ACCOUNTING FOR COMPANIES - I

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SYLLABUS

Accounting for Companies - I

Objectives: To enable the students to get familiarized with the existing accounting system for companies and to develop awareness about Corporate Accounting in conformity with the provision of Companies Act.

Sr. No.	Topics
1.	**Shares Capital:** Types of share capital, Issue of shares, Under and Over subscription of shares, forfeiture of shares, Pro-rata allotment.
2.	Reissue of forfeited shares.
3.	Buy Back of Shares, Rights and Bonus issue of shares, Private placement of shares.
4.	Issue and redemption of preference shares.
5.	**Debentures:** concept, types, issue and treatment of discount, Issue for consideration other than cash and as collateral security, conditions of issue of debentures from redemption point of view.
6.	**Redemption of Debentures:** Methods of redemption, sources of redemption.
7.	Underwriting of shares.
8.	Profit and loss prior to incorporation.
9.	Divisible profits and Managerial Remuneration.
10.	Final accounts of companies; meaning, contents, types and limitations of financial statements, preparation of financial statements as per schedule VI of companies act, 1956.

CONTENT

Notes

Unit 1: Share Capital – Issue of Shares

CONTENTS

Objectives

After studying this unit, you should be able to:

- Understand meaning of Share Capital
- Know classes of shares
- Define issue of shares
- Explain under and Over Subscription
- Understand issue of shares for consideration other than cash

Introduction

Share capital refers to the portion of a company's equity that is obtained by trading stock to a shareholder for cash or an equivalent item of capital value. The term has several meanings. In classical sense, share capital comprises the nominal values of all shares issued (that is, the sum of their "par values").

In a wider sense, if the shares have no par value or the allocation price of shares is greater than their par value, the shares are said to be at a premium (called share premium, additional paid-in capital or paid-in capital in excess of par); in that case, the share capital can be said to be the sum of the aforementioned "nominal" share capital and the premium. In the modern law of shares, the "par value" concept has diminished in importance, and share capital can simply be defined as the sum of capital (cash or other assets) the company has received from investors for its shares.

Notes

Share capital may also be used to describe the number and types of shares that compose a company's share structure. The legal aspects of share capital are mostly dealt with in a jurisdiction's corporate law system. An example of such an issue is that when a company allocates new shares, it must do so in a way that does not inequitably dilute existing shareholders.

1.1 Meaning and Categories of Share Capital

A share is a single unit into which the entire capital of a company is divided. A share is a fractional part of the share capital. On the basis of number of shares the ownership of a person is formed. The persons who contribute the money through shares are called shareholders. Probably the best description of a share is given in *Borland's Trustees* vs. *Steel* by Farewell, J. where he defines a share as "the interest of a shareholder in the company, measured as a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders *inter se*." Even though many people contribute varying sums to the company's share capital, there is no separate capital account for each shareholder. Therefore, a consolidated capital account called share capital account is maintained. The share capital of the company is divided into the following categories:

1. ***Registered, Nominal or Authorised Capital:*** The maximum amount of capital with which the company intends to be registered, is called registered capital. It is stated in the Memorandum of Association, which is registered with the Registrar of Companies. It is the maximum amount which the company is authorised to raise by the way of public subscription. Therefore, it is also called authorised share capital.
2. ***Issued Capital:*** The part of Authorised capital which is issued by the company to public for subscription in cash including shares allotted to vendors or promoters for consideration other than cash is called issued capital. The remaining part which is not issued, is called unissued capital. This part can be issued later on.
3. ***Subscribed Capital:*** That part of issued capital which is subscribed or applied by the public, is called subscribed capital. This capital can be more, less or equal to issued capital. If it is more than issued capital, the excess is returned back to the subscriber. The directors of the company can allot only upto the extent of issued capital. If the whole issued capital is not subscribed, the balance of the issued capital is called unsubscribed capital.
4. ***Called-up Capital:*** Generally, the full amount of share is not called at one time but for the convenience of shareholder and according to the requirement of the company, the amount is called in different instalments. The amount of share which is actually demanded by the company is known as called-up capital.
5. ***Paid up Capital:*** The part of called-up capital that is actually paid by the subscribers to the company is known as paid up capital. The paid up capital can be more, less or equal to called-up capital. If paid up capital is less than called-up capital, this difference is known as call-in-arrear or unpaid calls. However, some shareholders may also pay the amount for those calls which are not made. Such amount is known as calls-in-advance.
6. ***Reserve Capital:*** It is that part of the uncalled capital which, by passing a special resolution, can be called up only in the event of winding up of a company. This capital cannot be converted except with the leave of the court; it cannot be changed by directors. Therefore, this capital is left for the protection of the company's creditors.

1.2 Classes of Shares

Those companies which are formed after the commencement of the Companies Act 1956, are permitted to issue only preference shares and equity shares, not deferred shares.

1. ***Preference Shares:*** According to Section 85, preference shares are those shares which enjoy the following two rights:

   (a) Right to receive dividend at a fixed rate before any dividend is paid to equity shareholders.

   (b) Right to receive repayment of capital in the event of winding up, before the capital of equity shareholders is returned.

Caution In any condition, a preference shareholder cannot compel the company to pay his dividend. He can only prevent the company from paying dividend to equity shareholders without his dividend being paid first. In addition to these two preferential rights, a preferential shareholder may carry some other rights. On the basis of additional rights, preference shares can be classified as under:

(i) ***Cumulative vs. Non-Cumulative Preference Share:*** There is however, no obligation to pay until dividend is declared. The arrears of dividend are therefore, shown at the footnote of balance sheet as contingent liabilities only. Non-cumulative preference shareholders are entitled to take a fixed dividend only out of the profit each year. If in any year, due to shortage of profit, dividend is not paid to them, there will be no accumulation for unpaid dividend. The unpaid balance of dividend will automatically lapse.

(ii) ***Redeemable vs Irredeemable Preference Share:*** Redeemable Preference Share is that share whose amount is returned by the company to the shareholder within the lifetime of the company as per the provisions of Section 80 and Section 80A of the Companies Act 1956. The amount of irredeemable preference share can be returned only when the company is wound up. After the commencement of the Companies (Amendment) Act 1988, no company limited by shares can issue any preference share which is irredeemable. The Act also provides for the redemption of such shares issued prior to the amendment of the Act in 1988.

(iii) ***Participating vs Non-participating Preference Share:*** Participating preference shares are those shares that carry the right of sharing profit left after paying equity and preference dividend at a stipulated rates. The preference shareholders may also be extended to participate in the surplus assets available at the time of liquidation after paying off all equity shareholders. Non-participating preference shares are those shares which do not carry the right of sharing in the surplus profit after paying a certain rate of dividend to equity shareholders. These are entitled to receive only the fixed rate of dividend. Preference shares are assumed to be non-participating.

(iv) ***Convertible vs Non-convertible Preference Shares:*** Convertible preference shares are those which have the right to get them converted into equity shares. When such a right does not exist, those are called non-convertible prudential shares.

Did u know? Cumulative preference shareholders are entitled to a dividend at a stipulated rate. If the current year's profit are not sufficient, such dividend will be accumulated and will be payable out of future profit. All the arrears of dividend on these shares must be paid before the equity shareholders can participate in the profit.

Notes

Convertible Cumulative Preference Shares

Companies limited by shares are permitted by the Controller of Capital Issue (CCI) to issue cumulative convertible preference shares (CCP) for which guidelines are framed by the Central Government. For the objective of setting up new projects, expansion or diversification of existing projects, normal capital expenditure for modernisation and the requirement of working capital CCP shares can be issued. As per the guidelines of CCI, the entire issue of CCP shares would be convertible into equity shares between the end of 3 years and 5 years, as may be decided by the company and approved by the CCI. The rate of preference dividend on CCP shares would be 10%. The face value of these shares will ordinarily be ₹ 100 each.

Notes The conversion of Cumulative Preference Shares into equity shares would be compulsory at the end of five years and these preference shares would not be redeemable at any stage.

Equity Shares

Those shares which are not preference shares are called equity or ordinary shares. Equity shareholders do not have any priority as to dividend or refund of capital. The balance of profit after paying the preference dividend can be distributed among the equity shareholders as dividend. There is no fixed rate of dividend for these shareholders. Right to claim dividend on equity shares will arise only when the dividend is declared by the company in the general meeting. In the case of the liquidation of a company, the equity shareholders would be paid only if any surplus is left after the return of preference share capital.

1.3 Issue of Shares

The process of collecting the capital by issue of shares for a newly formed company, or an established company requiring more capital for its expanding operations, is the same. Only a public company can issue its shares to the public by issuing a prospectus. This invites the public to submit their applications to take up the shares of the company. The Prospectus gives detailed information about the company, the details of the issue, issue highlights, terms of present issue, risk factors, history of the company, main objectives and present business, details of the projects for which capital is being raised, prospects and profitability, market price of the share, previous issues, companies under the same management, minimum subscriptions and any other details as stated in the Companies Act. Details regarding the procedure to apply for the shares are also given in application form. The prospectus gives details of the number and class of shares offered and manner in which the amount of shares is to be paid by the public. Generally, the total amount of shares is paid in a number of instalments. These instalments are termed as:

First Instalment	:	Application Money
Second Instalment	:	Allotment Money
Third Instalment	:	First Call Money
Fourth Instalment	:	Second Call Money
Last Instalment	:	Final Call Money

Notes A printed application form is attached with the prospectus. After reading the prospectus, the public fills up the application form for shares and submits it with application money mentioned in the prospectus. As per Section 63 Less or Profit (3) the application money must not be less than 5% of the nominal value of the share. An application for shares without application money is not a valid offer and therefore, shares cannot be allotted to such an applicant. The company is permitted to ask the applicant to pay the full value on application or partly on application and the balance on allotment, or it may also collect the amount by providing the calls after allotment to suit the convenience of the applicant.

Procedure for Receipt of Application Money

The names of bankers to the issue are given in the application form. The investor applying for shares must fill the application form and remit the application money by cheque, draft or stock invest to the banker to the issue. The banker of the company presents the cheques and drafts immediately and amount is kept in a separate account. In the case of stock invests which are recently issued by the bankers against customers accounts after noting the lien, the company encashes the stock invests of only those applicants to whom the allotment is made. The balance of applicant's account is not reduced until allotment and the applicant continues to earn interest. In case of unsuccessful applicants the stock invests maybe returned to the investors. In the case of partial allotment, the stock invest is encashed only to the extent of the application money and allotment money in respect of the shares allotted.

Allotment of Shares

After receiving the applications, the boards of directors proceed to allot the shares in consultation with the stock exchange in the case of over-subscription. Prospectus is an invitation to offer, application for shares offer made by the applicant and hence the directors are free to accept or reject any application. Similarly, if the applicant wants to withdraw his offer before its acceptance, he can do so. For a valid allotment, it is compulsory that at least minimum subscription which is stated in prospectus should be received from public. If the minimum subscription is not received by the company within 120 days from the date of opening of the issue, the company has to refund the subscription without interest. If these moneys are not refunded within 130 days from the date of opening of issue, company is liable to pay interest @ 6% p.a. for such a delay.

Minimum subscription refers to the minimum amount which, in the consideration of directors, must be raised by the issue of shares to meet the following requirements:

(i) the purchase price of any property purchased or to be purchased, which is to be met out of the proceeds of the issue,

(ii) any preliminary expenses payable by the company and any commission payable in connection with the issue of shares,

(iii) the repayment of any money borrowed by the company in respect of any of the above two matters,

(iv) working capital, and

(v) any other expenditure stating the nature and purpose thereof and the estimated amount in each case.

Notes

Allotment is the acceptance of offer made by the applicant to purchase the shares. If there is oversubscription, the board of directors is free to allot the shares. Directors may allot the full number of shares applied for, or none at all, or a number less than applied for. A letter of regret along with refund of application money is dispatched to those applicants whose applications are rejected. Letters of Allotment are dispatched to other applicants whose applications are accepted and in this letter they are requested to remit any money due on allotment. Some applicants may be accepted partially or on a pro-rata basis. The surplus application money on such an application can be retained for allotment money; the balance of surplus application money will be refunded unless the applicant has agreed to get it treated as calls in advance. Such retention of over subscription is normally permitted up to 15% of the amount sanctioned. If the company wants such retention of application money, it should so state in the original application to the CCI and obtain the approval. It should inform the CCI and the Stock Exchange immediately after the issue about the outcome of the issue and the retention of oversubscription upto the permitted amount. In any case, the directors of a company cannot allot more than the number of shares offered to the public in the prospectus even if it has received applications for a large number.

Calls on Shares

5% of the face value of share is paid on application, some money is paid on allotment and the balance of the face value of share is paid on calls. This balance may be called in one call or in different calls. Call notices are sent to the shareholders who will make the payment. Generally, calls are due by the board of directors on particular dates fixed by its Articles. If the Articles are silent in this respect, provisions laid down in Table A shall apply. These are:

(i) a period of one month must elapse before another call is made

(ii) the amount of each call should not exceed 25% of the face value of the share, and

(iii) a notice of 14 days is given to the shareholders to pay the amount; a call must be made on a uniform basis on all shares within the same class.

Books of Account of a Public Company

As per Section 209 of the Companies Act 1956 a company is required to maintain such books as will give a true and fair picture in respect of :

(a) all sums of money received and extended by the company and the matters in respect of which receipts and expenditure take place.

(b) all sales and purchases of goods of company.

(c) all assets and liabilities of the company.

(d) and such particulars regarding utilisation of materials or labour or other items of cost as may be prescribed by the Central Government, in case the company belongs to a class of companies engaged in manufacturing, processing and mining.

Sub-section (3) makes it clear that these accounts should be maintained to show the true and fair picture of the state of affairs of the company. These books must be prepared on accrual basis and according to the double entry system of accounting. These must be preserved for a minimum period of eight years. Books of account should be kept at the registered office of the company and these should be open for the inspection of directors, the registrar and the officers authorized by the Central Government during business hours. If the directors decide to place these books of accounts of the company at a place other than registered office (but in India) the company shall within seven days of this decision, file with the registrar a notice in writing, giving the full address of that other place.

Accounting Treatment Regarding Issue of Shares

Notes

1. On receipt of application money:

   Bank Account Dr. (with the total application money)

   To Share Application Account

   (Being the receipt of application money on ——shares @————per share)

   The nature of share application account is a personal account which represents the total of all those people who have applied for shares. This application money is treated as deposit money of the applicants. These applicants are treated as creditors of the company until they are allotted some shares. If no share is allotted to them, their application money has to be returned. Upon the acceptance of application for shares, the boards of directors proceed to allot the shares. As soon as the shares are allotted, the creditors (applicants) become the shareholders of the company and their deposits are transferred into share capital account.

2. On the acceptance of applications for share:

   Share Application Account Dr. (with application money due on shares allotted)

   To Share Capital Account

   (Being the transfer of application money to share capital account.)

   When a company issues different types of shares, a separate share capital account will be opened for each type of shares. In order to distinguish one type of share from the other one, the name of the share must be prefixed with the word share i.e., Preference share capital, Equity share capital and Equity share application account.

3. On making the allotment money due:

   Share Allotment Account Dr. (With allotment money due)

   To Share Capital Account

   (Being share allotment money due on _______ shares @_______per share.)

   Here, the nature of share allotment account is a personal account which represents all the applicants. (now shareholders/debtors of the company).

4. On receipt of allotment money:

   Bank Account Dr. (with actual allotment money received)

   To Share Allotment Account

   (Being the receipt of allotment money)

   If any shareholder does not pay the allotment money, this unpaid amount is known as calls-in-arrear and shown in the liabilities side of Balance Sheet of the company.

5. On making the first call due:

   Share First Call Account Dr. (with first call money due)

   To Share Capital Account

   (Being first call money due ________shares @_______per share)

Notes

6. On receipt of first call money:

   Bank Account Dr. (with actual first call money received)

   To Share First Call Account

   (Being receipt of first call money)

   The above No. 5 & 6 entries would be similar for subsequent calls. These subsequent calls are distinguished from each other by their serial numbers i.e., second call, third call and so on. In the case of last call the word "Final" is also added to that call as second and final call. If there is requirement to prepare cash book too, above all, cash and bank transaction will be entered in the cash book and other transactions will appear in 'Journal Proper.'

Task If no contra information is given, preference shares are deemed to be:

(a) Cumulative, Convertible and Participating.

(b) Non-cumulative, Convertible and Participating.

(c) Non-cumulative, Non-Convertible and Participating

(d) Cumulative, Non-Convertible and Non-Participating.

Self Assessment

True or False:

1. Preference share is that share which alone enjoys a preferential right regarding payment of dividend.
2. At least 10% amount of the face value should be payable with application.
3. A maximum discount of 10% can be allowed on shares.

When Equity or Ordinary Shares are Issued at Par and Shares are Fully Subscribed

Example 1: X Ltd. was registered on January 1, 2006 with an authorised capital of ₹ 10,00,000 divided into 10,000 equity shares of ₹ 100 each. It offered 9,000 equity shares at par, payable as under:

On Application	₹ 10
On Allotment	₹ 50
On First Call	₹ 20
On Second and Final Call	₹ 20

All the shares were subscribed and amount duly received. Pass the necessary journal entries and prepare the Balance Sheet of the company.

Solution:

Notes

Journal Entries in the Books of X Ltd.

