earned		3,80,000	

Schedule 2

Claims incurred (Net)

Particulars	**Current Year (₹'000)**	**Previous Year (₹'000)**
Claims Paid	5,30,000	—
Add: Outstanding Claims on 31 March 2011	70,000	—
Claims Incurred (Net)	6,00,000	—

Schedule 3

Commission

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Commission Paid	31,200	
Net Commission	31,200	

Schedule 4

Operating Expenses Related to Insurance Business

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Expenses of Management	1,10,000	—
Foreign Taxes and Insurance	6,150	—
Total	1,16,150	—

Schedule 5

Share Capital

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Share Capital	7,50,000	—
Total	7,50,000	—

Schedule 6—Reserves and Surplus—Nil

Schedule 7—Borrowings—Nil

Schedule 8

Investments

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Govt. of India Securities	4,60,000	—
Share Goverment Securities	4,40,000	—
Debentures of Public Bodies	90,000	—
Shares in Limited Companies	1,80,000	
Total	11,70,000	—

Schedule 9—Loans—Nil

Schedule 10

Fixed Assets

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Furniture	4,200	—
Less: Depreciation: $\left(₹4{,}200 \times \frac{20}{100} \times 5/12\right)$	1,050	—
Total	3,150	—

Schedule 11

Cash and Bank Balances

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Cash and Bank Balances	47,200	—
Total	47,200	—

Schedule 12

Advances and Other Assets

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Advances:		
Advance Income Tax Payments	31,000	—
Others Assets:		
Outstanding Premiums	10,600	—
Agents Balances	73,200	—
Interest Accrued but not Due	4,100	—
Sundry Debtors	4,600	—
Stock of Stationery	1,250	—
Total	1,24,750	

Schedule 13

Current Liabilities

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Outstanding Claims	70,000	—
Due to Reinsurers	30,000	—
Sundry Creditors	6,300	—
Unclaimed Dividends	1,200	—
Total	1,07,500	

Schedule 14

Provisions

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Provision for Unexpired Risk of Marine Business	6,20,000	—
Total	6,20,000	—

Schedule 15

Miscellaneous Expenditure

Particulars	Current Year (₹'000)	Previous Year (₹'000)
Debit Balances in Profit and Loss Account	1,32,400	—
Total	1,32,400	—

Summary

Insurance is a method of averaging risks.

There are several types of insurance policies, which may be broadly grouped into two categories: life and non-life insurance.

Principles of insurance: Principle of indemnity, insurable interest and utmost faith.

Important legislations to govern insurance business in India: The Insurance Act 1939, IRDA Act 1999 and Regulations 2002.

Important books to be maintained are: (i) the register of policies, (ii) the register of claims (iii) the register of licensed insurance agents and (iv) subsidiary books.

Bonus in reduction of premium is granted on renewal of policies. This is treated as an expense.

Reinsurance: Sometimes insurance companies share a part of risk with other companies. Commission on reissuance accepted is an expense, whereas commission on reinsurance ceded is an income to the company.

Reserve for unexpired risk: This is applicable generally to non-life insurance. Premium is reserved in advance for a year, which may extend beyond the accounting period. Hence, a portion of premium collected has to be reserved for that period. For marine business, it is 100% of net premium and for others it is 50% of net premium.

IRDA Regulations relating to preparation of financial statements: Formats of final accounts and all the schedules to be accompanied by then are discussed in detail with illustrations 14.1–14.17 (Refer the text)

Key Terms

Insurance Policy: A document of a contract entered into between the insurer (company) and the insured (policyholder).

Bonus in Reduction of Premium: A reduction allowed at prescribed rate on renewal of policy, a reward for not making any claims in the period the policy was in force.

Reversionary Bonus: A specified percentage (up to 95%) paid out of profits of LIC on maturity to the policyholders in addition to the policy amount.

Reinsurance: The practice of an insurer sharing a part of the risk with some other insurers.

Commission or Reinsurance 'Ceded': Under reinsurance, the commission got from the company to whom such business is given.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. Presence of 'insurable interest' is an important ingredient in all insurance contracts.
2. All insurance contracts are contracts of indemnity.
3. Under whole life policy, premium has to be paid for a fixed specified period.
4. Profit on life insurance business is determined by preparing a P & L A/c.
5. Bonus payable on maturity is known as reversionary bonus.
6. Every insurer shall keep a required 'solvency margin'.
7. For life business premium income should be recognized on receipt basis.
8. Final accounts insurance business companies should be accompanied by schedules.
9. The balance sheet of life assurance business is also known as valuation balance sheet.
10. If life assurance, fund exceeds the net liability, and results in profit to the company.
11. Current liabilities are included as part of 'sources of funds'.
12. Reinsurance premiums, whether on business ceded or accepted, are to be brought into account.
13. Fees and expenses connected with claims should not be included in claims.
14. Items of expenses and income more than 1% of the total premium (less reinsurance) or ₹ 5,00,000, whichever is higher, should be shown as a separate line item.
15. Investment made out of catastrophe reserve need not be shown separately.
16. Annuity is an income for the insurance company.
17. Surrenders are shown as expenditure under Schedule I.
18. The terms 'insurance' and 'assurance' are synonymous.
19. The process by which net liability is determined by an actuary is called valuation of balance sheet.
20. Combined revenue account is prepared for a general insurance company, conducting more than one business.

Answers:

1. True	2. False	3. False
4. False	5. True	6. True
7. False	8. True	9. False
10. True	11. False	12. True
13. False	14. True	15. False
16. False	17. True	18. True
19. False	20. False	

II: Fill in the blanks with apt word(s)

1. Insurance is a contract of _____ .
2. All contracts of insurance are contract of _____.
3. _____ is a contract entered into between the insurer and the insured.
4. Insurance is a method of averaging _____.
5. The amount payable by the insurer to the insured when the policy becomes due for payment is referred to as _____.
6. The policy money, i.e. sum assured that will be payable only after the death of the insured is called _____ policy.
7. _____ provides a source of regular income to the assured or his nominee after the expiry of a specified period.
8. Insurance business may be broadly divided into two categories: (i) _____ and (ii) _____.
9. The Insurance Regulatory and Development Authority Act was passed in the year _____.

10. Generally, _____ year is the accounting year of insurance companies.
11. An insurer carrying on life insurance business should comply with the requirements of _____ of the IRDA Regulations, 2002.
12. Form _____ is the prescribed format for preparing revenue A/c of life insurance company, as per IRDA norms.
13. Form A-PL is the prescribed format for preparing _____of life insurance companies, as per IRDA norms.
14. Form _____ is the standard format for preparing the balance sheet of life insurance companies, according to the provision of IRDA Regulations, 2002.
15. The revenue A/c is the summarized form of _____schedules.
16. The first schedule to be prepared for revenue A/c deals with _____.
17. Schedule 3 is to be prepared by life insurance companies dealing with _____.
18. In revenue account of life insurance companies, balances of surplus transferred is represented by _____.
19. The balance sheet of insurance companies comprises of two parts: (i) _____ and (ii) _____.
20. Profit on life business is determined by the preparation of _____.
21. Valuation balance sheet is to be prepared _____ periodically.
22. The net liability on all outstanding policies is computed by experts called _____.
23. The concept of surrender value is exclusively confined to _____ business.
24. When an insurer reinsures a part of the risk with some other insurer, it is known as _____.
25. Taking more than one policy on the same subject with two or more companies is called _____
26. Only _____ of the balance of surplus amount should be earmarked as bonus to policyholders of life insurance.
27. Reserve for unexpired risk is peculiar to _____ business.
28. The reserve for unexpired risk should be _____ of the net premium earned for marine cargo business.
29. Revenue A/c is prepared in the Form _____ as per IRDI norms.
30. The excess provisions maintained by a general insurance company over the minimum prescribed amount is called _____.

Answers:

1. indemnity
2. utmost faith
3. A policy
4. risks
5. claims
6. whole life
7. Annuity
8. life insurance and non-life/general insurance
9. 1999
10. financial
11. Schedule A
12. A-RA
13. P & L A/c
14. A–BS
15. 4
16. premiums earned
17. commission
18. life assurance fund
19. sources of funds; application of funds
20. valuation balance sheet
21. once in 2 years
22. actuaries
23. life insurance
24. reinsurance
25. double insurance
26. 95%
27. general insurance
28. 50%
29. B-RA
30. additional reserve

III: Multiple choice questions—Choose the correct answer

1. In India, insurance business is regulated now by
   (a) IRDA Act, 1999
   (b) the Insurance Act, 1938
   (c) the General Insurance (Nationalization) Act, 1972
   (d) Insurance Rules, 1939
2. Which of the following is not a 'statutory book':
   (a) register of policies
   (b) register of proposals and proposal advance cash book
   (c) register of claims
   (d) register of licensed insurance agents
3. The final accounts of insurance business are accompanied by
   (a) 4 schedules (b) 11 schedules
   (c) 15 schedules (d) 12 schedules

4. Profit/loss of life business is determined by preparing
   (a) profit and loss A/c
   (b) profit and loss appropriations A/c
   (c) trading A/c
   (d) revenue A/c
5. The balance sheet of a life insurance company is to be presented in
   (a) the prescribed form as per IRDA norms
   (b) schedule VI of the Companies Act
   (c) the traditional format of a trading concern
   (d) the prescribed form as per Banking Regulation Act
6. Valuation balance sheet is prepared by a
   (a) trading company
   (b) life insurance company
   (c) general insurance company
   (d) banking company
7. In life insurance, the policy amount is payable
   (a) after the expiry of the policy period
   (b) after the death of the insured
   (c) (a) or (b), whichever is earlier
   (d) on the occasion of admission of insured in hospital
8. Claims paid by life insurance companies is shown in
   (a) schedule 4 (b) schedule 1
   (c) schedule 2 (d) schedule 3
9. The bonus that is to be paid on maturity of the policy is called
   (a) interim bonus
   (b) additional bonus
   (c) annual bonus
   (d) reversionary bonus
10. The percentage of profit of life insurance business to be distributed to share holders is
   (a) 95% (b) 100%
   (c) 5% (d) none of these
11. The commission paid by the reinsurer is called
   (a) commission on reissuance ceded
   (b) commission on reinsurance accepted
   (c) commission on direct business
   (d) commission on agency paid
12. Agents balances (Dr.) are shown in the balance sheet of life insurance companies as
   (a) other assets (b) fixed assets
   (c) current assets (d) none of these
13. In general insurance, the policy amount is payable
   (a) after the expiry of the policy period
   (b) after one accounting period
   (c) after the death of the insured
   (d) after the loss incurred to the insured property
14. Survey expenses for marine insurance claims must be
   (a) added to expenses of management
   (b) shown as a separate item
   (c) added to claims
   (d) shown directly in balance sheet
15. Expenses of management must be charged to
   (a) different revenue accounts
   (b) P & L A/c
   (c) P & L appropriation A/c
   (d) none of the above
16. Income tax on interest, dividends and rest has to be
   (a) added to provision for taxation
   (b) subtracted from interest, dividends and rent
   (c) debited to revenue A/c
   (d) debited to P & L A/c
17. During 2010, a general insurance company reveals the following:

	₹(in Lac)
Premium Received	1,250
Premium on Reinsurance Accepted	250
Premium on Reinsurance Ceded	500

The amount to be credited as premium to revenue A/c will be
   (a) ₹1000 Lakhs (b) ₹750 Lakhs
   (c) ₹500 Lakhs (d) ₹1500 Lakhs

Answers:

1. (a)	2. (b)	3. (c)
4. (d)	5. (a)	6. (b)
7. (c)	8. (a)	9. (d)
10. (c)	11. (b)	12. (a)
13. (d)	14. (c)	15. (a)
16. (b)	17. (d)	

Short Answer Questions

1. Define 'Insurance'.
2. What do you mean by 'Insure' and 'Insured'?
3. Explain the term 'Uberrimae fidei'.
4. Mention the name of types of life policies.
5. What is the main difference between life policy and non-life policy?
6. What is the difference between whole life policy and endowment policy?
7. Mention some types of general insurance.
8. What do you mean by 'life assurance fund'?
9. Explain the term 'annuity'.
10. Mention two important regulations issued by IRDA Regulations, 2002.
11. Mention the important statutory books to be-maintained by life insurance companies.
12. Name of relevant forms specified under Schedule A of the IRDA Regulations, 2002.
13. Write short notes on revenue account.
14. What are the constituents of the balance sheet?
15. Explain the term 'reinsurance'.
16. How can 'claims' be classified?
17. How will you determine 'paid-up value'?
18. What is meant by 'bonus in reduction of premium'?
19. Explain the term 'reversionary bonus'.
20. Explain 'surrender value'
21. What is 'double insurance'?
22. Write short notes on valuation balance sheet.
23. What is meant by 'actuarial valuation'?
24. Explain the term 'reserve for unexpired risk'.
25. What is the legal provision in respect of reserve for unexpired risk?
26. What is meant by 'additional reserve'?
27. What is the difference between 'commission on reinsurance accepted' and 'commission on reinsurance ceded'?
28. Explain the term 'net current assets'

Essay Type Questions

1. Distinguish between life and non-life insurance business.
2. How the insurance industry in India has been regulated since its inception? Give special emphasis on the latest regulations.
3. Enumerate the books that are to be maintained for recording the transactions and preparing final accounts of insurance companies.
4. How would you prepare 'revenue account'?
5. How would you prepare profit and loss account of life insurance companies?
6. Name the important schedules to be prepared, which form part of balance sheet. Explain the contents of each such schedule.
7. Explain the schedules to be prepared that form part of final accounts of general insurance companies.
8. Write notes on
   (i) Net liability
   (ii) Bonus to shareholders
   (iii) Reserve for unexpired risk
   (iv) Reinsurance
   (v) Net current assets

Exercises

Part A—For Undergraduate Level

1. A life assurance fund of ₹ 12,50,000 was ascertained without taking into account the following:
   (a) Claims covered under reinsurance: ₹ 9,000
   (b) Reinsurance premium: ₹ 7,500
   Calculate the correct life assurance fund.
   [**Ans.:** ₹ 12,51,500]
   [Model: Correct life assurance fund]
2. A life insurance company prepared a revenue A/c for the year ended on 31 March 2011 and ascertained its life assurance fund to be ₹ 67,03,200. It has found later that the following had been omitted from the accounts.

	₹
Interest Accrued on Investments	96,000
Income Tax Liable to be Deducted Estimated to Be ₹30,000	
Outstanding Premiums	94,200
Bonus Utilized for Reduction of Premium	19,800
Claims Intimated but not Admitted	45,600
Claims Covered under Reinsurance	15,900

Compute the true life assurance fund.

[**Ans.:** ₹68,33,700]

3. The life assurance fund of an insurance company on 31 March 2011 showed a balance of ₹43,88,250. It was found that the following were not taken into account.

	₹
Dividend from Investments	2,40,000
Income Tax on above	24,000
Bonus in Reduction of Premium	4,38,750
Claims Covered under Reinsurance	2,11,500
Claims Intimated but not Accepted by the Company	3,81,000

Ascertain the Correct Balance of Fund.

[**Ans :** ₹44,34,750]

4. The following balances are extracted from the books of XYZ Life Insurance Corporation:

Life Insurance Fund as on 31 March 2011 ₹6,400 Lakhs

Net Liabilities as per Valuation ₹4,800 Lakhs

Interim Bonus Paid ₹600 Lakhs

You are required to show (a) the valuation balance sheet as on 31 March 2011 and (b) the distribution statement.

[Model: Valuation balance sheet]

[**Ans :** Surplus ₹1,600 Lakhs; Bonus: ₹1490 Lakhs]

5. The Revenue A/c of a life insurance company showed a balanced of ₹23,75,000 at the end of 2010–11 before considering the following items:

	₹
(a) Bonus in Reduction of Premiums	2,00,000
(b) Outstanding Premiums	5,00,000
(c) Interest Accrued on Investments	1,00,000
(d) Claims Intimated but not Admitted	1,75,000
(e) Claims Recovered under Reinsurance	15,000

Pass necessary adjustment entries.

[**Ans:** Adjusted life assurance fund: ₹28,15,000]

Model: Adjustment entries—Life assurance fund

6. From the following you are required to calculate the amount on account of claim to be shown in revenue A/c for the year ending on 31 March 2011:

Intimated in	Admitted in	Paid in	₹
2009–10	2009–10	2010–11	90,000
2010–11	2010–11	2011–12	60,000
2008–09	2009–10	2009–10	30,000
2008–09	2009–10	2010–11	72,000
2010–11	2011–12	2011–12	48,000
2010–11	2010–11	2010–11	6,12,000

Claim on account of reinsurance in 2010–11 was ₹1,50,000.

[**Ans :** Net claim to be shown in revenue A/c: ₹5,70,000]

Model: Calculation of net claims

7. The following figures relate to a life insurance company for the year ended on 31

March 2011. Prepare the revenue A/c.

	(₹'000)		(₹'000)
Claims	156	Surrenders	36
Management Expenses	56	Premia Received	604
Directors' Fees	16	Life Fund (1.4.2010)	4600
Audit Fees	12	Interest Received	160
Medical Expenses	2	Rent Received	40
Agent's Commission	20	Claims Cancelled	2
Depreciation	16	Annuities	6
Bonus in Reduction of Premium	6		

Consideration for Annuities Granted	66		

Additional information:

(i) Premium outstanding: ₹ 36,000

(ii) Claims outstanding: ₹ 12,000

[**Ans :** Surplus: ₹ 5,70,000]

Model: Preparation of revenue A/c

8. From the following particulars prepare revenue A/c, in statutory form, of the Leo Life Assurance Co. Ltd. for the year ended on 31 March 2011:

	₹(in '000)
Claims Paid by Death	71,000
Claims Paid by Maturity	35,100
Premiums	7,06,000
Consideration for Annuities Granted	82,00
Annuities Paid	53,450
Bonus Paid in Cash	2,400
Management Expenses	31,900
Commission	9,570
Interest, Dividends and Rents	97,850
Surrenders	13,150
Bonus in Reduction of Premium	900
Dividend Paid to Shareholders	4,500
Life Assurance Fund (1 April 2010)	15,22,500
Claims Outstanding (1 April 2010)	11,000
Claims Outstanding (31 March 2011)	8,000

[**Ans :** Surplus before payment of dividend: ₹(in '000) 6,71,380]

9. The following trial balance was extracted from the books of a Life Insurance Company Ltd. as on 31 March 2011:

	Dr. ₹'000	Cr. ₹'000
Paid-up Share Capital (50,00,000 Shares of ₹ 10 Each)	—	50,000
Life Assurance Fund on 1 April 2010	—	14,86,150
Dividend Paid	7,500	—
Bonus to Policyholders	15,750	—
Premia Received	—	50,750
Claims Paid	98,500	—
Commission Paid	4,650	—
Expenses of Management	16,150	—
Mortgages in India	2,46,100	—
Interest and Dividends Received	—	86,350
Agents Balances	4,650	—
Freehold Premisesx	20,000	—
Investments	11,52,500	—
Loan on Company's Policies	86,800	—
Cash on Deposit	13,500	—
Cash in Hand	3,650	—
Surrenders	3,500	—
	16,73,250	16,73,250

You are required to prepare company's revenue A/c for the year ended on 31 March 2011 and its balance sheet as on that date after taking the following matters into consideration:

	₹'000
(a) Claims Admitted but not Paid	4,650
(b) Expenses of Management Due	100
(c) Interest Accrued	9,650
(d) Premiums Outstanding	6,000

[**Ans:** ₹ In '000—Surplus before divided: ₹ 9,450; balance sheet total: ₹ 15,38,100]

[Model: Revenue A/c and balance sheet]

10. The following trial balance was extracted from the books of a Life Assurance Company Ltd. as on 31 March 2011:

Debit Balances	₹'000	Credit Balances	₹'000
Claims by Death	1,35,000	Share Capital (1,00,00,000 Shares of ₹ 10 Each)	1,00,000
Claims by Maturity	1,15,000	Life Assurance Fund as on 1 April 2010)	16,19,100
Bonus in Reduction of Premium	22,750	Claims Outstanding (as on 1 April 2010)	12,500
Commission	6,250	Premiums Less Reinsurance	2,75,050

Management Expenses	25,150	Outstanding Commission	1,000
Building	25,000	Policy Renewal Fees	750
Investments	13,82,500	Interest and Dividends	1,45,000
Mortgages in India	2,75,000		
Loan on Company's Policies	1,07,500		
Outstanding Premiums	10,000		
Surrenders	4,150		
Dividend Paid	10,000		
Cash as Bank	17,000		
Cash in Hand	11,600		
Agent's Balances	6,500		
	21,53,400		21,53,400

You are required to prepare the company's revenue A/c for the year ended on 31 March 2011 and its balance sheet as on that date after taking the following matters into consideration

		(₹ '000)
(i)	Claims Outstanding at the End of the Year	10,000
(ii)	Interest Accrued but not Received	9,750
(iii)	Further Bonus Utilized in Reduction of Premium	4,250
(iv)	Claims Covered under Reassurance	6,000

[**Ans :** ₹ in '000s—Surplus before divided: ₹ 1,30,750; balance sheet total: ₹ 18,39,850]

[**Hint:** Life Assurance Fund: ₹ 17,39,850]

11. The following balances were extracted form the books of Moon Life Assurance Co. Ltd. as on 31 March 2011:

Debit Balances	**₹ '000**	**Credit Balances**	**₹ '000**
Mortgages	7,000	Outstanding Claims (1 April 2010)	110
Building	725	Premiums	16,970
Loans	775	Consideration for Annuities Granted	2,100
Investments	6,000	Interest and Dividend	500
Surrenders	125	Life Assurance Fund (1 April 2010)	4,750
Annuities	60		
Claims by Death	3,500		
Claims by Maturity	5,000		
Agent's Balances	25		
Deposit with RBI	150		
Outstanding Premiums	175		
Commission	270		
Cash as Bank	250		
Management Expenses	315		
Bonus in Reduction of Premium	25		
Interest Accrued but not Received	35		
	24,430		24,430

You are required to prepare the revenue A/c for the year ended on 31 March 2011 and the balance sheet as on that date after taking into account the following adjustments:

		₹('000)
(i)	Premiums Outstanding	22.5
(ii)	Interest Accruing but not Due	18.5
(iii)	Claims Admitted but not Paid	6.0
(iv)	Surrender Claims not Paid	5.5
(v)	Further Bonus Utilized in Premium Reduction of	10.0

[**Ans :** ₹ in '000s—Surplus ₹ 10,404.5; balance sheet total: ₹ 15,154.5]

12. From the following Trial balance of East Cost Life Insurance Co. Ltd., prepare revenue A/c and the balance sheet after taking into account the following adjustment:

	₹ ('000)
(a) Claims Outstanding as on 31 March 2011	90
(b) Claims Recoverable from Reinsurer	25
(c) Further Bonus Utilized in Reduction of Premium	12
(d) Further Claims Intimated	15
(e) Premiums Outstanding	12
(f) Management Expenses Due	36
(g) Surrenders Adjusted Against Loans on Policies	60

Trial Balance as on 31 March 2011

Debit Balances	**₹'000**	**Credit Balances**	**₹'000**
Claims Paid	390	Capital	1200
Mortgage Loans	2700	Life Fund on 1 April 2010	9600
Loan on Policies	840	Claims Outstanding on 1 April 2010	60
Management Expenses	600	Premium Deposits	180
Commission	120	Investment Fluctuation Fund}	300
Depreciation on Fixed Assets	30	Sundry Creditors	240
Investments	7800	Interest and Dividends	600
Fixed Assets	900	Premiums	2400
Surrenders	120		
Outstanding Premium 31 March 2011}	300		
Interest Accrued	60		
Sundry Debtors	150		
Income Tax Deducted on Interest	60		
Bonus in Reduction of Premium	24		
Agents Balance	6		
Cash as Bank	480		
	14,580		14,580

[**Ans :** (₹'000)—Surplus ₹1,617; balance sheet total: ₹12,717]

13. Model: Revenue A/c and valuation balance sheet

From the figures stared below prepare a revenue A/c and valuation balance sheet as on 31 March 2011 showing surplus for policyholders:

	₹'000
Life Assurance Fund (Opening)	20,000
Premiums	12,500
Interest, for Annuities Granted	7,500
Consideration for Annuities Granted	500
Claims Paid	1,500
Surplus on Revaluation of Reversions Purchased	40
Bonus in Reduction of Premium	25
Surrenders	500
Commission	250

Net Liabilities on Policies in Force on 31 March 2011 28,265

[**Ans :** (₹'000)—Surplus ₹18,265; life assurance fund at the end: ₹37,265; surplus as per valuation balance sheet: ₹10,000]

14. The following were the revenue items of a life insurance company for the year ended on 31 March 2011:

	(₹'000)		**(₹'000)**
Premiums	10,075	Management Expenses	650
Surrenders	487.5	Claims	6987.5
Interest, Dividend, Rent	3250	Annuities	2665
Bonus in Cash	292.5	Commission	325
Bonus in Reduction of Premium	13	Consideration for Annuities Granted	3575
Life Fund on 1 April 2010	12,500		

At the valuation on 31 March 2011, the actuary's certificate disclosed the net liability on policies and annuities at ₹14,40,45,000.

Prepare revenue A/c and ascertain the valuation surplus.

[**Ans :** Surplus in revenue A/c: ₹ 54,79,500
Surplus in valuation balance sheet: ₹ 35,75,000
Life assurance fund on 31 March 2011: ₹ 1,79,79,500]

15. Model: Calculation of bonus due to policyholders

The Life Insurance fund of a company was ₹ 17,00,000 on 31 March 2011. Its actuarial valuation on 31 March 2011 disclosed a net liability of ₹ 14,40,000. An interim bonus of ₹ 20,000 was paid to policyholders during the previous 2 years. It is now proposed to carrying forward ₹ 55,000 and to divide the balance between the policyholders and shareholders. Show (a) the valuation balance sheet; (b) the net profit for the 2-year period and (c) the distribution of profits.

[**Ans :** (a) Surplus: ₹ 2,60,000; (b) net profit: ₹ 2,80,000; (c) amount due to policyholders: ₹ 1,93,750; shareholders: ₹ 11,250]

16. Crescent Life Assurance Company gets its valuation made once in 2 years. Its life assurance fund on 31 March 2011 stood as ₹ 22,82,500; before providing for ₹ 22,500 being the shareholders dividend for 2010–11. Its actuarial valuation on 31 March 2010 disclosed a net liability of ₹ 16,10,000. An interim bonus of ₹ 40,000 was paid to the policyholders during the previous 2 years.

Prepare a statement showing the amount now available as bonus to policy holders.

[**Ans :** Amount available as bonus to policyholders: ₹ 6,15,500; surplus: ₹ 6,72,500]

17. A life insurance company got its valuation made once in 3 years. The life assurance fund on 31 March 2011 amounted to ₹ 20,96,000 before providing for ₹ 16,000 for the share holders' dividend for the year 2009–10. Its actuarial valuation on 31 March 2011 disclosed a net liability of ₹ 20,20,000. An interim bonus of ₹ 20,000 was paid to the policyholder during the previous 2 years.

Prepare a statement showing the amount now available to policyholders as bonus.

[**Ans:** Amount available as bonus to policyholders: ₹ 56,000; surplus as per valuation balance sheet: ₹ 76,000]

18. General Insurance

Revenue A/c of Single Business

From the following particulars, prepare the fire revenue A/c for 2010–11:

	₹'000
Claims Paid	940
Legal Expenses Regarding Claims	20
Premiums Received	2,400
Reinsurance Premium	240
Commission	400
Expenses of Management	600
Provision Against Unexpired Risk on 1 April 2010	1040
Claims Unpaid on 1 April 2010	80
Claims Unpaid on 31 March 2011	140

Model

[**Ans :** Operating profit: ₹ 1,00,000]

19. Prepare revenue A/c of the Marine Insurance Company Ltd. as on 31 March 2011 from the following information.

	₹'000
Reserve for Unexpired Risk (1 April 2010)	2483.00
Addition Reserve (1 April 2010)	248.30
Premiums Less Reinsurance	3600
Claims Outstanding (1 April 2010)	800
Claims Paid	2350
Commission	175
Management Expenses	270
Audit Fees	50
Directors Sitting Fees	17
Depreciation	25
General Charges	60

Outstanding claims due on 31 March 2011 was ₹ 300,000. Additional reserve is to be maintained at 10% on net premiums

[**Ans :** Operating loss: ₹ 75,700]

20. Model: More than one business—revenue A/c

The following balances are extracted from the books of Bharath General Insurance Company Ltd. Prepare revenue A/c of fire and marine business for the year ending on 31 March 2011.

Particulars	(₹'000)	Particulars	(₹'000)
Funds on 1 April 2010:		Claims Paid and Outstanding:	
Fire	1550	Fire	1307.5
Marine	4200	Marine	510
Premium:		Commission	
Fire	2782	Fire	105
Marine	4411	Marine	270
Due to Reinsurers:		Management Expenses:	
Fire	22	Fire	210
Marine	101	Marine	365

It was further noticed that premiums were outstanding:

Fire ₹70,00,000 and marine ₹80,00,000. Provision is to be made for unexpired risk on fire and marine at 40% and 100% of the premium received, respectively.

[**Ans.:** Operating profit fire: ₹15,87,700; Marine: ₹30,55,000]

21. Model: revenue A/c and P & L A/c for two businesses

From the following balances of Universal Insurance Co. Ltd. as on 31 March 2011, prepare (a) fire revenue A/c, (b) marine revenue A/c and (c) profit and loss A/c:

Particulars	₹'000	Particulars	₹'000
Bad Debts:		Difference in Exchange (Cr.)	300
Fire	5,000	Miscellaneous Receipts	5,000
Marine	12,000	Profit on Sale of Land	60,000
Auditor's Fees	3,000	Fire Premium Less Reinsurance}	6,00,000
Director's Fees	3,200	Marine Premium Less Reinsurance	10,80,000
Share Transfer Fees	800	Management Expenses:	
Bad Debts Recovered	1,200	Fire	1,45,000
Reserve (Fire as on 1 April 2010)	2,50,000	Marine	4,00,000
Reserve (Marine as on 1 April 2010)	8,20,000	Commission Earned on Reinsurance Ceded:	
Claims Paid and Outstanding:		Fire	30,000
Fire	1,90,000	Marine	60,000
Marine	3,60,000	Additional Reserve (Fire) as on 1 April 2010	50,000
Depreciation	35,000		
Interest, Dividend Received	14,000		
Commission Paid:			
Fire	90,000		
Marine	1,08,000		

In addition to the usual reserve additional reserve in the case of fire insurance is to be increased by 5% of net premiums.

[**Ans:** Operating Profit: Fire: ₹1.20,000; Operating loss: Marine: ₹20,000; Profit carried forward to B/S: ₹1,40,100]

22. Model: Revenue A/c; P & L A/c and balance sheet of general insurance companies

From the following trial balance of a marine insurance company prepare final accounts for the year ended on 31 March 2011:

Particulars	Debit (₹'000)	Particulars	Credit (₹'000)
Expenses of Management	45,000	Marine Fund as on 1 April 2010	7,25,000
Claims Paid	75,00	Marine Premium	3,15,000
Audit Fees	2,000	Interest and Dividend	65,000
Director's Fees	3,000	Investment Fluctuation Fund	14,000
Debtors for Premium Due	1,500	Staff PF	20,000

Furniture	6,000	Transfer Fees	300
Taxes	3,800	Sundry Creditors	4,500
Contribution to Staff PF	1,000	Reserve Fund	25,500
Commission	12,000	Share Capital:	
Investment	10,00,000	2,50,000 Shares of ₹100 Each	2,50,000
Land and Building	1,20,000	P & L A/c (1 April 2010)	10,000
Cash in Hand	20,000		
Cash as Bank	1,20,000		
PF Investment	20,000		
	14,29,300		14,29,300

(a) Depreciate furniture 10%; land and buildings 3%.

(b) Outstanding claims ₹55,00,000.

(c) Provide ₹35,00,000 to investment reserve fund in addition to existing balance.

(d) Adjustment has to be made for ₹50,00,000 reinsurance premium paid and ₹25,00,000 for claims covered under reinsurance.

[**Ans:** Operating profit: ₹6,41,300; Profit transferred to balance sheet: ₹6,47,800; Balance sheet total: ₹9,40,800]

23. On 31 March 2011, the trial balance of a general insurance company was as follows:

Particulars	**Debit (₹'000)**	**Particulars**	**Credit (₹'000)**
Management Expenses (Fire)	375	Fire Fund on 1 April 2010	6100
Management Expenses (Marine)	475	Fire Premium	1700
Claims Paid and Outstanding (Fire)	610	Marine Fund on 1 April 2010	9200
Claims Paid and Outstanding (Marine)	535	Marine Premium	3560
Audit Fees	20	Interest, Divided, etc.	1235
Director's Fees	35	Investments Reserve Fund	360
Motor Car	120	Provident Fund	460
Debtors for Premium Due	35	Transfer Fees	15
Fire Claims Recoverable	45	Preference Share Capital:	
Furniture (Cost: ₹4,50,000)	400	(50,000 Shares of ₹100 each ₹80 Paid)	4,000
Taxes	135	Equity Share Capital:	
Commission (Fire)	110	(2,50,000 Shares of ₹50 Each ₹40 Paid)	10,000
Commission (Marine)	135	Forfeited Shares A/c	35
Investments	30,000	Fire Claims Outstanding	105
Cash	155	Marine Claims Outstanding	85
Bank	750	Sundry Creditors	110
Land and Buildings	5,000	Reserve Fund	1135
Debts Due from Other Insurers	60	Amount Due to Other Insures	285
		Profit and Loss A/c	610
	38,995		38,995

Depreciate furniture by 10% on the original cost and motor car by 15% provide 40% on premiums for unexpired risk and ₹35,000 for investment reserve fund in addition to the existing balance. Prepare revenue account of fire and marine departments, profit and loss A/c and balance sheet.

[**Ans:** Operating profit fire: ₹60,25,000; Operating profit marine: ₹101,91,000; Profit carried to B/S: ₹177,88,000; Balance sheet total: ₹333,53,000

Model: Final accounts—more than one business

Exercises

Part B—For Advanced Level

24. The life insurance fund of Hindustan Life Insurance Co. Ltd. was ₹1,36,00,000 on 31 March 2011. Its actuarial valuation on 31 March 2011 disclosed a net liability of ₹1,15,20,000. An interim bonus of ₹1,60,000 was paid to the policyholders during the previous 2 years. It is not proposed to carrying forward ₹4,40,000 and to divide the balance between the policyholders and the share holders.

Show (a) the valuation balance sheet, (b) the net profit for the 2-year period and (c) the distribution of profits

[CA (Inter)—Modified]

[**Ans :** (a) Profit as per valuation balance sheet: ₹20,80,000; (b) Net profit for the 2-year; ₹22,40,000 period; (c) Amount due to policy-holders: ₹15,50,000; Amount due to shareholders: ₹90,000].

Model: valuation balance sheet and net profit and distribution of profits

25. The revenue account of a life insurance company shows the life assurance fund on 31 March 2011 at ₹3,11,06,550. Before taking into account the following items:

(i)	Claims Covered under Reinsurance:	₹60,000.
(ii)	Bonus Utilized in Reduction of Life Insurance Premium:	₹22,500
(iii)	Outstanding Premium:	₹27,050
(iv)	Claims Intimated but not Admitted:	1,32,500 ₹
(v)	Interest Accrued on Securities:	₹41,300.

What is the life assurance fund after taking into account the above omissions?

[CS (Inter)—Modified]

[**Ans :** ₹3,11,02,400]

Model: True life assurance fund

26. From the following trial balance of long life assurance company prepare the revenue account, profit and loss account and the balance sheet. The statements need to be prepared in prescribed formats.