Date	Particulars		Debit (₹)	Credit (₹)
2006 Jan. 1	Bank A/c	Dr.	90,000	
	To Equity Share Application A/c			90,000
	(Being application money received on 9,000 equity shares @ ₹ 10 per share)			
	Equity Share Application A/c	Dr.	90,000	
	To Equity Share Capital A/c			90,000
	(Being application money transferred to share capital A/c)			
	Equity Share Allotment Account	Dr.	4,50,000	
	To Equity Share Capital Account			4,50,000
	(Being allotment money due on 9,000 shares @ ₹ 50 per share)			
	In the place of above two entries one combined can be made as:			
	Equity Share application A/c	Dr.	90,000	
	Equity Share Allotment A/c	Dr.	4,50,000	
	To Equity Share Capital A/c			5,40,000
	(Being the transfer of application and allotment money to share capital A/c on 9,000 shares @ ₹ 60 per share)			
	Bank Account	Dr.	4,50,000	
	To Equity Share Allotment Account			4,50,000
	(Being allotment money received on 9,000 shares @ ₹ 50 per share)			
	Equity Share First Call Account	Dr.	1,80,000	
	To Equity Share Capital Account			1,80,000
	(Being 1st call money due on 9,000 shares @ ₹ 20 per share)			
	Bank Account	Dr.	1,80,000	
	To Equity Share First Call Account			1,80,000
	(Being 1st call money received on 9,000 shares @ ₹ 20 per share)			
	Equity Share Second & Final Call Account	Dr.	1,80,000	
	To Equity Share Capital Account			1,80,000
	(Being 2nd and final call money due on 9,000 shares @ ₹ 20 per share)			
	Bank Account	Dr.	1,80,000	
	To Equity Share Second & Final Call Account			1,80,000
	(Being 2nd and final call money received on 9000 shares & ₹ 20 per share)			

Balance Sheet of X Ltd. as on……….

Liabilities	₹	Assets	₹
Share Capital :		Current Assets :	
		Cash at bank	9,00,000
Authorised Capital (10,000 equity shares of ₹ 100 each)		10,00,000	
Issued, Subscribed, Called up and Paid up capital			
(9,000 equity shares of ₹ 100 each)	9,00,000		
	9,00,000		9,00,000

Notes

Issue of Two Classes of Shares

Example 2: Surjeet Ltd. was incorporated on January 1, 2006. The authorised capital of the company was ₹ 2,50,00,000 divided into 15,00,000 equity shares of ₹ 10 each and 1,00,000, 10% preference shares of ₹ 100 each. The company issued 6,00,000 equity shares and 50,000 preferences shares payable as follows:

- *Equity shares:* ₹ 3 on application, ₹ 3 on allotment, ₹ 2 on first call and ₹ 2 on second and final call.
- *Preference shares:* ₹ 30 on allotment, ₹ 30 on allotment, ₹ 20 on first call and ₹ 20 on second and final call.

All these shares were subscribed. Prepare cash book and journal assuming that all money was duly received:

Solution:

Journal of Surjeet Ltd.

Date	Particulars	L.F.	(Debit ₹)	(Credit ₹)
Equity Share Application Account	Dr.		18,00,000	
To Equity Share Capital Account				18,00,000
(Being transfer of application money to share capital account)				
Preference Share Application Account	Dr.		15,00,000	
To Preference Share Capital Account				15,00,000
(Being transfer of application money to preference share capital account)				
Equity Share Allotment Account	Dr.		18,00,000	
To Equity Share Capital Account				18,00,000
(Being allotment money due on 6,00,000 equity shares @ ₹ 3 per share)				
Preference Share Allotment Account	Dr.		15,00,000	
To Preference Share Capital Account				15,00,000
(Being allotment money due on 50,000 Preference share @ ₹ 30 per share)				
Equity Share First Call Account	Dr.		12,00,000	
To Equity Share Capital Account				12,00,000
(Being first call money due on 6,00,000 equity shares @ ₹ 2 per share)				
Preference Share First Call Account	Dr.		10,00,000	
To Preference Share Capital Account				10,00,000
(Being first call money due on 50,000 preference share @ ₹ 20 per share)				
Equity Shares Second & Final Call Account	Dr.		12,00,000	
To Equity Share Capital Account				12,00,000
(Being second and final call money due on 6,00,000 equity share @ ₹ 2 per share)				
Preference Share Second & Final Call Account	Dr.		10,00,000	
To Preference Share Capital Account				10,00,000
(Being second and final call money due on 50,000 preference shares @ ₹ 20 per share)				

Cash Book (Bank Column Only)

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application account	18,00,000		By Balance c/d	1,10,000
	To Preference Share Application Account	15,00,000			
	To Equity Share Allotment Account	18,00,000			

Contd...

Notes

To Preference Share Allotment Account	15,00,000	
To Equity Share First Call Account	12,00,000	
To Preferences Share First Call Account	10,00,000	
To Equity Share 2^{nd} and Final Call Account	12,00,000	
To Pref. Share 2^{nd} and Final Call Account	10,00,000	
	1,10,00,000	1,10,00,000

Self Assessment

Fill in the blanks:

4. A Public Company Limited by shares must have at least .... members.
5. A Private Company should have at least .... members.
6. Shareholders are the .... of the company.

1.3.1 Issue of Shares at Premium (Under Section 78)

When a share is issued at a price higher than the face value, par value or nominal value then it is said that it has been issued at premium. For instance, if a share of ₹ 100 is issued by a company for ₹ 110, ₹ 10 are the premium on share. Premium on issue of shares is the capital profit for the company and the amount so earned has to be credited to a separate account known as share premium account.

Caution No restriction is imposed on the issue of shares at premium and the power to issue shares at premium need not be taken in the Articles of Association. But there are some restrictions on the use of the amount of share premium.

Under Section 78 of the Companies Act 1956, the amount of share premium may be used wholly or partly in the following ways:

(a) It may be utilized in paying up unissued shares of a company, to be issued to members of the company as fully paid bonus shares, or

(b) It may be utilized in writing off the preliminary expenses of the company, or

(c) It may be utilized in writing off the expenses of, or the commission paid or discount allowed on any of shares or debentures of the company, or

(d) It may be utilized in providing for the premium payable on redemption of any redeemable preference shares or debentures.

Premium on shares maybe collected by a company in a lump sum or in instalments. According to the terms of issue the amount of share premium may be included in either application money or allotment money or one of call money. Usually, the amount of share premium is to be paid along with application or allotment money. If nothing is mentioned in the problem, it should be assumed that the entire amount of the share premium is to be paid along with allotment money.

Notes

Accounting Treatment: When the amount of premium is to be paid along with application money by a shareholder, entry will be:

Bank Account Dr. (with amount of application and premium)

To Share Application Account

When share are allotted, entry will be:

Share Application Account Dr.

To Share Capital Account

To Share Premium Account

When the entire amount of share premium is collected by the company on allotment or a call, the company may adopt any one of the following two alternatives:

(A) (i) When allotment money is due with share premium –

Share Allotment account Dr.

To Share Capital Account

To Share Premium Account

(ii) When allotment money is received along with share premium

Bank account Dr.

To Share Allotment Account

In this method, share premium is being credited even before the premium is received in cash. If any shareholder fails to pay the allotment money, the share premium will have to be debited at the time when shares are forfeited. Therefore, it is disliked by some accountants. They adopt the second alternative.

(B) In this method, the amount of share premium will be ignored at the time of passing the entry for allotment money due. Share premium is recorded only at the time of actual receipt of cash.

(i) When allotment money is due (without premium)

Share Allotment Account Dr. (only allotment money)

To Share Capital Account

(ii) When allotment money is received with premium

Bank account Dr.

To Share Allotment Account

To Share Premium Account

Considering the restrictions imposed by the Companies Act, there are some persons who doubt the propriety of debiting share premium account for non-receipt of cash at the time of forfeiture. Therefore, the second method is better in which share premium will be credited only when the amount of share premium has actually been received in cash.

Example 3: Mars Co. Ltd. issued 1,00,000 shares of ₹ 10 each at a premium ₹ 2 per share, the terms of payment per share were as follows:

₹ 3 on application

₹ 4 on allotment

Notes

₹ 5 on first and final call

The subscription list totalled 1,16,000 shares. Applications for 16,000 shares were rejected, all other applications were accepted in full. Call was duly made. All moneys were received in time. Pass the necessary journal entries for all the transactions in each one of the following cases:

Case I: Share premium is included in the application money

Case II: Share premium is included in the allotment money

Case III: Share premium is included in the call money.

Solution:

Mars Co. Ltd. Journal

Case I

Date	Particulars		L.F.	Debit ₹	Credit ₹
1.	Bank Account	Dr.		3,48,000	
	To Share Application Account				3,48,000
	(Being application money received on 1,16,000 shares @ ₹ 3 per share including ₹ 2 per share as premium)				
2.	Share Application Account	Dr.		3,00,000	
	To Share Capital Account				1,00,000
	To Share Premium Account				2,00,000
	(Being application money transferred to share capital and share premium account on 1,00,000 shares)				
3.	Share Allotment Account	Dr.		4,00,000	
	To Share Capital Account				4,00,000
	(Being due of allotment money on 1,00,000 share @ ₹ 4 per share)				
4.	Share Application Account	Dr.		48,000	
	To Bank Account				48,000
	(Being return of excess application money on 16,000 shares)				
5.	Bank Account	Dr.		4,00,000	
	To Share Allotment Account				4,00,000
	(Being receipt of allotment money on 1,00,000 shares)				
6.	Share First and Final Call Account	Dr.		5,00,000	
	To Share Capital Account				5,00,000
	(Being first and final call money due on 1,00,000 share @ ₹ 5 per share)				
7.	Bank Account	Dr.		5,00,000	
	To Share First and Final all Account				5,00,000
	(Being receipt of first and final call money on 1,00,000 shares)				

Notes

Case II

Date	Particulars	L.F.	Debit ₹	Credit ₹
1.	Bank Account Dr. To Share Application Account (Being receipt of application money on 1,16,000 shares @ ₹ 3 per share)		3,48,000	 3,48,000
2.	Share Application Account Dr. To Share Capital Account To Bank Account (Being transfer of application money to share capital on 1,00,000 shares & refund on 16,000 shares)		3,48,000	 3,00,000 48,000
3.	Share Allotment Account Dr. To Share Capital Account To Share Premium Account (Being allotment money due on 1,00,000 shares @ ₹ 4 per share with premium @ ₹ 2 per share)		4,00,000	 2,00,000 2,00,000
4.	Bank Account Dr. To Share Allotment Account (Being receipt of allotment money with premium) Alternate treatment of 3 & 4 entries may be as:		4,00,000	 4,00,000
5.	Share Allotment Account Dr. To Share Capital Account (Being allotment money due on 1,00,000 share @ ₹ 2 per share)		2,00,000	 2,00,000
6.	Bank Account Dr. To Share Allotment Account To Share Premium Account (Being receipt of allotment money with premium on 1,00,000 share)		4,00,000	 2,00,000 2,00,000
7.	Share First and Final Call Account Dr. To Share Capital Account (Being first and final call money due on 1,00,000 shares @ ₹ 5 per share)		5,00,000	 5,00,000
8.	Bank Account Dr. To Share First and Final Call Account (Being receipt of first and find call money)		5,00,000	 5,00,000

Case III

Notes

Journal

Date	Particulars		L.F.	₹	₹
1.	Bank Account To Share Application Account (Being receipt of application money on 1,16,000 shares @ ₹ 3 per share)	Dr.		3,48,000	 3,48,000
2.	Share Application Account To Share Capital Account To Bank Account (Being transfer of application money to share capital and refund of application money to unsuccessful applicants)	Dr.		3,00,000	 48,000
3.	Share Allotment Account To Share Capital Account (Being allotment money due on 1,00,000 shares @ ₹ 4 per share)	Dr.		4,00,000	 4,00,000
4.	Bank Account To Share Allotment Account (Being allotment money received)	Dr.		4,00,000	 4,00,000
5.	Share First and Final Call Account To Share Capital Account To Share Premium Account (Being first and final call due on 1,00,000 shares @ ₹ 3 per share with share premium @ ₹ 2 per share)	Dr.		5,00,000	 3,00,000 2,00,000
6.	Bank Account To Share First and Final Call Account (Being receipt of first and final call money with premium)	Dr.		5,00,000	 5,00,000
7.	Share First and Final Call Account To Share Capital Account (Being first and final call due on 1,00,000 share @ ₹ 3 per share)	Dr.		3,00,000	 3,00,000
8.	Bank Account To Share First and Final Call Account To Share Premium Account (Being receipt of first and final call money on 1,00,000 shares @ ₹ 3 per share along with share premium @ ₹ 2 per share)	Dr.		5,00,000	 3,00,000 2,00,000

1. Amount of share premium can be utilised in writing off the preliminary expenses of the company.
2. When the shares originally issued at discount are forfeited, discount account in respect of them is always credited.
3. Calls-in-advance is a part of share capital.

Notes

1.3.2 Issue of Shares at a Discount (Under Section 79)

When a share is issued at a price lower than the face value, par value or nominal value then it is said it has been issued at discount. For instance, if a share of ₹ 100 is issued by a company for ₹ 90, it is said that company has issued the share at discount of 10%. To issue the shares at discount a company has to fulfil the following conditions laid down in Section 79 of the Companies Act. These conditions are:

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

(ii) The resolution must specify the maximum rate of discount at which shares are to be issued, but the rate of discount must not exceed 10%. The rate may exceed 10% only if the Company Law Board is of the opinion that a higher percentage of discount may be allowed in the special circumstances of the case.

(iii) The share of a class that has already been issued.

(iv) At least one year has elapsed since the company was entitled to commerce the business.

(v) The shares are issued within two months from the date of receiving sanction from the Company Law Board, or within such extended time as the Company Law Board may allow.

Accounting Treatment

Did u know? Discount on issue of shares is a loss of money for a company, therefore, it must be debited to a separate account called "Discount on Issue of shares."

It is a loss of capital nature so we should show it in the assets side of Balance Sheet Show under the heading 'Miscellaneous Expenditure.' It is written off over three or four years.

In the absence of any instruction, generally, discount on issue of shares is allowed at the time of allotment of shares. At this time the journal entry will be:

Share Allotment Account	Dr.	(with amount due)
Discount on Issue of Shares Account	Dr.	(with amount of discount)
To Share Capital Account		(Total amount)

One more journal entry is passed at the time of writing off the discount on issue of share. This writing off can be from Profit and Loss Account or Share Premium Account:

Profit and Loss Account	Dr.	or
Share Premium Account	Dr.	
To Discount on Issue of Share Account.		

Example 4: Final Ltd. issued 1,00,000 shares of ₹ 100 each at a discount of 10%. If was payable as follows:

On Application	₹ 20 per share
On Allotment	₹ 30 per share
On First Call	₹ 15 per share

On the final call the balance amount.

Notes

Applications were received for 1,50,000 shares. The board of directors made pro-rata allotment to the applicants for 1,20,000 shares. A shareholder Akash could not pay the allotment money on 200 shares, while another shareholder Mukesh did not pay the final call on 120 shares. Pass necessary journal entries to record the above transactions.

Solution:

Fine Limited Journal

Date	Particulars		L.F.	₹	₹
1.	Bank Account	Dr.		30,00,000	
	To Share Application Account				30,00,000
	(Being receipt of application money on 150,000 shares @ ₹ 20 per share)				
2.	Share Application Account	Dr.		24,00,000	
	To Share Capital Account				20,00,000
	To Share Allotment Account				4,00,000
	(Being transfer of application money to share capital account on 1,00,000 shares and that for 20,000 shares utilized for allotment money)				
3.	Share Application Account	Dr.		6,00,000	
	To Bank Account				6,00,000
	(Application money for 30,000 shares refunded)				
4.	Share Allotment Account	Dr.		20,00,000	
	Discount on Issue of Shares Account	Dr.		10,00,000	
	To Share Capital Account				30,00,000
	(Being allotment money due @ ₹ 20 each and discount at ₹ 10 each)				
5.	Bank Account	Dr.		15,96,800	
	To Share Allotment Account				15,96,800
	(Allotment money received on 99,200 shares)				
6.	Share First Call Account	Dr.		15,00,000	
	To Share Capital Account				15,00,000
	(Being first call money due on 1,00,000 shares @ ₹ 15 each)				
7.	Bank Account	Dr.		14,97,000	
	To Share First Call Account				14,97,000
	(Being receipt of first call money on 99,800 shares)				
8.	Share Second and Final Call Account	Dr.		35,00,000	
	To Share Capital Account				35,00,000
	(Being second and final call money due on 1,00,000 shares @ ₹ 35 per shares)				
9.	Bank Account	Dr.		34,88,800	
	To Share Second & Final Call Account				34,88,800
	(Being receipt of second and final call on 99,680 shares)				

Working Note:

(i) In this problem allotment is on pro-rata basis. Therefore, Mr. Akash who was allotted 200 shares must have applied for:

	₹
Money received on 240 shares @ ₹ 20 each	48,00
App. money transferred to capital 200 × 20	4,000
Amount available for adjustment in allotment	800
Amount due on allotment on 200 shares	200 × 20 = 4,000
Amount already received with application	800
Amount not received on allotment	3200

(ii)

Total amount receivable on allotment	1,00,000 × 20 = 20,00,000
Received with application	20,000 × 20 = 4,00,000
	16,00,000
Not paid by Akash	3,200
	15,96,800

Example 5: Following are the excerpts from the balance sheet of Sushil Ltd. As on 31st Dec. 2005

Liabilities:	₹
Authorized Share Capital	90,00,000
Issued and subscribed:	
400,000 Equity shares of ₹ 10 each fully paid up	40,00,000
2,00,000 10% Preference shares of ₹ 10 each fully paid up	20,00,000
Reserve and surplus:	
Share premium	1,50,000

In January, 2006 the company issued to public 3,00,000 equity shares of ₹ 10 each at a discount of 5%. The amount per share was payable as follows:

With application	₹ 2.5
On allotment	₹ 4.5
On first and final call	₹ 2.5

The public applied for 2,70,000 shares only.