Credits	Amount ₹ '000	Debits	Amount ₹ '000
Life Assurance Fund Opening Balance	2,75,000	Income Tax on Interest Dividend and Rents	1,500
Premium Less Reinsurances	10,00,000	Income Tax Paid	1,250
Outstanding Claims (Net of Reinsurances)		Claims Paid (Net of Reinsurances):	
Opening Balances:		By Death	12,500
By Death	5,500	By Maturity	8,500
By Maturity	3,750	Property as Cost (Additions of ₹40 Lakhs)	30,000
Consideration for Annuities	5,000	Furniture and Office Equipment at Cost}	2,500
Registration Fees	250	Annuities	7,500
Interest, Dividend and Rents	12,500	Stationery	400
Contingencies Reserve	10,000	Cash as Bank	19,800
Provision for Taxation	2,500	Cash in Hand	200
Property Depreciation	1,750	Surrenders (Net of Reinsurend)	250
Furniture and Office Equipment Deprecation	250	Commission	4,000
Sundry Creditors	1,500	Expenses of Management	20,000
		Sundry Debtors	600
		Loans on Policies	17,500

		Deposits with RBI	1,500
		Investment in Equity Shares Companies	2,90,000
	4,18,000		4,18,000

Other information:

1. Premium less reinsurances include ₹ 4 crores as first year's premium, ₹ 5.5 crores as renewal premium and ₹ 50 Lakhs as single premium.
2. Premium outstanding at the end of the year is ₹ 1,25,00,000.
3. Commission on outstanding premium is ₹ 3,75,000.
4. Claims less reinsurances outstanding at the end of the year are ₹ 25,00,000 (by death) and ₹ 15,00,000 (by maturity).
5. Depreciation to be provided is ₹ 5,00,000 on property and ₹ 80,000 on furniture and office equipment.
6. Income tax provision to be made for ₹ 10,00,000.
7. Expenses of ₹ 15,00,000 and ₹ 5,00,000 are prepaid and outstanding respectively, at the end of the year.
8. Accrued interest, dividend and rent are ₹ 12,50,000.

[ICWA (Final)—Modified]

[**Ans :** Operating profit: ₹ 25,00,000; P & L A/c balance carried forward to B/S: ₹ 15,00,000; Total of balance sheet: ₹ 1,15,00,000]

27. From the following balances as on 31 March 2011, prepare the necessary revenue A/c for the marine insurance business of an insurance company:

Particulars	**Direct Business ₹'000**	**Reinsurance ₹'000**
A. Premium:		
Received	36,800	5,760
Receivable—1 April 2010	1,488	216
Receivable—31 March 2011	2,096	204
Paid	—	3,680
Payable—1 April 2010	—	225
—31 March 2011	—	372
B. Claims:		
Paid	18,800	2,400
Payable—1 April 2010	1,000	228
—31 March 2011	1248	264
Received	—	1,020
Receivable—1 April 2010	—	96
—31 March 2011	—	138
C. Commission:		
On Insurance Accepted	1760	152
On Reinsurance Ceded	—	156
D. Other Expenses and Income	—	—

Salaries ₹ 19,20,000; rates and taxes ₹ 232,000; postage, telegrams, stationery and printing expenses ₹ 344,000; income tax paid ₹ 26,40,000; interest, dividend and rent received (net) ₹ 11,20,000; income tax deducted at source ₹ 224,000; legal expenses (including ₹ 144,000 incurred for settlement of claims) ₹ 320.

Balance of fund on 1 April 2010 was ₹ 3,07,60,000 including additional reserve of ₹ 27,60,000.

Additional reserve is to be maintained at 5% premium in the year.

[CA (Inter)—Modified]

[**Ans :** Operating profit: ₹ 37,99,458; P & L A/c balance carried forward to B/s: ₹ 22,79,548]

Model: Revenue A/c and profit and loss A/c general insurance

28. From the following balances extracted from the books of Perfect General Insurance Company Ltd. as on 31 March 2011,

you are required to prepare revenue accounts in respect of fire and marine insurance business for the year ended on 31 March 2011 and a P & L A/c for the same period:

	(₹'000)		**(₹'000)**
Director's Fees	320	Interest received	76
Dividend Received	400	Fixed Assets (1 April 2011)	360
Provision for Taxation (1 April 2010)	340	Income Tax Paid During the Year	240

	Fire ₹('000)	Marine ₹('000)
Outstanding Claims on 1 April 2010	112	28
Claims Paid	400	320
Reserve for Unexpired Risk on 1 April 2010	800	560
Premium Received	1800	1320
Agent's Commission	160	80
Expenses of Management	240	180
Reinsurance Premium(Dr.)	100	60

The following additional points are also to be taken into account:

(a) Depreciation on fixed assets to be provided at 10% p.a.

(b) Interest accrued on investment: ₹ 40,000.

(c) Closing provision for taxation on 31 March 2011 to be maintained at ₹ 4,96,552.

(d) Claims outstanding on 31 March 2011 were:

Fire insurance ₹ 40,000

Marine insurance ₹ 60,000

(e) Premium outstanding on 31 March 2011 were:

Fire insurance ₹ 120,000.

Marine insurance ₹ 80,000.

(f) Reserve and unexpired risk to be maintained at 50% and 100% of net premiums in respect of fire and marine insurance, respectively.

(g) Expenses of management due on 31 March 2011 were ₹ 40,000 for fire insurance and ₹ 20,000 for marine insurance.

[CA (Inter)—Modified]

[**Ans:** Operating profit (fire): ₹ 9,42,000; Operating loss (marine): ₹ 72,000; Balance carried forward to balance sheet ₹ 6,33,448.]

Model: More than one business—revenue A/c and P & L A/c

29. The following figures have been extracted from the books of National Insurance Co. Ltd. in respect of their marine business for 2010–11:

Particulars	Schedule
Direct Premium Income Received	200
Reserve for Unexpired Risks as on 1 April 2010	240
Claims Outstanding as on 1 April 2010 (Net)	80
Bad Debts	40
Income from Investments and Dividends (Gross)	40
Rent Received from Properties	20
Investments in Govt. Securities as on 1 April 2010	400
Investment in Shares as on 1 April 2010	80
Commission Paid on Direct Business	20
Expenses of Management	20
Income Tax Deducted at Source	12
Profit and Loss A/c (Cr) Balance on 1 April 2010	40
Other Expenses	5
Reinsurance Premium Receipts	20
Outstanding Clams as on 31 March 2011 (Net)	120
Direct Claims Paid	100
Reinsurance Paid	16

Prepare revenue account, profit and loss account and profit and loss appropriation account for the year, after taking into account the following further information:

(a) All direct risks are reinsured for 20% of the risk.

(b) Claim a commission of 25% on reinsurance ceded.

(c) Provide 25% commission on reinsurance accepted.

(d) Market value of investment as on 31 March 2011 is as under:

(i) Government Securities: ₹ 420 Lakhs

(ii) Shares ₹ 72 Lakhs

Adjust separately for each of these two categories of investments.

(e) Provide 65% for income tax

[ICWA—Modified]

[**Ans:** Balance in revenue account: ₹ 72 Lakhs; Net profit: ₹ 41.40 Lakhs; Balance in P & L appropriation A/c: ₹ 81.40 Lakhs];

Model: Revenue A/c; P & L A/c and P & L appropriation A/c of general insurance business

30. From the following trial balance as on 31 March 2011 drawn from the books of Prompt General Insurance Co. Ltd., and with the help of further

information, draw separate revenue accounts and profit and loss appropriation account for the year 2010–11 and a balance sheet as on 31 March 2011:

Dr. Balances	(₹ '000)	Cr. Balances	(₹ '000)
Claims Paid Less Reinsurance:		Share Transfer Fees	1
Fire	1,000	Compensation from LIC	
Marine	375	(Transfer to P & L A/c)	1,000
Miscellaneous	750	General Reserve	250
Commission Paid:		Share Capital (Equity Shares of ₹ 10 Each)	1,500
Fire	225	Balances of Funds as on 1 April 2010	
Marine	150	Fire	1,250
Miscellaneous	185	Marine	250
Expenses of Management:		Miscellaneous	500
Fire	150	Premium Less Reinsurance:	
Marine	120	Fire	1500
	110	Marine	1000
Miscellaneous			
Investment (as cost)		Miscellaneous	1250
Deposits with RBI (Central Government Securities)	500	Unclaimed Dividend	25
Central Government Securities	3,250	Amount Due to Other Insurers	875
State Government Securities	1,000	Sundry Creditors	125
Fully Paid Shares of Joint-stock Companies	250	P & L A/c (Balance on 1 April 2010)	150
Interest Accrued but not Due	25	Interest and Loss a/c (not Relating to any Fund)	100
Amounts Due from Other Insurers	425	Investment Reserve	250
Furniture (Cost ₹ 40)	35	Outstanding Claims as on 1 April 2010:	
Building (Cost ₹ 700)	700	Fire	150
Cash in Hand	41	Marine	50
Cash as Bank in Current A/c			100
		Miscellaneous	
		Commission on Reinsurance Ceded:	
		Fire	75
		Marine	90
		Miscellaneous	50
	10,541		10,541

Further information:

(a) Outstanding claims on 31 March 2011 (less reinsurance):
Fire—₹ 200,000
Marine—₹ 100,000
Miscellaneous—₹ 125,000

(b) Market value of investments on 31 March 2011: ₹ 44,50,000.

(c) Depreciation on furniture @ 10% and on building @ 2% to be charged to P & L A/c.

(d) Reserve for unexpired risk to be provides @ 50% of the premium income for the year.

(e) Transfer to general reserve: ₹ 10,00,000.

(f) Ignore taxation.

[**Ans:** Balance in revenue A/c—fire: ₹ 6,50,000; Marine:
₹ 1,45,000; Miscellaneous: ₹ 1,05,000; P & L A/c balance:₹ 8,32,000; To be carried to B/S; Total of balance sheet: ₹ 38,32,000]

Model: More than one business—final Accounts

Double Account System 15

LEARNING OBJECTIVES

After studying this chapter you should be able to understand:

1. The meaning of double account system.
2. The salient features of double account system.
3. The differences between single account system and double account system.
4. The advantages and limitations of double account system.
5. The usage of double account system in public utility concerns such as water, gas, electricity.
6. The meaning and accounting treatment of: (i) Replacement of assets (ii) Tariffs and dividend control reserve (iii) Clear profits (iv)Reasonable returns and (v) Capital base.
7. The preparation of final accounts under double account system: (i) Revenue A/c (ii) Net revenue A/c (iii) Receipt and expenditure on capital A/c and (iv) general balance sheet.
8. Some important formats relating to electric supply companies as envisaged in Indian electricity rules.
9. The key terms associated with "Double Account System".

"Double account system", a different system of presenting accounts of public utility entities, owes its origin to England. This system is mainly vogue in organizations engaged in public utilities like electricity, water, gas and the like. These organizations enjoy a unique monopolistic right in their business activities. Mostly, they are formed under special Acts of Parliament. Every activity of such enterprise is specifically directed by the related provisions of the Act including the format preparation and presentation of accounts. All important aspects of this system of accounting are discussed in detail in the forthcoming pages.

15.1 DOUBLE ACCOUNT SYSTEM

Meaning: A system of presenting annual financial statements in two parts, viz. (i) Statement of receipts and expenditure on capital account and (2) General balance sheet, is referred to as "double account system".

The salient features of double account system are as follows:

1. Generally, this system is used by public utility entities incorporated under special Acts of parliament.
2. This is not a system of recording transactions or maintaining accounts, but is a system of presenting annual financial statements.
3. The balance sheet is split into two parts:
   (i) Statement of receipts and expenditure on capital account
   (ii) General balance sheet

4. The prime objective of this system is to show how much amount of fixed capital is raised from the public and how it has been spent on the acquisition of fixed assets. Its aim is not to reveal the financial position on a particular date
5. Profit and loss account is rechristened "revenue account", in which incomes and expenses of a public utility concern are disclosed.
6. Profit and loss appropriation account is renamed net revenue account, in which appropriation of profits is shown
7. Under this system, fixed assets are shown at cost in the capital account. Fixed assets are not shown at depreciated value.
8. Depreciation is not shown as a deduction from fixed assets. Depreciation on fixed assets is credited to revenue account and credited to depreciation reserve or fund which appears on the liability side of the general balance sheet.
9. Interest on debentures and other loans is shown on the debit side of net revenue A/c as an appropriation. Interest received is shown on the credit side of net revenue account.
10. Loans and debentures are treated as capital and shown in the capital account.
11. Discount and premium on issue of shares and debentures are permanently retained as capital items.
12. General reserves, sinking fund, depreciation fund, investment fluctuation fund, balance of net revenue A/c, capital reserve are shown on the liability side of the general balance sheet.
13. Renewals are provided out of current revenue.
14. The capital account shows the total expenditure to date on assets. It is immaterial whether such assets exist or not on the date of the account.
15. The published are to be accompanied by a huge number of statistical returns and statements—a cumbersome procedure.

15.1.1 Double Account System vs. Double Entry System

One should not confuse double account system with double entry system. Double entry system is a system of recording transactions and maintaining books of account. But double account system is a system of preparing and presenting final accounts of public utility undertakings. Even though the prime objective of double account system is different, the accounting is based entirely on the principles of doubly entry book-keeping only.

15.1.2 Double Account System vs. Single Account System

The single account system refers to the normal and established procedure of preparing final accounts on a particular date. But double account system differs from single account system in many ways, which are presented in the following tabular column:

Differences Between Doubles Account System and Single Account System

Basis of Difference	Single Account System	Double Account System
1. Prime object	The prime object is to show the financial position of an entity on a specified date	The prime purpose is to show how capital is raised and utilized
2. Presentation of account	Under this system, a single balance sheet is prepared	The balance sheet is split into two parts: (i) Capital A/c & (ii) General balance sheet

3. Ascertainment of profit	Profit is ascertained by preparing "profit and loss account"	Profit is ascertained by preparing "a revenue account"
4. Appropriation of profits	Appropriation of profits is carried out through "profit and loss appropriation account"	"A net revenue account" is prepared for disclosing appropriation of profits
5. Treatment of fixed assts	Fixed assets are shown after deducting depreciation in the balance sheet	Fixed assets are shown at their original cost without deducting depreciation in the capital account
6. Dealing with depreciation	Depreciation is charged to fixed assets. That means, it is deducted from fixed assets	Depreciation is charged to revenue A/c and credited to depreciation fund A/c, which is shown in the general balance sheet
7. Treatment of interest	Interest paid/payable and interest received/accrued are shown in profit and loss account	They are all shown in net revenue account
8. Discount on issue of shares and debentures	Discount on issue of shares and debentures is shown in the balance sheet under the head: "Miscellaneous Expenses & Losses"	They are subtracted from the share or debentures Capital in the "capital account"
9. Disposal of old assets	When an old fixed asset is replaced by a new fixed assets, the old fixed asset is "written off" wholly in the books of accounts	Even after the replacement, the original cost of old assets continues to appear in the books of account under this system
10. Applicability or usage	Generally, this system is used by non-public utility concerns	Mostly, this system is used in public utility concerns

15.1.3 Advantages of Double Account System

The following are the advantages of double account system:

1. **Easy to understand:** This system is easily understood even by persons who do not possess special knowledge of accounting as the capital account is in the form of "cash book".
2. **Ready disclosure of source and use of funds:** This system readily discloses the sources of capital and how it is utilized in acquisition of fixed assets. Further, the capital account discloses the cash balance left. One can easily understand whether the organization is over-capitalized or under-capitalized.
3. **Enhancement of cash resources:** Under this system, creation of depreciation fund is compulsory which in turn is invested in securities. This facilitates the replacement of fixed assets without draining resources of the concerns. Hence, it enhances the cash resources of the organizations.
4. **Enrichment of operating activities:** The income statement is split into revenue A/c and net revenue A/c. The revenue A/c is concerned purely with the operating activities of the concerns. All other activities are taken to net revenue A/c. Hence, the net operating results of the concerns will be enriched.

5. **Prescribed forms:** The undertakings which adopt double account system have to adopt prescribed forms for the preparation and presentation of accounts. This enables the state to ensure efficient service as reasonable cost to the public.
6. **Statistical returns:** The publications of accounts in the prescribed, standardized forms enable the concerns to compile varied statistical returns reflecting the services rendered to the public.

15.1.4 Disadvantages of Double Account System

The following are the disadvantages of double account system:

1. **Not a true and fair view:** The general balance sheet does not show a true and fair view of the financial position of the company, as the assets are shown at the cost price in the capital account. Depreciation is credited to depreciation fund which is shown on the liabilities side of the balance sheet.
2. **Shown profit or loss is not correct:** The repairs and renewals are charged to the revenue account of the same period in which they are incurred. This may result in little expenditure in some years and huge for some other years. Due to this, profit and loss arrived at is not a correct figure.
3. **Replacement of an asset:** The amount to be charged to revenue on replacement of an asset may not be ascertained precisely. This practice may mar the result.
4. **Interest paid/received:** This item, i.e., the interest paid or received, is not shown in the revenue account. As a result, the revenue A/c may not reflect a true view of its financial position.
5. **Not a correct accounting principle:** Some of the assets of short duration are taken to the capital A/c. Further, they are shown as cost price even after they reflect a true view of its financial position.

15.2 FINAL ACCOUNTS

Under double account system, the final accounts of public utility undertakings are prepared under the following heads:

1. Revenue account
2. Net revenue account
3. Capital account (Receipts and expenditure on capital A/c)
4. General balance sheet

15.2.1 Revenue Account

This is similar to profit and loss account of handing enterprises. All items of expenditure are shown on the debit side of this account and all items of income are shown on the credit side of this account. It is to be again noted that depreciation is debited to this account only. The following is the specimen of revenue account:

Revenue A/c for the Year Ended

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Staff Salaries	…	By Incomes (One by One)	…
To Rent, Rates, Taxes	…	(Excluding Interest Earned	
To Printing & Stationery	…	Earned & Subsidies	

To Postage & Telegrams	…	Received from Government)	
To Repairs & Renewals	…	By NET REVENUE A/c (Loss) (Balancing Figure)	xx
To Depreciations on Fixed Assets	…		
To Discount Allowed	…		
To Miscellaneous Expenses	…		
To NET REVENUE A/c (Balancing Figure) (Profit)	xx		
	xxx		xxx

15.2.2 Net Revenue Account

This is like the ordinary profit and loss appropriation account of trading entities.

It is to be noted here that interests on loans and debentures are shown on the debit side of net revenue A/c. This is the main difference between P&L appropriation A/c and net revenue A/c. This is due to the reason that loans and debentures are headed as a part of the capital of the public utility undertakings and shown in the capital accounts along with the fixed assets. The specimen of net revenue account is as follows:

Net Revenue Account
for the Year Ended…

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
To Balance b/d	…	By Balance b/d	…
(Last Year Balance, if any)		(Last Year Balance, if any)	
To Revenue A/c,		By Revenue A/c	
(Current Year's Loss Transfer from Revenue A/c)	…	(Current Year's Profit Transfer from Revenue A/c)	
To Interest on Debentures	…	By Government Subsidy	…
To Interest on Loans	…	By Interest Earned	…
To Interest on Security Deposits	…	By Transfer from Reserve	…
To Contingency Reserve	…	By General Balance Sheet	xx
To Dividend Control Reserve	…	(Balancing Figure)	
To General Balance Sheet (Balancing Figure)	xxx	(Loss—to Be Transferred to General Balance Sheet)	xxx
(Profit—to Be Transferred to General Balance Sheet)			
	xxx		xxx

15.2.3 Capital Account (Receipts and Expenditure on Capital A/c)

The prime object of preparing this account is to show how much capital is raised and how the same has been utilized. This consists of three columns on either side. This is also known as receipts and expenditure on capital account.

Capital expenditure is shown on the left-hand side and capital receipts on the right. The first column (on either side) is meant for recording transaction up to the time of commencement of the accounting period (previous years.) The second column indicates the items pertaining to the current accounting period.

The third column indicates the total of first two columns on either side of this account. It is to be noted here that preliminary expenses on forming the undertakings are to be taken as capital expenditure. Premium received on issue of shares and debentures is a capital receipt.

Regarding discount on issue of shares and debentures, they are to be deducted from the proceeds of respective issues and the net amount is to be shown here.

The balance of the capital account is carried down and shown as a separate item in the general balance sheet. But in case of electric supply companies, the total capital receipts and the total expenditure are shown in the general balance sheet instead of only the balance. The specimen of capital account is as follows

Capital Account

Or

Receipts and Expenditure on Capital A/c for the Year Ended …

Expenditure	Previous Year ₹	During the Year ₹	Total ₹	Receipts	Previous Year ₹	During the Year ₹	Total ₹
To Preliminary Expenses	…	…	…	By Equity Shares	…	…	…
To Land	…	…	…	By Preference Shares	…	…	…
To Building	…	…	…				
To Plant	…	…	…	By Debentures	…	…	…
				By Loans	…	…	…
				By Calls-in-Advance	…	…	…
Total Expenditure	xx	xx	xxx	Total Receipts	xx	xx	xxx
To BALANCE of Capital A/c (Transferred to General Balance Sheet)			…	By BALANCE of Capital A/c (transferred to General Balance Sheet			
			xxx				xxx

15.2.4 General Balance Sheet

The following are shown in the general balance sheet:

(i) The balance of the capital account
(ii) Current assets and
(iii) Current liabilities

On the left-hand side of the general balance sheet, various funds, such as depreciation fund, sinking fund, investment fluctuation fund and so on, and current liabilities are recorded.

On the right-hand side, the current and floating assets and other all other debit balances are recorded.

In case of electricity supply companies, total of the expenditure as per capital account is shown on the assets side and the total of receipts is shown on the liabilities side of the general balance sheet. The proforma for general balance sheet is as follows:

General Balance Sheet of ……. Ltd. as on……..

Particulars	₹	Assets	₹
Capital A/c	…	Stores	…
(Balance Brought Forward from Capital A/c)		Sundry Debtors	…
		Cash as Bank	…
Sundry Creditors for Capital A/c	…	Cash in Hand	…
Sundry Creditors on Open A/c	…	Securities	…
NET Revenue A/c		Special Items	…
(Balance Brought Forward from Net Revenue A/c)	…	Other Assets	…
Reserve Fund	…		
Depreciation Fund	…		
Sinking Fund	…		
Investments Fluctuation Fund	…		
Other Liabilities	…		
	xx		xx

15.2.4.1 Legal Provisions Relating to Electricity Companies

Electric supply industry in India is regulated by certain laws. The Indian Electricity Act, 1910 was the first one to govern electric supply industry. Then, in independent India, the Electricity (Supply) Act 1948 was enacted. It paved the way for establishing State Electricity Board. In 1998, Electricity Regulatory Commissions Act was enacted. In 2003, the Electricity Act was enacted which has replaced all the prior acts governing electric supply industry. This Act gave special emphasis to "annual statement of account". The legal provisions, the rules of the Central Electricity Regulatory Commission, stipulate strict accounting procedure to be followed, and the prescribed forms in which the accounts are to be published. Accordingly, all such forms are statutory under the (Repealed) Indian Electricity Act of 1910.

15.2.4.1.1 Repairs and Renewals

- Under double account system, repairs and renewals are to be charged to the revenue account. It should be recorded in the same year in which they are incurred.
- Despite the benefit derived by the use of the assets may remain almost same, the charge to revenue with respect to repairs and renewals may vary in different years.
- To explain in simpler terms, the profits in the first few years will be high as the charge for repairs and renewals will be very low. But in due course, the assets will become older—the charge for repairs and renewals will increase whereas the benefit or profit will get reduced in later years.
- To level this burden or inequality, the following accounting procedure is followed:
- Repairs & renewals reserve or fund is created.
- The amount to be spent on repairs is determined in advance, based on the life of the asset, and charged to revenue account, i.e., debited every year.

- The actual amount spent on repairs will be debited to the "repairs & renewals reserve A/c".
- The balance in "repairs & renewals reserve A/c" is to be taken to the general balance sheet.

This is explained by way of an illustration as follows:

Illustration 15.1

Model: Repairs & renewals

The following particulars are available from the books of Modern Electricity Company:

	₹
Balance of Repairs and Renewals Reserve Account as on 1 April 2009	2, 10,000
Actual Repairs Incurred During the Year Ended	
31 March 2010	90,000
31 March 2011	60,000

The Company transfers annually a sum of ₹ 80,000 to the "repairs and renewals" reserve account

Draw up the account for the years the years 2009–10 and 2010–11.

1. Provide depreciation on: building 21/2%, machinery 71/2%, mains 5%; transformers, etc. 10%; Meters 15%
2. A call of ₹ 5 per share was payable on 30 June 2010 and arrears are subject to interest at 5% per annum

You are required to prepare (a) revenue A/c; (b) capital A/c for the year ended 31 December 2010 and (c) the balance sheet as on that date.

Solution

Revenue Account
for the Year Ended 31 December 2010

(₹ '000)

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Coal and Fuel	38	By Sale of Meters	175
To Oil Waste & Engine Room Stores	15	By Sales by Contracts	100
To Salaries	30	By Meter Rents	6
To Wages	60		
To Directors' Fees	20		
To Stationary, Etc.	12		
To Incidental Expenses	2		
To Law Charges	4		
To Rates & Taxes	6		
To Repairs & Replacements	10		
To Depreciation:			
Building 2			

Machinery	9			
Mains	5			
Transformers	2			
Meters	1.5	19.5		
To Balance Carried Forward to General Balance Sheet		64.5		
		281		281

Repairs & Renewals Reserve A/c

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
31 March 2010	To Repairs & Renewals (Actual Repair During 2010)	90,000	1 April 2009	By Balance b/d	2,10,000
31 March 2010	To Balance c/d	2,00,000	31 March 2010	By Revenue A/c (Annual Transfer)	80,000
		2,90,000			2,90,000
31 March 2011	To Repairs & Renewals		1 April 2010	By Balance b/d	2,00,000
	(Actual Repair During 2011)	60,000			
31 March 2011	To Balance c/d	2,20,000	31 March 2011	By Revenue A/c (Annual Transfer)	80,000
		2,80,000			2,80,000
			1 April 2011	By Balance b/d	2,20,000

Illustration 15.2

Model: Replacement of assets

The Tiruchirapalli Municipal Corporation replaces part of its existing water mains with larger mains at a cost of ₹ 50,00,000 the original cost of laying the old mains was ₹ 10,00,000 and the present cost of laying those mains would be four times the original cost. ₹ 1,00,000 was realized by the sale of old materials and old materials of ₹ 3,00,000 were used in the replacement and included in the cost given above.

Give the journal entries to record the above and show the allocation of expenses between revenue and capital along with replacement account.

Solution

Stage I: Basic Calculations

1. Calculation of Total Cost of New Work:

	₹
Total Cost of New Mains – Given (Including Old Material Cost)	= 50,00,000

2. Calculation of Amount to Be Charged to Revenue A/c:

		₹
Step 1:	Estimated Present Cost of Replacement (₹ 10,00,000 × 4 Times)	= 40,00,000
Step 2:	Less:	
	(i) Sale of Old Materials: 1,00,000	
	(ii) Old Material Used in New Work}: 3,00,000	4,00,000
Step 3:	Amount to be Charged to Revenue A/c :	36,00,000

3. Calculation of Amount to Be Charged to Capital A/c:

Step 1:	Total Cost of New Work (Given)	= 50,00,000
Step 2:	Λεσσ: Estimated Present Cost of Replacement ((2)—Step 1)	= 40,00,000
Step 3:	Amount to Be Charged to Capital A/c	= 10,00,000

4. Calculation of Actual Cost Spent on Replacement:

		₹
Step 1:	Total Cost of Actual Cash Spent on Replacement: Total Cost of New Work	= 50,00,000
Step 2:	Less: Old Materials Used in New Project	= 3,00,000
Step 3:	Actual Cost Spent on Replacement	= 47,00,000

Stage II: Recording Journal:

Journal Entries

Date	Particulars		L.F	Dr. ₹	Cr. ₹
(i)	For Allocation of Actual Cash Spent Between Revenue and Capital:				
	Replacement A/c (Ref: Basic Calculation 2)	Dr.		40,00,000	
	Main A/c (Bal. Fig)	Dr.		7,00,000	
	To Bank A/c (Ref: Basic Calculation 4 (Step 3))				47,00,000
	(Actual Cost Spent on Replacement Allocated Between Revenue & Capital)				
(ii)	For Sale of Old Materials:				
	Bank A/c	Dr.		1,00,000	
	To Replacement A/c				1,00,000
	(Amount Realized on Sale of Old Materials)				
(iii)	For Usage of Old Material in New Work:				
	Main A/c	Dr.		3,00,000	
	To Replacement A/c				3,00,000
	(Old Materials Used in New Work)				
(iv)	For Transfer of Balance in Replacement A/c:				
	Revenue A/c (Ref: Basic Calculation 2 (Step 3))	Dr.		36,00,000	
	To Replacement A/c				36,00,000
	(Balance in Replacement A/c Transferred to Revenue A/c)				

Stage III: Preparation of Replacement A/c:

Replacement A/c

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Bank A/c	40,00,000	By Bank A/c	1,00,000
		By Main A/c	3,00,000
		By Revenue A/c	36,00,000
		(Bal. Fig)	
	40,00,000		40,00,000

Illustration 15.3

Model: Replacement of asset and preparation of new works A/c

A public utility undertaking rebuilt and re-equipped part of their works at a cost of ₹ 30,00,000. The part of the old works cost ₹ 16,00,000. ₹ 1,00,000 is realized by the sale of old materials and old materials valued ₹ 5,000 are used in the reconstruction and included in the cost of ₹ 30,00,000 mentioned above.

The cost of labour and materials now is 25% higher than when the old works were constructed.

Give journal entries and prepare the necessary ledger accounts.

Solution

Stage I: Basic Calculations:

			₹
1.	Calculation of Total Cost of New Work:		
	Total Cost of New Work (Given)		30,00,000
2.	Calculation of Estimated Present Cost of Old Work:		
	Step 1: Cost of Old work		16,00,000
	Step 2: Add: Increase in Cost of Material and Labour—25%		
	(₹ 16,00,000 × 25%)		4,00,000
	Step 3: Estimated Present Cost of Replacement:		20,00,000
3.	Calculation of Amount of Replacement to be Charged to Revenue A/c:		
	Step 1: Estimated Cost of Replacement (Ref: 2 (Step 2))		20,00,000
	Step 2: Less:	₹	
	(i) Sale of Old Materials:	1,00,000	
	(ii) Value of Old Material Used in New Work	5,000	1,05,000
	Step 3: Amount to be Changed to Revenue A/c		18,95,000
4.	Calculation of Amount of Replacement to Be Changed to Capital A/c:		
	Step 1: Total Cost of New Work		30,00,000
	Step 2: Less: Estimated Present Cost of Replacement (Ref: 2 (Step 3))		20,00,000
	Step 3: Amount of Replacement to be Changed to Capital A/c		10,00,000

5. Calculation of Actual Amount of Cash Spent On Replacement:

Step 1: Total Cost of New Work	30,00,000
Step 2: Less: Cost of Old Materials Used in New Work	5,000
	29,95,000

Stage II: Passing of Journal Entries:

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
(i)	Replacement A/c (Ref: Stage I (2))	Dr.		20,00,000	
	New Works A/c [Bal. Fig]	Dr.		9,95,000	
	To Bank A/c (Ref: Stage I (5))				29,95,000
	(Actual Cash Spent on Replacement Allocated Between Revenue & Capital A/c)				
(ii)	Bank A/c	Dr.		1,00,000	
	To Replacement A/c				1,00,000
	(Cash Realized on Realization of Old Materials)				
(iii)	New Work A/c	Dr.		5,000	
	To Replacement A/c				5,000
	(Value of Old Materials Used in New Work)				
(iv)	Revenue A/c (Ref: Stage I (3))	Dr.		18,95,000	
	To Replacement A/c				18,95,000
	(Balance in Replacement A/c Transferred to Revenue A/c)				

Stage III: Preparation of Ledger Accounts:

(i) New Works A/c

	₹		₹
To Balance b/d	16,00,000	By Balance c/d	26,00,000
To Bank A/c	9,95,000	(Bal. Fig)	
To Replacement A/c	5,000		
	26,00,000		26,00,000

(ii) Replacement A/c

	₹		₹
To Balance A/c	20,00,000	By Bank A/c	1,00,000
		By New Works A/c	5,000
		By Revenue A/c (Bal. Fig)	18,95,000
	20,00,000		20,00,000

Illustration 15.4

Model: Estimated cost of replacement adjustments

An electricity company in Himachal Pradesh decides to replace one of its old plants with a modern one with a larger capacity. The plant was installed in 1948 at the cost to the company of ₹ 90,00,000, the components of materials, labour and overhead being in the ratio of 4:3:3.

It is ascertained that the cost of materials and labour have gone up by 50% and 80%, respectively. The proportion of overheads to total costs is expected to remain the same as before.

The cost of the new plant as per improved design is ₹ 2,00,00,000 and in addition, materials recovered from the old plant was of the value of ₹ 10,00,000, have been used in the construction of the new plant. The old plant was scrapped and sold for ₹ 20,00,000.

The accounts of the company are maintained under double account system. Indicate how much would be capitalized and the amount that would be changed to revenue. Show journal entries and prepare necessary ledger accounts.

Solution

Stage I: Basic Calculations:

1. Calculation of Total Cost of New Plant:

		₹
(i)	Cost of New Plant (Given)	2,00,00,000
(ii)	Add: Value of Material of Old Plant Used in Construction of New Plant	10,00,000
(iii)	Total Cost of New Plant	2,10,00,000

2. Components Wise Distribution of Old Plant in 4:3:3 Ratio:

(i)	Materials: $\frac{4}{10} \times$ ₹ 90,00,000	=	36,00,000
(ii)	Labour: $\frac{3}{10} \times$ ₹ 90,00,000	=	27,00,000
(iii)	Overheads: $\frac{3}{10} \times$ ₹ 90,00,000	=	27,00,000
		=	90,00,000

3. Determination of Percentage of Overheads:

(i) Percentage of Overheads to Total Cost $= \frac{₹\,27,00,000}{₹\,90,00,000} \times 100 = 30\%$

(ii) Percentage of Overheads to Combined Cost of Materials and Labour:

$= \frac{₹\,27,00,000}{₹\,63,00,000} \times 100 = 42.8571\%$

4. Calculation of Current Cost of Replacement:

			₹
(i)	Materials (50% Increase on ₹ 36,00,000) (₹ 36,00,000 + 50% of ₹ 36,00,000)}	=	54,00,000
(ii)	Labour (80% increase over ₹ 27,00,000) (₹ 27,00,000 + 80% of ₹ 27,00,000)}	=	48,60,000
(iii)	Overheads (42.8571% of Combined Cost of Material and Labour (₹ 54,00,000 + ₹ 48,660,000)	=	42,25,710
(iv)	Estimated Cost of Replacement	=	1,44,85,710

5. Calculation of Amount of Replacement to be Capitalized:

(i) Total Actual Cost of New plant		2,10,00,000
(ii) Less: Estimated Present Cost of Replacement (Ref: 4 (iv) above)		1,44,85,710
(iii) Amount to be Capitalized		65,14,290

6. Calculation of Amount of Replacement to be Charged to Revenue:

(i) Estimated Cost of Replacement		=	1,44,85,710
Less: (i) Value of Old Material Used	10,00,000		
(ii) Realization on Sale of Old Plant	20,00,000		30,00,000
(iii) Amount to be Charged to Revenue			1,14,85,710

7. Calculation of Actual Amount of Cash Spent on Replacement:

(i) Total Cost of New Plant	2,10,00,000
(ii) Less: Value of Old Materials Used in the Construction of New Plant}:	10,00,000
(iii) Actual Amount of Cash Spent on Replacement	2,00,00,000

Stage II: Making Journal Entries

Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
(i)	Replacement A/c (Ref: Stage I (4))	Dr.		1,44,85,710	
	Plant A/c [Bal. Fig]	Dr.		55,14,290	
	To Bank A/c (Ref: Stage I (7))				2,00,00,000
	(Allocation between Revenue & Capital)				
(ii)	Bank A/c	Dr.		20,00,000	
	To Replacement A/c				20,00,000
	(Realization on Sale of Old Plant)				
(iii)	Plant A/c	Dr.		10,00,000	
	To Replacement A/c				10,00,000
	(Cost of Old Plant Used in New Plant)				
(iv)	Revenue A/c (Ref: Stage I (6))	Dr.		1,14,85,710	
	To Replacement A/c				1,14,85,710
	(Transfer of Balance in Replacement A/c to Revenue A/c)				

Stage III: Preparation of Ledger Accounts:

(i) **Plant A/c**

	₹		₹
To Balance b/d	90,00,000	By Balance c/d	1,55,14,290
To Bank A/c	55,14,290		
To Replacement A/c	10,00,000		
	1,55,14,290		1,55,14,290

(ii) Replacement A/c

Particulars	₹	Particulars	₹
To Bank A/c	1,44,85,710	By Bank A/c	20,00,000
		By Plant A/c	10,00,000
		By Revenue A/c (Bal. Fig)	1,14,85,710
	1,14,85,710		1,14,85,710

Illustration 15.5

Model: Partial replacement of asset

An electricity company laid down a main at the cost of ₹ 30,00,000. Some years later, the company laid down an auxiliary main for one-third of the length of the old main at a cost of ₹ 12,00,000. It also replaced the rest of the length of old main at a cost of ₹ 36,00,000. The costs of materials and labour have gone up by 20%. Sale of old materials realized ₹ 1,00,000. Old materials valued at ₹ 1,00,00 were used in the renewal and old materials valued at ₹ 1,50,000 were used in the auxiliary main.