These were allotted in February 2006. The call was made in March 2006. All the money ware received. Record the transactions relating to the issue in the books of company and draw the balance sheet as it would appear after the collection of money.

Solution:

Sushil Limited Journal

Date	Particulars	L.F.	₹	₹
Jan.	Equity Share Application Account Dr.		6,75,000	
	To Equity Share Capital Account			6,75,000
	(Being application money transferred to share capital account)			

Contd...

Notes

Feb.	Equity Share Allotment Account	Dr.		12,15,000	
	Discount on Issue of Shares Account	Dr.		1,35,000	
	To Equity Share Capital Account				13,50,000
	(Being allotment money due on 2,70,000 shares @ ₹ 4.5 each at a discount of 5%)				
March	Equity Share First and Final Call Account	Dr.		6,75,000	
	To equity Share Capital Account				6,75,000
	(Being first and final call money due on 2,70,000 shares @ ₹ 2.5 per share)				
	Share Premium Account	Dr.		1,35,000	
	To Discount on Issue of Shares Account				1,35,000
	(Being utilised share premium to write off the discount on issue of shares)				

Cash Book (Bank Column Only)

Dr. Cr.

	₹		₹
To Equity Share Application Account	6,75,000	By Balance c/d	25,65,000
To Equity Share Allotment Account	12,15,000		
To Equity Share First and Final Call Account	6,75,000		
	25,65,000		25,65,000

Equity Share Capital Account

	₹		₹
To Balance c/d	67,00,000	By Balance b/d	40,00,000
		By Equity Share Application Account	6,75,000
		By Equity Share Allotment Account	12,15,000
		By Discount on Issue of Share Account	1,35,000
		By Equity Share First and Final Call Account	6,75,000
	67,00,000		67,00,000

Equity Share Application Account

	₹		₹
To Equity Share Capital Account	6,75,000	By Bank Account	6,75,000
	6,75,000		6,75,000

Equity Share Allotment Account

	₹		₹
To Equity Share Capital Account	12,15,000	By Bank Account	12,15,000
	12,15,000		12,15,000

Equity Share First and Final Call Account

	₹		₹
To Equity Share Capital Account	6,75,000	By Bank Account	1,35,000
	6,75,000		1,35,000

Notes

Discount on Issue of Shares Account

	₹		₹
To Equity Share Capital Account	1,35,000 1,35,000	By Share Premium Account	1,35,000 1,35,000

Share Premium Account

	₹		₹
To Discount on Issue of shares account To Balance c/d	1,35,000 15,000 1,50,000	By Balance b/d	1,50,000 1,50,000

Balance Sheet of Sushil Limited as on __________

Liabilities		Amount	Assets	Amount
		₹		₹
Share Capital:			Sundry Assets	61,50,000
Authorised	90,00,000		Current Assets:	
Issued:			Bank Balance	25,65,000
7,00,000 Equity Shares of ₹ 10 each 70,00,000				
2,00,000, 10% Pref. Shares of ₹ 10 each 20,00,000	90,00,000			
Subscribed:				
6,70,000 equity shares of ₹ 10 each fully paid up	67,00,000			
2,00,000, 10% Preference shares of ₹ 10 each fully paid up		20,00,000		
Reserve and surplus	15,000			
		87,15,000		87,15,000

1.3.3 Issue of Shares at par

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

1.3.4 Issue of Shares at Calls-in-Arrear and Calls-in-Advance

If any amount has been called by the company in respect of shares allotment or call money and the shareholder has not paid that amount before or on the date fixed for payment thereof that amount which is not paid is known as Calls-in-Arrear.

Notes The company directors can charge interest on calls-in-arrear at a rate specified in the Articles from the last date fixed for payment to the date of actual payment. But if the Articles are silent, Table A (16) shall be applicable, which empowers the Board of Directors of the company to charge interest on the unpaid amount from the date fixed for payment thereof to the date of actual payment at a rate not exceeding 5% p.a.

The Board of Directors shall be at liberty to waive the payment of interest on unpaid amount.

Notes

Accounting Treatment

Though there is no requirement to open calls-in-arrear account separately and generally call-in-arrear account is not opened– yet some companies open this account and pass the following journal entry:

Call-in-arrear account Dr. (for unpaid amount)

To Relevant Call Account

And when the amount of calls in arrear is received.

Bank Account Dr.

To Call-in-Arrear Account

If there is any balance for calls-in-arrear account, it is shown by the way of deduction from the called up capital in the balance sheet.

Calls-In-Advance

When any applicant pays more amount than the amount due from him, this excess amount is known as call-in-advance. A company may, if so authorised by its Articles of Association, accept calls-in-advance from its shareholders. If there is a provision in the Articles of Association of a company, the Board of Directors must pay interest on call-in-advance at a rate specified in the articles of association from the date of its receipt to the date when the call became due. But if the Articles are silent at this point, Table A(18) shall be applicable, which provides the option to board of directors to pay interest on calls-in-advance at a rate not exceeding 6% per annum.

Accounting Treatment

Calls-in-advance is shown in the liability side of the balance sheet separately from paid up capital. Calls-in-advance are not entitled for any dividend declared by the company. The accounting journal entries relating to calls-in-advance are as follows:

When amount of calls in advance is received:

Bank Account Dr.

To Call-in-advance account

When the relevant call is received:

Calls-in-advance account Dr.

To relevant call account

Example 6: The authorised capital of Bhatia Limited is 200,000 shares of ₹ 10 each. On April 20, 2006. 1,00,000 shares are issued for subscription at a premium of 20%. The share money is payable as follows:

₹ 5 including premium with application

₹ 3 on allotment

₹ 2 on first call

₹ 2 on second and final call.

Notes

The subscription list closes on May 11, 2006 and directors proceed to allot on May 18, 2006. The shares are fully subscribed and the application money (including premium) is received in full. The allotment money is received by June 30, 2006, except as regards 1,000 shares. It is expected that the allotment money on these 1,000 shares will not be received. The first call and second call money is received by September 30, 2006 and December 30, 2006 respectively, barring the second call money on 400 shares, which is not received and which is not likely to be received.

Pass the necessary journal entries in the books of Bhatia Limited.

Solution:

Bhatia Limited Journal

2006			₹	₹
May 11	Bank Account	Dr.	5,00,000	
	To Share Application Account			5,00,000
	(Being receipt of application money on 1,00,000 shares @ ₹ 5 each)			
May 18	Share Application Account	Dr.	5,00,000	
	To Share Capital Account			3,00,000
	To Share Premium Account			2,00,000
	(Being transfer of application money to capital and share premium account)			
	Share Allotment Account	Dr.	3,00,000	
	To Share Capital Account			3,00,000
	(Being allotment money due on 100,000 shares @ ₹ 3 per share)			
	Either:			
June 30	Bank Account	Dr.	2,97,000	
	To Share Allotment Account			2,97,000
	(Being receipt of allotment money on 99000 shares)			
	OR			
	Bank Account	Dr.	2,97,000	
	Call-in-Arrear Account	Dr.	3,000	
	To Share Allotment Account			3,00,000
	(Being receipt of allotment money on 99,000 shares and unpaid amount on 1000 shares transferred to calls-in-arrear)			
Sep. 30	Share First Call Account	Dr.	2,00,000	
	To Share Capital Account			2,00,000
	(Being first call money due on 1,00,000 shares @ ₹ 2 each)			
	Either:			
	Bank Account	Dr.	1,98,000	
	To Share First Call Account			1,98,000
	(Being receipt of first call money on 99000 shares)			
	OR			
	Bank Account	Dr.	1,98,000	
	Calls-in-Arrear Account	Dr.	2,000	
	To Share First Call Account			2,00,000
	(Being receipt of first call money on 99000 shares and unpaid amount on 1,000 shares transferred to calls-in-arrear)			

Contd...

Notes

Dec. 31	Share Second & Final Call Account To Share Capital Account (Being second & final call money due on 1,00,000 shares @ ₹ 2 each) **Either:**	Dr.	2,00,000	 2,00,000
	Bank Account To Share Second & Final Call Account (Being receipt of second & final call on 98,600 shares) **OR**	Dr.	1,97,200	 1,97,200
	Bank Account Calls-in-arrear A/c To Second & Final Call Account (Being receipt of second & final call and unpaid transferred to calls-in-arrear account)	Dr. Dr.	1,97,200 2,800	 2,00,000

Example 7: On 1st January, 2006, XYZ Limited issued 5,000 equity shares of ₹ 100 each. Payment on shares is to be made in following manner. Application fees of ₹ 2 were received on 1st Feb. 2006, while allotment fees of ₹ 3 were received on 1st March, 2006. First and final call of ₹ 6 were received on 1st July, 2006. Applications were received for 6,500 shares and directors made allotment in full to the applicants demanding five or more shares and returned the money to the applicants for 1,500 shares. One shareholder who was allotted 20 shares paid the first and final call money with allotment money. Another shareholder did not pay allotment money on his 30 shares but paid the same with first and final call. The directors have decided to charge and allow interest, as the case may be, on calls-in-arrear and calls-in-advance, respectively according to the provisions of Table A.

Journalise the transactions–

Solution:

XYZ Limited Journal

2006			₹	₹
Feb. 1	Bank Account To Equity Share Application Account (Being receipt of application money on 6,500 shares @ ₹ 2 Per share)	Dr.	13,000	 13,000
	Equity Share Application Account To bank account To Equity Share Capital Account (Being application money transferred to share capital and refund to 1500 unsuccessful applicants)	Dr.	13,000	 3,000 10,000
March 1	Equity Share Allotment Account To Equity Share Capital Account To Equity Share Premium Account (Being allotment money due on 5000 share @ ₹ 3 each including premium of Re 1 per share)	Dr.	15,000	 10,000 5,000
	Bank Account To Equity Share Allotment Account To Calls-in-Advance Account	Dr.	15,030	 14,910 120

Contd...

Notes

	(Being receipt of allotment money on 4,970 shares and calls-in-advance on 20 shares)			
July 1	Equity Share First & Final Call Account	Dr.	30,000	
	To equity share capital account			30,000
	(Being first and final call money due on 5,000 shares @ ₹ 6)			
	Bank Account	Dr.	29,970	
	Calls-in-Advance Account	Dr.	120	
	To Equity Share First & Final Call Account			30,000
	To Equity Share Allotment Account			90
	(Being receipt of first and final call money on 4,980 shares and allotment money on 30 share.)			
	Interest on Calls in Advance Account	Dr.	2.4	2.4
	To Bank Account			
	(Being payment of interest on calls-in-advance)			
	Bank Account	Dr.	1.5	
	To Interest on Calls-in-Arrear Account			1.5
	(Being interest on calls in arrear received)			

Working Note:

(i) Calls-in-arrear on allotment = 30 × 3 = 90

Interest on calls-in-arrear for 4 months (March, April, May and June) @ 5% per annum

$$= 90 \times \frac{5}{100} \times \frac{4}{12} = ₹\ 1.50$$

(ii) Calls-in-advance on 20 shares for first and final call at the time of allotment = 20 × 6 = ₹ 120

Interest on calls-in-advance for four months (March, April, May and June) @ 6% p.a.

$$\frac{120 \times 6}{100} \times \frac{4}{12} = ₹\ 2.4$$

Interest on Calls in Advance Account	Dr.	2.4	
To Bank Account			2.4
(Being payment of interest on calls-in-advance)			
Bank Account	Dr.	1.5	
To Interest on Calls-in-Arrear Account			1.5
(Being interest on calls in arrear received)			

1.4 Undersubscription and Oversubscription

The issue of a company is called under-subscribed, if the number of shares applied for is less than the number of shares issued by the company. In this case the accounting entries are made on the basis of the number of shares applied for, but minimum subscription has been received by the company.

Notes

The issue is said to be over-subscribed if the number of shares applied is more than the number of shares offered to issue. As explained earlier, in any condition the board of directors cannot allot more shares than the shares offered for issue in the prospectus. Therefore, the board of directors have to adopt any one of the following methods in such a situation:

(a) Total excess applications of shares over the shares issued may be rejected and their application money refunded with the letter of regret. For this purpose, journal entry will be:

Share Application Account Dr. (with actual refund)

To Bank Account

(Being the refund of excess application money on ______ shares @ ₹_______ per shares)

(b) Allotment is made on pro-rata basis to the all applicants. In the pro-rata allotment, shares are partially allotted to all applicants. No application for shares is refused and also no applicant is allotted the shares in full. In pro-rata allotment all applicants get shares in the same proportion. This proportion is: Total shares issued : Total shares applied for. For instance, if one has applied for 200 shares and he is allotted 100 shares only. This would be pro-rata allotment. Here, the basis of allotment would be one share allotted for every two shares applied for. In this case, excess application money is not refunded to the applicant but is adjusted towards the money due on allotment and the deficit of allotment money will be payable by the applicant at the time of allotment money due. For this purpose entry will be:

Share Application Account Dr. (with the excess application money)

To Share Allotment Account

(Being the excess application money transferred to share allotment account)

(c) In the form of third alternative the directors may adopt the following criteria:

(i) Some applicant may be totally rejected.

(ii) Some applicants may be accepted in full.

(iii) The remaining applicants will be allotted on the basis of pro-rata.

Where pro-rata system is adopted to allot shares, the excess application money will be transferred from the share application account to the share allotment account. To the extent of allotment money on shares allotted, the balance of excess of application money is refunded. If the directors are authorised by the Articles, this balance of excess of application money will be transferred to calls-in-advance account. If the application money received from any applicant exceeds the total amount payable on shares allotted to him, such an excess will have to be refunded. Thus, the combined journal entry for the disposal of excess application money will be:

Share Application Account Dr.

To Share Allotment Account

To Share Calls-in-Advance Account

To Bank Account.

In brief, if the entire surplus application amount is not refunded and is equal to the allotment money due on shares allotted, these shareholders will not pay any amount on allotment. If it is less than the allotment money due, the applicants have to pay the deficit amount on allotment and if it is more that allotment money due, first it will be utilised for allotment money in full and balance can be returned or transferred to the calls-in-advance account.

Notes

Under-subscription

Example 8: Raja Ram Ltd. issued a prospectus for 20,000 shares of ₹ 25 each at par, payable as under:

On Application ₹ 6

On Allotment ₹ 6

On First Call ₹ 7

On Second Call ₹ 6

The applications were received for 19,000 shares and all these were accepted and all the money due received. Show the cash book and journal and prepare the balance sheet of the company.

Solution:

Raja Ram Ltd. Journal Entries

Date	Particulars		Debit (₹)	Credit (₹)
	Share Application Account	Dr.	1,14,000	
	To share capital account			1,14,000
	(Being application money transferred to share capital account on 19,000 shares @ ₹ 6 per share)			
	Share Allotment Account	Dr.	1,14,000	
	To Share Capital Account			1,14,000
	(Being allotment money due on 19,000 shares @ ₹ 6 per share)			
	Share First Call Account	Dr.	1,33,000	
	To Share Capital Account			1,33,000
	(Being first call money due on 19,000 shares @₹ 7 per share)			
	Share Second & Final Call Account	Dr.	1,14,000	
	To Share Capital Account			1,14,000
	(Being second & final call money due on 19,000 shares @ ₹ 6 per share)			

Balance Sheet As On …………….

Liabilities	₹	Assets	₹
Authorised & Issued Capital			
(20,000 shares of ₹ 25 each)	5,00,000	Cash at Bank	4,75,000
Subscribed, Called up and Paid up capital			
(19,000 shares of ₹ 25 each)	4,75,000		
	4,75,000		**4,75,000**

Over-subscription

Example 9: Waye Ltd. invited applications for 50,000 equity shares of ₹ 100 each on the following terms:

On applications ₹ 10 per share, on allotment ₹ 40 per share and on final payment ₹ 50 per share.

Over-payments on application were to be applied towards sums due on allotment. Where no allotment was made, application money was to be returned in full. The issue was over-subscribed to the extent of 15,000 shares. It was decided to :

(i) refuse allotment to the applicants for 10,000 shares and send them letters of regret.

(ii) allot 10,000 shares to Mr. *X* who has applied for 15,000 shares.

Notes

(iii) allot in full to other applicants

(iv) utilise excess application money in part payment of allotment.

All the moneys due on allotment and final calls were duly received. Make necessary journal entries in the books of company.

Solution:

Waye Ltd.Journal Entries

Date	Particulars		Debit (₹)	Credit (₹)
	Bank Account	Dr.	6,50,000	
	To Equity Share Application Account			6,50,000
	(Being receipt of application money on 65,000 shares @ ₹ 10 per share)			
	Equity Share Application Account	Dr.	5,50,000	
	To Equity Share Capital Account			5,00,000
	To Equity Share Allotment Account			50,000
	(Being application money on 50,000 shares transferred to share capital and that for 5,000 shares utilised for allotment money)			
	Equity Share Application Account	Dr.	1,00,000	
	To Bank Account			1,00,000
	(Being application money for 10,000 share refunded)			
	Equity Share Allotment Account	Dr.	20,00,000	
	To Equity Share Capital Account			20,00,000
	(Being allotment money due on 50,000 shares @ Rs 40 per share)			
	Bank Account	Dr.	19,50,000	
	To Equity Share Allotment Account			19,50,000
	(Being allotment money received)			
	Equity Share First and Final Call Account	Dr.	25,00,000	
	To Equity Share Capital Account			25,00,000
	(Being first and final call money due on 50,000 share @ ₹ 50 per share)			
	Bank Account	Dr.	25,00,000	
	To Equity Share First and Final Call Account			25,00,000
	(Being the receipt of first and final call on 50,000 shares)			

Task The main difference between subscribed capital and called up capital will be:

(a) Calls-in-Arrear

(b) Calls-in-Advance

(c) Uncalled Capital

(d) Paid up Capital

Example 10: ***(Adjustment of Excess Application Money in Various Ways)***

X and *Y* Ltd. made an issue of 60,000 equity shares of ₹ 100 each payable as under:

On Application ₹ 25

On Allotment ₹ 50

On Call ₹ 25

Notes

Total application were received for 100,000 shares and allotment was made as:

Applicants for 10,000 shares (in respect of applications for 2,000 or more) received 5,000 shares.

Applicants for 40,000 shares (in respect of applications for 1,000 or more) received 8,000 shares.

Applicants for 50,000 shares (in respect of applications for less than 500 shares) received 47,000 shares.

Excess application money was utilised for the payment of allotment and call and balance was returned. All money due on allotment and call was received. Make the necessary journal entries and show the relevant ledger accounts.

Solution:

Working Note:

Analytical Table for Adjustment of Excess Application Money

Category	No. of Shares Applied	No of Shares Allotted	Application Money received@ Rs. 25 per share	Application money due on allotted shares	Excess Application money	Allotment money due on allotted shares @ Rs. 50 per share	Excess transferred to allotment money	Balance due on allotment	Excess application money after adjusting in allotment	Call money due Rs. 25 per share	Excess application adjusted in call money	Balance due on Call	Excess application money after adjusting in call money-refunded
I	10,000	5,000	2,50,000	1,25,000	1,25,000	2,50,000	1,25,000	1,25,000	—	1,25,000	—	1,25,000	—
II	40,000	8,000	10,00,000	2,00,000	8,00,000	4,00,000	4,00,000	—	4,00,000	2,00,000	200,000	—	2,00,000
III	50,000	47,000	12,50,000	11,75,000	75,000	23,50,000	75,000	22,75,000	—	11,75,000	—	11,75,000	—
Total	1,00,000	60,000	25,00,000	15,00,000	10,00,000	30,00,000	6,00,000	24,00,000	4,00,000	15,00,000	2,00,000	13,00,000	2,00,000

X Y Ltd. Journal Entries

			₹	₹
1.	Bank Account	Dr.	25, 00,000	
	To Equity Share Application Account			25,00,000
	(Being receipt of application money on 1,00,000 shares @ ₹ 25 per share)			
2.	Equity Share Application Account	Dr.	2,00,000	
	To Bank Account			2,00,000
	(Being the refund of application money for 8000 shares @ ₹ 25 per share)			
3.	Equity Share Application Account	Dr.	15,00,000	
	To Equity Share Capital Account			15,00,000
	(Being share application money transferred to share capital a/c)			
4.	Equity Share Application Account	Dr.	8,00,000	
	To Equity Share Allotment Account			6,00,000
	To Calls-in-Advance Account			2,00,000
	(Being utilisation of excess application money in allotment and calls-in-advance)			

Contd...

Notes

5.	Equity Share Allotment Account Dr.	30,00,000	
	To Equity Share Capital Account		30,00,000
	(Being allotment money due on 60,000 shares @ ₹ 50 per share)		
6.	Bank Account Dr.	24,00,000	
	To Equity Share Allotment Account		24,00,000
	(Being the receipt of balance of allotment money)		
7.	Equity Share First and Final Call Account Dr.	15,00,000	
	To Equity Share Capital Account		15,00,000
	(Being first and final call due on 60,000 shares @ ₹ 25 per share)		
8.	Bank Account Dr.	13,00,000	
	Call-in-Advance Account Dr.	2,00,000	
	To Equity Share First and Final Call A/c		15,00,000
	(Being calls-in advance adjusted and balance of call money received)		

Ledger Accounts Bank Account

Particulars	₹	Particulars	₹
To Equity Share Application Account (Application money on 1,00,000 shares @ ₹ 25 per share)	25,00,000	By Equity Share Application Account (Application money refunded on 8,000 shares @ ₹ 25 per share)	2,00,000
To Equity Share Allotment Account (balance of allotment money received)	24,00,000	By balance c/d	60,00,000
To Equity Share First and Final Call Account (Balance of first and final call money)	13,00,000		
	62,00,000		62,00,000

Equity Share Application Account

Particulars	₹	Particulars	₹
To Bank Account	2,00,000	By Bank Account	25,00,000
To Equity Share Capital Account	15,00,000		
To Equity Share Allotment Account	6,00,000		
To Call-in-Advance Account	2,00,000		
	25,00,000		25,00,000

Equity Share Allotment Account

	₹		₹
To Equity Share Capital Account	30,00,000	By Equity Share Application A/c	6,00,000
		By Bank Account	24,00,000
	30,00,000		30,00,000

Equity Share First and Final Call Account

	₹		₹
To Call-in-Advance Account	2,00,000	By Equity Share Capital Account	15,00,000
To Bank Account	13,00,000		
	15,00,000		15,00,000

Notes

Equity Share Capital Account

	₹		₹
To balance c/d	60,00,000	By Equity Share Application Account By Equity Share Allotment Account By Equity Share First & final call account	15,00,000 30,00,000 15,00,000
	60,00,000		60,00,000

1.5 Combined Account for Share Application and Allotment

Some accountants prefer to prepare a combined account for share application and share allotment, which is called the share application and allotment account. By preparing this account, they save their time and energy. Only one journal entry is made for transferring the application money to share capital account and allotment money due. Along with it, they need not make an entry for transferring the excess application money to allotment account too.

Example 11: X Y Company was registered with an authorised capital of ₹ 10,00,000 which was divided into 6,000 equity shares of ₹ 100 each and 4,000, 8% preference shares of ₹ 100 each. The company issued a prospectus to issue these shares on the condition that full amount of the shares would be paid in lump sum. All these shares were taken up and paid by the public. Pass the necessary journal entries in the books of the company.

Solution:

Journal Entries

Date	Particulars		Dr. ₹	Cr. ₹
	Bank Account To Equity Share Application & Allotment Account (Being receipt of application money on 157,000 shares @ ₹ 10 per shares)	Dr.	15,70,000	 15,70,000
	Equity Share Application & Allotment Account To Equity Share Capital Account (Being application money @ ₹ 10 and allotment money ₹ 15 per share credited on 50,000 equity share)	Dr.	12,50,000	 12,50,000
	Equity Share Application and Allotment Account To Bank Account to Calls-in-advance account (Being refund of excess application money after adjusting allotment money and adjusting in calls in advance)	Dr.	4,70,000	 20,000 4,50,000
	Bank Account To Equity Share Application and Allotment Account (Being receipt of balance of allotment money due after adjustment of excess application money) Equity Share First and Final Call Account To equity share capital account (Being first and final call money due on 5000 shares @ ₹ 25 per share)	Dr. Dr.	1,50,000 7,50,000	 1,50,000 7,50,000
	Calls-in-advance Account Bank Account To Equity Share First and Final Call Account (Being receipt of balance first and final call money on 50,000 shares after adjusting calls in advance)	Dr. Dr.	4,50,000 3,00,000	 7,50,000

Self Assessment

Notes

True or False:

7. Share application account is a nominal account.
8. Right shares are those which are issued to the existing shareholder.

Fill in the blanks:

9. Rate of dividend for equity shares is .... fixed.
10. The .... of the company defines the objectives of the company.
11. Minimum subscription has been determined at .... of the total issue.
12. The nature of share application account is ....

1.6 Issue of Shares for Consideration Other than Cash

Sometimes, a company may issue fully paid shares to any person or firm from whom it purchases any assets such as land, plant and machinery, building etc. This type of issue is called issue of shares for consideration other than cash because this issue does not involve the receipt of cash. If such shares are issued, it must be clearly stated in the balance sheet and must be distinguished from the issue made for cash. Such an issue can be as follows:

1. ***Issue of Shares to Vendors:*** For the payment of purchase price of assets, the company may issue fully paid shares to vendors of assets. Such an issue can be at par, discount or premium. In such a case the following entries will be purchased:

   (a) When assets are purchased:

Assets Account	Dr.	(with the purchase price of assets)
To Vendors' Account		
(Being assets purchased)		

   (b) When shares are issued for payment –

   (i) if this issue of shares is at par –

Vendors account	Dr.	(with the nominal value of shares allotted)
To Share Capital Account		

   (ii) if this issue of shares is at discount –

Vendors' Account	Dr.	(with purchase price)
Discount on shares Account	Dr.	(with the amount of discount)
To Share Capital Account		(with the nominal value of shares allotted)

   (c) If the issue of shares is at premium –

Vendors' Account	Dr.	(with the purchase price)
To Share Capital Account		(with the nominal value of shares allotted)
To Share Premium Account		(with the amount of premium)

2. ***Issue of shares to promoters:*** A company may issue its fully paid shares to its promoters in recognition of their services to the company. Similarly a company may also issue shares

Notes

to other persons who might render technical information, engineering services, plant layout etc. Being are capital expenditure, these are therefore debited to the goodwill account. Its accounting record can be understood with the help of following journal entry.

Goodwill Account Dr. (with the nominal value of shares allotted)

To Share Capital Account

3. ***Issue of shares to under-writers:*** A company may issue its fully-paid shares to underwriters for the payment of underwriting commission.

(a) When commission is due–

Underwriting Commission Account Dr. (with the amount of commission)

To underwriter's account

(b) When commission is paid by shares –

Underwriters Account Dr. (with the nominal value of shares issued)

To share capital account

Example 12: Sikander Ltd. acquired the business of Subhash and Brothers for ₹ 5,40,000. The payment was made by the issue of fully paid shares of ₹ 100 each. What entries will be made in the books of Sikander Ltd. if such issue is (i) at par, (ii) at a premium of 20% and (iii) at a discount of 10%.

Solution:

Sikander Ltd.Journal

Date	Particualars		L.F.	₹	₹
(i)	Sundry Assets A/c	Dr.		5,40,000	
	To Subhash & Brothers				5,40,000
	(Being Business purchased)				
(ii)	***When issue is at par:***				
	Subhash & Brothers	Dr.		5,40,000	
	To Share Capital Account				5,40,000
	(Being issue of 5400 shares of ₹ 100 each to Vendor)				
(iii)	***When issue is at premium:***				
	Subhash & Brothers	Dr.		5,40,000	
	To Share Capital Account				4,50,000
	To Share Premium Account				90,000
	(Being issue of 4500 shares of Rs 100 each at a premium of 20% to vendor)				
(iv)	***When issue is at discount:***				
	Subhash & Brothers	Dr.		5,40,000	
	Discount on Issue of Shares A/c	Dr.		60,000	
	To Share Capital Account				6,00,000
	(Being issue of 6,000 shares to vendor at a discount of 10%)				

Working Note: In order to find out the number of shares allotted to vendor, first of all discounted price or price with premium, of one share which is issued to vendor, is calculated. Here it is ₹ 120 in the case of premium and ₹ 90 in the case of discount. The following formula is used:

(i) No of shares issued at premium of 20% $= \dfrac{\text{Purchase Price}}{\text{Issue price of one share}}$

Notes

$$= \frac{5,40,000}{120} = 4,500 \text{ shares}$$

Amount of share capital = 4500 × 100 = ₹ 450,000

Amount of share premium – 4,5000 × 20 = ₹ 90,000

(ii) No of shares issued at a discount of 10% $= \dfrac{\text{Purchase Price}}{\text{Issue price of one share}}$

$$= \frac{5,40,000}{90} = 6,000 \text{ shares}$$

Amount of share capital = 6000 × 100 = ₹ 6,00,000

Amount of discount on shares = 6000 × 10 = ₹ 60,000

Example 13: Agfa & Co. Ltd. has an authorised share capital of ₹ 5,00,000 divided into 50,000 shares of ₹ 10 each. Out of these, 8,000 shares were issued to the vendors as fully paid, 16,000 shares were subscribed for by the public and the first year ₹ 2 per share were paid on application, ₹ 2 per share on allotment and ₹ 6 per share were called up. 4,000 shares were issued as fully paid to promoters.

Of the 16,000 shares subscribed for by the public, these have been paid at the end of the first year. On 12,000 shares the full amount was called up. On 2,500 shares ₹ 4 per share were called up and on 1,500 shares ₹ 2 per share were called up.

You are required to prepare the journal and cash book entries and the balance sheet of the company.

Solution:

Agfa & Co. Ltd. Journal Entries

Date	Particulars		L.F.	₹	₹
	Sundry Assets Account	Dr.		80,000	
	To Vendors' Account				80,000
	(Being sundry assets purchased)				
	Vendors' Account	Dr.		80,000	
	To Share Capital Account				80,000
	(Being the issue of 8,000 shares of ₹ 10 each to vendor for the consideration of purchase of assets.)				
	Goodwill Account	Dr.		40,000	
	To Share Capital Account				40,000
	(Being issue of 4,000 shares of ₹ 10 each to promoters for their services)				
	Share Application Account	Dr.		32,000	
	To share Capital Account				32,000
	(Being application money transferred to share capital A/c)				
	Share Allotment Account	Dr.		32,000	
	To Share Capital Account				32,000
	(Being share allotment money due on 16,000 shares)				
	Share First & Final Call A/c	Dr.		96,000	
	To Share Capital Account				96,000
	(Being first and final call money due on 16,000 shares @ ₹ 6 per share)				

Notes

Cash Book (Bank Column Only)

Particulars	₹	Particulars	₹
To Share Application Account To Share Allotment Account To Share First and Final Call Account	32,000 29,000 72,000	By balance c/d	1,33,000
	1,33,000		1,33,000

Balance Sheet of Agfa Co. Ltd. for the year ending..................

Liabilities	₹	Assets	₹
Authorised capital: 50,000 shares of ₹ 10 each	5,00,000	Sundry Assets Goodwill Bank Balance	80,000 40,000 1,33,000
Paid up Capital 8,000 shares of Rs 10 each issued to vendor for the purchase of assets 4,000 shares of ₹ 10 each issued to promoters 16,000 shares of ₹ 10 each issued used for cash 1,60,000 Less : Call-in-Arrear 27,000	80,000 40,000 1,33,000		
	2,53,000		2,53,000

Self Assessment

Fill in the blanks:

13. A public limited company must have at least .... directors.
14. The director of a public limited company must be a ....

Choose the correct answer:

15. Right shares means such shares which are
    (a) issued by a newly formed company
    (b) issued to the directors of the company
    (c) first offered to the existing shareholders
    (d) issued to any person.
16. Preference shares of a company means:
    (a) Creditors
    (b) Owners
    (c) Customers
    (d) Partners

Notes

Case Study

Share Capital and Issue of Shares

Dabur Over the Years: The Dabur Story

A classic case of a family owned business being handed over to professionals, a company making timely strategic interventions to adapt to the business environment and maintaining its brand equity over the years.

Dabur India Limited (DIL) is the third largest FMCG Company operating in India with a turnover of more than ₹ 2,233 crores. It operates under three business categories namely Consumer Care Division (CCD), Consumer Healthcare Division (CHD) and Dabur foods Limited (in July 2007, Dabur announced the de-merger of DFL with DIL).

Background

Dr. S.K Burman started Dabur in 1884 as a small pharmacy. Initially, he prepared Ayurvedic medicines to treat diseases like malaria, plague and cholera that had no cure during that period. It was his dedication, commitment and empathy that made Dabur a renowned name among the masses. And today, after more than 120 years, Dabur is known for its trustworthiness more than anything else.

During this passage of time, Dabur went through several structural and strategic changes to maintain its market strength. The real mass production started in 1896. Early 1900's saw Dabur emerge as the first company to provide health care through scientifically tested methods. It achieved significant improvements after setting up Research and Development centers and manufacturing automation. The launch of Dabur's Amla hair oil and Chyawanprash was a boon to the expanding business. To keep up with the times, Dabur computerized its operations in 1957. Its *Dant Manjan* and digestive tablets were widely accepted as well.

However with a large product portfolio in the market, Dabur had to maintain operational efficiency. To make sure it adjusted to the business environment it became a public limited company in 1986 followed by diversification in Spain in 1992. A major change came when Dabur came up with its IPO in 1994. Because of its position, Dabur's issue was 21 times oversubscribed. Dabur further divided its business into three separate groups:

- Health Care Products Division
- Family Products Division
- Dabur Ayurvedic Specialties Limited

In 1998, for the first time in the history of Dabur, a non-family member took charge. Dabur handed over the operations to professionals. Successful implementation of procedures, timely changes and maintaining its essence, Dabur achieved its highest-ever sales figure of ₹ 1166.5 crore in 2000-01.

As FMCG sector was struggling with the slow growth in the Indian economy, Dabur decided to take numerous strategic initiatives, reorganize operations and improvise on its brand architecture beginning 2002. It decided to concentrate its marketing efforts on Dabur, Vatika, Anmol, Real and Hajmola to strengthen their brand equity, create differentiation and emerge as a pure FMCG player recognized as a herbal brand. This was

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chosen after a study with Accenture, which revealed that Dabur was mainly perceived as a Herbal brand and connected more with the age group above 35.

Also, larger retailers were making their foray into the FMCG market. Apart from HLL, P&G, Marico and Himalaya, ITC was also posing a challenge. The supply chain of Dabur was becoming complex because of the large array of products. Southern markets share in the sales figure was negligible. These factors posed a threat to Dabur and hence small changes were not enough.