Give the journal entries for recording the above transactions and show the capital expenditure and revenue expenditure.

Solution

Stage I: Basic Calculations:

1. Calculation of Total Actual Costs:			₹
(i) Total Actual Cost of Auxiliary Main		=	12,00,000
(ii) Total Actual Cost of Replacement		=	36,00,000
2. Calculation of Estimated Present Cost of Replacement:			
(i) Cost of (1 – 1/3 = 2/3) of Original Main (₹ 30,00,000 × 2/3)		=	20,00,000
(ii) Add: Increase in Material and Labour Costs (₹ 20,00,000 × 20%)		=	4,00,000
(iii) Estimated Present Cost of Replacement		=	24,00,000
3. Calculation of Amount to Be Charged to Capital A/c:			
(i) Auxiliary Main		=	12,00,000
(ii) Replacement:			
(a) Total Actual Cost of Replacement		=	36,00,000
(b) Less: Estimated Present Cost of Replacement (Ref: 2 above)		=	24,00,000
(iii) Amount to Be Capitalized		=	12,00,000
4. Calculation of Amount to Be Charged to Revenue A/c:			
(i) Estimated Present Cost of Replacement		=	24,00,000
(ii) Less:			
(a) Sale of Old Materials	1,00,000		
(b) Old Materials Used for Replacement	1,00,000		
(c) Old Materials Used for Auxiliary Main	1,50,000	=	3,50,000
(iii) Amount to Be Charged to Revenue		=	20,50,000

		₹
5. Calculation of Actual Amount of Cash Spent on Auxiliary Main:		
(i) Total Actual Cost	=	12,00,000
(ii) Less: Old Materials Used	=	1,50,000
(iii) Actual Amount Spent on Auxiliary Main	=	10,50,000
6. Calculation of Actual Amount of Cash Spent on Replacement:		
(i) Total Actual Cost	=	36,00,00
(ii) Less: Old Materials Used	=	1,00,000
(iii) Actual Amount Spent on Replacement	=	35,00,000

Stage II: Making Journal Entries:

Journal Entries

Date	Particulars		L.F.	Dr ₹	Cr ₹
(i)	Replacement A/c [Ref: Stage I (2))	Dr.		24,00,000	
	New Mains A/c (Bal. Fig)	Dr.		11,00,000	
	To Bank A/c (Ref: Stage I (6))				35,00,000
	(Allocation Between Replacement and New Main)				
(ii)	Bank A/c	Dr.		1,00,000	
	To Replacement A/c				1,00,000
	(Realization of Old Materials)				
(iii)	New Mains A/c	Dr.		2,50,000	
	To Replacement A/c				2,50,000
	(Transfer of Old Materials Used) (₹ 1,00,000 + ₹ 1,50,000)				
(iv)	New Auxiliary Main A/c [Ref: Stage I (5))	Dr.		10,50,000	
	To Bank A/c				10,50,000
	(Payment on Auxiliary Mains)				
(v)	Revenue A/c [Ref: Stage I (4))	Dr.		20,50,000	
	To Replacement A/c				20,50,000
	(Transfer of Balance of Replacement A/c to Revenue A/c				

Stage III: Preparation of Ledger Accounts:

Replacement A/c

Particulars	₹	Particulars	₹
To Bank A/c	24,00,000	By Bank A/c	1,00,000
		By New Mains A/c	2,50,000
		By Revenue A/c (Bal. Fig)	20,50,000
	24,00,000		24,00,000

Illustration 15.6

Model: Partial replacement of assets with special adjustment on estimation of present cost

A power supply company has built a power station and the connecting lines during 2007. The following further particulars are furnished:

(i) In the year 2007, the company incurred an amount of ₹ 9,00,000 towards purchase of machinery items and ₹ 1,00,000 towards labour expenses. The company also used stores worth ₹ 2,00,000 from its existing stock which was in the warehouse.

(ii) Extension and replacement was carried out to the power station in 2010 as a cost of ₹ 5,00,000 out of which material worth ₹ 10,000 was used from the existing stock for replacement purposes. The extent of replacement was estimated as 20% of original cost.

(iii) The cost of materials and wages in 2010 have gone up by 25%.

(iv) The old materials discarded in the process of extension and replacement were of the value of ₹ 50,000.

(v) Out of the above, material valued as ₹ 30,000 was used for extension purposes and the balance not being used was sold for ₹ 20,000.

You are required to show the journal entries in respect of the above transaction for the year 2010. Workings should form part of your answer.

Solution

STAGE I: BASIC CALCULATIONS:

1. Calculation of Total Actual Cost of New Work:

		₹
Total Actual Cost of New Work (To Be treated— to Be Inclusive of Material Used from Existing Stock of ₹ 10,000 and Value of Old Material Used ₹ 30,00,000)	=	5,00,000

2. Calculation of Estimated Cost of Replacement:

(i) Cost of Existing Work Incurred in 2007:

Machinery	=	9,00,000
Labour	=	1,00,000
Stores	=	2,00,000
	=	12,00,000
Cost of 20% of Work [20/100 × ₹ 12,00,000]	=	2,40,000

(ii) Current Cost of Replacement:

		₹
(a) Cost of 20% of Existing Work (As Above)	=	2,40,000
(b) Add: 25% Increase in Cost (25/100 × ₹ 2,40,000)	=	60,000
(c) Estimated Present Cost of Replacement	=	3,00,000

3. Calculation of Amount to be Capitalized:

(i) Total Actual Cost of New Work	=	5,00,000

(ii) Less: Estimated Cost of Replacement (Ref: 2 (iii))		=	3,00,000
(iii) Amount to Be Capitalized		=	2,00,000
4. Calculation of Amount to Be Charged to Revenue A/c:			
(i) Estimated Present Cost of Replacement		=	3,00,000
(ii) Less:			
(a) Value of Old Material Used		=	30,000
(b) Sale of Old Material	20,000	=	5,000
(iii) Amount to Be Charged to Revenue A/c		=	2,50,000
5. Calculation of Actual Amount to Cash spent on New Work:			
(i) Total Actual Cost of New Work		=	5,00,000
(ii) Less:			
(a) Value of Old Materials Used		=	30,000
(b) Stores Used from Existing Stock	10,000	=	40,000
			4,60,000

Stage II:

Journal Entries

Date	Particulars		L.F.	Dr ₹	Cr ₹
2007					
(i)	New Works A/c (Ref: Stage I (2 (i)))	Dr.		12,00,000	
	To Bank A/c (₹ 9,00,000 + ₹ 1,00,000)				10,00,000
	To Stores A/c (Given)				2,00,000
	(Cost of Building Power Station)				
2010					
(ii)	Replacement A/c (Ref: Stage I (2 (ii)))	Dr.		3,00,000	
	New Works A/c (Bal. Fig)	Dr.		1,70,000	
	To Bank A/c (Ref: Stage I (5))				4,60,000
	To Stores A/c				10,000
	(Cost of New Work Allocation Between Capital and Revenue)				
	Bank A/c	Dr.		20,000	
	To Replacement A/c				20,000
	(Realization on Sale of Old Materials)				
	New Work A/c	Dr.		30,000	
	To Replacement Work				30,000
	(Old Materials Used for New Works)				
	Revenue A/c (Ref: Stage I (4))	Dr.		2,50,000	
	To Replacement A/c				2,50,000
	(Balance of Replacement A/c Transferred to Revenue A/c)				

Replacement A/c

Particulars	₹	Particulars	₹
To Bank A/c	3,00,000	By Bank A/c	20,000
		By New Works A/c	30,000
		By Revenue A/c (Bal. Fig)	2,50,000
	30,00,000		30,00,000

Illustration 15.7

Model: Replacement A/c—Preparation

Electric Supply Ltd. rebuilt and re-equipped one of their mains at a cash cost of ₹ 80,00,000. The old mains, thus, superseded cost for ₹ 30,00,000. The capacity of the new main is double that of old main.

₹ 1,40,000 was realized from sale of old materials. Four old motors valued as ₹ 4,00,000 salvaged from the old main were used in the reconstruction. The cost of labour and material now is, respectively, 30% and 25% higher than when the old main was built. The proportion of labour to material in the main then and now is 2:3.

Show the journal entries for recording the above transactions if the accounts are mentioned under double account system. [C.A. (Inter). Modified]

Solution

Important Calculations:

1. Calculation of Current Cost of Replacement:

		₹
(i) Cost of Existing Main:		
Labour: Materials = 2:3	=	12,00,000
Labour = ₹ 30,00,000 × $\frac{2}{5}$	=	18,00,000
Material = ₹ 30,00,000 × $\frac{3}{5}$	=	30,00,000
(ii) Add: Increase in Cost:		
Labour 30% of ₹ 12,00,000	=	3,60,000
Material 25% of ₹ 18,00,000	=	4,50,000
(iii) Total Estimated Current Cost for Replacement	=	38,10,000

2. Calculation of Amount to Be Capitalized:

(i) Cost of Re-building New Main (Given)	=	80,00,000
(ii) Less: Estimated Cost of Replacement (Ref: 1 above)	=	38,10,000
	=	41,90,000

3. Amount to be Charged to Revenue A/c (Net Current Cost of Replacement A/c to be Transferred to Revenue A/c) Is To Be Determined by Preparing Replacement A/c as follows:

Replacement A/c

Particulars	₹	Particulars	₹
To Bank A/c (Current Cost of Replacement)	38,10,000	By New Main A/c (Use of Old Motors)	4,00,000
		By Bank A/c (Given)	1,40,000
		By Replacement A/c (Bal. Fig)	32,70,000
	38,10,000		38,10,000

Electric Supply Ltd
Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	New Main A/c	Dr.		41,90,000	
	Replacement A/c	Dr.		38,10,000	
	To Bank A/c				80,00,000
	(Current Cost of Replacement Charged to Replacement A/c)				
	New Main A/c	Dr.		4,00,000	
	To Replacement A/c				4,00,000
	(Value of Motors Salvaged in Construction of New Main)				
	Bank A/c	Dr.		1,40,000	
	To Replacement A/c				1,40,000
	(Realization on Sale of Old Materials)				
	Revenue A/c	Dr.		32,70,000	
	To Replacement A/c				32,70,000
	(Transfer of Net Current Cost of Replacement to Revenue A/c)				

15.2.4.2 Reasonable Return

The law seeks to prevent an electricity conern from earning very huge profit. For this, "reasonable return" is defined as consisting of:

(a) An yield at the standard rate, which is the Reserve Bank Rate (generally given in the problem) plus 2% on the capital base (defined later)
(b) Income derived from investments except investments made against "Contingencies Reserve"
(c) An amount equal to 1/2% on the loans advanced by the electricity board
(d) An account equal to 1/2% on the balance of development reserve
(e) An amount equal to 1/2% on debentures.

15.2.4.2.1 Capital Base

Capital base means:

(a) The original cost of fixed assets available for use minus the contribution made by the consumers for construction of service lines and also amounts written off
(b) The cost of intangible assets
(c) The original cost of works in progress
(d) The amount of investments made compulsorily against contingencies reserve
(e) The monthly average of stores, materials, supplies and cash and bank balances held as the end of the each month

Less:

(i) Amounts written off relating to depreciation of fixed assets and intangible assets
(ii) Loans advanced by the Board
(iii) Debentures
(iv) Security deposits of consumers held in cash
(v) The amount standing to the credit of tariff and dividends control Reserve
(vi) The amount set apart for the development reserve

15.2.4.2.2 Clear Profit

The difference between the total income and total expenditure PLUS specific appropriations is referred to as "clear profit".

Specific appropriations: The following is a list of specific appropriations, to arrive at clear profit: Taxes on income and profits, previous losses, installments relating to intangible assets, expenses on issue of capital contribution to contingencies reserve, development reserve, arrears of depreciation and appropriations permitted by the Government.

15.2.4.3.3 Disposal of Surplus

When the clear profit exceeds the reasonable return, the surplus should be disposed in the following manner:

(a) One-third of the surplus, not exceeding 5% of the reasonable return—that means, one-third of surplus or 5% of reasonable return, whichever is lower, is at the disposal of the concerns

(b) Of the balance, one-half will be transferred to "tariffs and dividends control reserve"

(c) The balance will be distributed among consumers by way to reduction of rates.

Surplus = Clear Profit – Reasonable Return

↓

[One-third of surplus (or) 5% of reasonable return] → for disposal of concern

(whichever is less)

[Balance]

↓

50% to tariffs and dividends control reserve

↓

Another 50%

[Balance]

↓

To consumers

(i.e. [1– ($\frac{1}{3}$ or 5% of Reasonable Return Lower of These Two)

[Balance → 50% → Tariff & Dividends Control

→ Remaining → To Consumers

NOTE:

1. An electricity undertaking should so adjust rates that the amount of clear profit in any year will not exceed the reasonable return by more than 20% of the reasonable return.
2. When clear profit is less than the reasonable return, "tariffs and dividends control" should be utilized.

[Disposal of surplus can be best understood with the help of the forthcoming illustrations.]

DISPOSAL OF PROFITS

Illustration 15.8

Model: Disposal of profits

An electric company earned a profit of ₹10,00,000 during the year ended 31 March 2011 after debentures interest @ 6% on ₹3,00,000. With the help of the figures given below, show the disposal of profits:

	₹
Original Cost of Fixed Assets	1,00,00,000
Formation and Other Expenses	4,00,000
Monthly Average of Current Assets (Net)	30,00,000
Reserve Fund (Represented by 4% Govt. Securities)	12,00,000
Contingencies Reserve Fund Investments	2,00,000
Loan from Electricity Board	12,00,000
Total Depreciation Written Off to Date	18,00,000
Tariff and Dividend Control Reserve	1,00,000
Security Deposits Received from Customers	2,00,000
Assume Bank Rate to be 6%	

Solution

STAGE I: CALCULATION OF CAPITAL BASE:

		₹	₹
Step 1:	Original Cost of Fixed Assets		1,00,00,000
Step 2:	Add:		
	(i) Formation and Other Expenses	4,00,000	
	(ii) Monthly Average of Current Assets	30,00,000	
	(iii) Contingency Reserve Fund Investment}	20,00,000	36,00,000
			1,36,00,000
Step 3:	Less:		
	(i) Depreciation Written off	18,00,000	
	(ii) Loan from Electricity Board	12,00,000	
	(iii) Debentures	3,00,000	
	(iv) Tariff & Dividend Control Reserve	1,00,000	
	(v) Security Deposit from Customers	2,00,000	36,00,000
Step 4:	Capital Base :		1,00,00,000

STAGE II: Calculation of Reasonable Return:

(i) 6% + 2%:8 % on Capital Base	
₹ 1,00,00,000 × $\frac{8}{100}$ (Ref: Stage I)	8,00,000
Add:	
(ii) $\frac{1}{2}$% on Loan from Electricity Board $\left(₹\,12,00,000 \times \frac{1}{2}\%\right)$	6,000
(iii) $\frac{1}{2}$% on Debentures: $\left(₹\,3,00,000 \times \frac{1}{2}\%\right)$	1,500
(iv) Income from Reserve Fund Investment:(₹ 12,00,000 × 4/100)	48,000
(v) Reasonable Return	8,55,000

Stage III: Calculation of Surplus:

(i) Clear Profit (As Given)	10,00,000
(ii) Less: Reasonable Return (Ref Stage II above)	8,55,000
(iii) Surplus	1,45,000

Stage IV: Calculation of Disposal of Surplus:

(i) One-third of the Company Limited to 5% of Reasonable Return (5% of ₹ 8,55,000) or (1/3 of ₹ 1,45,000) (₹ 42,750) or (48,333.33) Least is ₹ 42,750	42,750
(ii) Half of the Balance to Be Credited to Tariff & Dividends Control Reserve (₹ 1,45,000 – ₹ 42,750) × $\frac{1}{2}$ =	51,125
(iii) Balance Credited to Consumer Benefit Reserve (₹ 1,45,000 – ₹ 42,750 – ₹ 51,125)	51,125
Total	1,45,000

Stage V:

Journal Entry

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Net Revenue A/c Dr.		1,02,250	
	To Tariff and Dividend Control Reserve			51,125
	To Consumer Benefit Reserve A/c			51,125
	(Appropriation of Profits)			

Illustration 15.9

Model: Disposal of surplus—Amount refundable to customers

The following balances relate to an electric company and pertain to its accounts for the year ended 31 December 2010:

	₹
Share Capital	60,00,000
Reserve Fund (Invested) in 5% Govt. Securities at Par)	30,00,000
Contingencies Reserve (Invested in 6% Govt. Loan)	10,00,000
Loan from Stare Electricity Board …….	15,00,000
11% Debentures	5,00,000
Development Reserve	5,00,000
Fixed Assets	1,00,00,000
Depreciation Reserve on Fixed Assets	40,00,000
Consumer's Deposits	40,00,000
Amount Contributed by Consumers Towards Cost of Fixed Assets	1,00,000
Tariffs and Dividends Control Reserve	2,50,000
Monthly Average of Current Assets	10,00,000
Intangible Assets:	2,00,000

The Company earned a profit of ₹5,00,000. Show how the profits of the company will be dealt with under the provision of the Electricity Act, assuming that the bank rate during the year was 8%.

[C.A. (Inter). Modified]

Solution

Stage I: Calculation of Capital Base:

		₹	₹
(i)	Fixed Assets		1,00,00,000
		₹	
Add: (ii)	Intangible Assets	2,00,000	
(iii)	Monthly Average of Current Assets	10,00,000	
(iv)	Investments Against Contingent Reserve	10,00,000	22,00,000
			1,22,00,000
Less: (v)	Depreciation Reserve	40,00,000	
(vi)	Loan from Electricity Board	15,00,000	
(vii)	11% Debentures	5,00,000	
(viii)	Development Reserve	5,00,000	
(ix)	Consumer Deposits	40,00,000	
(x)	Amount Contributed by Customers	1,00,000	
(xi)	Tariffs & Dividend Control Reserve	2,00,000	1,08,00,000
(xii)	Capital Base:		14,00,000

Stage II: Calculation of Reasonable Returns:

(i)	Return on Capital Base @ 10% (Bank Rate 8% + 2%) on ₹14,00,000	1,40,000
(ii)	Return on Reserve Fund Investment (₹30,00,000 × 5%)= ₹1,50,000:	1,50,000
(iii)	$\frac{1}{2}$% on Electricity Board Loan $\frac{1}{2}$ % of ₹15,00,000 = ₹7,500:	7,500
(iv)	$\frac{1}{2}$% on Debentures $\left(\frac{1}{200} \times ₹5,00,000 = ₹2,500\right)$	2,500
(v)	$\frac{1}{2}$ % on Development Reserve $\left(\frac{1}{200} \times ₹5,00,000 = ₹2,500\right)$	2,500
(vi)	Reasonable Return :	3,02,500

Stage III: Calculation of Surplus:

(i)	Clear Profit (Given)	5,00,000
(ii)	Less: Reasonable Return	3,02,500
	Surplus	1,97,500

Stage IV: Calculation of Amount Refundable to Customers:	₹
(i) Surplus	1,97,500
(ii) Less: 20% of Reasonable Returns: (20/100 × ₹ 3.02,500)	60,500
(iii) Amount Refundable to Customers:	1,37,000
Stage V: Calculation of Disposal of Balance Surplus:	
(i) Amount Available to the Company for Its Disposal: $\left(\frac{1}{3}\text{of } ₹\,60,500\right)$ or (5% of 3,02,500) Whichever is Less (₹ 20,166.66) or (₹ 15,125)	15,125
₹ 15,125 is Less	
(ii) Amount to Be Credited to Tariffs & Dividend: Controls Reserve (₹ 60,500 – ₹ 15,125) = ₹ 45,375	
$\frac{1}{2}\times$ ₹ 45,375 = ₹ 22,687.50	22,687.50
(iii) Amount to Be Credited to Consumers:	
(₹ 60,500 – ₹ 15,125) × $\frac{1}{2}$ = ₹ 22,687.50	22,687.50
Total	60,500
Stage VI: Calculation of Total Amount as the Disposal of the Company:	
(i) Reasonable Return	3,02,500
(ii) Add: Share in Surplus (Ref: Stage V (i))	15,125
(iii) Total Amount as the Disposal of the Company:	3,17,625

Illustration 15.10

Model: Composition of clear profit

From the following details of an electric supply company, maintaining accounts under double account system, calculate the following:

(a) capital base; (b) reasonable return; (c) clear profit and (d) amounts available for dividends and contribution to tariff and dividend control reserve and consumer's rebate reserve.

	₹
Sale of Energy	14,60,000
Meter Rents	60,000
Transfer Fees	1,500
Cost of Generation	8,80,000
Distribution and Selling Expenses	80,000
Rent, Rates & Taxes	30,000
Audit Fees	2,400
Intangibles Written Off	9,000
Management Expenses	26,000
Depreciation	96,000
Interest on Loan of State Electricity Board	5,000
Contingency Reserve Investment Income	5,000

Interest on Security Deposit	1,000
Interest from Bank	800
Contribution to Provident Fund	70,000

No tax is payable for the year.

Original cost of fixed assets: ₹48,00,000; contributions by consumers for acquisition of such fixed assets: ₹2,40,000; cost of intangibles: ₹1,60,000; contingency reserve investments: ₹1,20,000; stores: opening ₹1,00,000 and closing ₹1,40,000; cash and bank balances: opening ₹1,20,000 and closing ₹80,000.

Depreciation up to the beginning of the year: ₹8,70,000; intangibles written off up to the beginning of the year; ₹70,000; security deposit of customers held in cash: ₹30,000; Tariffs and dividend control reserve at the beginning of the year: ₹1,80,000; Development reserve as the beginning of the year: ₹2,60,000; amount carried forward for distribution to consumers: ₹40,000; loan from state electricity board: ₹1,20,000. There is no addition to plant and machinery. Transfer to contingency reserve was ₹14,000and assume RBI rate as 8%.

Solution

Stage I: Calculation of Capital Base:	₹	₹
(i) Original Cost of Fixed Assets		48,00,000
Add:		
(i) Cost of Intangibles	1,60,000	
(ii) Investments out of Contingency Reserve	1,20,000	
(iii) Average Cash & Bank Balance: [(₹1,20,000 + ₹80,000) ÷ 2]	1,00,000	
(iv) Average Stores: [(₹1,00,000 + ₹1,40,000) ÷ 2]	1,20,000	5,00,000
		53,00,000
Less:		
(i) Provision for Depreciation (₹8,70,000 + ₹96,000)	9,66,000	
(ii) Intangibles Written Off (₹70,000 + ₹9,000)	79,000	
(iii) Loan from State Electricity Board	1,20,000	
(iv) Tariffs and Dividend Control Reserve Balance	1,80,000	
(v) Security Deposit of Customers	30,000	
(vi) Development Reserve	2,60,000	
(vii) Balance of Consumer Benefit Reserve	40,000	
(viii) Contribution by Customers for Acquisition of Fixed Assets	2,40,000	19,15,000
(ix) Capital Base		33,85,000

Stage II: Calculation of Reasonable Return:

8% Return on Capital Base ₹33,85,000 × 8/100 (RBI Rate 6% + 2% = 8%)	2,70,800

Add:	₹	
(i) Bank Interest	800	
(ii) $\frac{1}{2}$% on Loan from Board (1,20,000 × 1/200)	600	
(iii) $\frac{1}{2}$%on Development Reserve (2,60,000 × 1/200)	1,300	
Reasonable Return =	2,73,500	

Stage III: Calculation of Clear Profits:

(i) Incomes:		
Sale of Energy	14,60,000	
Meter Rent	60,000	
Transfer Fees	1,500	
Interest on Contingency Reserve Investment	5,000	
Bank Interest	800	
	15,27,300	
(i) Less: Expenses:	₹	
Cost of Generation	8,80,000	
Distribution & Selling Expenses	80,000	
Rent, Rates and Taxes	30,000	
Interest on Loan from Board	5,000	
Interest on Security Deposit	1,000	
Audit Fees	2,400	
Management Expenses	26,000	
Depreciation for the Year	96,000	
Contribution to Provident Fund	70,000	11,90,400
		3,36,900
(ii) Less: Special Appropriations:		
Intangible Written Off During the Year	9,000	
Contribution to Contingency Reserve	14,000	23,000
CLEAR PROFIT-		3,13,900

Stage IV: Calculation of Surplus:

(i) Clear Profit	3,13,900
(ii) Less: Reasonable Return	2,73,500
(iii) SURPLUS	40,400

Stage V: Calculation of Disposal of Surplus

	₹
(i) Available to the Company for Its Disposal:	
$\left(\frac{1}{3}\times$ ₹ 40,400$\right)$ or (5% of ₹ 2,73,500)	
₹ 13,466 or ₹ 13,675 Whichever Is Less	13,466

(ii) Amount to Be Credited to Tariffs and Dividend Control Reserve: ₹ (40,000 – 13,466) × $\frac{1}{2}$	13,467
(iii) Amount to Be Credited to Consumer Benefit service: ₹ (40,000 – 13,466) × $\frac{1}{2}$	13,467
Total	40,400

Stage VI: Calculation of Amount Refundable to Customers:

As the Surplus ₹ 40,000 Does Not Exceed 20% of Reasonable Return, i.e. 54,700, Nothing Is Refundable to Customers.

Stage VII: Calculation of Total Amount as the Disposable of the Company:

Reasonable Return	2,73,500
Add: Share in Surplus (Ref: Step V (i))	13,466
Total Amount as the Disposable of the company	2,86,966

Illustration 15.11

Model: Preparation of revenue A/c; net revenue A/c; capital A/c and general balance sheet

From the following balances as on 31 December 2010, appearing in the ledger of Electric Light and Power Co. Ltd, you are required to prepare: (a) revenue account; (b) net revenue account; (c) capital account and (d) general balance sheet.

(₹ in 000's)

	₹		₹
Equity Shares	1,09,800	Other Debtors	100
Debentures	40,000	Cash	600
		Stores on Hand	1,400
Lands on 31 December 2009	30,000	Cost of Generating Electricity	6,000
Lands Purchased in 2010	1,000	Cost of Distribution of Electricity	1,200
Machinery on 31 December 2009	1,20,000	Rent, Rates & Taxes ….	800
Machinery Purchased During 2000	1,000	Management Expenses	2,400
Mains Including Cost of Laying on 31 December 2009	40,000	Depreciation	4,000
Spent on Mains in 2000	10,200	Sale of Current	26,400
Sundry creditors	200	Rent of Meters	600
Depreciation Fund	50,000	Interest on Debentures	2,000
Sundry Debtors for Current Supplied	8,000	Dividends	4,000
		Balance of Net Revenue Account on 31 December 2009	5,700

[B.Com Modified]

Solution

(a) Revenue A/c
for the Year Ended 31 December 2010

(₹ in 000's)

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Cost of Generating Electricity	6,000	By Sale of Current	26,400
To Cost of Distribution of Electricity	1,200	By Rent of Meters	600
To Rent, Rates & Taxes	800		
To Management Expenses	2,400		
To Depreciation	4,000		
To Balance Carried to Net Revenue Account	12,600		
	27,000		27,000

(b) Net Revenue A/c
for the Year Ended 31 December 2010

(₹ in 000's)

	₹		₹
To Interest on Debentures	2,000	By Opening Balance b/d (Given)	5,700
To Dividends	4,000	By Revenue Account, Profit Made During the Year (Ref : Revenue A/c)	12,600
To Balance Carried to General Balances Sheet	13,300		
	18,300		18,300

(c) Receipts & Expenditure on Capital Account
for the Year Ended 31 December 2010

(₹ in 000's)

Dr. **Cr.**

Expenditure	Up To the End of Previous Year ₹	During the Year ₹	Total Expenditure ₹	Receipts	Receipts Up To the End of Previous Year ₹	Receipts During the Year ₹	Total Receipts ₹
To Lands	30,000	1,000	31,000	By Equity Capital	1,09,800	—	1,09,800
To Machinery	1,20,000	1,000	1,21,000	By Debentures	40,000	—	40,000

To Mains	40,000	10,200	50,200	By Balance of Capital Account	1,49,800	—	1,49,800 50,400
Total	1,90,000	12,200	2,02,200		1,49,800		2,02,200

(d) General Balance Sheet
as on 31 December 2010

Liabilities	₹	**Assets**	₹
Capital Account: Amount Received	1,49,800	Capital Account: Amount Spent	2,02,200
Sundry Creditors	200	Stores on Hand	1,400
Net Revenue Account	12,300	Sundry Debtors (For Current Supplied)	8,000
Depreciation Fund	50,000	Other Debtors	100
		Cash	600
	2,12,300		2,12,300

Illustration 15.12

Model: Preparation of final accounts

The following is the trial balance of the Electric Lighting Co Ltd. for the year ended 31 December 2010: Prepare its final accounts for the year ended 31 December 2010.

(₹ in '000's)

31 December 2009 Dr. ₹	**Particulars**	**31 December 2010 Dr.** ₹	**31 December 2010 Cr.** ₹
	Nominal Capital 40,000 Shares of ₹ 50 Each		
400	Subscribed—20,000 Shares, ₹25 Paid		500
300	Debentures, 6% Interest		300
22.40	Depreciation Fund		20
	Calls-in-Arrears	20	
186	Freehold Land	186	
80	Buildings	100	
120	Machinery as Station	200	
100	Mains	160	
20	Transformers, Motors, Etc.	40	
10	Meters	30	
6	Electrical Instruments	8	
32	General Stores (Cables, Mains, Etc.) in Stock	47	
5	Office Furniture	5	
	Coal and Fuel	38	

	Oil, Waste and Engine Room Stores	15	
	Coal, Oil Waste, Etc. in Stock	2	
	Repairs and Replacements	10	
	Rates and Taxes	6	
	Salaries of Secretary, Manager, Etc.	30	
	Wages as Station	60	
	Directors' Fees	20	
	Stationery, Printing & Advertising	12	
	Incidental Expenses	2	
	Law Charges	4	
	Sale of Meters		175
	Sales by Contracts		100
	Meters Rents		6
	Sundry Creditors		20
	Sundry Debtors	60	—
	Cash in Hand & as Fame	66	—
		1,121	1,121

Solution

Receipts and Expenditure on Capital A/c
for the Year Ended 31 December 2010

(₹ in 000's)

Dr. **Cr.**

Expenditure	Exp. Up To the End of Previous Year ₹	Expenditure During the Year ₹	Total Expenditure ₹	Receipts	Receipts Up To the End of Previous Year ₹	Receipts During the Year ₹	Total Receipts ₹
To Freehold Land	186	—	186	By Share Capital	400	80	480
To Building	80	20	100	By Debentures	300	—	300
To Machinery at Station	120	80	200				
To Mains	100	60	160				
To Transformers, Motors, Etc.	20	20	40				
To Meters	10	20	30				
To Electrical Instrument	6	2	8				
To General Stores (Mains, Etc)	32	15	47				
To Office Furniture	5	—	5				
Total Expenditure	559	217	776				
Balance			4				
			780		700	80	780

General Balance Sheet
as on 31 December 2010

Liabilities		₹	Assets	₹
Capital Account		7,80,000	Capital Account	7,76,000
Sundry Creditors		20,000	Coal, Oil Waste in Stock	2,000
Net Revenue		64,500	Sundry Debtors	60,000
Depreciation Fund:			Cash in Hand and as Bank	66,000
Balance	20,000			
Add: For 2010	19,500	39,500		
		9,04,000		9,04,000

Illustration 15.13

Model: Double account system—Water supply company's final A/c

From the following trial balance extracted from the books of water supply company, prepare its final accounts under the double account system for the year ended 31 December 2010:

Trial Balance of Water Supply Company
as on 31 December 2010

(₹ in 000's)

Debit Balances	₹	Credit Balances	₹
Stores in Hand	30	Equity Shares	21,000
Cash in Hand	50	12% Preference Shares	10,000
Cash as Bank	250	10% Debentures	8,000
Investments	3,140	Water Charges	3,400
Printing & Stationary	20	Meter Chargers	500
Sundry Debtors	640	Reserve Fund	150
Salaries	1,200	Unclaimed Dividends	50
Dividend on Pref. Shares	1,200	Balance to Net Revenue	1,070
Land & Building	5,000		
Plant & Machinery	10,000		
Pipelines & Reservoir	20,000		
Miscellaneous Expenses	40		
Water Meters	500		
Maintenance of:			
(i) Pipelines & Reservoirs	100		
(ii) Filter Beds	30		
(iii) Plant & Machinery	60		
General Repairs	170		
Taxes & Rates	20		
Overhead Expenses	280		
Interest on Debentures	800		
Interest Dividend on Equity Shares	40		
	44,170		44,170

Adjustments:

1. Outstanding Expenses:
   Taxes & Rates ₹ 40,000
   Salaries ₹ 60,000
2. Reserve Fund Should Be Raised to ₹2,00,000

Solution

Important Note: While preparing balance sheet of companies other than electricity companies, only capital account balance is to be shown. Total receipts and payments on capital A/c should not be shown.