Given below is the product portfolio of Dabur (Consumer Care Division 2006):

Product Category	Products
Hair oil	Vatika, Amla, Sarso
(Anmol coconut)	
Shampoo	Vatika heena conditioning, root-strengthening
Anmol-natural shine, silky	
Baby & Skin Care	Vatika fairness, Gulabari, Vatika fairness face pack
Janmaghutti, Olive oil, Gripe water, Dabur lal tel	
Digestive	Hajmola range, Hingoli, Pudin hara
Health Supplements	Chyawanprash, chyawanshakti, Dabur Honey, Glucose
Oral Care	Babool (rural market), Meswak (unani method), promise, Lal paste, Binaca, Promise
Home Care	Odomos, Odonil, Odopic, Sanifresh

Given Below is a Segment Wise Competitor list:

Category	Dabur's Share	Main Competitors
Fruit Juice	58% Real and Active	Tropicana
Fruit Drinks (coolers)	1% Coolers	Frooti and Maaza
Hair oil Coconut base	6.4% Vatika	HLL
Shampoo Vatika	7.1%	HLL and P&G
Hair care (overall)	27%	HLL, P&G and Himalaya
Chyawanprash	64%	Himani, Zhandu and Himalaya
Honey	40%	Himani, Hamdard and local Players
Digestives	37%	Paras and local players

Recent Initiatives

Following its plans, Dabur made significant changes in the time period 2002-2007.

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Brand Rejuvenation

With youth forming a major population of India, Dabur decided to revamp its brand identity. Dabur associated itself with Amitabh Bachchan, Vivek Oberoi, Rani Mukherjee and Virender Sehwag for endorsements. New packaging and advertising campaign saw the sales of Chyawanprash grow by 8.5 per cent in 2003-04.

The year 2004-05 saw a whole new brand identity of Dabur. The old Banyan tree was replaced with a new, fresh Banyan tree.

The logo was changed to a tree with a younger look. The leaves suggesting growth, energy and rejuvenation, twin colors reflecting perfect combination of stability and freshness, the trunk represented three people raising their hands in joy, the broad trunk symbolized stability, multiple branches were chosen to convey growth, and warmth and energy were displayed through the soft orange color. 'Celebrating Life' was chosen as a new tag that completely summarized the whole essence.

The Chairman in his annual report message said, "If I were to summarize your Company's performance during the year under review (2004-2005), it would be 'Pursuit of Profitable Growth'".

HR Initiatives

The culture at Dabur gives full autonomy to its employees. Various training and development programs like Young Manager Development Program, Prayas, Leading and Facilitating Performance, Campus to Corpora and a Balanced scorecard approach to performance evaluation, helps employees realize their potential.

Recently, Dabur has adopted an innovative HR program of offering ESOPs to new engineering and management trainees at the time of joining. Also in 2005, Dabur gave Bonus to its employees after 12 years. This boosted the employee morale further.

Dabur was listed as a "Great Place to Work", in a survey conducted by Grow Talent & Company and Great Place to Work Institute, USA. Dabur was listed as the 10th "Great Place to Work". The results were published in Business World dated February 2006.

IT initiatives

Dabur installed centralized SAP ERP system from 1st April 2006 for all business units. It also implemented a country wide new WAN Infrastructure for running centralized ERP system. Further it set up new Data Center at KCO Head Office.

Supply chain Initiatives

Dabur has undertaken e-procurement in a big way. In 2003-04 Dabur India procured ₹210 crore of raw materials through e-sourcing — or almost 50 per cent of total raw material expenditure — and, in the process, considerably controlled raw material costs which were on a rise.

For better production and operation management, Dabur included automation, debottlenecking, Kaizen and wastage control. It set up production units in locations providing tax holidays to reduce cost and improve efficiency.

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Notes

Other important changes

Dabur made its largest acquisition by **taking over Balsara** hygiene and home products business. Dabur bought the entire promoters' stake of three Balsara companies through an all-cash deal of ₹140 crore. This was done to ensure Dabur's presence in all price segments in the herbal oral care market. Moreover, it allowed Dabur's entry in the household care segment, where Balsara has well-established brands.

Dabur also **de-merged its pharmaceutical business** to come out as a pure FMCG player.

Dabur estimated that the southern region was contributing as low as 7% to its overall growth. For this purpose, the south team adopted a three-phase approach. First, it focused on point of sale promotions and stocking practices. Second phase included better marketing efforts in terms of advertising and packaging. Finally, it envisioned customized product launches for the Southern states. The completion of first two phases by 2005-06 resulted in increasing contribution to 10%.

Vision 2010

After the successful implementation of the 4-year business plan from 2002 to 2006, Dabur has launched another plan for 2010. The main objectives are:

- Doubling of the sales figure from 2006
- The new plan will focus on expansion, acquisition and innovation. Although Dabur's international business has done well — growing by almost 29 per cent to ₹292 crore in 2006-07, plans are to increase it by leaps and bounds.
- Growth will be achieved through international business, homecare, healthcare and foods.
- Southern markets will remain as a focus area to increase its revenue share to 15 per cent.

With smoothly sailing through its previous plans, this vision seems possible. Time and again, Dabur has made decisions that have led to its present position. However, if Dabur could be more aggressive in its approach, it can rise to unprecedented levels. To conclude, this is a 10 year performance table from Dabur's website.

Rs Crore	FY98	FY99	FY00	FY01*	FY02**	FY03	FY04***	FY05	FY06#	FY07^
Operating Results:										
Sales	811	915	1043	1166	1281	1371	1330	1537	1900	2233
Other Income	13	23	34	19	12	7	9	9	13	25
EBIDTA	86	98	128	137	144	162	164	217	304	375
EBIDTA Margins (%)	10.6	10.7	12.2	11.8	11.3	11.8	12.3	14.1	16.0	16.8
Profit Before Tax(PBT)	45	52	81	85	82	106	124	176	257	319
Taxes	1	2	4	7	14	14	15	19	30	37
Tax Rate (%)	2.2	2.9	4.5	8.5	16.6	13.3	12.0	10.8	11.7	11.7
Profit After Tax (PAT)	44	50	77	78	64	85	107	156	214	283
PAT Margins(%)	5.5	5.5	7.4	6.7	5.0	6.2	8.0	10.1	11.3	12.7
Financial Position:										
Fixed Assets (Net)	205	239	251	243	371	257	250	295	512	379
Current Assets Loans & Advances	327	344	412	393	504	522	340	408	471	640
Current Liabilities & Provisions	87	84	108	158	184	241	294	400	436	452
Net Working Capital	240	260	304	235	322	281	46	8	35	189
TOTAL ASSETS	497	556	609	558	705	640	433	543	624	670
Share Capital	29	29	29	29	29	29	29	29	57	86
Reserves & Surplus	199	233	292	334	305	388	256	335	439	393

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Notes

SHARE HOLDERS FUNDS	227	262	320	362	394	417	205	364	496	479
Loan Funds	270	295	289	196	311	[illegible]	132	164	121	160
TOTAL CAPITAL EMPLOYED	**497**	**556**	**609**	**558**	**705**	**640**	**432**	**542**	**624**	**670**
RoCE (%)	15.1	15.1	17.0	19.5	12.6	16.0	28.7	31.4	39.0	45.9
RONW (%)	20.2	10.9	24.7	22.0	16.6	20.6	38.5	43.6	46.2	61.6
Equity Share Data:										
Earnings Per Share (Rs)	15.6	17.5	27.1	2.7	2.3	3.0	3.7	5.5	3.7	3.3
Dividend Per Share (Rs)	3.9	5.0	10.0	1.0	0.5	1.4	2.0	2.5	1.8	1.4
No of Shares (In Crores)	2.9	2.9	2.9	28.5	28.5	28.6	28.6	28.6	57.3	85.3

* Stock split from ₹ 10/share to ₹ 1/share

** Consolidated results from FY02 onwards

*** Dabur Pharma got de-merged.

Bonus issue of 1:1 was issued during the year

^ Bonus Issue of 1:2 was issued during the year

1.7 Summary

- Share capital comprises the nominal values of all shares issued (that is, the sum of their "par values").
- In a wider sense, if the shares have no par value or the allocation price of shares is greater than their par value, the shares are said to be at a premium (called share premium, additional paid-in capital or paid-in capital in excess of par); in that case, the share capital can be said to be the sum of the aforementioned "nominal" share capital and the premium.
- In the modern law of shares, the "par value" concept has diminished in importance, and share capital can simply be defined as the sum of capital (cash or other assets) the company has received from investors for its shares.

1.8 Keywords

Nominal Capital: Authorised capital of a company.

Convertible Shares: Share that can be easily converted.

Stipulated Rate: Formal agreement on your permanent disability rating.

1.9 Review Questions

1. ABC Limited was registered with an authorised capital of 1,00,000 shares of ₹ 100 each. 80,000 shares were issued to the public. The public subscribed for 60,000 shares. The company called up ₹ 8 per share. All the money called up was duly received with exception of a call of ₹ 2 per share on 500 shares. Show the amounts of various types of capital in the balance sheet.

2. Authorised capital of Samraat Ltd. is ₹ 50,00,000 divided into 50,000 equity shares of ₹ 100 each. Out of these shares only 40,000 shares were issued to the public payable as follows:

With application	₹ 20
On allotment	₹ 25
On first call	₹ 30
On second and final call	₹ 25

Notes

All the shares were subscribed by the public. The board of directors accepted all the applications. Both the calls were made. All the moneys were duly received. You are required to:

(i) pass journal entries for all the transactions including cash transactions,

(ii) prepare cash book,

(iii) show ledger accounts, and

(iv) draw balance sheet after the receipt of final call money.

3. Subhash Limited was formed on 1st Jan, 2006 with an authorised capital of ₹ 3,00,000 divided into 10,000 equity shares of ₹ 100 each and 2,000; 9% preference shares of ₹ 100 each. The share capital was to be collected as under:

	Equity shares	9% Preference shares
	₹	₹
With application	15	20
On allotment	20	30
On first call	30	20
On second and final call	35	30

All the shares were subscribed. The first and second and final calls on 160 equity shares and 240; 9% preference shares were not received. Enter the transactions in the journal of the company. Ledger accounts are not required.

4. Cheema Limited was floated with a capital of ₹ 50,00,000 divided into 50,000 shares of ₹ 100 each. It offered 25,000 shares on the following terms: ₹ 2 per share on application, ₹ 3 on allotment, ₹ 3 on first call and ₹ 2 on final call. Applications were received for 40,000 shares. Applicants for 15,000 shares were sent letters of regret and application money was refunded. All the money due on shares was duly received. Pass the necessary journal entries and the balance sheet.

5. A company with an authorised capital of ₹ 15,00,000 invited applications for 1,00,000 shares of ₹ 10 each. The shares are payable as follows:

On application ₹ 3, on allotment ₹ 3 and on first and final call ₹ 4.

There was over-subscription and applications were received for 2,13,000 shares. The allotment of shares was made as under:

To applicants of 20,000 shares	20,000 shares
To applicants of 23,000 shares	Nil
To applicants of 1,70,000 shares	80,000 shares

Excess application money paid on applications was adjusted against sums due on allotment and first call. All money due were received.

Pass journal entries, ledger and balance sheet.

6. Anand Co. Limited invited the applications for 1,50,000 shares of ₹ 10 each payable as follows:

With applications ₹ 2 on 1st March 2005.

On allotment ₹ 3 on 1st April 2005.

On first call ₹ 2 on 1st September 2005.

Notes

On second call ₹ 3 on 1st January, 2006. Mr Ramesh had 1,500 shares paid the amount of second call with first call. According to the Articles of Association, 6% interest is payable on call-in-advance. All amounts were duly received. Mr. Dinesh who had 500 shares, paid the amount of the first and second call with allotment. Interest was paid to both of these shareholders on 1st January, 2006. Mr. Umesh who is the holder of 400 shares failed to pay allotment money on its due date, but later on paid this amount with interest @ 5% p.a. with first call. Pass the necessary journal entries to give the effect of above mentioned transactions.

7. Issue of Shares for Consideration other than Cash:

   (a) Suri Limited purchased the assets of Karim Limited for ₹ 25,00,000 payable 20% in cash and balance in fully paid up shares of ₹ 100 each. Give the necessary journal entries in the following cases:

   (i) if these shares are issued at par

   (ii) if these shares are issued at a premium of 25%

   (iii) if these shares are issued at a discount of 20%

   (b) Mehrotra Company Limited acquired the assets of Sudhir Limited for ₹ 50,00,000 payable as to ₹ 30,00,000 in equity shares ₹ 15,00,000 in 8% Preference shares and balance in cash. The assets were as:

	₹
Plant & Machinery	20,00,000
Stock of Materials	1,00,000
Land & Building	25,00,000
Furniture	2,00,000

   (c) Damodar Limited is floated to acquire the assets of Sonu Limited for a consideration of ₹ 2,00,000 payable in 15,000 shares of ₹ 10 each and balance in cash. The assets taken over include:

	₹
Land & Building	70,000
Furniture	80,000
Patents	70,000

Pass the necessary journal entries to give the effect of above mentioned transactions:

8. Expert Engineers Ltd. with an authorised capital of ₹ 10,00,000 divided into 1,00,000 equity shares of ₹ 10 each, issued 80,000 shares payable ₹ 3 on application, ₹ 5 on allotment (including ₹ 2 premium) and ₹ 2 each on two calls. Holders of 4,000 shares failed to pay allotment money and further on 2,000 shares there were arrears to the first call. All these shares were forfeited.

   Then the final call was made. There was arrear on 800 shares. All the shares on which only application money was paid and half of the shares on which there was default of first call money were reissued at ₹ 8 as fully paid shares.

   Pass journal entries and show how these will appear in the balance sheet.

Notes

9. Brij Lal & Co. Limited having a nominal capital of ₹ 10,00,000 in shares of ₹ 100 each, invited applications for 5,000 shares, payable as follows:

With application	₹ 20
On allotment	₹ 25
On first call	₹ 35
On second and final call	₹ 20

The company received application for 4,500 shares. All the applications were accepted. All money due on stated above were received with the exception of the second and final call on 100 shares; these shares were forfeited and reissued as fully paid @ ₹ 90 per share.

Record the entries relating to above mentioned transactions in the journal and balance sheet of the company.

10. (a) Explain fully the procedure to be adopted for forfeiture of shares for non-payment of allotment and for calls.

(b) 'X' Ltd. had an authorised capital of ₹ 10,00,000 divided into 10,000 shares of ₹ 100 each, out of which 7,500 shares were issued to the public for subscription. The terms of issue were that ₹ 20 was payable on application, ₹ 20 per share on allotment, ₹ 30 per share on first call and the balance of ₹ 30 on second call. All the amounts were duly received except the following:

From A - Holding 15 shares on which the allotment money and money due on the first and second call was in arrear.

From B – Holding of 10 shares, on which the first and second call money was in arrear.

From C – Holding 5 shares on which the second call money was in arrear.

The directors forfeited the shares and reissue the same to D on the following terms:

A's shares were issued at ₹ 90 per share

B's shares were issued at ₹ 70 per share.

C's share were issued at ₹ 50 per share.

Pass journal entries necessary to record the above-mentioned transactions assuming that D had paid whole amount due from him.

11. New comes Limited issued 4,00,000 equity shares of ₹ 10 each, payable as ₹ 3 on application, ₹ 4 on allotment and ₹ 3 on first call. Applications were received for 6,40,000 shares out of which letters of regret were issued for 1,20,000 shares. Full allotment was made to the applicants for 1,60,000 shares and pro-rata allotment was made on the balance. A shareholder holding 400 shares to whom the full allotment was made failed to pay the allotment money. Another shareholder holding 800 shares to whom pro-rata allotment was made also failed to pay the allotment money. On call there was a further default on 1200 shares.

All these shares were forfeited the first lot of 1,200 (400 + 800) shares was reissued at ₹ 8 per share. Pass journal entries in the books of the company to record the above transactions.

Answers: Self-assessment

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

Notes

5. Two
6. Owners
7. False
8. True
9. Not
10. Memorandum of Association,
11. 90%,
12. Personal Account,
13. Three
14. Shareholder
15. (c)
16. (a)

1.10 Further Readings

Books Corporate Accounting - Dr. K.K. Verma

Online links http://moneyterms.co.uk/rights-issue/

http://investmentarticle.com/why-do-companies-conduct-rights-issue.html

Notes

Unit 2: Forfeiture of Shares

CONTENTS

Objectives

After studying this unit, you should be able to:

- Understand the procedure of forfeiture of shares
- Know accounting treatment
- Explain forfeiture of shares issued at discount and premium

Introduction

Sometimes some shareholders fail to pay the called up amount in full i.e., they do not pay in one or more instalments after the allotment of the shares to them. In such a case either the company can go to the court and file a suit against the defaulting shareholders for recovery of the due amount or can cancel the membership of the defaulting shareholders. In case the membership is cancelled, the amount paid by the defaulting members towards share capital stands forfeited, is called 'Forfeiture of Shares.' In this lesson you will learn about different situations in which shares can be forfeited and accounting treatment thereof.

2.1 Meaning and Procedure

If a shareholder fails to pay the due amount of allotment or any call on shares issued by the company, the Board of directors may decide to cancel his/her membership of the company. With the cancellation, the defaulting shareholder also loses the amount paid by him/her on such shares.

When a shareholder is deprived of his/her membership due to nonpayment of calls, it is known as forfeiture of shares.

Caution The result of forfeiture of shares is: Cancellation of membership of the shareholder. Reduction of issued share Capital of the company.

Notes

Let us take an example to make it clearer. S.K. Ltd. issued 100000 shares of ₹ 10 each payable as ₹ 2 on application, ₹ 2 on allotment, ₹ 3 on first call and ₹ 3 on second and final call. Mr. Harish, the allottee of 100 shares, fails to pay the second and final call money made by the company. In this case if the Board of Directors decide to forfeit his shares, his membership will be cancelled and the amount of ₹ 700 paid by him (on 100 shares ₹ 2 on application, ₹ 2 on allotment and ₹ 3 on first call per share) will be forfeited. Now Mr. Harish will no longer be the member of the company and the issued capital of the company will be reduced by ₹ 1000.

Procedure of Forfeiture of Shares

The authority to forfeit shares is given to the Board of Directors in Articles of Association of the company. The Board of Directors has to give at least fourteen days notice to the defaulting members calling upon them to pay outstanding amount with or without interest as the case may be before the specified date. The notice must also state that if the shareholders fail to remit the amount mentioned therein within the stipulated period, their shares will be forfeited. If they still fail to pay the amount within the specified period of time, the Board of Directors of the company may decide to forfeit such shares by passing a resolution. The decision regarding the forfeiture of shares should be communicated to the concerned allottees and should be asked to return the allotment letters and share certificates of the forfeited shares to the company.

Self Assessment

Fill in the blanks:

1. If a shareholder fails to pay the due amount on shares, the board of directors may decide to .... shares.
2. The authority to forfeit shares is given by company's ....
3. The Board of Directors has to give at least .... days notice to the defaulting members.

2.2 Accounting Treatment

You have learnt that shares can be issued at par, at discount and at premium. Accounting treatment for forfeiture of shares in these three situations can be explained as under:

Forfeiture of shares issued at Par

When shares issued at par are forfeited the accounting treatment will be as follows:

(i) Debit Share Capital Account with amount called up (whether received or not) per share up to the time of forfeiture.

(ii) Credit Share Forfeited A/c. with the amount received up to the time of forfeiture.

(iii) Credit 'Unpaid Calls A/c' with the amount due on forfeited shares. This cancels the effect of debit to such calls which take place when the amount is made due.

The journal entry is:

Share capital A/c Dr

(Amount called up)

To share forfeited A/c

(Amount paid)

Notes

To unpaid calls A/c

(Amount called but not paid)

Notes (i) Amount called up = No. of shares × called up per share

(ii) Amount paid = No. of shares × Amount paid per share

(iii) Amount called but not paid = No. of shares × Amount called but not paid per share

Illustration 1:

X, a shareholder, holding 100 shares of ₹ 10 each has paid application money of ₹ 2 per share and allotment money of ₹ 3 per share, but has failed to pay the first call of ₹ 2 per share and second call of ₹ 3 per share. His shares were forfeited. Make the journal entry to record the forfeiture of shares.

Solution:

Journal Entry

Date	Particulars	L.F	Amount ₹	Amount ₹
	Share Capital A/c (100 × ₹ 10) To Share forfeited A/c (100 × ₹ 5) To Share First Call A/c (100 × ₹ 2) To Share Second and Final Call A/c (100 × ₹ 3) (forfeiture of 100 shares)	Dr	1000	 500 200 300

Illustration 2:

Alpha Ltd. issued 10000 shares of ₹ 100 each payable as: ₹ 25 on application.

₹ 25 on allotment

₹ 20 on First call and

₹ 30 on second and final call.

9000 shares were applied for and allotted. All the payments were received with the exception of allotment money, first call and second and final call money on 300 shares allotted to Ganesh. The Board of Directors decided to forfeit these shares. Make journal entry to record transaction relating to forfeiture of shares.

Solution:

Journal Entry

Particulars	Amount ₹	Amount ₹
Share Capital A/c (300 × ₹ 100) Dr To Share forfeited A/c (300 × ₹ 25) To Share allotment A/c (300 × ₹ 25) To Share first call A/c (300 × ₹ 20) To Share second call A/c (300 × ₹ 30)	30000	 7500 7500 6000 9000
(300 shares of ₹ 100 each forfeited due to non payment of allotment money and calls money)		

Notes

Forfeiture of Shares allotted on Pro-rata Basis

In case the shares being over subscribed one of the scheme of allotment of shares to applicants is to allot in the ratio of shares for which applications are entertained by the company for allotment and the number of shares company has offered for subscription. This is called allotment of shares on pro-rata basis. In case of pro-rata allotment the excess money received on applications is transferred to Share Allotment A/c from Share Application A/c. In case a shareholder fails to make payment on allotment and call money of shares held by him/her, the unpaid amount will be calculated as under:

(i) Number of shares applied for allotment

$$= \frac{\text{Total No. of shares applied} \times \text{shares allotted to defaulter}}{\text{Total shares allotted}}$$

(ii) Number of shares applied for (as per step) – number of shares allotted = Excess applications received.

(iii) Excess application money received = Excess number of applied shares × money called per share on application.

(iv) Amount unpaid on allotment = Amount due on allotment – excess application money adjusted towards allotment

Illustration 3:

A company has offered for subscription to the public 10000 shares of ₹ 10 each. It has received applications for 15000 shares. Company has decided to allot shares on pro-rata basis. Gunakshi holding 200 shares failed to pay allotment money and first call money. Her shares were forfeited:

Amount payable was as under:

₹ 2 per share on application.

₹ 3 per share on allotment.

₹ 5 per share on call.

Make journal entries and prepare relevant account in the books of the company.

Solution:

Working notes:

$$\text{Number of shares applied} = \frac{\text{Total No. of shares applied} \times \text{shares alloted to Gunakshi}}{\text{Total No. of shares allotted}}$$

$$\frac{15000}{10000 \times 200} = 300$$

Excess applications received = 300 – 200 = 100

Excess applications amount received = 100 × 2 = ₹ 200 Amount Due on allotment = 200 × 3 = ₹ 600

Excess application money adjusted = ₹ 200

Net unpaid amount on allotment = ₹ 600 – ₹ 200 = ₹ 400

Notes

Journal Entries

Particulars		Amount ₹	Amount ₹
Bank A/c Dr. To Share Application A/c (Share application money received for 15000 shares @ ₹ 2 per share)		30000	30000
Share Application A/c To Share capital A/c To Share Allotment A/c. (Share application money for 10000 shares transferred to share capital A/c on their allotment and application money for 500 shares transferred to share allotment A/c.)	Dr	 30000 30000	20000 10000
Share Allotment A/c To Share Capital A/c (Allotment money due on 10000 Shares @₹ 3 per share)	Dr		30000 19600
Bank A/c To Share Allotment A/c (Allotment money received on 9800 shares)	Dr	19600	
Share First & Final call A/c To Share Capital A/c. (Call money made due on 10000 Shares @₹ 5 per share)	Dr	50000	50000
Bank A/c To Share First & Final Call A/c (Call Money received on 9800 shares @₹ 5 per share)	Dr	49000	49000
Share capital A/c To Share forfeited A/c To Share Allotment A/c To Share First & Final call A/c (200 shares forfeited for non payment of allotment & call money)	Dr	2000	600 400 1000

Ledger Bank A/c

Dr **Cr**

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
	Share Applicaton A/c Share Allotment A/c Share First and Final all A/c Balance b/d		30000 19600 49000		Balance c/d		98600
			98600				98600
			98600				

Notes

Share Applicaiton A/c

Dr **Cr**

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
	Share Capital A/c Share Allotment A/c		20000 10000		Bank A/c		30000
			30000				30000

Share Capital A/c

Dr **Cr**

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
	Share forfeited A/c		600		Share Application A/c		20000
	Share Allotment A/c		400				
	Share First and Final call A/c		1000		Share Allotment A/c		30000
	Balance c/d		98000		Share First and		50000
			100000		Final call A/c		100000
					Balance b/d		98000

Share Allotment A/c

Dr **Cr**

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
	Share Capital A/c		30000		Bank A/c Share Application A/c Share Capital A/c		19600 10000 400
			30000				30000

Share First and Final Call A/c

Dr **Cr**

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
	Share Capital A/c		50000		Bank A/c Share Capital A/c		49000 1000
			50000				50000

Share Forfeited A/c

Dr **Cr**

Date	Particulars	JF	Amount ₹	Date	Particulars	JF	Amount ₹
	Balance c/d		600		Share Capital A/c		600
			600		Balance b/d		600

Notes

Balance Sheet of..Co. Ltd.
As on..

Liabilities		Amount (₹)	Assets	Amount (₹)
Authorised Capital				
Shares of ₹ 10 each			Cash at Bank	98600
Issued Capital				
10000 shares of ₹ 10 each	100000			
Less Capital of 200 shares forfeited	2000	98000		
Share forfeited A/c		600		

2.3 Forfeiture of Shares Issued at Premium and at Discount

Forfeiture of Shares Issued at Premium

In case shares are issued at premium and thereafter forfeited there can be two situations:

- Premium on shares has been received prior to the forfeiture.
- Amount of premium on shares has not been received and it still stands credited to the Securities Premium A/c.

Premium Money has been Received Prior to the Forfeiture

If the amount of premium on shares forfeited has been received by the company prior to the forfeiture, securities Premium A/c will not get affected. In this case the journal entry of forfeiture of shares will be similar to the entry made as if the shares had been issued at par.

The journal entry will be:

Share Capital A/c ...Dr

To Share forfeited A/c

To Unpaid Calls A/c./Calls in arrears A/c (forfeiture of share issued at premium)

Illustration 4:

M.B. Software Ltd. issued ₹ 500000 capital divided into equity shares of ₹ 10 each. The shares were issued at a premium of ₹ 4 per share and were payable as: ₹ 3 per share on application, ₹ 7 (including premium) per share on allotment and the balance on call.

All the shares applied for and were duly allotted. All the money was duly received except on 500 shares on which the call money was not received. Company decided to forfeit these shares. Make journal entry to record the forfeiture of 500 shares.

Solution:

Journal Entry

Share Capital A/c	Dr.	5000	
To Share Forfeited A/c			3000
To Share First & Final Call A/c			2000

(Forfeiture of 500 shares of ₹ 10 each due to on non payment of call money of ₹ 4 per share)

Notes

Premium on shares has not been received and stands credited to Securities Premium A/c as due but not paid

When a share is forfeited on which the amount of premium has been made due but has not been received, either wholly or partially, the Securities Premium A/c will be cancelled. At the time of making due, Securities Premium A/c will be credited. The journal entry will be as follows:

Share Capital A/c Dr

Securities Premium A/c Dr

To Share Forfeited A/c

To Unpaid call A/c.

(Forfeiture of shares originally issued at premium due to non payment of dues).

Forfeiture of shares issued at discount

Discount on issue of shares is a loss to the company. When shares issued at a discount are forfeited for non payment of dues, the discount allowed on such shares is written back. At the time of issue of shares, Discount on issue of Shares A/c is debited and when forfeited, this account is credited to cancel the discount allowed on such shares. In this case the following journal entry is made:

Share Capital A/c Dr.

To Share Forfeited A/c

To Discount on Issue of Shares A/c

To Unpaid call A/c

(Forfeiture of shares originally issued at discount for non payment of dues).

Illustration 5:

The Evergrowing Ltd. invited applications for 20000 shares of ₹ 50 each at a discount of 10% payable as follows:

On application	₹ 10 per share
On allotment	₹ 20 per share
On call	₹ 15 per share

Whole of the issue was subscribed and paid for except the calls money on 200 shares which were forfeited by the company.

Make journal entry for forfeiture of shares.

Solution:

Share Capital A/c (200 × 50)	Dr.	10000
To Shares forfeited A/c (200 × 30)		6000
To Discount on Issue of Shares A/c (200 × 5)		1000
To Share First and Final call A/c (200 × 15)		3000

(Forfeiture of 200 shares of ₹ 50 each issued at discount of 10% on nonpayment of call money)

Notes

Self Assessment

In the following cases write whether the account given is to be debited or credited and the amount by which it is debited or credited.

4. Forfeiture of 100 shares of ₹ 10 each fully paid issued at par on which final call of ₹ 3 per share is not received.

   Shares forfeited A/c.

5. 250 shares of ₹ 10 each issued at a premium of ₹ 4 per share forfeited for non payment of call money. ₹ 2 per share premium as called with allotment is paid.

   Shares forfeited A/c

6. 100 shares of ₹ 10 each issued as fully paid at a premium of ₹ 2 per share forfeited on which only application money @ ₹ 2 per share is received.

   Securities Premium A/c

7. 200 shares of ₹ 20 each issued at a discount of ₹ 2, ₹ 15 called are forfeited for non payment of final call of ₹ 5 per share.

   Discount on issue of shares A/c

2.4 Summary

Forfeiture of shares means cancellation of membership of a shareholder due to non-payment of calls made by the company. Forfeiture of shares amount to cancellation of the membership of the defaulting shareholder and reduction of share capital of the company. Power to forfeit shares is given in the Articles of Association of the company. The Board of Directors have to give a fourteen days notice to the defaulting shareholder There are three situations when shares can be forfeited: (i) Shares issued at par (ii) Shares issued at premium. Premium received in full Premium due but not yet received (iii) Shares issued at discount In all cases share capital is debited by the called up amount on forfeited shares. Shares forfeited A/c is credited by the amount received (excluding the amount of premium) on forfeited shares. Securities premium A/c will not get affected if premium on forfeited shares has been received but it will be debited if it is due but not received Shares issued at a discount when forfeited discount on issue of shares will always be credited by the amount of discount allowed on forfeited shares.

2.5 Keywords

Actual Payment – Real payment and not the assumed one.

Allotment of Shares – Allocation of shares in a company.

Par Value – Nominal or reasonable value.

Premium – A sum added to an ordinary price.

2.6 Review Questions

1. State the meaning of forfeiture of shares. When can shares be forfeited?

2. What accounting treatment is given to Securities Premium A/c on forfeiture of shares when:

   (i) Amount of premium has been received

(ii) Amount of premium has not been received on such forfeited shares.

3. X Ltd. forfeited 500 shares of ₹ 100 each on which final call of ₹ 30 per share has not been received. Other calls have been duly received. Make journal entry to record the forfeiture of shares.

4. All Time Entertainment Ltd. issued 50000 shares of ₹ 10 each at a premium of ₹ 4 per share payable as ₹ 3 per share on application ₹ 7 (including premium) on allotment and the balance on call. Akbar who was allotted 300 shares failed to pay the allotment amount and on his subsequent failure to pay the call money his shares were forfeited. Make the journal entry for the forfeiture of 300 shares.

5. Exe Ltd issued 10000 shares of ₹ 50 per share issued at a discount of ₹ 5 per share payable as ₹ 10 per share on application, ₹ 20 per share on allotment and the balance on call. All money was duly received except of 400 shares on which allotment and call money was not received. These shares were forfeited. Make journal entries in the books of the company and prepare ledger accounts also.

Answers: Self Assessment

1. Forfeit
2. Articles of Association
3. Fourteen
4. Credited by ₹ 700
5. Credited by ₹ 2000
6. Debited by ₹ 200
7. Credited by ₹ 400

2.7 Further Reading

Books Corporate Accounting - Dr. K.K. Verma

Notes

Unit 3: Reissue of Forfeited Shares and Bonus Issue

CONTENTS

Objectives

After studying this unit, you should be able to:

- Understand reissue of forfeited shares
- Explain forfeitures reissue of shown in over-subscription and pro-rata allotment
- Define right issue
- Explain Bonus shares

Introduction

Forfeiture is withdrawal of shares due to non-payment of any call by the shareholder or for any other ground as may be provided in the Articles. On forfeiture of shares the member loses the amount paid thereon and his interest in the ownership of the shares.

Reissue of forfeited shares is a sale of shares and it does not amount to an allotment. The company should duly record the particulars of the members who acquire those shares as if it were a transfer of shares. The directors would fix a price for the forfeited share that should not be lower than the amount of the call(s) due and unpaid on the share at the time of forfeiture. In the case of a company whose shares are listed in a recognized stock exchange, re-issue of forfeited shares shall be as per Guidelines for Preferential Issue of the Securities and Exchange Board of India and the listing agreement.

3.1 Reissue of Forfeited Shares

As per the Articles of Association, directors are empowered to reissue the forfeited shares when they find it suitable for sale and convenient to them. If there is no provision to reissue the forfeited shares in the Articles of Association, Table A of Companies Act confers the power upon them to do so.

Notes

Caution The directors can reissue the forfeited shares at any price which they like. But in any condition, the reissue price of forfeited share plus the amount already received on these forfeited shares from defaulters cannot be less than the amount credited as paid up on reissue of shares.

In other words, maximum discount on reissue of forfeited shares is permissible to the amount credited to forfeited shares account (when the shares were originally issued at discount, amount of original discount also included to this amount). This reissue price can be understood well by an illustration: if a share of ₹ 100 on which ₹ 15 are paid is forfeited and reissued (a) fully paid up, then a sum of ₹ 85 must be collected, or (b) as partly paid up ₹ 75 paid then a sum of ₹ 60 must be collected by the reissue of share. In the case of reissue of forfeited shares the following points are worth noting:

1. If the forfeited shares are reissued at discount, the amount of discount cannot be more than the amount earlier received in respect of these shares from defaulters. The journal entry for reissue will be:

   Bank Account Dr. (Amount actually received on reissue)

   Forfeited Shares Account Dr. (Discount given on reissue)

   To Share Capital Account (Paid up value of share)

2. If the discount allowed on the reissue of forfeited shares is less than the amount earlier received from defaulters, there will be some balance in the forfeited shares account. This balance is treated as net capital profit and is transferred to capital reserve account. The journal entry will be:

   Forfeited Shares Account Dr. (any balance in forfeited shares a/c after reissue)

   To Capital Reserve Account

3. If the whole of the forfeited shares are not reissued, only a proportionate profit on the reissue of these shares will be transferred to Capital Reserve Account. This profit will be calculated as under:

   $$\text{Profit} = \left(\frac{\text{Total amount Forfeited}}{\text{No. of shares forfeited}} \times \text{No. of shares reissued}\right) - \text{Amount with which forfeited}$$

   shares A/C was debited at the time of reissue of these shares.

4. If all the forfeited shares are reissued at par, entire amount of forfeited shares account will be treated as capital profit and will be transferred to Capital Reserve Account.