(i) **Revenue Account of Water Supply Company**
for the Year Ending 31 December 2010

(₹ in 000's)

Dr. **Cr.**

Particulars		₹	Particulars	₹
To Printing & Stationery		20	By Water Charges	3,400
To Salaries	1,200		By Meter Charges	500
Add: Outstanding	*60*	1,260		
To Miscellaneous Expenses		40		
To Maintenance of:				
(i) Pipelines & Reservoirs		100		
(ii) Filter Beds		30		
(iii) Plant & Machinery		60		
To General Repairs		170		
To Taxes & Rates	20			
Add: Outstanding	40	60		
To Overhead Expenses		280		
To Balance Carried to Net Revenue A/c		1,880		
		3,900		3,900

(ii) Net Revenue Account
for the Year Ending 31 December 2010

(₹ in 000's)

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Dividend on Pref. Shares	1,200	By Balance b/d	1,070
To Interim Dividend on Equity Shares	600	By Revenue A/c (Transfer)	1,880
To Interest on Debentures	800		
To Reserve Fund	50		
To Balance Carried to General Balance Sheet	300		
	2,950		2,950

Receipts & Expenditure on Capital A/c
for the Year Ended 31 December 2010

[₹ in '000 s]

Dr. **Cr.**

Expenditure	Up To 31 December 2009 ₹	During 2010 ₹	Total ₹	Receipts	Up to 31 December 2009 ₹	During 2010 ₹	Total ₹
To Land & Building	5,000	—	5,000	By Equity Shares	21,000	—	21000
To Plant & Machinery	10,000	—	10,000	By 12% Preference Shares	10,000	—	10000
To Pipelines & Reservoir	20,000	—	20,000	By 10% Debentures	8,000		8000
To Water Meters	500	—	500				
To Preliminary Expenses	40	—	40				
	35,540		35,540		39,000		39000
To Balance c/d			3,460				
			39,000				39000

General Balance Sheet
as on 31 December 2010

Liabilities		₹	Assets	₹
Capital A/c—Balance		34,60,000	Cash in Hand	50,000
Reserve Fund:	1,50,000		Cash as Bank	2,50,000
Add:	50,000	2,00,000	Investments	31,40,000
Unclaimed Dividends		50,000	Sundry Debtors	6,40,000
Outstanding Expenses:			Stores in Hand	30,000
(i) Salaries		60,000		
(ii) Taxes & Rates		40,000		
Net Revenue A/c Balance		3,00,000		
		41,10,000		41,10,000

Summary

Double account system of accounting adopts the procedure of preparing two accounts—(i) capital A/c and (2) general balance sheet—for presenting annual financial statements. This system is adopted by public utility concerns.

Salient features: (i) Splitting of balance sheet into two parts (ii) Revenue A/c and net revenue A/c in place of P&L A/c and P&L appropriation A/c (iii) Fixed assets shown at original cost (iv) Depreciation is provided by creating reserves (v) Loans and debentures are as capital items (vi) Provision of renewals out of current revenue and (vii) Continuation of fixed assets in books even after they are reduced to scrap value.

Difference between single account and double account system: Refer the text.

Advantages of double account system: (i) Easy interpretation (ii) Enhancement of cash resources (iii) Prescribed formats (iv) enriches operating activities and (v) Helps in preparation of statistical returns

Disadvantages: (i) Assets even shown as cost price without providing depreciation (ii) Adoption of huge formats with annexure (iii) Uneven allocation of repairs and renewals and (iv) Amount charged to revenue is arbitrary.

Final account under double account system: This comprises (i) Revenue A/c (ii) Net revenue A/c (iii) Capital A/c and (iv) The general balance sheet. Their formats and preparation are discussed in detail through illustrations—Refer the text.

Key Terms

Double Account System: A system of presenting annual financial by splitting the balance sheet into two parts: capital account and the general balance sheet.

Revenue Account: The account prepared in the place of profit and loss A/c.

Net Revenue Account: The account prepared instead of P&L appropriation A/c.

QUESTION BANK

Objective Type Questions

I: State whether the following statement are true or false

1. Double account system and double entry system are one and the same.
2. Profit and loss account is renamed as revenue account, under double account system.
3. Under double account system, depreciation is shown as a deduction from fixed assets.
4. Fixed assets are shown at their original cost.
5. Depreciation is provided by creating reserves.
6. Loans and debentures are shown in Revenue A/c.
7. Interest on loans and debentures is debited to net revenue A/c.
8. Discount and premium on issue of shares and debentures are treated at capital items.
9. Renewals are provided out of capital reserves.
10. Principles of double entry are not followed in double account system.
11. Under double account system, the main purpose of preparing financial statements is to depict the financial position of public utility undertakings on a particular date.
12. Fixed assets are always shown as original cost in the books, even if they become absolute.
13. The depreciation fund and the corresponding investments are shown only in capital accounts.
14. Creation of depreciation fund is obligatory.
15. The public utility concerns can use any format in the preparation and presentation of their final accounts.
16. Revenue account is concerned purely with the operating activities of the public utility concerns.
17. Repairs and renewals are charged to revenue account of the same period in which they are incurred.
18. Depreciation is debited to respective assets account.
19. Interest on loans and debentures is shown straightaway in the general balance sheet.
20. In case of electricity supply companies, the balance of the capital account is carried down and shown as a separate item in the general balance sheet.

Answers:

1. False	2. True	3. False	4. True
5. True	6. False	7. True	8. True
9. False	10. False	11. False	12. True
13. False	14. False	15. False	16. True
17. True	18. False	19. False	20. False

II: Fill in the blanks with apt word(s)

1. Under double account system, the balance sheet is split into _____ and _____.
2. Under double account system, P&L A/c is named as _____.
3. Under double account system, P&L appropriation A/c is called _____.
4. Public utility undertakings present financial statements by adopting _____ system.
5. Under double account system, capital A/c is named as _____and _____ on capital A/c.
6. Under double account system, fixed assets are shown at _____.
7. Depreciation is provided by _____.
8. Loans and debentures are treated as _____.
9. Interest on loans and debentures is treated as _____
10. Discount and premium on issue of shares and debentures are treated as _____.
11. Renewals are provided for out of _____.
12. Balance of net revenue A/c is shown in the _____ side of the general balance sheet.
13. The capital A/c is in the form of _____.
14. Revenue A/c is purely concerned with _____ activities of the concerns.
15. Depreciation is debited to _____ and credited to _____.
16. Preliminary expenses on formation of concerns are treated as _____.
17. The actual repairs are debited to the _____ A/c and not to the _____A/c.
18. Assets continue to appear in the books as _____ and not as _____even if they are absolute.
19. _____ is not at all affected by cost of material reused.
20. Formats for preparation of various accounts relating to electricity companies are statutory forms under the _____ Act, 1910.

Answers:

1. capital A/c; general balance sheet
2. revenue A/c
3. net revenue A/c
4. double account
5. receipts and expenditure
6. original cost
7. creating reserve
8. capital items
9. appropriation of profit
10. capital items
11. current revenue
12. liability
13. cash book
14. operating
15. revenue; depreciation fund A/c
16. capital expenditure
17. reserve; revenue
18. original cost; reduced value
19. Capitalization
20. Indian Electricity

III: Multiple choice questions—Choose the correct answer

1. The name of the account showing profit/loss under double account system is
   (a) revenue A/c
   (b) net revenue A/c
   (c) income & expenditure A/c
   (d) receipts & payments A/c
2. Under double account system, the P&L appropriation A/c is otherwise named as
   (a) revenue A/c
   (b) net revenue A/c
   (c) income & expenditure A/c
   (d) receipts & payments A/c
3. Under double accounts system, when an asset is replaced
   (a) the original cost reduced by the amount of depreciation is written off to revenue
   (b) the current cost of replacement is written off to revenue
   (c) the original cost of the asset is written off to revenue
   (d) the lower of (b) and (c)
4. When an asset is replaced, any amount realized on sale of old materials is credited to
   (a) net revenue A/c
   (b) revenue A/c
   (c) replacement A/c
   (d) respective asset A/c

5. Under double account system, shares forfeited account is shown in
   (a) credit side of capital A/c
   (b) credit side of net revenue A/c
   (c) credit side of revenue A/c
   (d) assets side of the general balance sheet
6. Original cost of an asset: ₹ 3,00,000; present cost of replacement: ₹ 5,00,000; amount spent on replacement: ₹ 5,75,000. The amount charged to revenue is
   (a) ₹ 3,00,000
   (b) ₹ 5,00,000
   (c) ₹ 5,50,000
   (d) ₹ 2,50,000
7. Original cost of an asset: ₹ 2,50,000; present cost of replacement: ₹ 3,50,000; amount spent on its replacement: ₹ 4,00,000. The amount to be capitalized is
   (a) ₹ 3,50,000
   (b) ₹ 2,50,000
   (c) ₹ 50,000
   (d) ₹ 1,00,000
8. Cost of license is to be shown in
   (a) revenue A/c
   (b) net revenue A/c
   (c) the general balance sheet
   (d) capital A/c
9. Preliminary expenses is to be shown in
   (a) capital A/c
   (b) revenue A/c
   (c) net revenue A/c
   (d) the general balance sheet
10. The essential feature of double account system is
   (a) principles of double entry system
   (b) capital receipts and capital expenditure shown in separate accounts
   (c) showing assets as original cost, charging depreciation to depreciation reserve account
   (d) all of these

Answers:

1. (a)	2. (b)	3. (d)	4. (c)
5. (a)	6. (b)	7. (c)	8. (d)
9. (a)	10. (d)		

Short Answer Questions

1. What do you mean by "double account system"?
2. State any four salient features of double account system.
3. Mention any four differences between double account system and single account system.
4. State any two advantages of double account system.
5. What are the limitations of double account system (any two)?
6. Name the constituents of final accounts prepared under double account system.
7. What do you mean by revenue A/c?
8. How will you treat depreciation on fixed assets?
9. What is meant by net revenue A/c?
10. What is the main purpose of preparing capital A/c under double account system?
11. How would you treat the balance of the capital account?
12. What is means by general balance sheet?
13. How will you treat repairs and renewals under double account system?
14. What is the accounting treatment for replacement of assets when there is no improvement or additions to them?
15. How will you determine the amount to be charged to the revenue A/c in replacement of asset?
16. How will you ascertain the amount to be capitalized in replacement of asset?
17. How will you compute reasonable return?
18. What is meant by "clear profits"?
19. Explain the provision relating to "disposal of surplus"?
20. What is "capital base"?

Essay Type Questions

1. Explain the term: double account system. Enumerate the main features of this system.
2. Distinguish between double account system and single account system.

3. Discuss the advantages and limitations of double account system.
4. Enumerate the salient features of revenue A/c. Draw a format of revenue A/c. How it is prepared?
5. How will you prepare the net revenue A/c?
6. Draw the format of receipts and expenditure on capital account? Is there any difference in treatment of balance with respect to electricity companies and non-electricity public utility concerns? Substantiate your answer.
7. How does the general balance sheet differ from that of balance sheet of trading concerns?
8. Explain the accounting treatment for replacement of assets.
9. Explain the special provision relating to reasonable returns and disposal of surplus of an electric supply company.
10. Define "capital base. How will you treat this? Explain with an example.
11. Explain the procedure involved in calculation of clear profit.
12. What treatment would you recommend in double account system for the following:
    (i) Depreciation
    (ii) Replacement of an asset, including additions & alterations
    (iii) Tariffs and dividend control reserve
    (iv) Loans & debentures and interest there on
    (v) Discount and premium on issue of shares & debentures

Exercises

Part I—For Undergraduate Level

[Model: Replacement of assets and Allocation between revenue and capital]

1. A water supply company had to replace a quarter of its mains and lay auxiliary mains for the remaining length. The total cost of old mains is ₹25,00,000. The cost of auxiliary mains is ₹22,50,000 and that of the new mains has gone up by 30%. Amount spent on replacement is ₹8,75,000. Journalize.

   [**Ans:** Amount to be capitalized: ₹62,500; & ₹22,50,000]

2. An electric supply company laid down a main at a cost of ₹25,00,000. Some years later, the company laid down an auxiliary main for one-fifth of the length of the old main at a cost of ₹7,50,000 and also replaced the rest of the length of the old main at a cost of ₹30,00,000, the cost of labour and materials having gone up by 15%. Sale of old materials realized ₹40,000. Old materials valued as ₹50,000 were used in renewal and those valued as ₹25,000 were used in construction of the auxiliary main.

   You are required to give the journal entries for recording the above transactions. Also show how you would apportion the above expenditure between capital and revenue.

   [**Ans:** Amount to be charged to revenue: ₹21,85,000; Amount to be capitalized ₹15,25,000]

3. An old water works was replaced by a new one at a cost of ₹48,00,000. The old waterworks cost only ₹12,81,000, materials forming of three-sevenths of the expenditure have now doubled and labour cost had risen by 250%. Old materials worth ₹66,000 were sold. Pass journal entries showing the allocation between capital and revenue.

   [**Ans:** Current replacement cost: ₹29,28,000; Amount to be charged to revenue: ₹28,62,000; Amount to be capitalized: ₹18,72,000]

4. The coastal gas company rebuilt its works with double the capacity at a cost of ₹32,00,000. The cost of the part of old works was ₹14,00,000. In working the new works, old materials of ₹60,000 were reused and material worth ₹1,00,000 was sold away. The cost of labour and materials are 50% higher now than when the old works were built. You are required to make necessary calculations and give journal entries.

   [**Ans:** Current replacement cost: ₹21,00,000;

   Amount to be charged to revenue: ₹19,40,000; Amount to be capitalized ₹11,00,000]

5. A water supply concern had to replace a quarter of the mains and lay an auxiliary main for the remaining length in order the augment supplies of water to a locality. The total cost of the original main was ₹24,00,000. The auxiliary main cost ₹27,00,000 and the new main cost

₹ 10,50,000. It is estimated that the cost of laying a main has gone up by 30% and part of the old main realized ₹ 90,000.

[**Ans**: Amount to be charged to revenue ₹ 6,90,000; Amount to be capitalized: ₹ 29,70,000]

[Model: Replacement of asset]

6. The Kolkata Corporation decides to replace water mains with a modern one with a larger capacity. The cost of installation in 1980 was ₹ 96 lakh, The components of materials, labour and overheads being in the ratio of 5:3:2. It is ascertained that the costs of materials and labour have gone up by 40% and 80%, respectively. The proportion of overheads to total cost is expected to remain the same as before.

   The cost of the new mains as per improved design is ₹ 240 lakh and in addition, material recovered from the old mains of the value of ₹ 9,60,000 has been used in the construction of new mains. The old man was scrapped and sold for ₹ 30 lakh.

   You are asked to make the allocation between capital and revenue and pass necessary journal entries under double accounts system.

   [**Ans:** Amount to be charged to revenue ₹ 1,09,20,000; Amount to be capitalized ₹ 1,00,80,000]

7. A railway station was built in 1980 at a cost of ₹ 18,00,000. It was replaced in 2010 by a new railway station at a cost of ₹ 96,00,000. Since 1980, prices of materials have a risen to 250% and the labour rates have trebled. The proportion of materials and labour in the old station was 2:3. Old materials valued at ₹ 1,50,000 are used in the construction of new station and included in the cost of ₹ 96,00,000. ₹ 2,52,000 is realized by the sale of old materials.

   Give journal entries for recording the above transactions.

   [**Ans:** Amount to be charged to revenue: ₹ 46,38,000; Amount to be capitalized: ₹ 45,60,000]

   [Model: Disposal of profit]

8. From the following information and details relating to the year ended 31 March 2011 and bearing in mind the provision of the Electricity (supply) Act, 1948, indicate the disposal of profits of an Electric Corporation Ltd:

	₹
Net Profit Before Charging Debentures Interest	17,50,050
Fixed Assets	2,10,00,000
Depreciation Written Off on Fixed Assets	49,00,000
Loan from Electricity Board	60,00,000
6% Investments of the Reserve Fund	45,00,000
(FV ₹ 45,00,000)	
6% Investments of the Contingencies Reserve	38,00,000
Tariffs and Dividends Control Reserve	4,20,000
Security Deposits of Customers	2,42,000
Customer's Contribution to Main Lines	70,000
Preliminary Expenses	
Average of Current Assets—Excluding Customers'	13,85,000
Balance of ₹ 3,10,000	
Development Reserve	2,20,000
10% Debenture Interest Paid in the Year	3,75,000
The RBI rate on the relevant date was 8%.	

[**Ans:** Capital base: ₹ 1,03,63,000;

Reasonable Return: ₹ 13,56,150;

Surplus: ₹ 18,900;

Amount as the disposal of the company: ₹ 6,300;

Amount credited to tariffs & dividend control reserve: ₹ 6,300;

Amount to consumer benefit reserve: ₹ 6,300]

9. Best Electricity Supply Ltd earned a profit of ₹ 2,11,250 during the year ended 31 March 2011 after debentures interest @ 71/2%on ₹ 62,500. With the help of the figures given below, show the disposal of profits:

	₹
Original Cost of Fixed Assets	25,00,000
Formation & Other Expenses	1,25,000

Monthly Average of Current Assets	6,25,000
Reserve Fund (Represented by 4% Govt. Securities)	2,50,000
Contingencies Reserve Fund Investments	62,500
Loan from Electricity Board	3,75,000
Total Depreciation Written Off To Date	5,00,000
Tariff and Dividend Control Reserve	12,500
Security Deposits Received from Customers	50,000
Assume bank rate to be 6%	

[**Ans:** Capital base: ₹23,12,500; Reasonable return: ₹1,97,187.50; Surplus: ₹14,062.50; Tariff and dividends control reserve: ₹4,687.50; Consumer benefit reserve: ₹4,687.50]

10. The following balances release to an Electric Company and pertain to its are the accounts for the year ended 31 December 2010:

	₹
Share Capital	50,00,000
Reserve Fund (Invested in 5% Govt. Securities)	30,00,000
Contingencies Reserve (Invested in 6% State Government Loan)	10,00,000
Loan from State Electricity Board	15,00,000
11% Debentures	4,00,000
Development Reserve	5,00,000
Fixed Assets	1,00,00,000
Depreciation Reserve on Fixed Assets	40,00,000
Consumer's Deposits	37,50,000
Amount Contributed by Consumers Towards Cost of Fixed Assets	1,00,000
Intangible Assets	2,50,000
Tariffs and Dividends Control Reserve	3,00,000
Current Assets (Monthly Average)	10,00,000

The company earned a profit of ₹4,50,000. Show how the profits of the company will be dealt with under the provisions of the Electricity Act, assuming that the bank rate during the year was 8%. All workings should form part of your answer.

[**Ans:** Capital base; ₹17,00,000; Reasonable return: ₹3,32,000; Surplus: ₹1,18,000; To tariffs & dividend: ₹29,900; Consumer's benefit reserve: ₹29,900]

[Model: Final accounts]

11. The following are the balances on 31 March 2011 in the books of Shimla Power and Light Company Ltd:

Particulars	₹	₹
Lands on 31 March 2010	3,60,00	—
Lands Expended During 2010–11	12,000	—
Machinery on 31 March 2010	14,40,000	—
Machinery Expended During 2010–11	12,000	—
Mains Including Cost of Laying	4,80,000	—
Mains Expended During 2010–11	1,22,400	
Equity Shares	—	13,17,600
Debentures	—	4,80,000
Sundry Creditors	—	2,400
Depreciation Fund A/c		6,00,000
Sundry Debtors for Current Supplied	96,000	—
Other Debtors	1,200	—
Cash	12,000	—
Cost of Generation of Electricity	84,000	—
Cost of Distribution of Electricity	12,000	—
Rent, Rates & Taxes	12,000	—
Management Expenses	28,800	—
Depreciation	48,000	
Sale of Current	—	3,12,000
Rent of Meters	—	12,000
Interest on Debentures	24,000	—
Interim Dividend	48,000	—
Net Revenue A/c Balance on 31 March 2010	—	68,400
	27,92,400	27,92,400

From the above trial balance, prepare revenue A/c; net revenue A/c; capital A/c and general balance sheet.

[**Ans:** Revenue A/c: ₹1,29,200; Net revenue A/c: ₹1,35,600; (Balance) (Balance)

Receipts total: ₹17,97,600; General balance sheet total – ₹25,35,600]

12. From the following as at 31 March 2011, prepare revenue A/c; net revenue A/c; capital A/c and general balance sheet of an electric supply company:

	₹		₹
Balance as on 1 April 2010:			
Land	90,000	Cost of Distribution	3,000
Machinery	3,60,000		
Mains	1,20,000	Depreciation	12,000
Expenditure During the Years:		Sale of Power	78,000
		Meter Rent	3,000
Land	3,000	Interest on Debentures	6,000
Machinery	3,000		
Mains	30,600	Interim Dividend	12,000
Share Capital			
Ordinary Shares	3,29,400	Net Revenue A/c as on 1 April 2010	17,100
Debentures	1,20,000		
Sundry Creditors	600	Depreciation Fund	1,50,000
Cost of Generation	21,000	Sundry Debtors:	
Rent, Rates & Taxes	3,000	For Energy Supplied	24,000
Expenses of Management	7,200	For Others	300
		Cash Balance	3,000

[Ans: Revenue A/c (Balance): ₹39,800; Net revenue A/c (Balance): ₹38,900; Capital A/c: ₹1,57,200; General balance sheet total: ₹6,33,900]

13. From the following particulars, draw up (i) balance Sheet as on 31 December 2010 on the basis of the single account system and (ii) the capital A/c and the general balance sheet on the same date under the double account system:

Authorized capital is 1,500 shares of ₹10 each, of which issued and paid up capital is ₹13,500; 6% Debentures: ₹1,500; Trade creditors: ₹800; Trade debtors: ₹1,900; Cash at bank ₹1,750; Stock-in-trade: ₹1,200; P&L A/c: ₹800; Land: ₹1,850; Machineries: ₹8,000;

Shafting: ₹2,500; Buildings: ₹650; Depreciation fund (Machinery): ₹1,250.

[**Ans:** (i) Balance sheet total: ₹16,600; (ii) Capital A/c balance: ₹2,000; General balance sheet total: ₹17,850]

14. The following are the balance as at 31December 2010 in the books of the Utopian Railway Co Ltd. Make out the receipts and expenditure on capital A/c for 2010 and the general balance sheet as at 3 December 2010:

	₹
Traffic Accounts Due from Other Railways	65,950
Expenditure on Lines Open for Traffic	1,44,000
Expenditure on Working Stock	48,000
Expenditure on Motor Books	24,000
Expenditure on Docks, Harbors & Wharves	22,500
Subscription to Other Companies	15,000
Preference Shares Paid up as at 31 December 2010	1,27,500
Ordinary Shares Paid up as at 1 January 2010	1,20,000
Ordinary Shares Issued as at 1 January 2010	30,000
Premium on Shares as at 1 January 2010	8,250
Premium on Shares Received in 2010	3,300
Debentures	49,500
Net Revenue A/c, Balance as Credit	430
Renewals Reserve A/c	3,750
Sundry Creditors	1,875
Cash at Bank	2,055

Cash on Deposit in Bank	6,750
Investments	4,350
Spares Stock	3,750
Sundry Debtors	8,250

[**Ans:** Capital A/c balance: ₹85,050; General balance total: ₹91,105]

15. From the following particulars for the year ending 31 December 2010, prepare under the double account system, the receipts and expenditure on capital A/c and general balance sheet of an electric supply company:

	Debit Balances ₹	**Credit Balances** ₹
Capital:		
Authorized: 5,00,000 Equity Shares of ₹10 Each ₹50,00,000		
Issued, Subscribed & Paid up:	—	24,00,000
3,00,000 Equity Shares of ₹10 Each (₹8 per Share Paid up)		
6% Debentures	—	7,00,000
Depreciation Fund	—	2,50,000
Buildings	6,00,000	—
Freehold Lands	4,50,000	—
Plants and Machinery	11,67,500	—
Mains	2,30,000	—
Sundry Machine Parts	25,000	—
Meters	20,000	—
Instruments and Appliances	32,000	—
Stock and General Stores	1,88,000	—
Office Furniture	15,000	—
Fuel	22,500	—
Sundry Machine Room Materials (Lubricants, Cotton, Waste)	5,000	—
Sundry Debtors	1,75,000	—
Sundry Creditors	—	85,000
Investments	4,50,000	—
Cash in Hand and Cash as Bank	3,95,000	—
Balance Transferred from Net Revenue A/c	—	3,40,000
	37,75,000	37,75,000

[**Ans:** Balance—Capital A/c; ₹3,72,500; General balance sheet total: ₹37,75,000]

Exercises

Part B—For Advanced Level

16. The following balances appeared in the books of Mauna Power Ltd. as on 31 March 2011:

Particulars	**Dr** ₹	**Cr** ₹
Equity Shares	—	12,00,000
Debentures	—	4,00,000
Land on 31 March 2010	3,00,000	—
Land Purchased During the Year	1,20,000	—
Mains Including Cost of Laying to 31 March 2010	3,20,000	—
Mains Expended During the Year	1,52,000	—
Machinery on 31 March 2010	11,00,000	—
Machinery Purchased During the Year	1,32,000	—
Sundry Creditors		2,000
Depreciation Fund Account		5,00,000
Sundry Debtors for Current Supplied	80,000	—
Other Book Debts	1,000	—
Stores on Hand	12,000	—
Cash in Hand	8,000	—
Cost of Generation of Electricity	60,000	—
Cost of Distribution	18,000	—
Sale of Current	—	3,00,000
Meter Rent	—	10,000
Rent, Rates and Taxes	24,000	—
Establishment Expenses	42,000	—
Interest on Debentures	20,000	—
Interim Dividend	40,000	—

Depreciation	40,000	—
Net Revenue A/c Balance on 31 March 2010	—	57,000
	24,69,000	24,69,000

From the above balances prepare capital A/c; revenue A/c; net revenue A/c and general balance sheet.

[I.C.W.A. Modified]

[**Ans:** Revenue A/c (Balance): ₹1,26,000; Net revenue A/c (Balance): ₹1,23,000; Capital A/c (Balance): ₹5,24,000; General balance sheet (Total): ₹22,25,000]

17. The following balances were extracted from the books of an electric supply company, as on 31 March 2011. Prepare revenue, net revenue and appropriation accounts and the balance sheet in the form prescribed under the Electricity Act.

	₹		₹
Power Purchased	5,66,794	Interest Paid & Accrued	12,178
Distribution Expenses	93,316	Plant & Machinery	9,19,936
Rates & Taxes General	30	Public Lighting	1,63,330
Establishment		General	30,734
Charger Management	60,814	Equipment Capital Paid	7,10,000
Expenses	35,460	up	
Sale of	8,39,868	Bills	1,792
Electricity		Payable	
Meter Rent,		Sundry	5,272
Reconnection Fee	55,092	Creditors Consumers	
Depreciation	37,516	Sundry	238
Income Tax	36,488	Creditors	
		(Others)	
Repairs and Maintenance of Building	1,052	Consumer's Security Deposit	3,75,132
Contribution to Contingency Reserve	6,286	Depreciation Reserve Balance	2,57,570
Contingency Reserve		Stores in Hand	96,704
Balance on 1 January	13,804	Sundry Debtors for Supply of	
Services Advance	15,914	Electricity	78,438
Unpaid Wages	36	Advance to Staff	20,090
Income Tax Reserve	36,488	Cash at Bank	14,668
Interest Payable	23,810	Cash in Hand	2,984

[I.C.W.A. Modified]

[**Ans:** Revenue A/c: ₹86,800; Net revenue A/c: ₹86,800; General balance sheet total: ₹15,27,884; Hint: Difference in trial balance: ₹31,230]

18. Bright Electricity Ltd earned a profit of ₹13,47,500 for the year ended 31 March 2011 after debenture interest as 14% on ₹2,50,000. Calculate the reasonable return after taking into consideration the following facts also:

	₹
Fixed Assets (Original Cost)	1,00,00,000
Formation and Other Expenses	5,00,000
Monthly Average of Current Assets (Net)	25,00,000
Reserve Fund (Represented by 8% Govt. Securities)	10,00,000
Contingencies Reserve Investments	2,50,000
Loan from Electricity Board	15,00,000
Total Depreciation on Fixed Assets, Written Off To Date	20,00,000
Tariffs and Dividends Control Reserve	50,000
Security Deposits Received from Customers	2,00,000

Assume the Bank Rate to be 10%

[C.S. (Inter). Modified]

[**Ans:**Capital base: ₹92,50,000; Reasonable return: ₹11,98,750]

19. An electricity supply company rebuilt and re-equipped a power station and the connecting lines during the year ended 31 March 2011. For this

purpose, it purchased materials for ₹21,70,000 and used stores costing ₹9,80,000 from its existing stock. The cost of labour came to ₹10,44,000. The estimated supervisory overheads attributed to this project were ₹26,000. The power station was ejected during the year ended 31 March 1990 at a cost of ₹10,00,000. The index of costs in the line stood at 385 in the year ended 31 March 2011, taking the year ended 31 March 1990 as the base year. Discarded materials from the old power station fetched ₹24,000.

Show journal entries to record the above-mentioned transactions relating to the replacement of the power station. Show all your working notes.

[C.S. (Inter). Modified]

[**Ans:** ₹3,70,000 to be capitalized]

20. The following are the balances of Modern Electric Co. Ltd. as on 31 March 2011:

Balances on 31 March 2010 ₹	**Authorized Capital: 20,000 Equity Shares of ₹1,000 Each Subscribed Paid-up Capital:**	₹	₹
1,12,50,000	15,000 Shares of ₹1000 Each, ₹800 Paid up		1,20,00,000
	14% First Mortgage Debentures:		
64,00,000	6,400 Debentures of ₹100 Each		64,00,000
73,800	Share Premium Reserve		82,100
16,40,000	Depreciation Fund		16,40,000
	Depreciation Fund Investments	16,40,000	
64,00,000	Freehold Land	67,10,000	
23,00,000	Buildings	25,72,500	
15,52,680	Mains and Meters	16,98,560	
69,64,400	Plant	77,58,000	
64,000	Wages and Vans	95,000	
40,000	Office Furniture	40,000	
	Stock on Hand (1 April 2010):		
	Coal	7,70,600	
	Other Materials	4,320	
	Purchases:		
	Coal	34,26,980	
	Other Materials	52,900	
	Repairs & Renewals of Plant	7,36,940	
	Repairs & Maintenance of Mains and Meters	3,79,640	
	Wages	5,58,400	
	Salaries	89,100	
	Director's Fees	1,90,000	
	Rates & Taxes	1,89,200	
	Bad Debts	64,200	
	Legal Charges	2,600	
	Audit Fees	4,900	
	General Expenses:		
	Administrative Expenses	2,13,060	
	Sickness & Accident Compensation Paid to Workmen	84,400	
	Certificate Fees	—	400
	Sale of Electricity—Power	—	79,76,520
	Sale of Electricity—Lighting, Heading, Etc.	—	25,45,000
	Dividend Paid	24,88,000	
	Interest on Debentures	8,96,000	
	Net Revenue A/c Balance	—	8,17,340
	Sundry Creditors	—	3,66,520
	Sundry Debtors	8,69,940	—
	Balance in Current A/c	2,82,250	—
		10,390	
		3,18,27,880	3,10,27,880

Stock on hand on 31 March 2011:

Coal ₹6,92,940

Other Materials ₹10,700

Depreciation is to be provided as follows:

15% of value of plant & 10% of value of buildings on 1 April 2010. Prepare revenue A/c, capital A/c, net revenue A/c and general balance sheet under double account system.

[C.A. (Final). Modified]

[**Ans:** Profit: ₹31,18,060; Capital A/c (Total): ₹1,88,74,060; General balance sheet total: ₹2,23,80,880]

[Model: Disposal of profit]

21. Gopal Electricity Co. Ltd. earned a profit of ₹67,94,000 after paying ₹2,40,000 @ 6% as debenture interest for the year ended 31 March 2011. The following further information is supplied:

	₹
Fixed Assets	14,20,00,000
Depreciation Written Off	4,00,00,000
Loan from Electricity Board	3,20,00,000
Reserve Fund Investment at Par (4%)	80,00,000
Contingency Reserve Investment at Par (4%)	60,00,000
Tariffs and Dividend Control Reserve	8,00,000
Security Deposits of Customers	12,00,000
Customer's Contribution to Assets	4,00,000
Preliminary Expenses	3,20,000
Monthly Average of Current Assets Including	
Amount Due from Customers ₹20,00,000	60,80,000
Development Reserve	20,00,000

Show the disposal of the profits.

[C.A. (Final). Modified]

[**Ans:** Capital base: ₹7,40,000; Reasonable return: ₹86,50,000; Surplus: NIL]

22. The following balances have been extracted from the books of an electricity company at the end of March 2011:

	₹
Share Capital	40,00,000
Fixed Assets	1,00,00,000
Depreciation Reserve on Fixed Assets	12,00,000
Reserve Fund (Invested in 8% Government Securities at Par)	24,00,000
Contingency Reserve (Invested in 7% State Government Loan)	4,80,000
Consumer's Deposit	16,00,000
Amount Contributed by Consumers	
Towards Cost of Fixed Costs	80,000
Tariffs & Dividends Control Reserve	4,00,000
Development Reserve	3,20,000
12% Debentures	8,00,000
Loan from State Electricity Board	10,00,000
Intangible Assets	3,20,000
Current Assets (Monthly Average)	6,00,000

The company earned a profit of ₹11,20,000 (after tax) in 2010–11. Show how the profits are to be dealt with by the company assuming the bank rate was 10%.

All workings should form part of your answer.

[I.C.W.A. Modified]

[**Ans:** Capital base: ₹60,00,000; Reasonable return: ₹9,22,600; Surplus: ₹1,97,400; Amount refundable to customers: ₹12,880; Amount credited to tariffs and dividends control reserve: ₹69,195; Amount credited to consumer benefit reserve: ₹69,195]

23. Saharanpur Electricity Co. Ltd. earned a profit of ₹8,70,000 during the year ended 31 March 2011, after charging interest on debentures amounting to ₹22,500 @ 71/2%. You are required to show the disposal of profit assuming bank rate as 6% with the help of the following data:

	₹
Fixed Assets as Cost	1,25,00,000
Preliminary Expenses	2,50,000
Monthly Average of Current Assets including Amount	18,00,000
Due to Customers ₹3,00,000	
Reserve Fund (Represented by 6% Government Securities)	20,00,000
Total Depreciation Written Off	38,50,00
Contingencies Reserve Investments	5,00,000
Loan from Electricity Board	25,00,000

Tariff & Dividend Control Reserve	1,00,000
Security Deposits Received from Customers	2,50,000
Development Reserve	2,50,000

[I.C.W.A. (Final) Modified]

[**Ans:** Capital base: ₹75,00,000; Reasonable returns: ₹7,35,250; Surplus: ₹1,34,750; Amount at the disposal of the company: ₹36,762.50; Amount transferred to tariffs and dividend control reserve and consumer benefit reserve: Each ₹48,993.75]

[Model: Final accounts]

24. The following were extracted from the books of urban Electric Supply Co. Ltd as on 31 December 2010. Prepare revenue, net revenue accounts and balance sheet in the form prescribed under the Electricity Act:

	₹		₹
Power Purchased	14,16,985	Income Tax	91,220
Distribution Expenses	2,33,290	Repairs & Maintenance of Building	2,630
Rates and Taxes	75	Contribution Towards	
General Establishment Charges	1,52,035	Contingency Reserve	15,715
Management Expenses	88,650	Interest Paid & Accrued	30,445
Sale of Electricity	20,97,170	Plant & Machinery	22,99,840
Meter Rent,		Public Lighting	4,08,325
Reconnection Fee	1,37,730	General Equipment	76,835
Depreciation	93,790	Capital Paid up	17,75,000
Sundry Creditors		Bills Payable	4,480
(Consumers)	13,180		
Sundry Creditors		Income Tax Reserve	91,220
(Others)	595	Interest	59,525
Consumer's Security Deposit	9,37,830	Payable	
		Stores in Hand	2,44,260
Depreciation Reserve		Sundry Debtors for	
Sundry Debtors for Balance	6,43,925	Supply of Electricity	1,96,095
Contingency Reserve		Advances to Staff	50,225
Balance on 1 January 2010	34,510	Cash at Bank	36,670
		Cash in Hand	7,460
Services Advance	39,785		
Unpaid Wages	90		

[C.A. (Final). Modified]

[**Ans:** Revenue A/c: ₹2,17,000; Net revenue: A/c ₹2,17,000; General balance total: ₹38,19,710; Difference in trial balance: ₹78,075]

[Model: Final accounts]

25. The following balances appeared in the books of Eastern Electric Supply Corporation Ltd as on 31 December 2010:

Particulars	**Debit Balances** ₹	**Credit Balances** ₹
Equity Shares	—	12,00,000
Debentures	—	4,00,000
Land on 31 December 2010	3,00,000	—
Land Purchased During the Year	1,20,000	—
Mains Including Cost of Laying to 31 December	3,20,000	—
Mains Expended During the Year	1,52,000	—
Machinery on 31 December 2010	11,00,000	—
Machinery Purchased During the Year	1,32,000	
Sundry Creditors	—	2,000
Depreciation Fund Account	—	5,00,000

Sundry Debtors for Current Supplied	80,000	—
Other Book Debts	1,000	—
Stores in Hand	12,000	—
Cash in Hand	8,000	—
Cost of Generation of Electricity	60,000	—
Cost of Distribution of Electricity	18,000	—
Sale of Current	—	3,00,000
Meter Rent	—	10,000
Rent, Rates and Taxes	24,000	—
Establishment Expenses	42,000	—
Interest on Debentures	20,000	—
Interim Dividend	40,000	—
Depreciation	40,000	—
Net Revenue A/c Balance on 31 December 2010	—	57,000
	24,69,000	24,69,000

From the above balances, prepare revenue A/c; net revenue A/c; capital A/c and general balance sheet.

[I.C.W.A. (Final). Modified]

[**Ans:** Revenue A/c: ₹1,26,000; Net revenue A/c: ₹1,23,000; Capital A/c: ₹5,24,000; Balance sheet total: ₹22,25,000]

Cash Flow Statement 16

LEARNING OBJECTIVES

After studying this chapter you should be able to understand:

1. The meaning of cash flow and cash flow statement
2. The uses of cash flow statement
3. The limitations of cash flow statement
4. The classification of business transactions into operating activities, investing activities and financing activities according to Accounting Standard-3 (Revised)
5. Preparation of cash slow statement as per (AS)-3 by both direct and indirect methods
6. Accounting treatment of special items (non-cash expense non-operating income)
7. Various stages involved in the preparation of cash flow statement (six stages with illustrations) in accordance with accounting standard (AS)-3 (Revised)

The end product of the accounting process is the 'financial statements'. These are nothing but the summarized statements of accounting data produced at the end of the accounting process by a business entity. These statements communicate accounting information to the users. The balance sheet and the profit and loss account (income statement) are the traditional financial statements of any business entity. A balance sheet shows the financial position of a business enterprise on the last day of an accounting period. It is only a statement of assets and liabilities stating the financial position of an enterprise at a given date. A profit and loss account (income statement) shows the financial performance (i.e. profit or loss) of a business entity during the specified period (i.e. accounting period). However, revenue recorded in profit and loss account will not reflect cash inflows. Likewise, some of the expenses shown in profit and loss account will be non-cash expenses (like depreciation and amortization) and some will not be paid in full (goods purchased on credit outstanding expenses). As such the periods profit or loss will not be bear any direct relationship with cash flows relating to that specified accounting period. No exact information will be obtained from these two traditional financial statements with regard to investing or financing activities of business entities. Hence, the need arises to access the inflows and outflows of cash during the accounting period. Keeping in view this aspect, the Institute of Chartered Accountants of India (ICAI) introduced one more essential component of financial statements known as cash flow statement. As per accounting standard-3 (Revised), the preparation of cash flow statement—as the third financial statement—has become statutory for any companies registered under the Companies Act 1956. The other forms of business organizations also prepare this third financial statement, namely cash flow statement. This cash flow statement has to be prepared to provide information

about the cash flows associated with operating, investing and financing activities of business entities during an accounting period. In a nutshell, the cash flow statement reflects 'sources and uses of cash'. This statement reveals 'where cash comes from and where it goes'. This chapter describes the financial statement in detail.

16.1 CASH FLOW STATEMENT

16.1.1 Meaning of Cash Flow and Cash Flow Statement

Cash flow and cash flow statement are described as follows:

1. Cash flow refers to movement, both inflow and outflow, of cash and cash equivalents during a period.
2. Inflow of cash refers to all transactions, which lead to increase in cash and cash equivalents.
3. Outflow of cash refers to all transactions, which lead to decrease in cash and cash equivalents.
4. Cash flow statement is defined as a statement which shows flow of cash and cash equivalents during a period.

16.1.1.1 Meaning of Cash, Cash Equivalents and Cash Flows

Cash: This term includes cash on hand and also demands deposits with banks. The demand deposit is a deposit, which can be repayable in cash by bank on demand by the person who made such a deposit.

Cash equivalents: This term represents the highly liquid investments, which are convertible into cash with ease and speed. They are relatively short-term investments. No risk arises in converting them into cash. Their maturity period is below 3 months; preferably investments in shares are not treated as cash equivalents. The prime object of cash equivalent is to meet short-term cash commitments. Hence, they are not meant for investments or other purposes.

Cash flows: This term refers to inflows and outflows of cash and cash equivalents. An outflow will increase the cash and cash equivalents. The difference between the cash inflows and cash outflows is termed as 'net cash flow'. The net cash flow may be either a net cash inflow or a net cash outflow. It is pertinent to note that cash flows exclude movements between the items, which constitute cash or cash equivalents.

Cash flow statements: Cash flow statement is nothing but a statement that reflects inflows and outflows of cash and cash equivalents. Simply put, inflow means receipts and outflow means payment of a business entity.

The revised accounting standard [AS-3 (Revised)] is issued by the ICAI in March 1997.

Accordingly, cash flow statement has replaced statement of changes in financial position. The accounting standard [As-3 (Revised)] has been made mandatory with effect from accounting period on or after 1 April 2001 for enterprises, which fall in anyone or more of the specified categories.

16.1.2 Uses of Cash Flow Statement

Following are the uses of cash flow statement:

(a) **Short-term planning:** It gives information for a specific period. It is useful in short-term planning of an enterprise.

(b) **Easy analysis of liquidity and solvency:** Periodical cash flow statements assist in ascertaining liquidity and solvency of a concern.

(c) **Cash management:** This provides information about cash, i.e. surplus or deficit, thereby resulting in an efficient cash management.

(d) **Prediction:** This predicts about the soundness of financial status of a concern.

(e) **Cash budget:** Cash flow statement is useful in preparing cash budgets of an enterprise.

(f) **Cash position:** This not only ascertains the cash position, but also explains the reasons for such cash position (lower or higher).

(g) **Management decisions:** This is useful in determining the urgeness of management decisions and thereby acting as a deterrent against incorrect decisions.

(h) **A tool of planning:** All future investments may be effectively planned with the help of cash flow statements.

(i) **Dividend policy:** This statement also helps an enterprise in planning a good dividend policy.

16.1.3 Limitation of Cash Flow Statement

Limitations of cash flow statements are as follows:

(a) **Non-cash transactions are not covered:** As this statement is based on the limited concept of cash and cash equivalents, all non-cash transactions are not covered.

(b) **Not a proper substitute:** As this statement reveals only the net cash flow, it may not be useful as a substitute for income statement.

(c) **Not an effective tool:** This is not a good indicator of financial position of a concern, as it ignores mainly the working capital part.

(d) **Historical in nature:** It is based on past records. No future planning can be properly made unless and otherwise it is accompanied by some other documents.

16.1.4 Preparation of Cash Flow Statements

Cash flow statements may be prepared by two methods: (a) direct method and (b) indirect method.

(a) **Direct method:** Under this method, individual cash inflows and outflows and disclosed. First, let us take the operating activities. Cash receipts from operating revenues and cash payments for operating expenses are ascertained. The same are shown in precise form in cash flow statement. The difference between the total cash receipts and the total cash payments gives the net cash provided (or used) by operating activities.

Following are example of cash inflows (cash receipts):

(i) Cash from customers, specifically credit customers

(ii) Cash sales of goods and services

(iii) Cash receipts on royalties, fees, commission and so on

Following are example of cash outflows (cash payments):

(i) Cash payment for purchase of goods, inventories and so on

(ii) Cash payments for operating expenses such as rent and power

(iii) Cash payments for wages and salaries

(iv) Cash payment for taxes

The difference between total cash receipts and total payments is found out, which is called 'the net cash' provided by (or used in) operating activities.

(b) **Indirect method:** Under this method, instead of individual cash flow, necessary adjustments are carried out to net profit or loss as shown by P & L A/c. The end result is the net cash flow from operating activities.

These two methods are explained through illustrations in the forthcoming pages.

The other two activities, i.e. cash flows from investing activities and financing activities also are illustrated.

Finally, in illustration No. 37, both the methods are explained, from which the students can understand with ease and better comprehension.

As per the syllabus, cash flow statements are to be prepared as per revised standard issued by ICAI.

This revised standard is better known among professional accountants, as 'accounting standard-3 (Revised)'.

This AS-3 requires a cash flow statement to be prepared and presented in a manner that it shows cash flow from business transactions during a period, which is classified as follows:

1. Operating activities
2. Investing activities
3. Financing activities

This classification of business transactions as per AS-3 may be represented as follows for easy comprehension:

A—Operating Activities

Cash Inflow	Cash Outflow
1. Cash Sales: Cash Receipts from Sale of Goods & Other Related Services	1. Cash Purchases
2. Cash Receipts from Debtors	2. Cash Payment to Suppliers of Goods and Services
3. Cash Receipts from Royalties, Fees, Commission and Others	3. Cash Payment to Suppliers of Goods and Services
4. Cash Receipts from Insurance Company on Policy Benefits	4. Cash Payment of Wages
	5. Cash Payment to Insurance Companies as Premium and so on
	6. Cash Payment to Income Tax

A (1)—Operating Activities for Financial Companies

(a) Cash Received on Interest and Dividends	(a) Interest Payment
(b) Sale of Securities	(b) Securities Purchased

B—Investing Activities

Cash Inflow	Cash Outflow
1. Cash Receipts from Sale of Fixed Assets Including Intangible Assets	1. Cash Payment to Purchase, Shares or

2. Cash Receipts from Sale of Shares, Warrants and Other Type of Investments	2. Cash Payment Relating to Future Contract
3. Cash Receipts on Interest and Dividend	3. Cash Repayment to Purchase of Investments

C—Financing Activities

Cash Inflow	Cash Outflow
1. Cash Proceeds (Receipts) from Issue of Shares (in Cash)	1. Payment of Loans
2. Cash Proceeds from Issue of Debentures	2. Redemption of Preference Shares
3. Cash Proceeds from Long-term Borrowings	3. Payment of Dividend
	4. Payment of Interest
	5. Repayment of Any Finance Liability

***Note*:**

1. Except A (1), all items relate to manufacturing concerns.
2. Students should not misunderstand the above representations.

This is not a distinction or difference between cash inflow and outflow, but only a representation of various cash inflows and outflows for each type of activities. This only facilitates easy comprehension and better remembrance of cash inflow and outflow for each of the activities classified.

Illustration 16.1

From the following activities, classify (1) operating activities, (2) investing activities and (3) financing activities.

Requirements:

1. Issue of debentures
2. Sale of machinery
3. Sale of investment
4. Sale of patent
5. Bank balance
6. Investment in marketable securities (only short term)
7. Buy-back of equity shares
8. Income tax paid
9. Office expenses
10. Repayment of a long-term loan

Solution

Financing activities: Issue of debenture, buy-back of shares and repayment of long-term loan (manufacturer concern)

Operating activities: Sale of investment, income tax paid and office expenses

Investing activities: Sale of machinery, sale of investment (financial concerns) and sale of patent

Cash equivalents: Bank balance and investment in marketable securities (short term)

16.2 CASH FLOW STATEMENT—PREPARATION

AS-3 requires that the cash flow statement should show separately the activities, i.e.:

1. Cash flow from investing activities
2. Cash flow from financing activities

Before the preparation of cash flow statements, one should be familiar with the proforma or format of cash flow statement under two different methods: (i) direct method and (ii) indirect method.

These are the revised formats as issued by ICAI (Revised) as per (AS)-3 (Revised)

16.2.1 Direct Method Proforma or Format Cash Flow Statement for the Year Ended

Particulars	₹	₹
1. Cash From Operating Activities		
A: Operating Cash Receipts		
(i) Cash Sales	...	
(ii) Cash Received from Customers	...	
(iii) Trading Commission Received	...	
(iv) Royalties Received	...	
(v) Others	...	xxx (A)
B: Operating Cash Payment		
(i) Cash Purchases	(...)	
(ii) Cash Paid to Suppliers	(...)	
(iii) Cash Paid to Business Expenses (Office Expenses, Manufacturing Expense, Selling Expense)	(...)	
(iv) Others	(...)	xxx (B)
C: Cash Generated from Operation (A – B)		xxx (A – B)
D: Income Tax Paid		
E: Cash Flow Before Extra Ordinary Items		xx
F: Extraordinary Items (Receipts/Payments)	+	xxx
G: Net Cash from Operating Activities	or (–)	(...)
		xxxx
2. Cash Flow from Investing Activities (As in Indirect Method)		xxx
3. Cash Flow from Financing Activities (As in Indirect Method)		xx
4. Net Increase/Decrease in Cash and Cash Equivalents		xx
(As in Indirect Method) (1 + 2 + 3)		
5. Add Cash and Cash Equivalents At the Beginning of the Year (Same as in Indirect Method)		xx
6. Cash and Cash Equivalent at the End of the Year		xx

16.2.2 Indirect Method Proforma or Format Cash Flow Statement for the Year Ended

Particulars	₹	₹
1. Cash From Operating Activities		
A: Net Profit Before Taxation and Extraordinary Items		xxx
B: Add: Items to Be Added:		
(i) Depreciation	…	
(ii) Preliminary Expenses Written off	…	
(iii) Discount on Issue of Shares and Debentures Written off	…	
(iv) Goodwill Written off	…	
(vi) Interest on Borrowings and Debentures	…	
(vi) Interest on Borrowings and Debentures (Only for Non-finance Companies to be Shown—Under Financial Activities)	…	
Loss on Sale of Fixed Assets	…	xxx
C: Less: Items to Be Deducted:		
(i) Interest Income (Only for Non-finance Companies—to be Shown Under Investment Activities)	…	
(ii) Dividend Income (for Non-finance Companies—to be Shown Under Investment Activities	…	
(iii) Rental Income	…	
(iv) Profit on Sale of Fixed Assets	…	xxx
(To Be Shown Under Investment Activities—Sale Price)		
D: Operating Profit Before Working Capital Charges (A + B – C)	…	
E: Add: Decrease in Current Assets and Increase in Current Liabilities Detail:		
(i) Decrease in Stock/Inventories	…	
(ii) Decrease in Debtors/B/R	…	
(iii) Decrease in Accrued Incomes	…	
(iv) Decrease in Prepaid Expenses	…	
(v) Increase in Creditors/B/P	…	
(vi) Increase in Outstanding Expenses	…	
(vii) Increase in Advanced Income	…	
(viii) Increase in Provision for Doubtful Debt	…	xxx
F: Less: Increase in Current Assets and Decrease in Current Liabilities		

(i) Increase in Stock/Inventories	…	
(ii) Increase in Debtors/B/R	…	
(iii) Increase in Accrued Incomes	…	
(iv) Increase in Prepaid Expenses	…	
(v) Decrease in Creditors/B/P	…	
(vi) Decrease in Outstanding Expenses	…	
(vii) Decrease in Advanced Income	…	
(viii) Decrease in Provision for Doubtful Debt	…	xxx
G: Cash Generated from Operations (D + E – F)		xxx
H: Less Income Tax Paid		(…)
I: Cash Flow Before Extraordinary Items, Extraordinary Items (±)		xxx
J: Net Cash from (or Used in) Operating Activities		xxx
2. Cash Flow from Investing Activities	…	
(i) Proceeds from Sale of Fixed Assets	…	
(ii) Proceeds from Sale of Investments	…	
(iii) Interest and Dividend Received (for Non-finance Companies Only)	…	
(iv) Rent Income		
(v) Purchase of Fixed Assets	(…)	
(vi) Purchase of Investments	(…)	
(vii) Purchase of Intangible Assets, e.g. Goodwill	(…)	
(viii) Extraordinary Items (± or)	(…)	…
Net Cash from (Used in Investing Activities)		xxx
3. Cash Flow from Financing Activities		
(i) Proceeds from Issue of Shares and Debentures	…	
(ii) Proceeds from Other Long-term Borrowings	…	
(iii) Financial Dividend Paid	…	
(iv) Interim Dividend Paid	(…)	
(v) Interest on Loans and Debentures	(…)	
(vi) Repayment of Loans	(…)	
(vii) Redemption of Debentures/Prêt	(…)	
(viii) Extraordinary Items (+ or–)	(…)	…
Net Cash from (or Used in) Financing Activities		xxx
4. Net Increase/Decrease in Cash and Cash Equivalents (1 + 2 + 3)		xxx

5. Cash and Cash Equivalents at the Beginning of the Year		
(i) Cash in Hand	…	
(ii) Cash at Bank (Less: O/D)	…	
(iii) Short-term Deposits	…	
(iv) Marketable Securities	…	xx
		xxx
6. Cash and Cash Equivalents at the End of the Year		
(i) Cash in Hand	…	
(ii) Cash at Bank (Less: O/D)	…	
(iii) Short-term Deposits	…	
(iv) Marketable Securities	…	xxx

16.3 CASH INFLOW FROM DEBTORS

Illustration 16.2

You are required to calculate cash inflow from debtors from the following data.

Particulars	₹
Total Sales	5,00,000
Cash Sales	2,00,000
Opening Debtors	50,000
Closing Debtors	80,000
Sales Returns	20,000

Solution

Cash inflow from debtors has to be computed. This can be prepared by two methods.

Method 1: Cash inflow from debtors: first the format has to be drawn. Then transfer the items as follows:

Method 1—Cash Inflow From Debtors

Particulars	₹	₹
Opening Balance		50,000
Add: Credit Sales: Total Sales	5,00,000	
Less: Cash Sales	2,00,000	3,00,000
Less: Sales Returns	(20,000)	3,50,000
Closing Balance of Debtors	(80,000)	(1,00,000)
Cash Inflow from Debtors		2,50,000

Note:

Step (a): Opening Debtors Has to be Taken as Base (Given in the Question).

Step (b): With this Credit Sales (Total Sale – Cash Sale) is Added.

↓ ↓

(₹5,00,000 – ₹2,00,000)

(Given) (Given)

Step (c): Then, Sales Returns and Closing Balance of Debtors to be Deducted.

Step (d): The Result Shows Cash Inflow from Debtors.

Method 2—Total Debtors Account

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Particulars		₹	Particulars	₹
To Balance b/a		50,000	By Sales Returns	20,000
To Credit Sales			*By Cash Inflow from Debtors	2,50,000
Total Sales	5,00,000		(Balancing Figure)	
Less: Cash Sales	2,00,000	3,00,000	By Balance c/d	80,000
		3,50,000		3,50,000

Total debtors account (ledger) is computed as above.

Note:

*1. Cash inflow from debtors is the balancing figure (₹2,50,000).

2. Any one method may be adopted. The result will be the same under both the methods, i.e. cash inflow from debtors: ₹2,50,000.

Illustration 16.3

From the following calculate cash inflow from debtors.

Particulars	₹
Opening Debtors	20,000
Closing Debtors	40,000
Opening Bills Receivables	15,000
Closing Bills Receivables	25,000
Total Sales	3,00,000
Cash Sales	20% of Credit Sales
Discount Allowed	10,000
Bad Debts	15,000
Discount Allowed	20,000
Sales Returns	35,000

Solution

First value of credit sales is to be calculated (irrespective of the method to the adopted)

Let Credit sales be taken as $= x$

Cash sales $= 20\%$ of x

$= \frac{x}{5}$

Total sales $= x + \frac{x}{5} = 3,00,000$

$$= \frac{5(x) + x}{5} = 3,00,000$$

$$= \frac{6x}{5} = 3,00,000$$

$$= 6x = 15,00,000$$

$$= x = \frac{15,00,000}{6}$$

Hence x: credit sales = ₹ 2,50,000

Method 1—Cash Inflow from Debtors

Particulars	₹	₹
Opening Debtors		20,000
Opening Bills Receivable		15,000
Add: Credit Sales (Worked Out Above)		2,50,000
		2,85,000
Less: Discount Allowed	(10,000)	
Bad Debts	(15,000)	
Sales Returns	(35,000)	
Closing Debtors	(40,000)	
Closing Bills Receivables	(25,000)	(1,25,000)
		1,60,000

Total Debtors Account

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Particulars	₹	Particulars	₹
To Balance b/d	20,000	*1By Bills Receivables (See B/R A/c)	10,000
To Credit Sales (Worked Out)	2,50,000	By Discount Allowed	10,000
		By Bad Debts	15,000
		By Sales Returns	35,000
		*2By Cash Inflow from Debtors (Balancing Figure)	1,60,000
		By Balance c/d	40,000
	2,70,000		2,70,000

Bills Receivables

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	15,000	By Balance c/d	25,000
To Debtors A/c* (Balancing Figure)	10,000		
	25,000		25,000

16.4 CASH INFLOW FROM TRADING COMMISSION

Illustration 16.4

Calculate the amount of trading commission received during the year 2010 from the following data.

	January 2010 (₹)	31 December 2010 (₹)
Accrued Trading Commission	10,000	15,000
Advance Trading Commission	45,000	60,000

Trading commission earned during the year 2010 is ₹ 1,70,000.

Solution

Trading commission received can also be computed in two different ways: (i) statement form and (ii) account form.

16.4.1 Statement Form

Particulars	₹	₹
Trading Commission Earning During 2010		1,70,000
Add:		
1. Accrued Trading Commission as on 1 January 2010	10,000	
2. Advance Trading Commission as on 31 December 2010	60,000	70,000
Less:		2,40,000
1. Accrued Trading Commission as on 31 December 2010	15,000	
2. Advance Trading Commission as on 1 January 2010	45,000	60,000
		1,80,000

16.4.2 Account Form

Trading Commission Account

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Particulars	₹	Particulars	₹
To Accrued Commission A/c (at the Beginning)	10,000	By Advance Commission A/c (at the Beginning)	45,000
To P & L A/c	1,70,000	*By Cash/Bank A/c (Balancing Figure)	1,80,000
To Advance Commission A/c (at the End)	60,000	By Accrual Commission A/c (at the End)	15,000
	2,40,000		2,40,000

16.5 CALCULATION OF CASH OUTFLOW ON PURCHASES—PURCHASES INCLUDE BOTH CASH AND CREDIT PURCHASES

Credit Purchases:

$$\left.\begin{array}{l} + \bullet \text{ Credit Purchases} + \\ + \bullet \text{ Opening Creditors} + \\ + \bullet \text{ Opening Bills Payable} \end{array}\right\} \text{ (Items to be Added)}$$

$$\left.\begin{array}{l} - \bullet \text{ Closing Creditors} \\ - \bullet \text{ Closing Bill Payable} \\ - \bullet \text{ Discount Received} \\ - \bullet \text{ Purchase Returns} \end{array}\right\} \quad \text{(Items to Be Deducted)}$$

This can also be calculated by preparing total creditors account (the balancing figure and bills payable can be inserted in the A/c by preparing bills payable A/c (balancing figure)

Illustration 16.5

Calculate cash outflow to creditors from the following.

Total Purchases	:	₹ 1,80,000
Cash Purchases	:	50% of Credit Purchases
Opening Creditors	:	₹ 5000
Closing Creditors	:	₹ 20,000
Purchase Returns	:	₹ 25,000
Discount (Received)	:	₹ 10,000

Solution

First, we have to calculate credit purchase. Credit purchase is not given in the problem. So, let us assume, credit purchases = ₹ x.

Cash purchase is given as 50% of credit purchase

So, cash purchase = $x/2$

Total Purchases = Cash Purchase + Credit Purchase

$$= x + \frac{x}{2}$$

$$= x + \frac{x}{2} = ₹\,1,80,000$$

$$= \frac{2 \times x + 1 + x}{2} = ₹\,1,80,000$$

$$= \frac{3x}{2} = 2 \times ₹\,3,60,000 = ₹\,1,20,000$$

Method 1—Calculation of Cash Outflow to Creditors

Particulars	₹	₹
Opening Balance of Creditors		5,000
Add: Credit Purchases		1,20,000
Less:		1,25,000
(i) Closing Balance of Creditors	(20,000)	
(ii) Discount Received	(10,000)	
(iii) Purchase Returns	(25,000)	(55,000)
Cash Outflow to Creditors		70,000

Method 2—Total Creditors Account

Particular	₹	Particulars	₹
To Discount Received	10,000	By Opening Balance	5000

To Purchase Returns	25,000	By Credit Purchases	1,20,000
*[1]To Cash Outflow to Creditors (Balancing Figure)	70,000		
To Closing Balance C/d	20,000		
	1,25,000		1,25,000

*[1]**Note:** Balancing figure = ₹ 1,25,000 – ₹ 55,000 = ₹ 70,000.

Illustration 16.6

Complete cash outflow to creditors from the following.

		₹
Cost of Goods Sold	:	3,00,000
Operating Stock	:	5,000
Closing Stock	:	15,000
Opening Balance of Creditors	:	25,000
Return Outwards	:	10,000
Discount Received	:	15,000
Opening Bills Payable A/c	:	40,000
Closing Bills Payable A/c	:	50,000
Closing Balance of Creditors	:	40,000
Cash Purchases	:	60,000

Solution

Credit purchase will have to be calculated first.

For this, total purchase is calculated from the figures.

Total Purchases = Cost of Sales + Closing Stock – Opening Stock

↓

(cost of goods sold)

(Students should note that cost of sales and cost of goods sold are one and the same).

= ₹ 3,00,000 + ₹ 15,000 – ₹ 5,000 = ₹ 3,10,000

Then, Credit Purchases = Total Purchases – Cash Purchases

= ₹ 3,10,000 – ₹ 60,000

= ₹ 2,50,000

Method 1—Cash Outflow to Creditors Account

Particulars	₹	₹
Opening Balance of Creditors A/c		25,000
Opening Balance of Bills Payable A/c		40,000
Add: Credit Purchases		2,50,000
		3,15,000

Less:		
1. Discount Received	(15,000)	
2. Return Outwards	(10,000)	
3. Closing Balance	(40,000)	
4. Closing Balance of Bills Payable	(50,000)	(1,15,000)
Cash Outflow to Creditors		2,00,000

Method 2—Total Creditors Account

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Particular	₹	Particulars	₹
To Discount Received	15,000	By Balance b/d	25,000
To Returns Outwards	10,000	By Credit Purchase	2,50,000
*To Bills Payable A/c	10,000		
To Cash Outflow to Creditors	2,00,000		
To Balance c/d	40,000		
	2,75,000		2,75,000

Bills Payable A/c

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance c/d	50,000	By Balance b/d	40,000
		By Creditors A/c*	10,000
	50,000		50,000

16.6 CASH OUTFLOW ON EXPENSES INCURRED

To find out cash outflow, the amount of expenses (given in P & L A/c) has to be adjusted.

Step 1: For this * (i) Amount outstanding at the beginning and (ii) prepaid at the end have to be added (given in P & L A/c)

Step 2: (i) Amount outstanding at the end and (ii) prepaid at the beginning have to be deducted from P & L A/c.

Step 3: Net figure arrived will be the cash paid for expenses.

Note 1: All non-cash expenses have to be ignored because no cash payment is involved, i.e. cash flow does not take place.

Such expenses are:

(a) Depreciation
(b) Preliminary expenses written off
(c) Discount on issue of shares and debentures written off
(d) Goodwill written off
(e) Patents and copyrights written off
(f) Underwriting commission written off

Note 2: All appropriations (to be ignored): Outflow of cash does not occur

(a) Proposed divided
(b) Provision for taxation
(c) Transfers to general reserves

Note 3: All items related to investing activities and financing activities are ignored because they are taken into calculation of cash flow from investing or financing activities. Examples: Profit/loss on sale of fixed assets.

Illustration 16.7

Compare cash outflow on business expenses from the following (taken from P & L A/c).

		₹
Expenses Occurred During the Year 2010	:	25,000
Opening Outstanding Expenses	:	3,000
Closing Outstanding Expenses	:	5,000
Opening Prepaid Expenses	:	4,000
Closing Prepaid Expenses	:	2,500

Solution

Method 1—Cash Outflow on Business Expenses

Particulars		₹	₹
Expenses Incurred During the Year			25,000
Add:	Opening Outstanding Expenses	3,000	
	Closing Prepaid Expenses	2,500	5,500
			30,500
Less:	Closing Outstanding Expenses	(5,000)	
	Opening Prepaid Expenses	(4,000)	(9,000)
	Cash Outflow Expenses		21,500

Method 2—Expenses Account

Particulars	₹	Particulars	₹
To Prepaid Expenses (in the Beginning)	4000	By Outstanding Expenses (in the Beginning)	3,000
To Outstanding Expense (at the End)	5,000	By Profit and Loss A/c (Total Expenses)	25,000
* To Bank A/c (Balancing Figure)	21,500	By Prepaid Expenses (at the End)	2,500
	30,500		30,500

16.6.1 Calculation of Cash from Operating Activities—Direct Method

Illustration 16.8

Calculate cash flow from the following data by direct method.

		₹
Cash Sales	:	6,00,000
Cash Purchases	:	3,00,000
Royalties Received	:	25,000

Commission Paid	:	15,000
Rent Paid	:	12,000
Tax Paid	:	33,000
Tax Refund Received	:	13,000
Received from Debtors	:	15,000
Paid to Creditors	:	5,000
and Salaries Paid	:	30,000
Expenses Paid	:	10,000
Expenses Paid	:	8,000
Claim for Tsunami Loss	:	35,000

Solution

Cash Flow from Operating Activities

Particulars	₹	₹
A: Operating Cash Receipts		
Cash Sales		6,00,000
Cash Received from Debtors		15,000
Royalties Received		25,000
		6,40,000
B: Operating Cash Payments		
Cash Paid to Creditors	5,000	
Cash Purchases	3,00,000	
Commission Paid	15,000	
Rent Paid	12,000	
Wages and Salaries	30,000	
Manufacturing Expenses	10,000	
Office Expenses	8,000	(3,80,000)
		2,60,000
C: Cash from Operations Before Tax		
D: Income Tax Paid	33,000	
Less: Refund Received	13,000	20,000
E: Cash Flow from Operations Before Extraordinary Items		2,40,000
F: Extraordinary Items: Insurance Claim for Tsunami		35,000
G: Net Cash Flow from Operating Activities		2,05,000

16.6.2 Cash Flow From Operating Activities—Indirect Method

So far, we have discussed the calculation of cash flow (operating activities) by direct method, stage by stage. Now we have to discuss this by indirect method.

One has to make adjustments on net profit arrived as in P & L A/c.

To put in a nut shell, the net operating profit before working capital changes has to be adjusted as:

Items to be added: Items, which lead to increase in cash have to be added. They are as follows:

1. Decrease in current assets
2. Increase in current liabilities

Items to be deducted: Items, which lead to decrease in cash have to be deducted. They are the following:

1. Increase in current assets
2. Decrease in current liabilities

Illustration 16.9

Calculate cash flow from operating activities: from the following P & L A/c by indirect method.

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Particulars	₹	Particulars	₹
Salary	20,000	Gross Profit	60,000
Rent	15,000	Profit on Sale of Building	12,000
Depreciation	3,000	Income Tax Refund	3,000
Loss on Sale of Machinery	2,000		
Goodwill Written off	5,000		
Proposed Dividend	10,000		
Provision for Taxation	5,000		
Net Profit	15,000		
	75,000		75,000

Solution

First, net profit before tax has to be calculated:

Net Profit as per P & L A/c:			₹15,000
Items to be Added:	1.	Proposed Dividend:	₹10,000
	2.	Provision for Tax:	₹5,000
			30,000
Items to Be Added:	1.	Refund to Tax:	₹3,000
		Net Profit Before Tax:	₹27,000

Now, we have to compute cash flow.

Cash Flow from Operating Activities

Particulars	₹	₹
Net Profit Before Tax		27,000
Adjustments		
Add: Depreciation	3,000	
Goodwill Written off	5,000	

Loss on Sale of Machinery	2,000	10,000
		37,000
Less: Profit on Sale of Building		(12,000)
Operating Profit Before Working Capital Change		25,000
IT Refund Received		3,000
Net Cash Flow from Operating Activities		28,000

Illustration 16.10

The following is the position of current assets and current liabilities of a company.

Particulars	Balance	
	Opening	Closing
	₹	₹
Provision for Bad Debts	5000	
Short-term Loan	20,000	30,000
Creditors	25,000	20,000
Bills Receivable	30,000	50,000

The company incurred a loss of ₹ 70,000 during the year 2010. Calculate cash flows from operating activities by indirect method.

Solution

Calculation of Cash Flow from Operating Activities—Indirect Method

Particulars	₹	₹
Loss During 2010		– (70,000)
Adjustments:		
(a) Increase in Current Liabilities Bills Receivable	(20,000)	
(b) Decrease in Current Liabilities Creditors	(5000)	
Provision for Bad Debts	(5000)	– (30,000)
Cash Used in Operating Activities		– (1,00,000)

Here, students should note that net loss is given, instead of net profit. The result is negative. This means (negative cash from operation) that there is net outflow of cash from operating activities.

Short-term Loan: This is a financing activity. Therefore, it has to be shown under cash flow from financing activities.

Increase in short-term loan is ignored.

Adjustments: For sale and purchase of (non-current) fixed assets (as per revised standard):

- Cash received from sale of an item of (non-current) fixed assets is not to be considered as cash flows from investing activities.

- The profit/loss on sale of (non-current) fixed assets is taken into account in calculating cash flow from operating activities.
- While preparing (non-current) fixed assets account much care should be taken.

  There are two methods for this:

  1. **On original cost basis**
     (a) Look at the balance sheet.
     (b) If there is 'provision for depreciation', or 'accumulated depreciation' for both years, it shows that fixed assets are shown at their original cost.
     (c) In such cases, both, 'fixed assets accounts and provision for depreciation account' will have to be prepared to arrive at purchase and sale of fixed assets and the actual amount of depreciation.
  2. **On written down value basis**
     (a) If there is no such items (depreciation) appear in the balance sheet, it means that fixed assets are shown at written down value (i.e. after depreciation).
     (b) Only fixed asset account has to be prepared and current year's depreciation has to be credited to fixed assets account (that means no need to prepare 'provision for depreciation account').

Illustration 16.11

Compare cash flow from operating activities by indirect method.

Particulars	Opening Balance ₹	Closing Balance ₹
P & L Account	45,000	55,000
General Reserve	25,000	30,000
Provision for Depreciation on Plant	40,000	45,000
Outstanding Expenses	5,000	2,000
Goodwill	25,000	15,000
Sundry Debtors	60,000	50,000

An item of plant costing ₹50,000 having book value of ₹40,000 was sold for ₹45,000 during the year.

Solution

Step 1: First Net Profit Before Tax is to be Calculated.

Net Profit for the Year	
Difference Between Opening and Closing Balances in the Problem (i.e. ₹55,000 – ₹45,000)	₹10,000
Adjustment:	
Add General Reserve (Difference ₹30,000 – ₹25,000)	₹5,000
Net Profit Before Tax:	₹15,000

Step 2:

(a) Plant account has to be prepared.
(b) This has to be prepaid to arrive at depreciation, as cost, book value and sale of plant were given.
(c) Balancing figure in the plant account is the figure arrived at for depreciation.

(d) Profit on Sale = Sale Price – Book Price

= ₹45,000 – ₹40,000

= ₹5,000

Plant Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance A/c	50,000	By* Provision for Depreciation A/c (Balancing Figure)	10,000
To P & L A/c (Profit on Sale) (45,000 – 40,000)	5,000	By Bank A/c (Sale of Assets)	45,000
	55,000		55,000

Step 3:

(a) Provision for depreciation of Plant A/c has to be prepared.

(b) Balancing figure in this account is the amount provided for depreciation during the year.

(c) Depreciation arrived at, as in plant account, has to be transferred here under 'plant A/c'.