5. If all the forfeited shares are reissued at a premium, the amount of premium will be transferred to Share Premium Account. And in this case too, the entire amount will be treated as capital profit and will be transferred to Capital Reserve Account. The entry will be:

   (i) On Reissue:

   Bank Account Dr.

   To Share Capital Account

   To Share Premium Account

   (ii) On transfer of forfeited shares account:

   Forfeited Shares Account Dr.

   To Capital Reserve Account.

Notes

6. If the forfeited shares, which were previously issued at discount, are reissued at discount "Discount on Issue of Shares Account" will be re-recorded with the proportionate amount the shares reissued.

   If the discount on reissue of forfeited shares is more than the original discount, this loss due to excess of discount will be debited to forfeited shares account. The journal entry will be:

Bank Account	Dr.	
Discount on Issue of Shares A/c	Dr.	(with original discount)
Forfeited Shares Account	Dr.	(excess over original discount)
To Share Capital Account		

   If the forfeited shares previously issued at discount, are reissued at par or premium, discount on issue of shares account will not be rerecorded.

7. If the forfeited shares were previously issued at premium and premium has been received fully, share premium will not be recorded again on the reissue of shares.

   If the premium has not been collected earlier, share premium will be recorded on reissue to the extent it is available. This availability depends on the amount collected earlier and reissue price.

Example 1: **Forfeiture & Reissue**

Sanjay Mills Limited issued 1,50,000 shares of ₹ 10 each at par payable as under:

On application	₹ 2 per share
On allotment	₹ 5 per share
On first and final call	₹ 3 per share.

Only 1,20,000 shares were subscribed and allotted call money on 2,000 shares was not received. These shares were forfeited. Out of forfeited shares 1,200 shares were reissued to Mr. *X* @ ₹ 8 per share. Later, 200 shares were reissued to Mr. *Y* at their paid up value and still later the remaining 600 shares were reissued to Mr. *Z* @ ₹ 11 per share.

Pass journal entries for the above mentioned transactions in the books of Sanjay Mills Limited.

Solution:

Sanjay Mills Limited

Date	Particulars	L.F.	₹	₹
	Bank Account Dr. To Share Application Account (Application money received on 1,20,000 shares @ ₹ 2 each)		2,40,000	 2,40,000
	Share Application Account Dr. To Share Capital Account (Being transfer of application money to share capital account)		2,40,000	 2,40,000
	Share Allotment Account Dr. To Share Capital Account (Allotment money due on 1,20,000 shares @ ₹ 5 per share)		6,00,000	 6,00,000
	Bank Account Dr. To Share Allotment Account (Allotment money received on 1,20,000 shares)		6,00,000	 6,00,000
	Share First Final Call Account Dr. To Share Capital Account		3,60,000	 3,60,000

Contd...

Notes

	(Being forfeiture of 2,000 shares for non-payment of first & final call of ₹ 3 per share)			
	Bank Account Dr. Forfeited Shares Account Dr. To Share Capital Account (Being reissue of 1200 shares @ ₹ 8 per shares and loss of ₹ 2 per share transferred to forfeited shares account)		9,600 2,400	 12,000
	Forfeited Shares Account Dr. To Capital Reserve Account (Profit on the reissue of 1200 shares transferred from forfeited shares account to capital reserve account)		6,000	 6,000
	Bank Account Dr. To Share Capital Account (Being reissue of 200 shares at par)		2,000	2,000
	Forfeited Shares Account Dr. To Capital Reserve Account (Profit on reissue of 200 shares transferred to capital reserve)		1,400	1,400
	Bank Account Dr. To Share Capital Account To Share Premium Account (Reissue of 600 shares to Mr. Z @ ₹ 11 per share)		6,600	 6,000 600
	Forfeited Shares Account Dr. To Capital Reserve Account (Profit on reissue of the remaining shares transferred to capital reserve)		4,200	 4,200

Working Note:

(i) Amount forfeited on 1,200 shares 12007 = 8,400

Less: Loss on reissue of 1200

Forfeited shares 12002 2,400

Profit on reissue of 1,200 shares ₹ 6,000

(ii) Since 200 forfeited shares are reissued at par, entire forfeited amount on these shares will be treated as capital profit i.e., 200 × 7 = ₹ 1,400.

(iii) In this case also the entire forfeited amount on 600 shares will be treated as capital profit because these shares are reissued at premium.

Example 2: **Reissue of Forfeited Shares Originally Issued at Discount**

Anuj Cloth Mills Limited invited applications for 50,000 shares of ₹ 100 each at a discount of 5% payable as follows:

On application ₹ 30 per share

On allotment ₹ 25 per share

On first and final call ₹ 45 per share

The applications received were for 45,000 shares. All of these were accepted. All moneys due were received except the first and final call on 500 shares, which were forfeited. 250 shares were reissued @ ₹ 90 as fully paid. Pass necessary journal entries in the books of the company.

Notes

Solution

Anuj Cloth Mills Limited Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Bank Account	Dr.		13,50,000	
	To Share Application Account				13,50,000
	(Application money received on 45,000 share @ ₹ 30 each)				
	Share Application Account	Dr.		13,50,000	
	To Share Capital Account				13,50,000
	(Application money transferred to share capital account)				
	Share Allotment Account	Dr.		9,00,000	
	Discount on Issue of Shares Account	Dr.		2,25,000	
	To Share Capital Account				11,25,000
	(Allotment money due on 45,000 shares @ ₹ 20 each and discount allowed at ₹ 5 each)				
	Bank Account	Dr.		9,00,000	
	To Share Allotment Account				9,00,000
	(Allotment money received on 45,000 shares)				
	Share First and Final Call Account	Dr.		20,25,000	
	To Share Capital Account				20,25,000
	(Being first and final call money due on 45,000 shares @ ₹ 45 each)				
	Bank Account	Dr.		20,02,500	
	To Share First and Final Call Account				20,02,500
	(Being first and final call money received on 44,500 shares)				
	Share Capital Account	Dr.		50,000	
	To First and Final Call Account				22,500
	To Discount on Issue of Shares Account				2,500
	To Forfeited Shares Account				25,000
	(Being forfeiture of 500 shares for non-payment of first and final call money)				
	Bank Account	Dr.		22,500	
	Discount on Issue of Shares Account	Dr.		1,250	
	Forfeited Shares Account	Dr.		1,250	
	To Shares Capital Account				25,000
	(Being 250 forfeited shares reissued at ₹ 90 each as fully paid)				
	Forfeited Shares Account	Dr.		11,250	
	To Capital Reserve Account				11,250
	(Profit on reissue of 250 shares transferred to capital reserve)				

Working Note:

₹

Total amount forfeited on 250 shares = 25050 = 12,500

Notes

Basis loss on reissue of share = 2505	= 1,250
Profit on reissue of shares	11,250

Example 3: **(Reissue of forfeited shares previously issued at premium)**

Dynamic Ltd. makes an issue of 5,000 equity shares of ₹ 100 each at a premium of ₹ 12.50 per share payable as follows:

1. ₹ 12.50 on application,
2. ₹ 25.00 on allotment (including premium),
3. ₹ 50.00 on first call,
4. ₹ 15 on second all,
5. ₹ 10 on final call.

The application and allotment money are duly received and in addition, holders of 2,500 shares pay in full on allotment. Holders of 100 shares fail to pay first call and after due notice their shares are forfeited. The amounts payable on second call (made after forfeiture) are paid in full, except that a holder of 50 shares fails to pay. 75 of the 100 shares forfeited are reissued, credited with ₹ 90 paid for ₹ 65 per share. The new shareholder pays these shares in full. The balance of ₹ 10 per share is being treated as calls-in-advance. The final call is met in full including the arrears of the second call.

Show the necessary journal entries including cash in the books of Dynamic Ltd.

Solution:

Dynamic Limited Journal

Date	Particulars		L.F.	Dr. ₹	Dr. ₹
	Bank Account	Dr.		62,500	
	To Equity Shares Application Account				62,500
	(Being application money received on 5,000 shares @ ₹ 12.5 per share)				
	Equity Share Application Account	Dr.		62,500	
	To Equity Share Capital Account				62,500
	(Being transfer of application money to shares capital account)				
	Equity Share Allotment Account	Dr.		62,500	
	To Equity Share Capital Account				62,500
	(Being allotment money due on 5,000 shares @ ₹ 12.5 each)				
	Bank Account	Dr.		3,12,500	
	To Share Allotment Account				62,500
	To Share Premium Account				62,500
	To Calls-in-Advance Account (2500×75)				1,87,500
	(Being allotment money received along-with premium @ ₹ 12.5 each and advance call Pr.-money on 2,500 shares @ ₹ 75 each)				
	Equity Share First Call Account	Dr.		2,50,000	
	To Equity Share Capital Account				2,50,000

Contd...

Notes

	(Being first call money due on 5,000 shares @ ₹ 50 per share)			
	Bank Account Dr.		1,20,000	
	Calls-in-Advance Account (2500 × 50) Dr.		1,25,000	
	To Equity Share First Call Account			2,45,000
	(Being receipt of first call money on 4900 shares.)			
	Equity Share Capital Account Dr.		7,500	
	To Equity Share First Call Account			5,000
	To Forfeited Share Account			2,500
	(Being forfeiture of 100 shares for non-payment of first call)			
	Equity Share Second Call Account Dr.		73,500	73,500
	To Equity Share Capital Account			
	(Being second call money due on 4,900 shares @ ₹ 15 per share)			
	Bank Account Dr.		35,250	72,750
	Call-in-Advance Account (2500 × 15) Dr.		37,500	
	To Equity Share Second Call Account			
	(Being second call money received on 2,350 shares)			
	Bank Account (75 × 65) Dr.		4,875	6,750
	Forfeited Shares Account (75 × 25) Dr.		1,875	
	To Equity Share Capital Account (75 × 90)			
	(Being reissue of 75 shares at ₹ 65 each ₹ 90 paid up at a discount of ₹ 25 each)			
	Bank Account Dr.		750	
	To calls in Advance Account			750
	(Being receipt of calls-in-advance from new share-holders on 75 shares @ ₹ 10 each)			
	Equity Share Third & Final Call Account Dr.		49,750	49,750
	To Equity Share Capital Account			
	(Being third and final call money due on 4,975 (4,900 + 75) shares @ ₹ 10 each)			
	Bank Account Dr.		24,750	
	Calls-in-Advance Account (2500 + 75) × 10 Dr.		25,750	
	To Equity Share Third & Final Call Account			49,750
	To Equity Share Second Call Account (50 × 15)			750
	(Being receipt of third and final call money with arrear of second call)			

Example 4: Pass journal entries in the following cases for forfeiture and reissue of shares:

(a) The directors of Sanjay Ltd. forfeited 100 shares of ₹ 50 each fully called up for non-payment of allotment money of ₹ 15 per share and final call of ₹ 20 per share. These shares were reissued to Mr. *X* for ₹ 40 per share.

(b) Wazid Ltd. forfeited 300 shares of ₹ 100 each. ₹ 70 was called up on which, Mr. Suresh has paid only ₹ 50 for application and allotment money and first call of ₹ 20 has been unpaid. The company forfeited these shares and reissued to Mr. *Y* crediting ₹ 70 per share paid for a payment of ₹ 50 each.

(c) Vijay Limited's directors forfeited 500 shares of ₹ 50 each (₹ 30 were called up) issued at a discount of 10% on which Mr. *X* paid on ₹ 15 for application money only. Out of these 500 shares, 300 shares were reissued to Mr. Sohan as ₹ 40 called up for ₹ 30 per share.

Notes

(d) Laxam Limited forfeited 80 shares of ₹ 50 each ₹ 40 were called up issued at 5% discount on which ₹ 2,400 has been paid. These shares were reissued to Mr. Ram for a payment of ₹ 2,800 credited as fully paid.

(e) Alfa Limited forfeited 250 shares of ₹ 50 each fully called up for non-payment of final call of ₹ 25 per share. Subsequently, 200 shares were reissued at ₹ 65 per share as fully paid.

(f) Thomson Limited forfeited 250 shares of ₹ 50 each, ₹ 45 were called up issued at 8% premium to Mr. Axe on which he failed to pay allotment (including premium) of ₹ 15 and first call of ₹ 10. Out of these forfeited shares, 150 shares were reissued to Mr. Waye as fully called up for ₹ 40 per share and 50 shares to Mr. Zed as fully paid up for ₹ 60 and 50 shares to Mr. Dawlo as fully paid up for ₹ 25. These all were issued on different dates.

Solution:

Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Share Capital Account (100 × ₹ 50)	Dr.		5,000	
	To Share Allotment Account (100 × ₹ 15)				1,500
	To Share Find Call Account (100 × ₹ 20)				2,000
	To Forfeited Shares Account (100 × ₹ 15)				1,500
	(Being 100 shares forfeited for non-payment of allotment and final call money)				
	Bank Account (100 × ₹ 40)	Dr.		4,000	
	Forfeited Shares Account (100 × ₹ 10)	Dr.		1,000	
	To Share Capital Account (100 × ₹ 50)				5,000
	(Being reissue of forfeited share @ ₹ 40 per share)				
	Forfeited Share Account	Dr.		500	
	To Capital Reserve Account				500
	(Profit on reissue of forfeited shares transferred to capital reserve i.e., 1500 – 1000)				
	Share Capital Account (300 × ₹ 70)	Dr.		21,000	
	To Share First Call Account (300 × ₹ 20)				6,000
	To Forfeited Shares Account (300 × ₹ 50)				15,000
	(Being forfeiture of 300 shares for non-payment of first call of ₹ 20 each share)				
	Bank Account (300 × ₹ 50)	Dr.		15,000	
	Forfeited Shares Account (300 × ₹ 20)	Dr.		6,000	
	To Share Capital Account (300 × 70)				21,000
	(Being reissue of 300 shares @ ₹ 50 per share at a discount of ₹ 20 per share)				
	Forfeited Share Account	Dr.		9,000	
	To Capital Reserve Account				9,000
	(Profit on reissue of forfeited shares transferred to capital reserve i.e., 15,000 – 6,000)				
	Share Capital Account (500 × ₹ 30)	Dr.		15,000	
	To Calls-in-Arrear Account (500 × ₹ 10)				5,000
	To Discount on Issue of Shares Account (500 × 5)				2,500
	To Forfeited Shares Account (500 × ₹ 15)				7,500
	(Being forfeiture of 500 shares for non-payment of call money)				

Contd...

$\frac{7,500}{500}$ 8 300

Notes

Bank Account (300 × ₹ 30) Discount on Issue of Shares Account (300 × ₹ 5) Forfeited Shares Account (300 × ₹ 5) To Share Capital Account (300 × ₹ 40) (Being reissue of 300 shares for ₹ 30 per share as paid up ₹ 40 each)	Dr. Dr. Dr.		9,000 1,500 1,500	 12,000
Forfeited Shares Account To Capital Reserve Account (Being profit on reissue of 300 forfeited shares transferred to capital reserve, i.e. $\left(\frac{7,500}{500} \times 300\right) - 1,500$)	Dr.		3,000	 3,000
Share Capital Account (80 × 25) To Call-in-Arrear Account (80 × ₹ 2.50) To Discount on Issue of Shares Account (80 × ₹ 2.50) To Forfeited Share Account (Being forfeiture of 80 shares for non-payment of call money)	Dr.		3,200	 600 2,400
Bank Account Discount on Issue of Share Account (80 × 2.5) Forfeited Share Account To Share Capital Account (80 × ₹ 50) (Being reissue of 80 forfeited shares for a payment of ₹ 2,800)	Dr. Dr. Dr.		2,800 200 1,000	 4,000
Forfeited Shares Account To Capital Reserve Account (Profit on reissue of 80 shares transferred to capital reserve account i.e., ₹ 2400 – ₹ 1000)	Dr.		1,400	1,400
Share Capital Account (250 × 50) To Share Final Call Account (250 × ₹ 25) To Forfeited Shares Account (250 × ₹ 25) (Being forfeiture of 250 shares for non-payment of final call of ₹ 25 per share)	Dr.		12,500	 6,250 6,250
Bank Account To Share Capital Account (200 × 50) To Share Premium Account (200 × 15) (Being reissue of 200 shares for ₹ 65 per share at premium)	Dr.		13,000	 10,000 3,000
Forfeited Shares Account To Capital Reserve Account (Profit on reissue of 200 shares transferred, i.e. $\frac{6250}{250} \times 200$)	Dr.		5,000	 5,000
Share Capital Account (250 × ₹ 45) Share Premium Account (250 × ₹ 4) To Share Allotment Account (250 × ₹ 15) To Share First Call Account (250 × ₹ 10) To Forfeited Share Account (250 × ₹ 24) (Being forfeiture of 250 shares for non-payment of allotment and first call money)	Dr. Dr.		11,250 1,000	 3,750 2,500 6,000

Contd...

Notes

	Bank Account (150 × ₹ 40)	Dr.		6,000	
	Forfeited Share Account	Dr.		2,100	
	To Share Capital Account (150 × ₹ 50)				7,500
	To Share Premium Account (150 × ₹ 4)				600
	(Being reissue of 150 share @ ₹ 40 per share)				
	Forfeited Shares Account	Dr.		1,500	
	To Capital Reserve Account				1,500
	(Being profit on reissue of 150 shares transferred to capital reserve i.e. $\frac{6,000}{250} \times 150 - 2,100$)				
	Bank Account (50 × ₹ 60)	Dr.		3,000	
	To Share Capital Account (50 ×₹ 50)				2,500
	To Share Premium Account (50 × ₹ 10)				500
	(Being reissue of 50 shares for ₹ 60 per share)				
	Forfeited Share Account	Dr.		1,200	
	To Capital Reserve Account				1,200
	(Profit on reissue of 50 forfeited shares transferred to capital reserve a/c i.e., $\frac{6,000}{250} \times 50$)				
	Bank Account (50 × 25)	Dr.		1,250	
	Forfeited Shares Account (50 × ₹ 25)	Dr.		1,250	
	To Share Capital Account (50 × ₹ 50)				2,500
	(Being reissue of 50 shares for ₹ 25 each.)				