Provision for Depreciation on Plant Account

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Particulars	₹	Particulars	₹
To Plant A/c	10,000	By Balance b/d (Given)	40,000
To Balance c/d (Given)	45,000	*By P & L A/c (Depreciation to be Provided) (Balancing Figure)	15,000
	55,000		55,000

Step 4: Finally, Computation of Cash Flow From Operating Activities Has to be Worked out as Follows:

Calculation of Cash Flows from Operating Activities

Particulars	₹	₹
Net Profit Before Tax		15,000
Adjustments:		
Add: Non-cash Expenses:		
Depreciation	15,000	
Goodwill Written off	10,000	25,000
		40,000
Less: Non-cash Incomes:		
Profit on Sale of Plant		(5,000)
Operating Profit Before Working Capital Changes		35,000
Add: Decrease in Current Assets Sundry Debtors		10,000
		45,000
Less: Decrease in Current Liabilities: Outstanding Expenses		(3,000)
Cash Flows from Operating Activities		42,000

Illustration 16.12

Calculate cash flows from operating activities from the following information.

Particulars	2008 (₹)	2009 (₹)
Debtors	42,000	46,000
Prepaid Expenses	2,000	2,700
Accrued Income	1,500	1,200
Income Revised in Advance	800	1,000
Creditors	26,000	29,000
Bills Payable	13,000	11,000
Outstanding Expenses	8,000	6,000

Profit made during 2009 amounted to ₹ 1,00,000 after taking into account the following adjustments:

(i) Profit on Sale of Investment ₹ 2,000
(ii) Loss on Sale of Machine ₹ 900
(iii) Goodwill Amortized ₹ 3,000
(iv) Depreciation Charged ₹ 2,900

Solution

Cash flow for operating activities

Particulars	₹	₹
Profit for the Year		1,00,000
Items to Be Added Back to Profit		
Add: Depreciation	2,900	
Goodwill Amortized	3,000	
Loss on Sale of Machine	900	6,800
		1,06,800
Less: Profit on Sale of Investment	(2,000)	(2,000)
Cash Generated from Operation Before Working Capital Changes (Operation Profit)		1,04,800
Add : Decrease in Current Assets and Increase in Current Liabilities Accrued Income	300	
Income Received in Advance	200	
Creditors	2,000	2,500
		1,07,300
Less: Increase in Current Assets and Decrease in Current Liabilities Debtors	(4,000)	
Prepaid Expense	(200)	
Bills Payable	(2,000)	
Outstanding Expenses	(2,000)	(8,700)
Net Cash Flows from Operating Activities		98,600

Illustration 16.13

The net profit of a company before tax is ₹12,50,000 as on 31 March 2011 after considering the following.

Depreciation on Fixed Assets	₹25,000
Goodwill Written off	₹15,000
Loss on Sale of Machine	₹12,000

The current assets and current liabilities at the beginning and end of the year were as follows:

Particulars	31 March 2010 (₹)	31 March 2011 (₹)
Bills Receivables	25,000	15,000
Bills Payable	10,000	12,500
Debtors	30,000	38,800
Stock in Hand	18,000	14,000
Outstanding Expenses	8,000	7,000

Solution

Calculate cash flow from operating activities:

Students should once again remember the steps in preparing cash flow from operating activities]:

Step 1: Net Profit Before Tax is Taken as the Base.

Step 2: Items to be Added Back to the Net Profit have to be written One by One and Add with Net Profit.

Step 3: This Added Value is 'Operating Profit Before Working Capital Changes.

Step 4: With this, the Following Items to be Added:
(a) Decrease in the value of current assets
(b) Increase in the value of current liabilities

Step 5: Then, the following items have to be deducted:
(a) Increase in the Value of Current Assets
(b) Decrease in the Value of Current Liabilities

Step 6: Net Result is 'Net Cash Flow from Operating Activities.

Calculation of Cash Flow from Operating Activities

Particulars	₹	₹
A: Net Profit Before Tax		12,50,000
B: Add: (Items to Be Added Back to Net Profit)		
Depreciation on Fixed Assets	25,000	
Goodwill Written off	15,000	
Loss on Sale of Machine	12,000	52,000
C: Operating Profit Before Working Capital Changes (A + B)		13,02,000
D: Add: (Decrease in Current Assets and Increase in Current Liabilities)		

Decrease in Bills Receivables	9,500	
Decrease in Stock	4,000	
Increase in Bills Payable	2,500	16,000
E: (Deduct) Less: (Increase in Current Assets and Decrease in Current Liabilities)		13,18,200
Increase in Debtors	8,000	
Decrease in Outstanding Expenses	1,000	(9,000)
F: Net Cash Flow from Operating Activities (C + D – E)		13,09,200

16.7 CASH FLOW INVESTING ACTIVITIES

1. The investing activities of a concern relate to the acquisition and disposal of long-term assets and other reinvestments not included in cash equivalents.
2. The cash flow from investing activities is ascertained by analysing the changes in fixed assets and long-term investments at the beginning and end of the year.
3. The cash inflow and outflow (i.e. cash flow) of items included in this category of investing activities are as follows:
   (a) Payments (cash outflow)
      (i) Cash payments to acquire fixed assets
      (ii) Cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures
      (iii) Cash advances and loans to third parties
   (b) Receipts (cash inflow)
      (i) Cash receipts from disposal of fixed assets
      (ii) Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures
      (iii) Cash receipts from the repayments of loans and advances made to third parties

16.7.1 Accounting Treatment

16.7.1.1 Fixed Assets

There are two categories as follows:

First category: Fixed assets are shown at written down value (WDV). No additional information will be shown:

1. To compute the missing figures, fixed asset account is opened. All items are recorded.
2. To ascertain purchase of fixed assets → balancing figure on the debit side of the A/c.
3. To ascertain sale of fixed assets → balancing figure on the credit side of the A/c.
4. To ascertain depreciation → balancing figure on the credit side of the account.
5. In case, if both sale and depreciation are not given, it may be assumed to be either sale or depreciation and such assumption should be expressly recorded.
6. In case of land, no depreciation is recorded.
7. In case of patents, trade marks, goodwill and so on, the amount has to be written off.

Illustration 16.14

A public limited company has plant and machinery whose written down value on 1 April 2010 was ₹7,50,000 and on 31 March 2011 was ₹9,00,000. Depreciation for the year was ₹30,000. At the beginning of the year a part of the plant was sold for ₹20,000, which had written down value of ₹17,500. Calculate the net cash flow from investing activities.

Solution

Note: Fixed assets are shown at written down value.

Stage 1: Purchasing Amount has to be Calculated.

So, Plant and Machinery A/c has to be Opened.

Plant and Machinery Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	7,50,000	By Bank A/c (Plant Sale)	20,000
To Profit and Loss A/c (Profit on Sale) (₹20,000 – ₹1,75,000)	2,500	By Depreciation A/c (from the Question)	30,000
*[1]To Bank A/c (Purchase: Plant and Machinery) (Balancing Figure)	1,97,500	By Balance c/d (Value at the End)	9,00,000
	9,50,000		9,50,000

*[1]Cash payment to acquire plant and machinery is ascertained as ₹1,97,500

Stage 2:

Cash Flow from Investing Activities

Particulars	₹	₹
Cash Payments to Acquire Plant and Machinery	(1,97,5000)	
Cash Receipts from Sale of Plant and Machinery (Given in Question)	20,000	(1,77,500)
Cash Flow from Investing Activities		(1,77,500)

Second category: Fixed assets are shown at cost and accumulated depreciation (separately maintained) or provision for depreciation

1. In the case, depreciation is not directly charged to the fixed assets account.
2. Depreciation for the year is ascertained from provision for depreciation account (accumulated depreciation A/c).

This can be explained with the help of following illustration.

Illustration 16.15

From the following information, calculate the cash flow from investing activities.

Particulars	31.03.2010 ₹	31.3.2011 ₹
Machinery (At Cost)	5,00,000	5,50,000
Accumulated Depreciation	1,00,000	1,20,000
Patents	3,00,000	1,90,000

Additional information:

1. During 2010–11, a machine costing ₹ 50,000 with accumulated depreciation of ₹ 30,000 was sold for ₹ 25,000.
2. Patents were written off to the extent of ₹ 55,000 and some patents were sold at a profit of ₹ 25,000.

Solution

1. Fixed assets value is shown at cost.
2. Accumulated depreciation is also shown.
3. Further information are also in the problem.
4. In this question details on patents are also shown.
5. So, we have to open the following accounts separately to ascertain all the missing figures:
   (i) Machinery
   (ii) Accumulated depreciation account
   (iii) Patents account

Step 1: Profit on Sale of Machinery is to be Calculated.

Profit on Sale of Machinery = Sale Price – Book Value
= ₹ 25,000 – (Cost – Accumulated Depreciation)
= ₹ 25,000 – (₹ 50,000 – ₹ 30,000)
= ₹ 25,000 – ₹ 20,000
= ₹ 5,000

This Amount has to be Debited to Machinery A/c as P & L A/c.

Step 2:

Machinery Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Opening Balance b/d (Machinery in the Beginning)	5,00,000	By Bank A/c (Inflow) (Receipts—Sale)	25,000
To Profit and Loss A/c (Profit on Sale)	5,000	By Accumulated Depreciation A/c (Depreciation on Machine Sold)	30,000
*[1]To Bank A/c (Outflow) (Balancing Figure) (Purchase of Machinery)	1,00,000	By Balance c/d (Machinery at the End)	5,50,000
	6,05,000		6,05,000

Step 3:

Accumulated Depreciation Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Machinery A/c (Dep. On Machinery Sold)	30,000	By Balance b/d (Acc. Dep. at the beginning)	1,00,000
To Balance c/d (Acc. Dep. at the end)	1,20,000	*[2]By Profit and Loss A/c (Balancing Figure)	50,000
	1,50,000		1,50,000

Step 4:

Patents Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d (Patents in the Beginning)	3,00,000	*3 By Bank A/c (Inflow) (Balancing Figure)	80,000
To Profit and Loss A/c (Given in the Question)	25,000	By Profit and Loss A/c (Written off)	55,000
		By Balance c/d (at the End)	1,90,000
	3,25,000		3,25,000

Step 5:

Cash Flow from Investing Activities

Particulars	₹
Inflow from Sale of Machinery	25,000
*1 Outflow on Purchase of Machinery	(1,00,000)
*3 Inflow from Sale of Patents	80,000
Net Cash Flow from Investing Activities	5,000

Illustration 16.16

From the following particulars, calculate the cash flows from investing activities.

	Purchases (₹)	Sales (₹)
Investments	3,00,000	2,00,000
Goodwill	1,50,000	—
Machinery	6,50,000	2,10,000
Patents	—	1,00,000

Dividend received on shares held as investment ₹ 30,000. Interest received on debentures held as investment ₹ 40,000. A building purchased for investment purposes (out of surplus funds) was let out and rent proceeds received thereby ₹ 1,20,000.

Solution

This is a different problem.

1. All purchases and sales are given straight.
2. No need to prepare separate account for any item.
3. So, cash flow from investing activities can straight away be calculated as follows:

Cash Flow from Investing Activities

Particulars	₹
Investments Purchased	(3,00,000)
Proceeds from Sale of Investments	2,00,000
Goodwill Purchased	(1,50,000)
Machinery Purchased	(6,50,000)

Proceeds from Sale of Machinery	2,10,000
Proceeds from Sale of Patents	1,00,000
Interest Received on Debentures	40,000
Dividend Received on Shares	30,000
Rent Received	1,20,000
Net Cash Flow from Investing Activities	(4,00,000)

Illus tration 16.17

A company has an investments of ₹ 40,000 at the beginning of the year and ₹ 30,000 at the end of the year. During the year the company had sold 50% of its investments held at the beginning of the year at a profit of ₹ 10,000. Compute cash flow from investing activities.

Solution

Step 1: First, Cost of Sales is to be Calculated: 50% of the Investments Held at the Beginning
= 50/100 × 40,000 = ₹ 20,000

With this, Profit has to be Added to arrive at cash inflow from sale of investment. So sale of investment = ₹ 20,000 + ₹ 10,000 = ₹ 30,000.

Step 2: Next: Investment account is to be prepared to compute outflow on purchase of investment (i.e. the balancing figure in this account).

Investment Account

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
To Balance b/d	40,000	By Bank A/c (Sale: 50% ₹ 20,000 + ₹ 10,000)	30,000
To P & L A/c (Profit on Sale of Investment) (Given)	10,000	By Balance c/d (Closing)	30,000
*[1]To Bank A/c (Purchase) (Balancing Figure)	10,000		
	60,000		60,000

Step 3:

Calculation of Cash Flow from Investing Activities

Particulars	₹	₹
Inflow from Sale of Investment		
Cost of Investment Sold	20,000	
Add: Profit on Sale	10,000	30,000
Less: Outflow on Purchase of Investment		(10,000)
Net Cash flow from Investing Activities		20,000

Illustration 16.18

Calculate cash flow from investing activities.

Particulars	Opening (₹)	Closing (₹)
Machinery (At Cost)	6,00,000	6,25,000
Accumulated Depreciation	1,10,000	1,25,000

During the year, one of the machines costing ₹ 60,000 with accumulated depreciation of ₹ 35,000 was sold for ₹ 30,000.

Solution

Step 1:

Profit on Sale of Machinery has to be Calculated.

Profit on Sale of Machinery = Sale Price – Book Value

Sale Price is Given = ₹ 30,000

Step 2: Book Value is to be Found Out.

Book Value = (Cost – Accumulated Depreciation)

= (₹ 60,000 – ₹ 35,000)

= ₹ 25,000

Step 3: Profit on Sale of Machinery = ₹ 30,000 – ₹ 25,000

= ₹ 5,000

Step 4: Then Machinery Account is to be Prepared.

Machinery Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d (Opening)	6,00,000	By Accumulated Depreciation A/c (Given)	35,000
To P & L A/c (Profit on Sale)	5,000	By Bank A/c (Inflow) (Given) (Sale)	30,000
* To Bank A/c (Outflow) (Balancing Figure)	85,000	By Balance c/d (Closing)	6,25,000
	6,90,000		6,90,000

Step 5: Accumulated depreciation account is to be prepared.

Accumulated Depreciation Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Machinery A/c (Given)	35,000	By Balance b/d (Opening)	1,10,000
To Balance c/d (Closing)	1,25,000	*2 By Profit and Loss A/c (Bal. Fig.)	50,000
	1,60,000		1,60,000

Step 6: Cash flow from investing activities is prepared.

Cash Flow from Investing Activities

Particulars	₹
Inflow from Sale of Machinery	30,000
Outflow from Purchase of Machinery (Bal. Fig. in Machinery A/c)	(85,000)
Net Cash Flow from Investing Activities	(55,000)

16.8 CASH FLOW FINANCING ACTIVITIES

16.8.1 Meaning

Activities that result in change in the size and composition of owners' capital and borrowing of the enterprises are termed as financing activities.

Items included in financing activities are as follows:

1. Proceeds from issue of shares
2. Proceeds from issue of debentures
3. Proceeds from long-term borrowings
4. Receipts by way of loan
5. Proceeds from issue of bonds
6. Redemption of preference shares/debentures
7. Repayment of long-term borrowings, loans, etc.
8. Interest paid (non-financial concerns only)
9. Dividend paid (in all concerns)

Note:

1. Issue of bonus shares—(by which the increase in share capital) is not to be shown as a financing activity is the cash flow statement.
2. But in case, when shares are issued at premium, that will be shown in cash flow statements.
3. The cash flow from financing activities is ascertained by analysing the changes in equity share capital, preference share capital, debentures and other borrowings.

Illustration 16.19

Calculate the cash flow from financing activities of a concern from the following information.

Particulars	31 March 2008 ₹	31 March 2009 ₹
Equity Share Capital	5,00,000	6,75,000
9% Debentures	2,00,000	1,50,000
Securities Premium	50,000	70,000

Interest paid on debentures = ₹ 18,000

Solution

Note:

1. Change in share capital (₹ 6,75,000 – ₹ 5,00,000) reveals issue of shares.
2. Premium—increase also is included.
3. Change in debentures (₹ 2,00,000 – ₹ 1,50,000) reflects redemption: included
4. Interest paid on debentures : also included

Calculation of Net Cash Flow from Financing Activities

Particulars	₹	₹
Cash Receipts from Issue of Shares	1,75,000	
Add: Proceeds from Premium	20,000	1,95,000
Redemption of Debentures	(50,000)	
Interest Paid on Debentures	(18,000)	(68,000)
Net Cash Flow from Financing Activities		1,27,000

Illustration 16.20

A public limited company extends the following information. Calculate the net cash flow from financing activities.

Particulars	₹	₹
Equity Shares Capital	20,00,000	30,00,000
12% Debentures	1,00,000	—
9% Debentures	—	3,00,000

Additional information:

1. Dividend paid is ₹ 75,000.
2. Interest paid on debentures is ₹ 12,000.
3. During the year 2010–11, the company issued bonus shares in the ratio of 2:1 by capitalizing the reserve.

Solution

Note:

1. Nine per cent debentures shown for the year 2011: proceeds from new issue of debentures—included
2. Twelve per cent debentures redeemed in full—included
3. Interests and dividends paid—included
4. Capital increase due to issue to bonus share not to be included (capitalization of reserve)

So, care should be taken before ascertaining the cash flow from financing activities, whether those items that form part of financing activities should be included or not.

Calculation of Net Cash Flow from Financing Activities

Particulars	₹
Cash Proceeds from the Issue of 9% Debentures	3,00,000
Payments on Redemption of 12% Debentures	(1,00,000)

Interest Paid on Debentures	(12,000)
Payment of Dividend	(75,000)
Net Cash Flow from Financing Activities	1,13,000

16.9 ACCOUNTING TREATMENT OF SPECIAL ITEMS

16.9.1 Interest and Dividend

This depends on the following:

1. The nature of business entities (i.e. financial or non-financial)
2. The nature of transactions (i.e. received or paid)
   (a) Dividends paid is always treated as a financing activity (financial or non-financial)
   (b) Dividends received: for financial operating activity.
      (i) For non-financial concerns
                ↓
      (ii) Investing activity
   (c) Interest: both paid and received:
      (i) For financial enterprises:
                ↓
      (ii) Operating activity
      (iii) For non-financial enterprises:
                ↓
      • Interest paid → financing activity
      • Interest received → investing activity

These can be represented by a tabular column as follows:

S. No.	Items/Cash Flow	Financial Enterprise	Non-financial Enterprise
1.	Dividend—Paid	Financing Activity	Financing Activity
2.	Dividend—Received	Operating Activity	Investing Activity
3.	Interest—Paid	Operating Activity	Financing Activity
4.	Interest—Received	Operating Activity	Investing Activity

16.9.2 Proposed Dividend

(i) Proposed dividend for current year:
To be added back to current years profit to ascertain cash flow from operating activity.
(ii) Proposed dividend for previous year:
To be treated as financing activity.

16.9.3 Interim Dividend

(i) To be added back to current year's profits to ascertain cash flow from operating activities.
(ii) Further, it has to be treated as cash used as a financing activity.

16.9.4 Discount on Issue of Shares or Debentures

(i) Discounts are to be written off through profit and loss account.
(ii) Discount written off: To be added back to current year's profits to ascertain cash from operating activities.
(iii) Discount allowed during the year: To be treated as financing activity.

16.9.5 Non-cash Transactions

(i) As no cash flow takes place, they are not included in the preparation of cash flow statement.
(ii) But AS-3 (Revised) stipulates that such items have to be disclosed as foot note in the statement.
(iii) Example
  (a) Issue of shares for consideration other than cash
  (b) Conversion of debentures into shares

16.9.6 Taxes on Income

(i) In general, it is treated as an operating activity
(ii) But at times, if it is associated with any specific activity, then it may be treated as investing or financing activity, depending upon the nature of transactions.

16.9.7 Extra–ordinary Items

(i) Extra-ordinary items have to be classified under appropriate activity. It may be one of the three following activities:
(ii) Insurance claims
(iii) Buy-back of shares
(iv) Compensation—land acquisition

Illustration 16.21

From the following information, calculate the cash flow from (i) investing activities and (ii) financing activities.

Particulars	1 April 2010 (₹)	31 March 2011 (₹)
Furniture (At Cost)	25,000	35,000
Accumulated Depreciation on Furniture	5,000	8,000
Capital	2,00,000	2,75,000
Loan	50,000	30,000

During the year 2010–11, furniture costing ₹ 7,000 was sold at a profit of ₹ 2,500.

Depreciation on furniture charged during the year amounted to ₹ 6,000.

Solution

1. In this question, items related to investing activities and financing activities are shown. So cash flow has to be computed for each separately.
2. Changes in capital and loan are related to financing activities and the remaining items are related to investing activities.

Step 1: First, cash flow from financing activities is to be computed as follows:

Cash Flow from Financing Activities

Particulars	₹
Cash Inflow by Issue of Fresh Capital {i.e. Increase in Capital = ₹ 2,75,000 – ₹ 2,00,000}	75,000
Cash Outflow on Repayment of Loan {i.e. Loan Decreased: ₹ 50,000 – ₹ 30,000}	(20,000)
Net Cash from Financing Activities	55,000

Next, Furniture Account and Accumulated Depreciation Accounts have to be Computed.

Sale Price = Cost – Accumulated Depreciation + Profit on Sale

= ₹ 7,000 – ₹ 3,000* + ₹ 2,500 = ₹ 6,500*[1]

Step 2:

Accumulated Depreciation Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance c/d (As at 31 March 2011)	8,000	By Balance b/d (as at 1 April 2010)	5,000
*[2] To Furniture A/c (Acc. Dep. on Furniture Sold) (Balancing Figure)	3,000	By Depreciation A/c (from Information)	6,000
	11,000		11,000

Step 3:

Furniture Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d (As at 1 April 2010)	25,000	By Bank A/c *1	6,500
To Profit on Sale A/c	2,500	By Accumulation Depreciation A/c*[2]	3,000
To *[3] Bank A/c (Furniture Purchases) (Bal. Fig.)	17,000	By Balance c/d (As at 31 March 2011)	35,000
	44,500		44,500

Step 4: Finally, Cash Flow From Investing Activities has to be Ascertained.

Cash Flow from Investing Activities

Particulars	₹
Cash Inflow by Sale of Furniture *[1]	6,500
Cash Outflow on Purchase of Furniture *[3]	(17,000)
Net Cash Flow from Investing Activities	(10,500)

Note: Here, negative net cash flow indicates the net cash used in investing activities.

Illustration 16.22

An extract from the balance sheets of ABC Ltd.

Liabilities	31 March 2010 (₹)	31 March 2011 (₹)	Assets	31 March 2010 (₹)	31 March 2011 (₹)
Profit & Loss A/c	7,00,000	10,00,000			
Proposed Dividend	40,00,000	5,00,000			
Dividend Payable	—	70,000			

You are required to prepare the cash flow statement for the year ended on 31 March 2011.

Solution

Computation of cash flow statement of ABC Ltd. for the year ended on 31 March 2011

A: Cash Flow from Operating Activities	₹	₹
Closing Balance as per P & L A/c	10,00,000	
Less: Opening Balance as per P & L A/c	7,00,000	
Net Profit	3,00,000	
Add: Proposed Dividend During the Year	5,00,000	
Net Cash from Operating Activities		8,00,000
B: Cash Flow from Financing Activities	₹	₹
Final Dividend Paid	4,00,000	
(i.e.) Proposed Dividend (Previous Year) Payable	(70,000)	3,30,000
Net Cash Used in Financing Activities		(3,30,000)

Proposed Dividend Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Dividend Payable A/c	4,00,000	By Balance A/c	4,00,000
To Balance c/d	5,00,000	By Profit & Loss A/c	5,00,000
	9,00,000		9,00,000

Dividend Payable Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Bank A/c (Dividend Paid)	3,30,000	By Proposed Dividend A/c (Prev. Year)	4,00,000
To Balance c/d (Dividend Payable)	70,000		
	4,00,000		4,00,000

Illustration 16.23

An extract from the balance sheets of XY Ltd. is as follows.

Liabilities	31 March 2010 (₹)	31 March 2011 (₹)	Assets	31 March 2010 (₹)	31 March 2011 (₹)
Equity Share Capital	8,00,000	8,00,000			
10% Redeemable Preference Shares	6,00,000	6,00,000			

Profit and Loss A/c	3,00,000	5,50,000			
Proposed Dividend on Equity Shares	1,75,000	2,50,000			
Dividend Payable	—	55,000			

Additional information:

The final dividend on preference shares and an interim dividend of ₹ 60,000 on equity shares were paid on 31 March 2011.

How these items will be recorded in the cash flow statement?

Solution

1. Items shown in the balance sheet extract relate to operating activities and financing activities.
2. First, cash flow from operating activities is calculated.

A: Cash Flow from Operating Activities		₹
Closing Balance as per Profit and Loss A/c		5,50,000
Less: Opening Balance as per Profit and Loss A/c		3,00,000
Net Profit		2,50,000
Add: Proposed Dividend During the year 2010–11	2,50,000	
Dividend Paid on Pref. Shares.	60,000	
Interim Dividend Paid	60,000	3,70,000
Net Cash from Operating Activities		6,20,000
B: Cash Flow from Financing Activities:		
Final Dividend Paid on Equity Shares (₹ 1,75,000 – ₹ 55,000)		(1,20,000)
Final Dividend Paid on Preference Shares		(60,000)
Interim Dividend Paid on Equity Shares		(60,000)
Net Cash Used in Financing Activities		(2,40,000)

Illustration 16.24

An extract from the balance sheet of Renu Ltd. is as follows.

Liabilities	**31 March 2010 (₹)**	**31 March 2011 (₹)**	**Assets**	**31 March 2010 (₹)**	**31 March 2011 (₹)**
Share Capital	20,00,000	20,00,000	Discount on Issue of Shares	3,50,000	2,50,000
10% Debentures	15,00,000	20,00,000	Discount on Issue of Debentures	2,00,000	2,75,000
Unpaid Interest	—	25,000			
Profit and Loss A/c	2,00,000	2,50,000			

Solution

1. In this problem also items related to both operating and financing activities appear.

2. First, discount on issue of shares account and then discount on issue debenture account have to be prepared.
3. After ascertaining the missing figures, we can compute the cash flows.

Step 1:

Discount on Issue of Shares Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d (As at 31 March 2010)	3,50,000	*1 By Profit & Loss A/c (Balancing Figures)	1,00,000
		By Balance c/d (As at 31 March 2011)	2,50,000
	3,50,000		3,50,000

Step 2:

Discount on Issue of Debentures Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d (As at 31 March 2010)	2,00,000	By Balance c/d (As at 31 March 2011)	2,75,000
*2 To 10% Debentures A/c (Balancing Figures)	75,000		
	2,75,000		2,75,000

Step 3:

10% Debentures Account

Dr **Cr**

Particulars	₹	Particulars	₹
To Balance b/d (As at 31 March 2011)	20,00,000	By Balance b/d (As at 31 March 2010)	15,00,000
		By Discount on Issue of Debentures A/c (from *2)	75,000
		*3 By Bank A/c (Bal. Fig.)	4,25,000
	20,00,000		20,00,000

Step 4:

An Extract of Cash Flow Statement for the Year Ended on 31 March 2011.

1. **Cash Flow Operating Activities**	₹
Closing Balance as per Profit and Loss A/c	2,50,000
Less: Discount Balance as per Profit and Loss A/c	(2,00,000)
Add: Discount on Issue of Shares (from *1)	1,00,000
Interest on Debentures (₹ 1,50,000 × 10/100)	1,50,000
Net Cash from Operating Activities	3,00,000
2. **Cash Flow from Financing Activities**	
Proceeds from Issue of Debentures (from *3)	4,25,000

Interest Paid on Debentures (₹ 1,50,000 – ₹ 25,0000)	1,25,000
↓ (As Calculated) ↓ (Unpaid)	
Net Cash from Financing Activities	3,00,000

Illustration 16.25

An extract from the balance sheet of Verma Ltd. is as follows.

Dr. **Cr.**

Liabilities	31 March 2010 (₹)	31 March 2011	Assets	31 March 2010 (₹)	31 March 2011 (₹)
Share Capital	15,00,000	15,00,000	Discount on Issue of Shares	2,60,000	1,90,000
10% Debentures	15,00,000	20,00,000	Discount on Issue of Debentures	2,00,000	2,50,000
Unpaid Interest	—	20,000			
Profit and Loss A/c	1,50,000	2,25,000			

Additional information:

Discount on the issue of debentures written off during the year 2010–11 was ₹ 25,000.

You are required to depict the related items in the cash flow statement.

Solution

1. Steps will be the same as explained in the previous illustration.
2. Only additional adjustment to be made in for written off amount on debentures.

Step 1:

Discount on Issue of Shares Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d (As at 31 March 2010)	2,60,000	By *1 Profit and Loss A/c (Balancing Figure)	70,000
		By Balance c/d (as at 31 March 2011)	1,90,000
	2,60,000		2,60,000

Step 2:

Discount on Issue of Debentures Account

Particulars	₹	Particulars	₹
To Balance b/d (As at 31 March 2010)	2,00,000	By Profit and Loss A/c (Written off)	25,000
*2 To 10% Debentures A/c (Bal. Fig.)	75,000	By Balance c/d (As at 31 March 2011)	2,50,000
	2,75,000		2,75,000

Step 3:

10% Of Debentures Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance c/d (31 March 2011)	20,00,000	By Balance b/d (as at 31 March 2010)	15,00,000
		By Discount on Issue of Debentures (from *2)	75,000
		By Bank A/c (Bal. Fig.)	4,25,000
	20,00,000		20,00,000

Step 4: An Extract of Cash Flow Statement for the Year Ended on 31 March 2011.

	₹
1. **Closing Balance as per Profit and Loss A/c**	**2,25,000**
Less: Opening Balance as per Profit and Loss A/c	(1,50,000)
Add: Discount on Issue of Shares *1	70,000
Discount on Issue of Debentures *2	75,000
Interest on Debentures	1,50,000
Net Cash from Operating Activities	3,70,000
2. **Cash Flow from Operating Activities**	
Proceeds from Issue of Debentures	4,25,000
Interest Paid on Debentures	(1,30,000)
Net Cash from Financing Activities	2,95,000

Illustration 16.26

From the following information, prepare a cash flow statement for the year ending on 31 March 2011.

Liabilities	31 March 2010 (₹)	31 March 2011 (₹)	Assets	31 March 2010 (₹)	31 March 2011 (₹)
Share Capital	80,000	1,60,000	Goodwill	30,000	20,000
General Reserve	4,000	10,000	Buildings	40,000	90,000
Profit and Loss A/c	50,000	60,000	Machinery	49,000	98,000
Creditors	5,000	3,000	Debtors	15,000	20,000
Bills Payable	15,000	25,000	Cash in Hand	20,000	30,000
	1,54,000	2,58,000		1,54,000	2,58,000

Depreciation provided during the year 2010–11 = ₹ 10,000

[B.Com. (Madras)—Modified]

Solution

Stage I: Cash flow from operating activities has to be calculated first.

Step 1: For this profit as per balance sheet has to be taken as base figure (₹ 60,000 – ₹ 50,000)

↓ ↓

(given) (given)

Step 2: General Reserve (₹ 10,000 – ₹ 4,000) has to be added

↓ ↓

(From Information) (Given)

Step 3: Here, Depreciation and Goodwill,

₹ 10,000 and (₹ 30,000 – ₹ 20,000)

↓ ↓

(From Information) (Given) have to be Added back to Profit.

Important step: Sum of (i), (ii) and (iii) = operating profit before working capital changes.

Step 4: With this

(a) Increase in current liabilities (here, bills payable only):

₹ 25,000 – ₹ 15,000 have to be added. And

↓ ↓

(given) (given)

(b) Increase in current assets, here debtors: (₹ 20,000 – ₹ 15,000) and decrease in current liabilities (here, creditors (2010–11) have to be deducted.

Step 5: Result—net cash from operating activities

Stage II (B) Cash flow from investing activities has to be calculated.

Here, in this question, cash outflows occur on purchase of machine and building

Step 1: *Accrual cash flow—amount spent on purchase of machineries—is ascertained by separately preparing machinery account and the balancing figure from that account has to be transferred here.

Step 2: Purchase of Building

₹ 90,000 – ₹ 40,000

↓ ↓

(2010) (2011)

[These two items are recorded one by one.]

Note: The values are written without brackets—which means outflow of cash.

Stage III (C) Cash flow from financing activities has to be computed.

Step 1: Here, in the problem, cash flow or share capital (₹ 1,60,000 – ₹ 80,000) is recorded.

↓ ↓

(2010) (2011)

Stage IV: Net increase in cash and cash equivalents is to be computed as

Add = A (Stage I)

Less = B (Stage II)

Add = C (Stage III)

[(i.e.) A – B + C] shown as

↓

Net increase in shows as

Stage V: With this

Add cash and cash equivalents at the beginning.

Stage VI: Finally, we arrive at

Cash and cash equivalents at the end.

These are represented in the following format:

Cash Flow Statement

A: Cash Flow Statement from Operating Activities	₹	₹	₹
Net Profit Before Taxation			
Profit as per Balance Sheets	10,000		
(₹ 60,000 – ₹ 50,000) (Ref: Stage I, Step 1)			
Add: General Reserve	6,000	16,000	
(₹ 10,000 – ₹ 4,000) (Ref: Stage I, Step 2)			
Add Adjustments			
Depreciations (from Information) (from Step 3)	10,000		
Goodwill (₹ 30,000 – ₹ 20,000) (Step 3)	10,000	20,000	
Operating Profit Before Working Capital Changes		36,000	
Add: Increased in Current Liabilities			
Bills Payable (₹ 25,000 – ₹ 15,000) (Step 4a)		10,000	
		46,000	
Less: Increase in Current Assets:			
Debtors (Step 4b)	5,000		
Decrease in Current Liabilities (Creditors) (Step 4)	2,000	(7,000)	
Net Cash from Investing Activities			39,000

B: Cash Flow from Investing Activities	₹	₹
Purchase of Machine (Transferred from Machinery A/c) (Step 1)	(59,000)	
Purchase of Building (₹ 90,000 – ₹ 40,000) (Step 2)	(50,000)	
Net Cash Used in Investing Activities		(1,09,000)
C: Cash Flow from Financing Activities		
Issue of Share Capital (Stage III, Step 1)		80,000
A – B + C → Net Increase in Cash and Cash Equivalents (Stage IV)		10,000
Cash and Cash Equivalents at the Beginning (Stage V) (Given—2007)		20,000
Cash and Cash Equivalents at the End (Stage VI)		30,000

***Machinery A/c**

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
To Balance b/d	49,000	By Balance c/d	98,000
* To Bank A/c (Cash Flow, Bal. Fig.)	59,000	By Depreciation	10,000
	1,08,000		1,08,000

16.10 IMPORTANT STEPS (STAGES) IN THE PREPARATION OF CASH FLOW STATEMENT

Stage I: Cash flow from operating activities.

Step 1: Net profit before tax is taken as base, instead of showing separately the closing balances and opening balances of P & L A/c straight away. Net profit (closing balance – opening balance) amount can be recorded and with this transfer to general reserve is added).

Step 2: Add:

(i) Transfer to general reserve

(ii) Other adjustments (items added back to profit, i.e. depreciation; goodwill; loss on sale, etc.)

Step 3: Figure arrived at this stage is termed as operating profit before working capital changes.

Step 4: With this, the following items have to be added.

Add:

(i) Decrease in the value of current assets

(ii) Increase in the value of current liabilities

Step 5: Less: following items have to be deducted.

(i) Increase in the value of current assets

(ii) Decrease in the value of current liabilities

Step 6: Figure arrived at this stage is termed as 'net cash flow from operating activities'. Now we have to go to the next stage.

Stage II: Cash flow from investing activities

Purchases of plant, machinery, land and buildings have to be recorded here.

Important note: If depreciation amount is given in additional information, separate account (plants A/c – building A/c) has to be prepared to ascertain the value of its purchase, which is cash flow from investing activities.

(In this stage such items, as described above, are to be recorded and the sum of all the items to be shown within brackets, which means that due to investing activities, cash outflow actually place).

Figure arrived is termed as 'net cash from financing activities'.

Stage III: Cash flow from financing activities.

Step 1: Issue of share capital to be recorded.

Step 2: Less: If any redemption, such amount has to be recorded and deducted from Step 1.

Step 3: Figure arrived at this stage is termed as 'net cash from financing activities'.

Stage IV: Net increase and decrease in cash and cash equivalents

[Stage I + Stage II + Stage III]

Stage V: Cash and cash equivalents at the beginning of the year to be added.

Stage VI: Cash and cash equivalents at the end of the year to be recorded.

Note: This is a simplified form. Only one or two items are shown. Students should practice with this first and then proceed to all the other items mentioned in the standardized format as prescribed by [(AS-3)].

Illustration 16.27

The following is the financial position as on 31 March.

Dr. **Cr.**

Particulars	2010 ₹	2011 ₹	Particulars	2010 ₹	2011 ₹
Current Liabilities	80,000	1,00,000	Cash	12,000	11,000
Loan from Bank	—	40,000	Debtors	80,000	85,000
Ltd.					
Loan from Bank	80,000	50,000	Stock	68,000	54,000
Share Capital	3,00,000	3,00,000	Land	70,000	90,000
Profit and Loss A/c	1,40,000	1,60,000	Building	2,00,000	2,20,000
			Machinery	2,00,000	2,30,000
			Provision for Deprecation	(30,000)	(40,000)
	6,00,000	6,50,000		6,00,000	6,50,000

During the year ₹ 60,000 was paid as dividend. You are required to prepare cash flow statement as per revised accounting standard [(AS)-3 (Revised)].

Solution

First, net profit has to be calculated because all adjustments have to be carried on unit net profit as base.

		₹
Profit as on 31 March 2011	:	1,60,000
Profit as on 31 March 2010	:	1,40,000
(Difference) Profit for the Year	:	20,000
Add: Dividend Paid During the Year	:	60,000
*[1]Net Profit Before Tax and Extraordinary Items	:	80,000*[1]

Cash Flow Statement
for the Year 31 March 2011

Particulars	₹	₹
A: Cash Flow from Operating Activities		
*1 Net Profit Before Tax and Extraordinary Items (as Calculated Above)	*[1]80,000	
Add: Depreciation	10,000	
Operating Profit Before Working Capital Changes	90,000	
Add: Decrease in Stock	14,000	
Increase in Current Liabilities	20,000	
Increase in Debtors	(5,000)	
Net Cash from Operating Activities		1,19,000
B: Cash Flow from Investing Activities		
Purchase of Building	(20,000)	

Purchase of Land	(20,000)	
Purchase of Machinery	(30,000)	
Net Cash Used in Investing Activities		(70,000)
C: Cash Flow from Financing Activities		
Proceeds of Loan from Ram Ltd.	40,000	
Repayment of Bank Loan	(30,000)	
Payment of Dividend	(60,000)	(50,000)
Net Decrease in Cash and Cash Equivalents		(1,000)
Cash and Cash Equivalents at the Beginning		12,000
Cash and Cash Equivalents at the End		11,000

Notes:

1. Figures mentioned within brackets means negative items (minus items—to be deducted).
2. If there is negative cash from activities, then it is understood that there is *net outflow of cash from such activities.*

16.11 SOME IMPORTANT HINTS

Hint 1: Instead of profit/loss, capital alone may be given in the problem. In such cases, profit is arrived at as:

		₹
Capital at the End of the Period:	…	x x
Less: Capital at the Beginning of the Period:	…	x x
Profit for the Year:	…	x x

Hint 2: In case, if capital at the beginning and at the end of the period is given, students have to prepare capital account and the balancing figure is taken as 'drawings'.

Format

Capital A/c

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
To Bank A/c (Drawing)		By Balance b/d (Beginning)	—
(Balancing Figure)	—	By Adjusted P & L A/c	—
To Balance c/d (Closing)	—		

(or)

Calculation of Drawings:

Opening Capital:	…
Add: Net Profit:	…
Less: Closing Profit:	…
Drawings:	…

This amount has to be included in cash flow financing activities under 'drawings'.

Hint 3: Loss on sale of fixed assets is calculated as follows:
Loss on sale of fixed assets: cost – selling price
And, if in case of any depreciation: cost – accumulated depreciation – selling price

Hint 4: Provision for taxation

Case 1: Item, 'provision for taxation' appears on the liabilities side of *previous year's* balance sheet.

(i) This shows that the taxes were paid during the year.
(ii) So, while calculating net cash from operating activities, this has to be deducted.

Case 2: This item 'provision for taxation' appears on the liabilities side of the currents year's balance sheet.

(i) This amount is to be added to profits.
(ii) Net profit before tax is to be shown under 'cash flow from operating activities'.
(iii) This treatment (adjustment) is done, if tax paid during the year is not given in the problem.
(iv) If 'tax paid' is given in question, then the 'provision for tax account' is prepared and the amount of tax paid is found out (balancing figure) (provision for taxation).

Format

Provision for Tax Account

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
To Cash A/c (Tax Paid: Additional Information)		By Balance b/d (Opening)	
To Balance c/d (Closing)		By P & L A/c (Provision Arranged) (Balancing Figure)	

Hint 5: Dividend paid during the year:
Interim dividend for the year is calculated as follows:

(i) Net profit for the year is first calculated.
(ii) This amount is added with opening balance of P & L A/c.
(iii) Then it is deduced by closing balance of P & L A/c.

Dividend Paid: Opening balance of P & L + net profit – closing balance of P & L A/c.

Hint 6: If appropriate adjustments have to be made for both provision for tax and interim dividend to arrive at net profit before tax, then the following adjustment are to be made:

	₹
Profit at the End of the Period (Closing):	
Less: Profit at the Beginning (Opening):	—
Profit of the year:	—
	xx
Appropriations:	
Add: 1. Interim Dividend Paid:	—
2. Provision for Tax:	—
Profit Before Tax:	xx

Illustration 16.28

From the following information, prepare a cash flow statement as on 31 March 2009.

Dr. **Cr.**

Liabilities	2010 ₹	2011 ₹	Assets	2010 ₹	2011 ₹
Share Capital	80,000	1,60,000	Goodwill	30,000	20,000
General Reserve	4,000	10,000	Buildings	40,000	90,000
Profit and Loss A/c	50,000	60,000	Machinery	49,000	98,000
Creditors	5,000	3,000	Debtors	15,000	20,000
Bills Payable	15,000	25,000	Cash in Hand	20,000	30,000
	1,54,000	2,58,000		1,54,000	2,58,000

Depreciation provided during the year on machine was ₹ 10,000.

Solution

Cash Flow Statement

A: Cash Flow from Operating Activities:	₹	₹	₹
Net Profit Before Taxation			
Profit as per Balance Sheet (₹ 60,000 – ₹ 50,000)	10,000		
Add: General Reserve (Transfer) (₹ 10,000 – ₹ 4,000)	6,000	16,000	
Add: Adjustments (Items Added Back to Profit)			
Depreciations	10,000		
Goodwill	10,000	20,000	
Operating Profit Before Working Capital Changes		36,000	
Add: Increase in Current Liabilities:			
Bills Payable		10,000	
		46,000	
Less: Increased in Current Assets (Debtors)	5,000		
Decrease in Current Liabilities (Creditors)	2,000	(7,000)	
Net Cash from Investing Activities			39,000
B: Cash Flow From Investing Activities			
Purchase of Machine (Prepare Machinery A/c and Transfer Its Balance Amount) (Step 1)	(59,000)		
Purchase of Building	(50,000)		
(₹ 90,000 – ₹ 40,000			
Net Cash Used in Investing Activities			(1,09,000)
C: Cash Flow from Financing Activities			
Issue of Share Capital			80,000
Net Increase in Cash and Cash Equivalents (A – B + C)			10,000
Cash and Cash Equivalents at the Beginning			20,000
Cash and Cash Equivalents at the End			30,000

Illustration 16.29

From the following balance sheet of Raja Ltd., prepare a cash flow statement as on 31 December 2011.

Dr. **Cr.**

Liabilities	2010 ₹	2011 ₹	Assets	2010 ₹	2011 ₹
Equity Share Capital	1,50,000	2,00,000	Goodwill	36,000	20,000
12% Pref. Share Capital	75,000	50,000	Buildings	80,000	60,000
General Reserve	20,000	35,000	Plant	40,000	1,00,000
P & L A/c	15,000	24,000	Debtors	1,19,000	1,54,500
Creditors	37,500	49,500	Stock	10,000	15,000
			Cash	12,500	9,000
	2,97,500	3,58,500		2,97,500	3,58,500

Depreciation charged on plant was ₹ 10,000 and on building was ₹ 60,000.

Solution

As depreciation is given in additional information plant A/c and building A/c have to be prepared separately to ascertain the value of their purchase, which are cash flow from investing activities.

Plant A/c

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d (Opening: 2010)	40,000	By Depreciation A/c (Given)	10,000
*[1]To Bank A/c (Purchase Value) (Balancing Figure)	70,000	By Balancing c/d (Closing : 2011)	1,00,000
	1,10,000		1,10,000

Building A/c

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d (Opening : 2010)	80,000	By Depreciation A/c (Given)	60,000
*[2]To Bank A/c (Purchase Value) (Balancing Figure)	40,000	By Balancing c/d (Closing : 2011)	60,000
	1,20,000		1,20,000

Cash Flow Statement for the Year Ended on 31 December 2011

Net Profit Before Taxation	₹	₹
Closing Balance of P & L A/c	24,000	
Add: Transfer of General Reserve	15,000	
	39,000	
Less: Opening Balance of P & L A/c	15,000	24,000

Note: Instead of showing separately closing and opening balance adjustments, straight away net profit can be found as (closing balance – opening balance) as ₹ 9000 and with this transfer to general reserve is added.

A: Net Profit Before Tax and Extraordinary Items	₹	₹
Adjustment for		
Depreciation on Plant	10,000	
Depreciation on Building	60,000	
Goodwill Written off	16,000	86,000
Operation Profit Before Working Capital Changes		1,10,000
Adjustments for :		
Add: Increase in Creditors	12,000	
Less: Increase in Debtors	(35,500)	
Increase in Stock	(5,000)	(28,500)
Net Cash from Operating Activities		81,500—A
B: Cash Flows from Investing Activities		
Purchase of Plant	70,000	
Purchase of Building	40,000	
Net Cash in Investing Activities		(1,10,000)—B
C: Cash Flow from Financing Activities		
Issue of Share Capital	50,000	
Redemption of 12% Pref. Share Capital	(25,000)	
Net Cash from Financing Activities		25,000—C
Net Decrease in Cash and Cash Equivalents (A + B + C)		(3,500)
Cash and Cash Equivalents at the Beginning of the Year		(12,500)
Cash and Cash Equivalents at the End of the Year		9,000

Illustration 16.30

From the following balance sheet of Vivek Ltd., prepare a cash flow statement.

Balance Sheet

Dr. **Cr.**

Liabilities	**2008** ₹	**2009** ₹	**Assets**	**2008** ₹	**2009** ₹
Equity Share Capital	2,00,000	2,50,000	Goodwill	30,000	20,000
12% Pref. Share Capital	50,000	40,000	Buildings	1,00,000	80,000
General Reserve	35,000	55,000	Plant	40,000	70,000
P & L A/c	15,000	17,000	Debtors	1,20,000	1,60,000
Creditors	35,000	5,000	Stock	18,000	20,000
			Cash	15,000	17,000
	3,23,000	3,67,000		3,23,000	3,67,000

Depreciation charged on plant was ₹ 30,000 and on building was ₹ 50,000.

Solution

Cash Flow Statement for the Year Ended on 31 December 2009

A: Cash Flow from Operating Activities:	₹	₹	₹
Net Profit Before Tax			
Closing Balance as per P & L A/c	17,000		
Less: Opening Balance of P & L A/c	(15,000)		
Add: Transfer to General Reserve	20,000		22,000
Add: Items to be Added (Adjustment for)			
Depreciation for Plant	30,000		
Depreciation for Buildings	50,000	80,000	
Goodwill Written off		10,000	90,000
Operating Profit Before Working Capital Changes			1,12,000
Add: Decrease in Current Assets and Increase in Current Liabilities			Nil
Less: Increase in Current Assets and Decrease in Current Liabilities			
Debtors		40,000	
Stock		2,000	
Creditors		18,000	(60,000)
Net Cash from Operating Activities			52,000—A
B: Cash Flows from Investing Activities			
Plant Purchased			(60,000)
Building Purchased			(30,000)
Net Cash in Investing Activities			90,000)—B
C: Cash Flow from Financing Activities			
Proceeds from Issue of Equity Shares			50,000
Redemption of Pref. Shares			(10,000)
Net Cash from Financing Activities			40,000—C
D: Net Increase in Cash and Cash Equivalents (A + B + C)			3,000
(₹ 52,000 + (₹ –90,000) + ₹ 40,000)			
E: Cash and Cash Equivalents at the Beginning of the Year: Cash-in-Hand			15,000
Cash and Cash Equivalents at the End of the Year			17,000

Illustration 16.31

What is meant by investing activities? From the following particulars prepare cash flows from investing activities.

	Purchased	Sold
	₹	₹
1. Machinery	4,00,000	2,00,000
2. Investments	2,00,000	3,00,000

3. Goodwill	1,00,000	
4. Patents		1,50,000
5. Interest Received or Debentures Held as Investments	10,000	
6. Dividend Received on Shares Held as Investments	5,000	
7. A Plot of Land Was Purchased out of Surplus Funds for Investment Purposes and Was Let out for Commercial Use and Rent Received	20,000	

Solution

The acquisition and disposal of long-term assets (not included in cash equivalents) is called investing activities.

Cash Flow from Investing Activities

Particulars	₹
Purchase of Machinery	(4,00,000)
Proceeds from Sale of Machinery	2,00,000
Purchase on Investments	(2,00,000)
Proceeds from Sale of Investments	3,00,000
Purchase of Goodwill	(1,00,000)
Proceeds from Sales of Patents	1,50,000
Interest Received	10,000
Dividend Received	5,000
Rent Received	20,000
Net Cash Used in Investing Activities	(15,000)

Note: Figures within the brackets means items that are to be deducted. This comes to be ₹4,00,000, ₹2,00,000, ₹1,00,000 = ₹7,00,000

This has to be deducted from (₹2,00,000 + ₹3,00,000 + ₹1,50,000 + ₹10,000 + ₹5,000 + ₹20,000 = ₹6,85,000. Again (– 7,00,000 + 6,85,000) = net result (– ₹15,000). So cash is used. Cash flows out on investing activities.

Illustration 16.32

Calculate cash flows from operating activities from the following information.

Particulars	**2010** ₹	**2011** ₹
Stock	60,000	50,000
Debtors	25,000	23,000
Creditors	32,000	28,000
Expenses Outstanding	3,500	4,500
Bills Payable	35,000	22,000
Accrued Income	8,000	9,000
Profit and Loss A/c	80,000	90,000

Solution

Calculation of Net Cash Flows from Operating Activities

Particulars	₹	₹
Profit for the Year (Closing – Opening)		10,000
Decrease in Stock	10,000	
Decrease in Debtors	2,000	
Decrease in Creditors	(4,000)	
Increase in Expenses Outstanding	1,000	
Increase in Accrued Income	(1,000)	
Decrease in Bills Payable	(13,000)	(5,000)
Net Cash Flow from Operating Activities		5,000

Illustration 16.33

From the following information prepare a cash flow statement.

	₹
Opening Cash Balance	10,000
Closing Cash Balance	12,000
Decrease in Debtors	5,000
Increase in Creditors	7,000
Sale of Fixed Assets	20,000
Redemption of Debtors	50,000
Net Profit for the Year	20,000

Solution

Cash Flow Statement for the Year Ended

Particulars	₹	₹
A: Cash Flows from Operating Activities		
Net Profit for the Year	20,000	
Add: Decrease in Debtors	5,000	
Increase in Creditors	7,000	
Net Cash Flows from Operating Activities		32,000—A
B: Cash Flows from Investing Activities		
Sale of Fixed Assets	20,000	
Net Cash from Investing Activities		20,000—B
C: Cash Flows from Financing Activities		
Redemption of Debtors	(50,000)	
Net Cash from Financing Activities		(50,000)—C
D: Net Increase in Cash and Cash Equivalents (A + B + C) (32,000 + 20,000 – 50,000)		2,000
E: Cash and Cash Equivalents at the beginning		10,000
F: Cash and Cash Equivalents at the End of the Period		12,000

Illustration 16.34

Prepare a cash flow statement on the basis of the information given in the balance sheet of P.S. Ltd.

Dr. **Cr.**

Liabilities	2010 ₹	2011 ₹	Assets	2010 ₹	2011 ₹
Share Capital	2,00,000	2,50,000	Goodwill	10,000	2,000
12% Debtors	1,00,000	80,000	Land and Building	2,00,000	2,80,000
General Reserve	50,000	70,000	Machinery	1,00,000	1,30,000
Creditors	40,000	60,000	Debtors	40,000	60,000
Bills Payable	20,000	1,00,000	Stock	70,000	90,000
Outstanding Expenses	25,000	20,000	Cash	15,000	18,000
	4,35,000	5,80,000		4,35,000	5,80,000

Solution

Cash Flow Statement for the Year Ended 2011

Particulars	₹	₹
A: Cash Flows from Operating Activities		
Closing Balance of General Reserve	70,000	
Less: Operating Balance of General Reserve	(50,000)	
Net Profit: (Before Tax and Extraordinary Items)		20,000
(***Note:*** Net Profit Is Not Disclosed in the Balance Sheet. Only General Reserve Appears Here)		
Add: Items to be Added:		
Amortization of Goodwill	8,000	
Investment on Long-term Loan (Debtors = 1,00,000 × 12/100 × 1)	12,000	20,000
Operating Profit Before Working Capital Charges		40,000
Add: Decrease in Current Assets and Increase in Current Liabilities:		
Increase in Creditors	20,000	
Increase in Bills Payable	80,000	1,00,000
Less: Increase in Current Assets and Decrease in Current Liabilities:		
Decrease in Outstanding Expenses	(5,000)	
Increase in Debtors	(20,000)	
Increase a Stock	(20,000)	(45,000)
Net Cash from Operating Activities		95,000—A
B: Cash Flows from Investing Activities		
Purchase of Land and Building	(80,000)	
Purchase of Machinery	(30,000)	(1,10,000)
Net Cash Used in Financing Activities		(1,10,000)—B

C: Cash Flows From Financing Activities		
Proceeds From Equity Shares	50,000	
Payment of Long Term (Debenture Redeemed)	(20,000)	
Payment of Interest on Debtors	(12,000)	18,000
Net Cash from Financing Activities		18,000—C
D: Net Increase in Cash and Cash Equivalents (A + B + C) (95,000 – 1,10,000 + 18,000)		3,000
E: Cash and Cash Equivalents at the Beginning Cash in Hand		15,000
F: Cash and Cash Equivalents at the End of the Period		18,000

Illustration 16.35

Prepare a cash flow statement of Bulbul Ltd. on the basis of the information given in the balance sheets.

Dr. **Cr.**

Liabilities	**2010** ₹	**2011** ₹	**Assets**	**2010** ₹	**2011** ₹
Equity Share Capital	4,00,000	5,00,000	Goodwill	70,000	50,000
12% Debtors	2,00,000	1,50,000	Land and Building	5,00,000	8,00,000
General Reserve	1,00,000	1,80,000	Machinery	1,20,000	1,30,000
Creditors	40,000	60,000	Debtors	10,000	20,000
Bills Payable	80,000	75,000	Stock	1,40,000	20,000
Outstanding Expenses	55,000	65,000	Cash	35,000	10,000
	8,75,000	10,30,000		8,75,000	10,30,000

Solution

Cash Flow Statement for the Year Ended on 31 December 2011

Particulars	₹	₹
A: Cash Flows from Operating Activities:		
Closing Balance of General Reserve	1,80,000	
Less : Operating Balance of General Reserve	(1,00,000)	
Net Profit Before Tax		80,000
Add: Items to Be Added:		
Amortization of Goodwill	20,000	
Invest on Debenture	24,000	44,000
Operating Profit Before Working Capital Charges		1,24,000
Add: Decrease in Current Assets and Increase in Current Liabilities:		
Decrease in Stock	1,20,000	
Increase in Creditors	20,000	
Increase in Outstanding Expenses	10,000	1,50,000
		2,74,000

Less: Increase in Current Assets and Decrease in Current Liabilities:		
Increase in Debtors	(10,000)	
Decrease in Bills Payable	(5,000)	(15,000)
Cash Generated from Operation:		2,59,000
Less Income Tax Paid		—
Cash from Operating Activities		2,59,000
B: Cash Flows from Investing Activities:		
Purchase of Land	(3,00,000)	
Purchase of Machinery	(10,000)	(3,10,000)
Net Cash Used in Investing Activities		(3,10,000)
C: Cash Flows from Financing Activities:		
Proceeds from Issue of Equity Shares	1,00,000	
Payment for Debentures (Redemption)	(50,000)	
Payment of Interest on Debentures	(24,000)	26,000
Net Cash from Financing Activities		26,000
D: Net Increase/Decrease in Cash and Cash Equivalents (A – B + C) (₹ 2,59,000 – ₹ 3,10,000 + ₹ 26,000)		25,000
E: Cash and Cash Equivalents at the Beginning (Cash)		10,000
F: Cash and Cash Equivalents at the End		35,000

Illustration 16.36

The following balances appeared in plant A/c and accumulated depreciation A/c in the books of Bhart Ltd.

	As on 31 March 2010	As on 31 March 2011
	₹	₹
Plant	7,50,000	9,70,000
Accumulated Depreciation	1,80,000	2,40,000

Additional information:

Plant costing ₹ 1,45,000 accumulated depreciation thereon ₹ 70,000 was sold for ₹ 35,000. You are required to do the following:

1. Compute the amount of plant purchased, depreciation charged for the year and loss on sale of plant.
2. Show how each of the items related to the plant will be shown in the cash flow statement.

Solution

Note:

1. Students have to prepare
   (i) Plant account
   (ii) Accumulated depreciation account

2. From the balancing figures obtained in each account, inflow or outflow of cash has to be found out. Accordingly it has to be treated in cash flow statement.

I. Plant Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d (Opening Fig.)	7,50,000	By Accumulated Depreciation A/c (Given in Additional Information)	70,000
*[1] To * Bank A/c (Purchase) (Balancing Figure)	3,65,000	By Bank A/c (Sales) (Given in Additional Information)	35,000
		By Profit and Loss A/c (Loss on Sale; 1,45,000 – 70,000 – 35,000)	40,000
		By Balance c/d (Closing Fig.)	9,70,000
	11,15,000		11,15,000

II. Accumulated Depreciation Account

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Plant A/c (Given in Information)	70,000	By Balance b/d (Opening Fig.)	1,80,000
To Balance c/d (Closing Figure)	2,40,000	*[2] By * Profit and Loss A/c (Bal. Fig) (Dep. Charged)	1,30,000
	3,10,000		3,10,000

(i) Sale of plant: Given in additional information: ₹35,000: Inflow of cash: 'investing activities'

(ii) Purchase of plant: Balancing figure in the plant account: ₹3,65,000: Outflow of cash: 'investing activities'

(iii) Loss on sale of plant: (From plant account) ₹1,45,000 – ₹70.000 – ₹35,000 = ₹40,000 will be added back to net profit of the year while preparing cash flow statement.

(iv) Depreciation charged: ₹1,30,000 (balancing figure in accumulated depreciation account) will also have to be added to net profit.

(Model: Both direct and indirect methods—preparation of cash flow statement)

Illustration 16.37

Comparative balance sheets for 2009 and 2010 and income statement of for 2010 of PQR Ltd. are presented as follows.

Comparative Balance Sheets
As on 31 December

	2010 ₹	2009 ₹
Assets:		
Cash	27,000	36,000
Short-term Investments	6,000	3,000

Debtors	2,85,000	2,37,000
Provision for Doubtful Debts	(9,000)	(6,000)
Inventory	3,09,000	2,76,000
Prepaid Expenses	18,000	15,000
Land	2,07,000	1,98,000
Machinery and Equipment	5,16,000	4,68,000
Provision for Depreciation	(3,39,000)	(3,06,000)
	10,20,000	9,21,000
Liabilities:		
Creditors	1,98,000	2,34,000
Dividends Payable	6,000	—
Income Tax Payable	9,000	15,000
Long-term debt	2,25,000	1,26,000
Equity Share Capital	78,000	78,000
P & L Appropriation Account	5,04,000	4,68,000
	10,20,000	9,21,000

Income Statement for the Year Ended on 31 December 2010

Particulars	₹
Net Sales Revenue	18,00,000
Cost of Good Sold	(15,00,000)
Gross Margin	3,00,000
Operating Expenses	(1,98,000)
Operating Income	1,02,000
Indirect Expenses	(12,000)
Income Before Tax	90,000
Lawsuit Compensation	15,000
	1,05,000
Income Tax	(51,000)
Net Income	54,000

The following additional information is available:

(i) Dividends declared during 2010 is ₹ 18,000

(ii) Market price per share on 31 December 2010 is ₹ 14.50

(iii) Equipment worth ₹ 48,000 was acquired by the issuance of long-term note ₹ 30,000 and by paying cash of ₹ 18,000

(iv) Land was acquired for ₹ 9,000

(v) There were no accruals and prepaid amounts of interest.

Instructions:

1. Prepare a cash flow statement [As per AS-3 (Revised)]
2. Short-term investments are assumed to be a part of cash and cash equivalents

Solution

I—Indirect Method

PQR Ltd. Statement for Cash Flows
for the Year Ended on 31 December 2010 [AS-3 (Revised)]

Particulars	₹	₹
A: Cash Flows from Operating Activities:		
Net Income Before Tax and Extraordinary Items Adjustments for:	90,000	
Depreciation	33,000	
Interest Expense	12,000	
Provision for Doubtful Debts	3,000	
Operating Profit Before Working Capital Changes	1,38,000	
Increase in Debtors	(48,000)	
Increase in Inventories	(33,000)	
Increase in Prepaid Expenses	(3,000)	
Decrease in Creditors	(36,000)	
Cash Generated from Operations	18,000	
Taxes Paid	(57,000)	
Cash Flow from Extraordinary Item	(39,000)	
Law Suit Compensation	15,000	
Net Cash Used in Operating Activities		(24,000)
B: Cash Flows from Investing Activities:		
Purchase of Land	(9,000)	
Purchase of Equipment	(18,000)	
Net Cash Used in Investing Activities		(27,000)
C: Cash Flows from Financing Activities:		
Proceeds from Long-term Borrowings	69,000	
Dividends Paid	(12,000)	
Interest Paid	(12,000)	
Net Cash from Financing Activities		45,000
Net Decrease in Cash and Cash Equivalents: (A + B + C)		(6,000)
Cash and Cash Equivalents at the Beginning		39,000
Cash and Cash Equivalents at the End		33,000
Significant Non-cash Transaction Purchase of Equipment for Long-term Note: ₹ 30,000		

II—Direct Method

Statement of Cash Flows of POR Ltd.
for the Year Ended on 31 December 2010 [AS-3 (Revised)]

Particulars	₹	₹
A: Cash Flows from Operating Activities		
Cash Receipts from Customers	1752,000	
Cash Paid to Suppliers and Employees	17,34,000	
Cash Inflows from Operations	18,000	
Income Tax Paid	(57,000)	
Cash Flow from Extraordinary Item	(39,000)	
Law Suit Compensation	15,000	
Net Cash Used in Operating Activities		(24,000)
B: Cash Flows from Investing Activities:		
Purchase of Land	(9,000)	
Purchase of Equipment	(18,000)	
Net Cash Used in Investing Activities		(27,000)
C: Cash Flows from Financing Activities:		
Proceeds from Long-term Borrowings	69,000	
Dividends Paid	(12,000)	
Interest Paid	(12,000)	
Net Cash from Financing Activities…		45,000
Net Decrease in Cash and Cash Equivalents (A + B + C)		(6,000)
Cash and Cash Equivalents at the Beginning		29,000
Cash and Cash Equivalents at the End		33,000

Significant Non-cash Transaction

Purchase of Equipment for Long-term Note ₹ 30,000

Calculations	₹
1. Calculation of Cash Receipts from Customers:	
Sales Revenue	18,00,000
Add: Sundry Debtors at the Beginning	2,37,000
	20,37,000
Less: Sundry Debtors at the End	2,85,000
	17,52,000
2. Calculation of Cash Paid to Suppliers and Employees:	
Cost of Goods Sold	15,00,000
Operating Expenses	1,62,000
[₹ 1,98,000 – ₹ 33,000 (Depreciation) – ₹ 3,000 (Provision for Doubtful Debts)	
	16,62,000

Add: Creditors at the Beginning	
Payments at the End	2,34,000
Inventories at the End	18,000
	22,23,000
Less: Creditors at the End	(1,98,000)
Payments at the Beginning	(15,000)
Inventories at the Beginning	(2,76,000)
	17,34,000
3. Calculation of IT Paid:	
Income Tax Expense	51,000
Add: IT Liabilities at the Beginning	15,000
	66,000
Less: IT Liabilities at the End	(9,000)
	57,000
4. Calculation of Dividend Paid:	
Amount Appropriated	18,000
Less: Liability at the End	6,000
	12,000

Summary

Cash flow statement depicts sources of cash inflows and transactions of cash outflows during a period. It is a statement indicating flow of cash and cash equivalents during a period.

Now, preparation of cash flow statement is mandatory for all the companies. It is also mandatory for all business entities, which has turnover of more than ₹ 50 crores in a financial year.

Main 'sources' of cash inflows are the following:

(i) Proceeds from sale of long-term assets
(ii) Long-term borrowings
(iii) Cash receipts from raising additional share capital
(iv) Business operations
(v) Cash receipts from non-business operations (e.g. investment, dividends, etc.)

Main 'uses of cash' (or) cash outflows are as follows:

(i) Payment of dividend interest
(ii) Purchase of assets
(iii) Redemption of debentures
(iv) Repayment of borrowings

The cash flow statement shows cash flows (inflow and outflow) in terms of three components as per accounting standard-3: (i) operating, (ii) investing and (iii) financing activities.

The cash flow statement shows the net increase/decrease of cash and cash equivalents under each activity individually and collectively.

Cash flows from operating activities result from the major revenues producing activities of a business concern. The major operating items are: cash inflow (cash sales), cash received from debtors, cash proceeds from extraordinary items, royalty, commission, etc.) and cash outflow (cash purchases, cash paid to suppliers and employees and cash operating expenses, income tax, etc.)

Major investing activities are cash inflows: sale of fixed assets, investments, interest and dividends, received and cash outflows: purchase of fixed assets and investments.

Major financing activities are cash inflows: issue of shares in cash, issue of debentures, proceeds from long-term borrowings and cash outflows; redemption of preference shares/debentures, repayment of loans, buy-back of equity shares, payment of interest and dividend, etc.

Importance of (activities) cash flow statement—operating activities—net cash flow is an indicator to assets cash generation and to forecast future cash flows.

Investing activities: To study the net result of the amount spent on investment, usefulness of such expenditure and thereby the future income from such investments.

Financing activities: To assess claims on future cash flows.

Important steps to prepare cash flow statement:

Step 1: Cash flow from operating activities is computed either by direct or indirect method.

Step 2: Net cash flow from investing activities is calculated.

Step 3: Net cash flow from financing activities is determined.

Step 4: Net flow, i.e. net increase or decrease in cash or cash equivalents is determined from Steps 1–3.

Step 5: Cash and cash equivalent balance at the beginning of the period is added to the net cash flows determined in Step 4.

Step 6: The amount arrived in Step 4 must be equal to cash and cash equivalents balance at the end of the year.

Key Terms

Cash Equivalents: Short-term, highly liquid investments that are readily convertible into known amount of cash.

Cash Flow Statements: A statement that shows the flow of cash and equivalents during a period.

Cash Flow: Inflow and outflow of cash and equivalents.

Cash: Cash constitutes cash on banks.

Debenture: A debt security with a general claim against all assets.

Debtor: A person who owes money to another; (or) a business enterprise that owes money to another.

Direct Method: The method that calculates net cash provided by operating activities.

Financing Activities: Activities that result in change in size and composition of the owners' capital and borrowing of the enterprises.

Indirect Method: The method that adjusts net income to reveal only.

Investing Activities: Activities that result in change in size and composition of fixed assets and long-term investments.

Operating Activities: Principal revenue-producing activities of business enterprises that are not investing and financing activities.

QUESTION BANK

Objective Type Questions

I: State whether the following statements are true or false

1. Inflow of cash refers to all transactions, which lead to increase in cash and cash equivalents.
2. Outflow of cash refers to all transactions, which lead to decrease in cash and cash equivalents.
3. Non-cash transactions are covered in cash flow statements.
4. Cash sales is cash outflow.
5. Cash receipts from debtors is a financing activity.
6. Cash payment relating to a future contract is an investing activity.

7. Cash receipts from debtors is treated as cash inflow for operating activities.
8. Cash receipts on interest and dividend is treated as cash inflow for financing activities.
9. Cash proceeds from issuing share is treated as cash inflow from financing activities.
10. Cash receipts from sale of fixed assets is shown as cash inflow from financing activities.
11. Cash payment to creditors is treated as cash outflow for investing activities.
12. The cash flow statement is based upon accrual basis of accounting.
13. Redemption of preference shares is an investing activity.
14. Cash payment to income tax is an operating activity.
15. Repayment of any finance liability is a financing activity.
16. Cash proceeds from long-term borrowings is an investing activity.
17. Cash receipts from royalties is an operating activity.
18. Cash flow statement is concerned with change in working capital position between the two different dates of balance sheet.
19. Cash payment to creditors is a financing activity.
20. Accounting standard (AS)-3 sets standards to the preparation of cash flow statement.
21. Bank balance is cash equivalent in the preparation of cash flow statement.
22. Decrease in current assets will result in increase in cash.
23. Increase in current liabilities will result in decrease in cash.
24. If there is net loss (negative cash from operation), then there is net outflow of cash from operating activities.
25. Acquisition and disposal of long-term asset is termed as 'investing activities' of a concern.
26. A change in owners' capital and borrowing capital is revealed in cash flow from financing activities of a concern.
27. If there is negative cash from activities, then there will be net inflow of cash.
28. Revaluation of building affects cash flows.
29. Sources and uses of cash are to be equal.
30. Sources of cash should always be more than uses of cash.

Answers:

1. True	2. True	3. False
4. False	5. False	6. True
7. True	8. False	9. True
10. False	11. False	12. False
13. False	14. True	15. True
16. False	17. True	18. False
19. False	20. True	21. True
22. True	23. False	24. True
25. True	26. True	27. False
28. False	29. False	30. False

II: Fill in the blanks with apt word(s)

1. Cash flow refers to the movement both inflow and outflow of_____ and_____during a period.
2. Cash flow statement is a _____ which shows flow of cash and cash equivalents during a period.
3. Cash flow statement is based on past records. So it is _____ in nature.
4. Cash equivalents are usually of short term, but highly _____ investments.
5. Cash equivalents reveal that change is _____ and _____.
6. Cash flow statement (based on AS-3) should be prepared and presented under _____ method.
7. Taxes paid on income should be shown separately as the cash flows from _____ activities.
8. Decrease in creditors _____ cash.
9. The activities that result in changes in the size and composition of the owner's capital and borrowing of the enterpriser are _____ activities.
10. Decrease in inventory _____ cash.
11. Buy-back of shares is shown under _____.
12. Increase in pre-paid expenses _____ cash.
13. Dividends paid are classified under _____.
14. Cash payments to suppliers of goods and services are shown under _____.
15. Long-term assets acquired are classified under _____ activities.

Answers:

1. cash and cash equivalents
2. statement
3. historic
4. liquid
5. cash and cash equivalents

6. indirect
7. operating
8. decreases
9. financing activities
10. increases
11. financing activities
12. decreases
13. financing activities
14. operating
15. investing

III: Multiple choice questions—Choose the correct answer

1. The cash flow statement is based on
   (a) cash basis of accounting
   (b) accounting equation
   (c) accrual basis of accounting
   (d) none of the above
2. Dividend paid is always classified as
   (a) operating activity
   (b) investing activity
   (c) financing activity
   (d) none of the above
3. Proposed dividend is classified as
   (a) investing activity
   (b) financing activity
   (c) operating activity
   (d) cash equivalent
4. Interest received by (other than) financial concerns is classified as
   (a) investing activity
   (b) financing activity
   (c) operating activity
   (d) cash equivalent
5. Profit on sale of machinery comes under
   (a) investing activity
   (b) financing activity
   (c) operating activity
   (d) none of the above
6. Sale of patents is classified under
   (a) investing activity
   (b) financing activity
   (c) operating activity
   (d) cash equivalent
7. Rent received by a company (whose main business is real estate) is classified as
   (a) investing activity
   (b) financing activity
   (c) operating activity
   (d) cash equivalent
8. Rent received by a company (whose main business is manufacturing) falls under
   (a) investing activity
   (b) financing activity
   (c) operating activity
   (d) cash equivalent
9. Sale of investments by a finance company is classified as
   (a) investing activity
   (b) financing activity
   (c) operating activity
   (d) cash equivalent
10. Sale of investments by a non-finance company comes under
    (a) investing activity
    (b) financing activity
    (c) operating activity
    (d) none of the above

Answers:

1. (a)	2. (b)	3. (c)
4. (a)	5. (c)	6. (a)
7. (a)	8. (b)	9. (c)
10. (a)		

Short Answer Questions

1. Explain ‘cash flow’.
2. Define ‘cash flow statement’.
3. What do you mean by cash equivalent? Give two examples.
4. Name the classification of cash flows from business transactions while preparing cash flow statements as per (AS)-3.
5. What do you mean by operating activities?
6. What is meant by investing activities?
7. What are financing activities?
8. Mention the two methods of cash flow from operating activities.
9. Give four examples for operating activities.
10. Give four examples for investing activities.

11. Give four examples for financing activities.
12. Identify the transactions as belonging to
    (a) operating,
    (b) investing,
    (c) financing and
    (d) cash equivalent activities
        (i) short-term deposit in banks
        (ii) cash credit
        (iii) issue of share capital
        (iv) repayment of long-term loan
        (v) cash received from debtors
        (vi) sale of patents
        (vii) commission received
        (viii) income tax paid
13. When does the flow of cash arise?
14. What are non-cash expenses? Give any four examples.
15. Explain current assets. Give four examples.
16. How an increase/decrease in current assets will affect cash flows?
17. Explain current liabilities: Give four examples.
18. How an increase/decrease will affect cash flows?
19. How the cash flow from investing activities is ascertained?
20. How the cash flow from financing activities is ascertained?

Essay Type Questions

1. Explain cash flow statement. Elucidate the main objectives of cash flow statement.
2. 'The analysis of cash flow statement in any organization can be very useful to the management'. Discuss.
3. What are the limitations of cash flow statement?
4. Explain the following terms by citing two examples each:
    (i) cash equivalents
    (ii) cash flow (including movement between the items of cash or cash equivalents)
    (iii) operating activities
    (iv) investing activities
    (v) financing activities.
5. Explain the classification of businesses activities as per AS-3, showing the inflow and outflow of cash.
6. Explain the accounting treatment for the following while calculating cash flow from operating activities under direct method.
    (i) cash inflow from debtors (sales)
    (ii) cash inflow from operating income
    (iii) cash outflow to creditors (purchases)
    (iv) cash outflow on expenses (both outstanding and paid in advance)
    (v) non-cash expenses and appropriations
7. Explain the accounting treatment in the preparation of cash flow from operating activities under indirect method for the following items:
    (i) net profit before tax
    (ii) non-cash and non-operating items
    (iii) changes in current assets and current liabilities
    (iv) fixed assets
8. Explain the accounting treatment for the following while preparing cash flow from investing activities.
    (i) fixed assets (shown at written down value)
    (ii) fixed assets (shown at cost and accumulated depreciation is separately maintained)
9. Explain the accounting treatment for the following items while preparing cash flow from financing activities.
    (i) dividend (proposed dividend and interim dividend)
    (ii) taxes on income
    (iii) discount on issue of shares/debentures (amount of discount written off and amount of discount allowed during the year)
10. Draw the format for cash flow statement (operating activities) by direct method as per (AS)-3 (Revised).
11. Draw the format for cash flow statement (operating activities) by indirect method as per (AS)-3 (Revised).
12. Differentiate between 'funds flow' statement and 'cash flow' statement.

Exercises

Part A—For Undergraduate Level

1. Calculate cash flow from operating activities from the following information.

Particular	2010	2011
	₹	₹
Stock	60,000	50,000
Debtors	25,000	23,000
Creditors	32,000	28,000
Expenses Outstanding	3,500	4,500
Bills Payable	35,000	22,000
Accrued Income	8,000	9,000
Profit and Loss A/c	80,000	90,000

[Ans.: Net cash flow from operating activities: ₹5,000]

2. X Ltd. made a profit of ₹1,00,000 after charging depreciation of ₹20,000 on assets and a transfer to general reserve of ₹30,000. The goodwill written off was ₹7,000 and the gain on sale of machineries was ₹3,000. The other information available: charges in the value of current assets and current liabilities. At the end of the year debtors show an increase of ₹6,000; creditors an increase of ₹10,000. Prepaid expenses and increase of ₹200; bills receivable a decrease of ₹3,000; bills payable at decrease of ₹4,000; and outstanding expenses a decrease of ₹2,000. Ascertain cash flow from operating activities.

   [Ans.: Net cash flow from operating activities: ₹1,54,800]

3. X Ltd. made a profit of ₹1,20,000 after charging depreciation of ₹20,000 on assets and a transfer to general reserve of ₹30,000. The goodwill written off was ₹7,000 and the gain on sale of the machineries was ₹3,000. Changes in the value of current assets and liabilities at the end of the year:

   Debtors showed an increase of ₹6,000; creditors an increase of ₹10,000; prepaid expenses an increase of ₹200; bills receivable a decrease of ₹3,000; bills payable a decrease of ₹4,000 and outstanding expenses a decrease of ₹2,000.

   Ascertain cash flow from operating activities.

   [Ans.: Net cash from operating activities: ₹1,74,800]

4. On 31 March 2011 Y Ltd. made a profit of ₹1,25,000 after considering the following.

Depreciation on Billings	₹25,000
Depreciation on Plant and Machinery	₹45,000
Amortization or Goodwill	₹20,000
Gain on Sale of Machinery	₹10,000

   The Current Assets and Current Liabilities:

	1.4.2010	31.3.2011
	₹	₹
Accounts Receivable	35,000	45,000
Stock on Hand	75,000	69,000
Cash on Hand	18,000	30,000
Accounts Payable	30,000	32,000
Expenses Payable	10,000	5,000
Bank Overdraft	60,000	35,000

   Ascertain Cash Flow from Operating Activities

   [Ans.: Net cash flow from operating activities: ₹1,98,000]

5. Calculate net cash flows from operating activities from the following details.

Profits Earned During the Year 2011	50,000
Transfer to General Reserve	10,000
Depreciation Provided	20,000
Profit on Sale of Furniture	5,000
Loss on Sale of Machineries	10,000
Preliminary Expenses Retain off	10,000

Particulars	2010	2011
	₹	₹
Accounts Receivable	35,000	45,000
Debtors	10,000	15,000
Bills Receivable	7,000	5,000
Stock	15,000	18,000
Prepaid Expenses	2,000	3,000
Bills Expenses	15,000	25,000
Creditors	20,000	18,000
Outstanding Expenses	3,000	4,000

   [Ans.: Net cash from operating activities: ₹87,000]

6. Y Ltd. made a net profit of ₹15,000 for the year ending on 31 March 2011 after taking the following into consideration.

Depreciation on Plant and Machinery	15,000

Depreciation on Buildings	45,000
Amortization of Goodwill	20,000
Loss on Sale of Machinery	5,000

Current assets and current liabilities at the beginning and at the end of the year

Particulars	1.4.2010	31.3.2011
	₹	₹
Accounts Receivables	35,000	40,000
Stock in Hand	55,000	42,000
Cash in Hand	12,000	2,000
Expense Due	6,000	8,000
Accounts Payable	60,000	53,000

Calculate cash flow from operating activities

[Ans.: Cash flow from operating activities: ₹97,000]

7. The following balances appeared in machinery account and accumulated depreciation account in the books of XYZ Ltd.

	31 March 2010	31 March 2011
	₹	₹
Machinery Account A/c	17,78,985	26,55,450
Accumulated Depreciation A/c	3,40,795	4,75,690

Additional Information:

A machinery costing ₹2,60,000 on which accumulated depreciation ₹1,00,000 was sold for ₹75,000. You are required to

1. Compute the amount of machinery purchased depreciation charged for the year and loss on sale of machinery.
2. How shall each of the items related to machinery be shown in cash flow statement?

[Ans.:

1. Amount spent on purchase of machinery ₹11,41,465
2. Depreciation charged for the year ₹2,34,895
3. Loss on sale of machinery ₹90,000]

8. Calculate the cash flow from operating activities form the following information.

Profit for the Year	₹50,000
Transfer to General Reserve	₹10,000
Depreciation Provided	₹20,000
Profit on Sale of Furniture	₹5,000
Loss on Sale of Furniture	₹10,000
Preliminary Exp. Written off	₹10,000

Particulars	31 March 2008	31 March 2009
	₹	₹
Debtors	10,000	15,000
Bills Receivable	7,000	5,000
Stock	15,000	18,000
Prepaid Expenses	2,000	3,000
Creditors	20,000	18,000
Bills Payable	15,000	25,000
Outstanding Expenses	3,000	4,000

[Ans.: Net cash flow from operating activities: ₹97,000]

9. From the following summarized balance sheets of a company, compute cash flow from operating activities.

Dr. **Cr.**

Liabilities	2010	2011	Assets	2010	2011
	₹	₹		₹	₹
Creditors	20,000	25,000	Cash	20,000	10,000
Bills Payable	20,000	5,000	Investments	40,000	30,000
Other Current Liabilities	40,000	45,000	Stock	30,000	45,000
6% Debentures	60,000	80,000	Debtors	30,000	40,000
Profit and Loss A/c	80,000	1,10,000	Gross Block	1,00,000	1,40,000
	2,20,000	2,65,000		2,20,000	2,65,000

[Ans : (i) Net profit before tax and extraordinary items: ₹30,000

(ii) Net cash flow operating activities: ₹3,600]

10. From the following summarized balance sheets of a company calculate cash flow from operating activities.

Dr. **Cr.**

Liabilities	2010 ₹	2011 ₹	Assets	2010 ₹	2011 ₹
Creditors	20,000	25,000	Cash	20,000	30,000
Bills Payable	20,000	25,000	Investments	40,000	30,000
Other Current Liabilities	40,000	45,000	Stock	30,000	45,000
6% Debentures	60,000	80,000	Debtors	30,000	40,000
Profit and Loss A/c	90,000	1,10,000	Gross Block	1,00,000	1,40,000
	2,30,000	2,85,000		2,30,000	2,85,000

[Ans.: Cash flow from operating activities: ₹13,600]

11. From the following statement compute cash generated from operating activities. Statement of profit for the year ending on 31 March 2011.

Dr. **Cr.**

Particulars	₹	Particulars	₹
To Salaries	10,000	By Gross Profit	80,000
To Rent	5,000	By Profit on Sale	10,000
To Depreciation	20,000	of Machinery	
To Loss on Sale	5,000	By Dividend	3,000
of Building		Received	
To Goodwill Written off	8,000	By Commission Acquired	4,000
To Proposed Dividend	10,000		
To Provision for Tax	10,000		
Net Profit	29,000		
	97,000		97,000

[**Ans.:** Cash generated from operating activities: ₹55,000]

12. From the following summarized balance sheets calculate flow from operating activities.

Liabilities	2010 ₹	2011 ₹	Assets	2010 ₹	2011 ₹
Creditors	30,000	45,000	Cash	30,000	50,000
Bills Payable	30,000	35,000	Investments	50,000	40,000
Other Current Liabilities	50,000	55,000	Stock	40,000	65,000
Share Capital	1,00,000	1,30,000	Debtors	40,000	50,000
Profit and Loss A/c	80,000	1,00,000	Fixed Assets	1,30,000	1,60,000
	2,90,000	3,65,000		2,90,000	3.65,000

[**Ans.:** Cash flow from operating activities: ₹10,000]

13. A company had the following balances; investment at the beginning of the period is ₹46,000. Investment at the end of the period is ₹30,000. During the year, the company sold 60% of its investment held at the beginning of the period at a profit of ₹10,000. Calculate the cash flow from investing activities.

[**Ans.:** Cash flow from investing activities: ₹26,000]

[**Hint:** Investment A/c (Bal. Fig.): ₹11,600]

14. From the following information calculate cash flow from investing activities.

Investment at the beginning of the period: ₹25,000

Investment at the end of the period: ₹24,000

During the year, the company sold 40% of its investments held at the beginning of the period at a profit of ₹9,000

[**Ans.:** Cash flow from investing activities: ₹20,000]

[**Hint:** Purchase value {₹9,000}]

15. From the following particulars calculate cash flow from investing activities.

	Purchase	Sold
	₹	₹
Investment	2,30,000	1,40,000
Goodwill	1,75,000	—
Machinery	5,30,000	2,10,000
Patents	—	75,000

Interest received on debentures held as an investment ₹18,000. Dividend received on shares held as investments ₹25,000. A part of the building was purchased out of surplus funds for investment purposes, which earned ₹75,000 by way of rent.

[**Ans.:** Net cash used in investing activities: ₹3,92,000]

16. From the following information calculate cash flow from investing activities.

	31 March 2010	31 March 2011
	₹	₹
Machinery	5,00,000	5,50,000
Accumulated Depreciation	1,00,000	1,20,000
Patent Rights	3,00,000	1,80,000

Additional Information:

(a) During the year, a machine costing ₹50,000 with accumulated depreciation of ₹30,000 was sold for ₹25,000.

(b) Patents were written off to the extent of ₹30,000 and some patents were sold at a profit of ₹25,000

[**Ans.:** Net cash flow from investing activities: ₹40,000]

[Hint: Balancing figures: machinery A/c is ₹1,00,000, accumulated depreciation A/c is ₹50,000 and patents account is ₹1,15,000]

17. Ajay & Co. has plant and machinery, whose written down value on 1 April 2008 was ₹7,50,000 and on 31 March 2009 was ₹9,00,000. Depreciation for the year was ₹30,000. At the beginning of the year, a part of the plant was sold for ₹20,000, which had a written down value of ₹16,000.

[Ans.: Net cash flow from investing activities: ₹1,76,000]

[**Hint:** Plant & machinery A/c Bal. Fig.: ₹1,96,000]

18. Calculate cash flow from financial activities from the following information.

	31 March 2010	31 March 2011
	₹	₹
Equity Share Capital	6,00,000	8,00,000
9% Debentures	2,00,000	1,00,000
Securities Premium	50,000	75,000

Additional Information:

Interest paid on debentures is ₹18,000.

[**Ans.:** Net cash from financing activities: ₹1,07,000]

19. A public limited company provides the following figures. Calculate the net cash flow from financing activities.

	31 March 2010	31 March 2011
	₹	₹
Equity Share Capital	8,00,000	12,00,000
10% Debentures	1,50,000	—
6% Debentures	—	3,00,000

Additional Information:

(i) Interest paid on debentures: ₹15,000

(ii) Dividend paid: ₹40,000

(iii) During the year 2010–11, the company issued bonus shares in the ratio of 2:1 by capitalizing the reserve.

[**Ans.:** Net cash flow financing activities: ₹95,000]

20. Calculate cash flow from (i) investing activities and (ii) financing activities from the following information.

	31 March 2010	31 March 2011
	₹	₹
Furniture (at Cost)	30,000	40,000
Accumulated Depreciations Furniture	7,000	10,000
Capital	1,50,000	2,25,000
Loan from Bank	40,000	25,000

During the year 2010–11, furniture costing ₹5,000 was sold at a profit of ₹3,000. Depreciation charged during the year was ₹6,000.

[**Ans.**

1. Net cash from financing activities: ₹60,000
2. Net cash flow from investing activities: ₹10,000]

[**Hint:** Sale price: ₹5,000; Furniture purchased: ₹15,000; Accumulated depreciation: ₹3,000]

21. From the following summary cash account of XYZ Ltd. you are required to prepare a cash flow statement for the year ended on 31 March 2011 in accordance with AS-3.

Summary Cash Account for the Year Ended on 31 March 2011

Dr. **Cr.**

Particulars	₹	**Particulars**	₹
Opening Balance	50,000	Payment to Suppliers	20,00,000
Issue of Equity Shares	3,00,000	Purchase of Fixed Assets	2,00,000
Receipts from Customers	28,00,000	Overhead Expenses	2,00,000
Sale of Fixed Assets	1,00,000	Wages and Salaries	1,00,000
		Taxation	2,50,000
		Dividend	50,000
		Repayment of Loan	3,00,000
		Closing Balance	1,50,000
	32,50,000		32,50,000

[**Ans.:**

1. Net cash from operating activities: ₹2,50,000
2. Net cash used in investing activities: (₹1,00,000)
3. Net cash used in financing activities: (₹50,000)]

22. The balance sheet of J.K. Ltd. as on 31 March 2010 and 31 March 2011 are as follows:

Dr. **Cr.**

Liabilities	**31 March 2010** ₹	**31 March 2011** ₹	**Assets**	**31 March 2010** ₹	**31 March 2011** ₹
Share Capital	1,60,000	1,80,000	Fixed Assets	80,000	1,12,000
Profit and Loss A/c	60,000	96,000	Inventories	40,000	28,000
Creditors	40,000	60,000	Debtors	1,20,000	1,80,000
Liabilities for Expenses	12,000	20,000	Cash and Bank Balance	20,000	28,000
Advance Income	8,000	4,000	Prepaid Expenses	12,000	8,000
			Deferred Expenses	8,000	4,000
	2,80,000	3,60,000		2,80,000	3,60,000

Additional Information:

An old machine was sold for ₹20,000, which had a written down value of ₹10,000; dividend paid during the year was ₹16,000 and depreciation charged to profit and loss account for the year amounted to ₹10,000. Prepare the cash flow statement.

[**Ans.:**

1. Cash flow from operating activities: ₹36,000
2. Cash used in investing activities: ₹32,000
3. Cash flow from financing activities: ₹4,000]

Exercises

Part B—For Advanced Level

23. X Ltd. gives you the following information for the year ended on 31 March 2011:
    (a) Sales for the year totalled is ₹48,00,000. The Company sells goods for cash only.
    (b) Cost of goods sold was 60% of the sales. Closing inventory was higher than the opening inventory by ₹21,500. Trade creditors on 31 March 2011 exceeded those on 31 March 2010 by ₹11,500.
    (c) Net profit before tax was ₹6,90,000. Tax paid amounted to ₹3,50,000. Depreciation on fixed assets for the year was ₹1,57,000, whereas other expenses totalled ₹10,72,500. Outstanding expenses on 31 March 2010 and 31 March 2011 totalled ₹41,000 and ₹45,000, respectively.
    (d) New machinery and furniture costing ₹5,13,750 in all were purchased.
    (e) A right issue was made of 1,000 equity shares of ₹250 each at a premium of ₹75 per share. The entire money was received along the applications.
    (f) Dividends and corporate dividend tax totalling ₹2,03,500 were paid.
    (g) Cash in hand and at bank as on 31 March 2010 totalled ₹1,06,900.

    You are required to prepare cash flow statement using indirect method.

    [B.Com (Hons)—Delhi 2007, Modified]

    [**Ans.:** Net cash from operating activities: ₹4,92,000

    Net cash used in investing activities: ₹(5,13,750)

    Net cash from financing activities: ₹1,21,500]

24. The following data were provided by the accounting records of X Ltd. as the year ended on 31 March 2011:

	₹
Sales	40,00,000
Cost of Goods Sold	(24,00,000)
Gross Profit	16,00,000
Operating Expenses (Including Depreciation)	(2,00,000)
Indirect Expenses Paid	(1,20,000)
Interest Income Received	40,000
Gain on Sale of Investments	60,000
Loss on Sale of Plant	(20,000)
Net Profit Before Tax	7,60,000
Provision for Income Tax	(2,80,000)
Net Profit After Tax	4,80,000

Balance Sheets

Assets	**As on 31 March 2011** ₹	**As on 31 March 2010** ₹
Plant	28,00,000	20,00,000
Less: Accumulated Depreciation	(4,00,000)	(3,20,000)
	24,00,000	16,80,000
Investment (Long-term)	4,00,000	6,40,000
Inventory	6,00,000	4,40,000
Accounts Receivable	1,80,000	2,20,000
Cash at Bank	2,00,000	1,80,000
	37,80,000	31,60,000
Liabilities	₹	₹
Equity Share Capital	16,00,000	8,00,000
Securities Premium	80,000	-
General Reserve	6,00,000	5,20,000
P & L A/c	1,40,000	32,000
Debentures	10,00,000	14,00,000
Accounts Payable	2,40,000	2,08,000
Provision for Tax	1,20,000	2,00,000
	37,80,000	31,60,000

Additional Information:

(i) Sol investment for ₹3,00,000.

(ii) Issued equity shares of ₹10 each at 10% premium.

(iii) Sold plant that cost ₹48,000 with accumulated depreciation of ₹8,000 for ₹20,000.

(iv) Paid dividend.

You are required to prepare cash flow statement as per AS-3 (Revised)

[B.Com (Hons)—Delhi 2008, Modified]

[**Ans :** Net cash from operating activities: ₹4,40,000

Net cash used in investing activities: ₹(4,88,000)

Net cash from financing activities: ₹68,000

Net increase in cash and cash equivalents: ₹20,000]

25. The data given ahead were provided by the accounting records of Shuchi diamonds Ltd.:

Income Statement

(for the Year Ended on 31 March 2010)

		₹
Sales		3,49,000
Cost of Goods Sold		(2,60,000)
Gross Margin		89,000
Operating Expenses (Including Depreciation Expenses of ₹18,500)		(73,500)
		15,500
Other Income (Expenses):	₹	
Interest Expenses Paid	(11,500)	
Interest Income Received	3,000	
Gain on Sale of Investments	6,000	
Loss on Sale of Plant	(1,500)	(4,000)
Provision Before Tax		11,500
Provision for tax		(3,500)
Provision After Tax		8,000

Comparative Balance Sheets (as on 31 March)

Liabilities	2011	2010	Assets	2011	2010
Share Capital:	2,32,500	1,57,500	Plant Assets	3,57,500	2,52,500
Reserves and Surplus	70,000	66,000	Less: Accumulated Depreciation	(51,500)	(34,000)
Current Liabilities:				3,06,000	2,18,500
Account Payable	25,000	21,500	Investment (Long Term)	57,500	63,500
Accrued Liabilities	6,000	4,500	Current Assets:		
Income Tax Payable	1,500	2,500	Inventory	72,000	55,000
Secured Loan:			Accounts Receivable	23,500	27,500
Bonds	1,97,500	1,22,500	Cash	23,000	7,500
			Prepaid Expenses	500	2,500
	4,82,500	3,74,500		4,82,500	3,74,500

Analysis of selected transactions and accounts during 2010–11:

(i) Sold investments costing ₹45,000 for ₹51,000. Some investments were purchased for cash.

(ii) Sold plant assets that cost ₹5,000 with accumulated depreciation of ₹1,000 for ₹2,500.

(iii) Issued ₹50,000 of bonds at face value in exchange for plant assets on 31 March 2011. Some plant assets were purchased for cash also.

(iv) Repaid ₹25,000 of bonds as face value as majority.

(v) Issued 7,500 shares of ₹10 each for cash at par.

(vi) Paid cash dividends ₹4,000—ignore corporate dividend tax.

Prepare cash flow statement for the year ended on 31 March 2011 as per AS-(3) (Revised) using indirect method.

[B.Com (Hons)—Delhi 2009, Modified]

[**Ans:** Net cash from operating activities: ₹23,500

Net cash used in investing activities: ₹(42,500)

Net cash from financing activities: ₹34,500]

26. From the information given below relating to Pooja Ltd., you are required to prepare a cash flow statement:

Assets	**31 March 2011 ₹**	**31 March 2010 ₹**
Freehold Land and Building at Cost	50,000	—
Less: Depreciation	(10,000)	—
Leasehold Land and Building	—	25,000
Less: Depreciation	—	(500)
Plant and Equipment at Cost	1,50,000	6,00,000
Less: Depreciation	(1,25,000)	(1,60,000)
Investment at Cost	30,000	—
Stock in Hand	1,50,000	1,00,000
Debtors	50,000	50,000
Bank	5,000	—
Discount on Issue of Debentures	—	1,250
	3,00,000	6,15,750
Liabilities and Capital	₹	₹
Preference Shares of ₹ 10	—	25,000
Ordinary Shares of ₹ 10	1,00,000	1,60,000
Capital Redemption Reserve Account	20,000	—
Securities Premium Account	10,000	20,000
Surplus on Sale of:		
Freehold Land and Building	—	60,000
Investment	—	10,000
Govt. Grants	15,000	25,000
Retained Profits	1,05,000	1,25,000
Debentures	—	50,000
Loan from UTI for 5 years	—	25,000
Creditors for Goods	20,000	35,000
Bank Overdraft	—	47,000
Taxation	30,000	30,000
Acceptance Credit	—	3,750
	3,00,000	6,15,750

Additional information:

(i) No plan and equipment was sold or scrapped during the year.

(ii) On 1 January 2011, The freehold land and building were sold and leased back from the purchaser.

(iii) A bonus issue of ordinary shares on the basis of one new share for every five held has been made. The capital redemption reserve was used for this purpose.

(iv) The preference shares were issued for cash at par.

(v) An issue of ₹10 ordinary shares was made at a price of ₹ 12.50 per share.

(vi) Debentures were issued at a discount of 10%.

(vii) No dividends were paid or proposed for the year.

(viii) Explain briefly why the cash at bank has become nil although the retained earnings have registered an increase over the last year.

[B.com (Hons)—Delhi 2009, Modified]

[**Ans:** Net cash from operating activities: ₹ 1,28,000

Net cash used in investing activities: ₹ (3,35,000)

Net cash from financing activities: ₹ 2,02,000)]

27. The following are the balance sheets of Subhikishu Ltd. as on 31 March 2010 and 31 March 2011, respectively.

Liabilities	**31 March 2011 ₹**	**31 March 2010 ₹**	**Assets**	**31 March 2011 ₹**	**31 March 2010 ₹**
Equity Share Capital	13,50,000	12,50,00	Land	3,75,000	3,75,000
Securities Premium	3,85,000	3,75,000	Buildings	20,62,500	17,87,500
P & L A/c	27,52,500	25,22,500	Plants	1375,000	11,25,00
15% Debentures	2,50,000	5,00,000	Investments	13,75,000	11,25,000

Expenses Due	52,500	65,000	Patents	35,000	25,000
Tax Payable	3,75,000	2,57,500	Debtors	10,00,000	10,62,500
Bills Payable	1,25,000	1,75,000	Bills Receivable	25,000	20,000
Creditors	5,50,000	4,50,000	Stock	11,55,000	11,35,000
Accumulated Depreciation			Cash	3,37,500	2,50,000
Plants	2,25,000	1,87,500	Preliminary Expense	12,500	15,00
Buildings	6,25,000	5,75,000			
Provision for Doubtful Debts	50,000	62,500			
	67,40,000	64,20,000		67,40,000	64,20,000

Additional Information:

(i) Debentures were redeemed at a premium of 10% on 1 October 2010.

(ii) Investments were sold at a profit of 50% on cost.

(iii) During the year a machine costing ₹2,50,000 (accumulated depreciation of ₹1,00,000) was sold at a profit of 20% on book value.

(iv) During the year building costing ₹5,25,000 was purchased by issue of 10,000 equity shares of ₹10 each at a premium of ₹1 per share and balance by cash.

(v) A building costing ₹2,50,000 (with accumulated depreciation of ₹1,75,000) was sold for ₹85,000.

Prepare cash flow statement as per AS-3 (Revised). Show all working clearly.

[B.Com (Hons)—Delhi 2010, Modified]

[**Ans :** Cash from operating activities: ₹6,85,000

Cash used in investing activities: ₹(2,66,250)

Cash used in financing activities: ₹(3,31,250)]

28. From the following details relating to the account of Grow More Ltd. prepare cash flow statement:

	31 March 2011 ₹	**31 March 2010** ₹
Assets:		
Plant and Machinery	14,00,000	10,00,000
Land and Building	12,00,000	8,00,000
Investments	2,00,000	—
Sundry Debtors	10,00,000	14,00,000
Stock	8,00,000	4,00,000
Cash on Hand/Bank	4,00,000	4,00,000
	50,00,000	40,00,000
Liabilities:		
Share Capital	20,00,000	16,00,000
Reserve	4,00,000	3,00,000
P & L A/c	2,00,000	1,20,000
Debentures	4,00,000	—
Provision for Taxation	2,00,000	1,40,000
Proposed Dividend	4,00,000	2,00,000
Sundry Creditors	14,00,000	16,40,000
	50,00,000	40,00,000

(i) Depreciation at 25% was charged on the opening value of plant and machinery.

(ii) During the year one old machine costing ₹1,00,000 (WDV ₹40,000) was sold for ₹70,000.

(iii) ₹1,00,000 was paid towards income tax during the year.

(iv) Building under construction was not subject to any depreciation.

Prepare cash flow statement.

[C.A. (Final)—November 2005, Modified]

[**Ans:** Net cash from operating activities: ₹6,20,000

Net cash used in investing activities: ₹(12,20,000)

Net cash from financing activities: ₹6,00,000]

29. From the summary cash account of X Ltd. prepare a cash flow statement for the year ended on 31 March 2011 in accordance with AS-3 (Revised) using direct and indirect methods. The company does not have any equivalents:

Summary Cash Account
for the Year Ended on 31 March 2011

(₹ '000)

Particulars	₹	Particulars	₹
Balance on 1 April 2010	300	Payment to Supplies	12,000
Issue of Equity Shares	1,800	Purchase of Fixed Assets	1,200
Receipts from Customers	16,800	Overhead Expenses	1,200
Sale of Fixed Assets	600	Wages and Salaries	600
		Taxation	1,500
		Dividend	300
		Repayment of Bank Loan	1,800
		Balance on 31 March 2011	900
	19,500		19,500

[C.A. (Final)—Modified]

[**Ans:** Net cash from operating activities: ₹ 15,00,000
Net cash used in investing activities ₹ (6,00,000)
Net cash from financing activities:₹ (3,00,000)
[**Note:** Answers will be the same under both the methods.]

30 The balance sheet of New Light Ltd. for the years ended on 31 March 2010 and 2011 are as follows:

(₹ '000)

Liabilities	31 March 2010 ₹	31 March 2011 ₹	Assets	31 March 2010 ₹	31 March 2011 ₹
Equity Share Capital	2400	3200	Fixed Assets	6400	7600
10% Pref. Share Capital	800	560	Less: Depreciation	1840	2320
Capital Reserve	—	80		45,60	52,80
General Reserve	1360	1600	Investment	800	640
P & L A/c	480	600	Cash	20	20
9% Debentures	800	560	Other Current Assets	2220	2620
Current Liabilities	960	1040	Preliminary Expenses	160	80
Proposed Dividend	240	288			
Provision for Tax	720	680			
Unpaid Dividend	—	32			
	7760	8640		7760	8640

Additional Information:

(i) The company sold one fixed asset for ₹ 2,00,000. The cost of which was ₹ 4,00,000 and the depreciation provided on it was ₹ 1,60,000.

(ii) The company also decided to write off another fixed asset costing ₹ 1,12,000 on which depreciation amounting to ₹ 80,000 has been provided.

(iii) Depreciation on fixed assets provided ₹ 7,20,000.

(iv) Company sold some investments at a profit of ₹ 80,000, which were credited to capital reserve.

(v) Debentures and preference share capital redeemed at 5% premium.

(vi) Company decided to value stock as cost, whereas previously the practice was to value stock at cost less than 10%. The stock according to books on 31 March 2010 was ₹ 4,32,000. The stock on 31 March 2011 was correctly valued at ₹ 6,00,000.

Prepare cash flow statement as per revised accounting standard-3 by indirect method.

[C.A. (Final) 2003—Modified]

[**Ans:** Net cash from operating activities: ₹ 11,84,000
Net cash used in investing activities:
₹ (12,72,000)
Net cash from financing activities: ₹ (88,000)]

31. XYZ Ltd. gives you the following information. You are required to prepare a cash flow statement by using indirect methods as per AS-3 for the year ended on 31 March 2011:

Balance Sheet as on

(₹ ' 000)

Liabilities	31 March 2010 ₹	31 March 2011 ₹	Assets	31 March 2010 ₹	31 March 2011 ₹
Capital	2500	2500	Plant and Machinery	1365	2035
Retained Earnings	1325	1845	Less: Depreciation	305	395
Debentures	—	450	Current Assets:	1060	1640
Current Liabilities			Debtors	1195	1415
Creditors	440	410	Less: Provision	75	95
Bank Loan	75	150		1120	1320
Liabilities for Expenses	165	135	Cash	760	910
Dividend Payable	75	150	Marketable Securities	590	750
			Inventories	1005	960
			Prepaid Expenses	45	60
	4580	5640		4580	5640

Additional Information:

(i) Net profit for the year ended on 31 March 2011, after charging depreciation of ₹ 90,000 is ₹ 11,20,000.

(ii) Debtors of ₹ 1,15,000 were determined to be worthless and were written off against the provisions for doubtful debts account during the year.

(iii) XYZ Ltd. declared divided of ₹ 6,00,000 for the year 2010–11.

[C.A. (Final)—2004, Modified]

[**Ans:** Net cash from operating activities: ₹ 9,80,000
Net cash used in investing activities: ₹ (6,70,000)
Net cash used in financing activities: ₹ (nil)]

32. Nee Ltd. had the following figures as on 1 April 2010:

	₹
Fixed Assets—Cost	18,00,000
Less: Depreciation	6,30,000
	11,70,000
Bank Balance	1,05,000
Current Assets, other than Bank Balance	7,50,000
Current Liabilities	3,00,000
Capital (Shares of ₹ 10 Each)	12,00,000

The company made the following estimates:

(i) The profit would be ₹ 1,74,000 after depreciation of ₹ 1,80,000.

(ii) The company will acquire fixed assets costing ₹ 3,00,000 after selling one machine for ₹ 60,000 costing ₹ 1,50,000 and on which depreciation provided will amount to ₹ 1,05,000.

(iii) Current assets and current liabilities, other than bank balance, at the end of March 2011 are expected to be ₹ 8,85,000 and ₹ 3,90,000, respectively.

(iv) The company will pay dividend of 10% and corporate dividend tax thereon of 11%.

At the end of the accounting year, the company sends all the cash in hand to the bank.

Prepare a cash flow statement for the year ended on 31 March 2011 and estimate the bank balance or overdraft as on that date.

[**Ans:** Net cash from operating activities: ₹ 2,94,000
Net cash used in investing activities: ₹ (2,40,000)
Net cash from financing activities: ₹ 1,33,200
Bank balance as on 31 March 2011: ₹ 25,800