Self Assessment

Fill in the blanks:

1. As per the ...., directors are empowered to reissue the forfeited shares when they find it suitable.
2. The directors can reissue the .... shares at any price which they like.
3. .... will not be recorded again on the reissue of shares if already recorded.

True or False:

4. The reissue price of forfeited share plus the amount already received on these forfeited shares from defaulters cannot be less than the amount credited as paid up on reissue of shares.
5. If the forfeited shares, which were previously issued at discount, are reissued at discount "Discount on Issue of Shares Account" will not be re-recorded with the proportionate amount the shares reissued.

3.2 Forfeiture and Reissue of Shares in the Case of Over-Subscription and Pro-rata Allotment

If a company has a reputation in the market, there is a possibility that shares applied for would be more than what the company proposes to issue. In such a condition it is not possible for a company to allot shares to the all applicants, therefore, the company rejects some applications altogether, allots in full to some applicants and makes a pro-rata allotment to the remaining applicants.

Notes

Notes In solving the examination problem, students generally face a difficulty in calculating the amount of arrears on allotment and forfeited amount, in the case on shares are allotted the basis of pro-rata.

In such a case the following procedure may be adopted to calculate these correct amounts and to avoid difficulties:

1. Calculate the total number of shares applied for by the defaulters (if not given) as under.
2. Calculate the total amount of application money received by the company from the defaulters, by multiplying the number of shares applied for by defaulters and application money per share. This is the forfeited amount which would be transferred to the forfeited shares account.
3. Calculate application money due on shares allotted to defaulters by multiplying the shares allotted to defaulters and application money per share and deduct it from total application money received. The result would be the excess application money to adjust in allotment money.
4. Calculate the allotment money due to defaulters by multiplying the number of shares allotted to defaulters and allotment money per share and deduct it from excess application money received from defaulters (calculated above in No. 3). This will be the net amount of arrears on allotment, which will be credited to share allotment account at the time of forfeiture.

Example 5: Bharat Limited invited applications for 20,000 shares of ₹ 10 each at a discount of 5% (allowed at the time of allotment). The amount was payable as under:

On application ₹ 2.5, on allotment ₹ 5, and balance on call.

The public applied for 18,000 shares and these were allotted. All money due was received with the exception of allotment and call money on 300 shares. These shares were forfeited afterwords. 200 of these forfeited shares were reissued as fully paid for a payment of ₹ 7.50 per share.

Journalise the transaction in the books of the company.

Solution:

Bharat Limited Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Bank Account	Dr.		45,000	45,000
	To Share application Account				
	(Being receipt of application money on 18000 shares @ ₹ 2.50 per share)				
	Share Application Account	Dr.		45,000	45,000
	To Share Capital Account				
	(Being application money transferred to share capital account)				
	Share Allotment Account	Dr.		81,000	
	Discount on Issue of Shares Account	Dr.		9,000	
	To Share Capital Account				90,000

Contd...

Notes

	(Being allotment money due on 18,000 shares @ ₹ 5 per share at a discount of 5%)				
	Bank Account To Share Allotment Account (Being allotment money received on 1700 shares)	Dr.		79,650	 79,650
	Share Final Call Account To Share Capital Account (Being final call money due on 18,000 shares ₹ 2.5 per share)	Dr.		45,000	 45,000
	Bank Account To Share Final Call Account (Being final call money received on 17,700 shares)	Dr.		44,250	44,250
	Share Capital Account To Share Allotment Account. To Share Final Call Account To Discount on Issue of Shares Account To Forfeited Shares Account (Being forfeiture of 300 shares for non-payment of allotment and final call money)	Dr.		3,000	 1,350 750 150 750
	Bank Account Discount on Issue of Shares Account Forfeited Shares Account To Share Capital Account (Being reissue of 200 forfeited shares @ ₹ 7.5 per shares as fully paid).	Dr. Dr. Dr.		1,500 100 400	 2,000
	Forfeited Shares Account To Capital Reserve Account (Profit on reissue of 200 forfeited shares transferred.)	Dr.		100	 100

Working Note:

Profit on reissue of 200 forfeited shares	₹
Forfeited amount on 200 shares $\frac{750}{300} \times 200$	500
Less: loss on reissue of 200 share	400
Profit on reissue of 200 forfeited Shares transferable to Capital Reserve.	100

Example 6: Seema Limited offered to public 1,00,000 shares of ₹ 100 each at a premium of ₹ 10 each. The payment was to be made as follows:

On application	₹ 20
On allotment	₹ 40 including premium
On first and final call	₹ 50

Applications were received for 1,82,500 shares. Applications for 20,000 were accepted in full, those for 2,500 were rejected and on the remaining applications 80,000 shares were allotted, on pro-rata basis. Varun who had applied for 200 shares and to whom 100 shares had been allotted failed to pay the balance of allotment money due from him. His shares were forfeited and then reissued to Ankur as ₹ 60 (including premium of ₹ 10) per share paid up @ ₹ 40 per share. Gitesh another shareholder failed to pay call money on 50 shares held by him. His shares were also

Notes

forfeited. Later, these shares were reissued as fully paid up, to Vikram @ ₹ 120 per share. Expenses regarding the issue of shares were ₹ 30,000. Prepare journal, cash book and balance sheet in the books of company.

Solution:

Cash Book (Bank Column Only)

Dr. **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application Account	36,50,000		By Equity Share Application Account	50,000
	To Equity Share Allotment Account	23,98,000		By Expenses on Issue of Share Account	30,000
	To Equity Share Capital Account (100 × ₹ 40)	4,000		By Balance c/d	1,09,75,500
	To Equity Share First and Final Call Account (99,950 × ₹ 50)	49,97,500			
	To Equity Share Capital Account (50 × ₹ 100)	5,000			
	To Share Premium Account (50 × ₹ 20)	1,000			
		1,10,55,500			1,10,55,500

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Application Account Dr.		36,00,000		
	To Equity Share Capital Account				20,00,000
	To Equity Share Allotment Account				16,00,000
	(Being transfer of application money to share capital and excess application money to allotment account).				
	Equity Share Allotment Account Dr.		40,00,000		
	To Equity Share Capital Account				30,00,000
	To Equity Share Premium Account				10,00,000
	(Being allotment money due on 1,00,000 shares @ ₹ 40 per share including premium)				
	Equity Share Capital Account (100 × ₹ 50) Dr.		5,000		
	Share Premium Account (100 × ₹ 10) Dr.		1,000		
	To Equity Share Allotment Account				2,000
	To Forfeited Shares Account (200 × 20)				4,000
	(Being forfeiture of 100 shares for non-payment of allotment money)				
	Forfeited Shares Account Dr.		2,000		
	To Equity Share Capital Account				1,000
	To Share Premium Account				1,000
	(Being reissue of 100 forfeited shares @ ₹ 60 each as paid up ₹ 40 each)				
	If cash transaction is not recorded in cashbook directly, entry will be: Dr.		4,000		
	Bank Account (100 × ₹ 40) Dr.		2,000		

Contd...

	Forfeited Shares Account (100 × ₹ 20)				
	To Equity Share Capital Account (100 × ₹ 50)				5,000
	To Share Premium Account (100 × ₹ 10)				1,000
	Forfeited Shares Account Dr.		2,000		
	To Capital Reserve Account				2,000
	(Profit on reissue of 100 forfeited shares transferred to capital reserve a/c i.e., 4000 – 2000)				
	Equity Share First and Final Call Account Dr.		50,00,000		
	To Equity Share Capital Account				50,00,000
	(Being first and final call money due on 1,00,000 shares @ 50 per share)				
	Equity Share Capital Account (50 × ₹ 100) Dr.		5,000		
	To Equity Share First and Final Call Accounts (50 × ₹ 50)		2,500		2,500
	To Forfeited Shares Account				
	(Being forfeiture of 50 shares for non-payment of first & final call money)				
	Forfeited Shares Account Dr.		2,500		
	To Capital Reserve Account				2,500
	(Profit i.e., entire forfeited amount on reissue transferred to capital reserve a/c)				

Working Note:

1. Analytical Table for Adjustment of Excess Application Money

No. of shares applied for	No. of shares allotted	Application money received (₹)	Application money due on allotted shares (₹)	Excess application money (₹)	Allotment money due (₹)	Excess Transfer to allotment money (₹)	Balance due on allotment (₹)	Refund (₹)
20,000	20,000	4,00,000	4,00,000	Nil	8,00,000	–	8,00,000	–
2,500	Nil	50,000	–	–	–	–	–	50,000
1,59,800	79,900	31,96,000	15,98,000	15,98,000	31,96,000	15,98,000	15,98,000	–
200	100	4,000	2,000	2,000	4,000	2,000	2,000	–
1,82,500	1,00,000	36,50,000	20,00,000	16,00,000	40,00,000	16,00,000	24,00,000	50,000

2. Amount Received on allotment

Total amount due on allotment (1,00,000 ₹ 40)	40,00,000
–Excess application money adjusted in allotment (as per above table)	16,00,000
Balance receivable on allotment	24,00,000
– Amount not paid by Varun on allotment	2,000
	23,98,000

3. Share Premium Account

	₹		₹
To equity share allotment a/c	1,000	By E share allotment account	10,00,000
To balance c/d	10,01,000	By forfeited shares account	1,000
		By bank account	1,000
	10,02,000		10,02,000

Notes

4. Balance Sheet of Seema Limited as on................

Liabilities	Amount ₹	Assets	Amount ₹
Share Capital:		***Fixed assets:***	
Issued & subscribed:	1,00,00,000	Current Assets:	1,09,75,500
(1,00,000 equity shares of ₹ 100 each	10,01,000	Bank Balance	30,000
fully paid up).	4,500	Miscellaneous	
Reserve & Surplus:		***Expenditure:***	
Share premium		Expenses on issue of shares	
Capital reserved (2,000 + 2,500)			
	1,10,05,500		1,10,05,500

Task Over-confident Co. Ltd. issued a prospectus offering 2,00,000 shares of ₹ 10 each on the following terms:

On application Re. 1 per share.
On allotment ₹ 3 per share (including premium of ₹ 2)
On first call (three months after allotment) ₹ 4 per share.
On second call (three months after first call) ₹ 4 per share.

Subscriptions were received for 3,17,000 shares on 23rd April and allotment was made on 30th April as under:

Shares allotted

(i) Allotment in full (two applicants paid in full on allotment in respect of 4,000 shares each.) 38,000

(ii) Allotment of two-third of shares applied for 1,60,000

(iii) Allotment of one-fourth of shares applied for 2,000

Cash amounting to ₹ 31,000 (being application money received with applications for 31,000 shares upon which no allotments were made) was returned to the applicants on 5th May. The amounts due were received on the due dates with the exception of final call on 100 shares. These shares were forfeited on 15th November and reissued to Varun on the 16th November for payment of ₹ 9 per share. The company paid the interest due on calls-in-advance on 31st October in cash. Show the journal and cash book entries and draw a balance sheet of the company giving effect to the above transactions.

Self Assessment

True or False:

6. If a company has a reputation in the market, there is a possibility that shares applied for would be more than what the company proposes to issue.

7. In case of difficulty, calculating the amount of arrears on allotment and forfeited amount, on shares are not allotted the basis of pro-rata.

Notes

Fill in the Blanks:

8. In solving the examination problem, students generally face a difficulty in calculating the amount of arrears on allotment and forfeited amount, in the case on shares are allotted the basis of ....
9. If a company has a .... the market, there is a possibility that shares applied for would be more than what the company proposes to issue.

3.3 Right Issue (Under Section 81)

If a company proposes to increase its subscribed capital by allotment of further shares at any time after the expiry of two years from the formation of the company, or at any time after the expiry of one year from the allotment of shares whichever is earlier, then:

(a) Such further shares must be offered to the persons, who at the time of offer, are holders of the equity shares of the company, in preparation, as nearly as circumstances admit, to the capital paid up on those shares at that time.

(b) The above offer is made by giving a notice mentioning the number of shares. This notice should also fix a time which should not be less than fifteen days from the date of offer within which the offer must be accepted.

(c) On the receipt of the notice the existing shareholder may exercise his right to take new shares himself or may transfer his right in favour of any other person.

(d) After the expiry of the time specified in the notice or on the receipt of earlier intimation from the shareholder to whom the notice is served, that he declines to accept the shares, the board of directors may dispose off these shares in such a manner as the board thinks most beneficial to the company.

On the basis of above conditions if the further share capital is issued to existing shareholders who are entitled to take these shares, such shares are known as Right Share.

"The objective of Section 81 obviously is that there should be an equitable distribution of shares and the holding of shares by each shareholder should not be affected by the issue of new share." This further issue of shares can be offered to any person other than existing shareholder in any manner whatsoever:

(i) If a special resolution has been passed by the company to allot the new shares in a different manner than that provided in the Section 81 in the general meeting.

(ii) If an ordinary resolution has been passed by the company to that effect and the Central government is satisfied on an application made by the board of directors that the proposed offer of shares to the other persons is most beneficial to the company.

The provisions of Section 81 do not apply in the following cases:

1. Where the object of the issue is to allot qualification shares to one or more persons to enable them to become the directors of the company.
2. Where the issuing company is a private limited company.
3. Where the increase in subscribed capital is due to the conversion of debentures or loans into shares in the company.
4. Where, by the order of government, debentures issued to government or loan obtained from government by the company, are converted into shares.

Notes

Method of Calculating the Value of Right

Sometimes in the examination, the students are asked to calculate the value of right. The following procedure is adopted to calculate the value of right:

1. First of all, find out the basis or rate of right issue and then calculate the market value of shares held by the shareholder. For example, if a company makes a right issue of one share for every four shares held, a shareholder who wants to take a right share, must hold four shares. And if the market value of one share of this company is ₹ 150, the total market value of shares will be 4₹ 150 = ₹ 600

2. The amount paid to acquire the right share should be added to the total market value of the shares calculated in (1) for example if the company is issuing one right share for ₹ 140, total value of 5 shares will be = (4150) + (1140) = ₹ 740.

3. Calculate the average price of the shares including right share. In the given example:

$$\frac{740}{5} = ₹148 \text{ per share}$$

4. Deduct the average price of a share from the market value of a share in order to calculate the value of right in the given example:

   Value of right = market value – average price

   ₹ 150 – ₹ 148 = ₹ 2

3.4 Right Issue

1.(a) ABX Corp. decides to issue the stock via a general cash offer. The board believes it can raise the $18 million the company requires by issuing shares at $36. The company has 5 million shares outstanding and the current stock price is $40. Ignoring the underwriter's spread, calculate the following:

(a) The number of new shares that ABX will have to offer.

(b) The expected price of the shares after the issue.

(c) The loss per share to existing holders.

(d) The percentage reduction in value of an existing stockholder's investment in the company

(e) The net present value of purchasing 100 shares via the general cash offer.

(b) ABX is considering the alternative of a privileged subscription stock issue to raise $18 million. The terms of the issue are 1 for 10 at $36, and the corporation's current stock price is $40. Calculate the following:

(a) The market value of the corporation's equity prior to the issue.

(b) The percentage increase in market value due to the issue.

(c) The expected price of one right.

(d) The expected price of the stock ex-rights.

Solution:

1.(a) (a) Number of new shares = $18,000,000/$36 = 500,000 shares

(b) Value of company after issue = $200,000,000 + $18,000,000 = $218,000,000

Share price after issue $218,000,000/5,500,000 = $39.64

(c) Loss per share to existing holders = $40 - $39.64 = $0.36

(d) Percentage reduction in value = ($0.36/$40) × 100 percent = 0.90 percent

(e) NPV purchasing shares via offer = $39.64 – $36 = $3.64

(b) (a) Value of equity before issue = 5,000,000 × $40 = $200,000,000

(b) Increase in value = $18 m/$200 m × 100 percent = 9%

(c) Value of right = (rights-on price - issue price)/(N+ 1) = ($40 – $36)/11 = $0.36

(d) Ex-rights price = (rights-on price - value of right) = $40 – $0.36 = $39.64

2. Jackrabbits Corporation is making a right issue to raise $6 million. Just before the issue, Jackrabbits' stock price was $20, and the terms of the issue are 1 for 4 at a subscription price of $15.

   Calculate (a) the expected price of the stock ex-rights and (b) The value of one right. (c) Baby Rabbit owns 20,000 shares. How many rights will he have to sell to maintain the same ($400,000) investment in the company? (d) Show that in general, the value of a right is given by the formula (rights-on price - issue price)/ (N + I) when the terms of the issue are 1 for N.

Solution:

(a) After the issue is completed, all shares will be ex-rights. For every 4 shares worth $20 before the issue, there will be 5 shares worth $20 x 4 + $15 (= $95) after the issue. Each share will, therefore, be worth $95/5, so the ex-rights price is $19.

(b) The value of one right is the difference between the rights-on price (the share price before the issue) and the ex-rights price. This is $1.

(c) Baby Rabbit will get 5,000 rights and if he were to keep all his rights, he would end up with 25,000 shares valued at a total of 25,000 × $19 = $475,000. In order to retain his original investment, he should have $400,000/$19 = 21,053 shares. Therefore, he needs to keep only 1,053 rights and sell the remaining 3,947 rights. This will give him $3,947.

(d) N shares at the rights-on price gets an additional share subscribed to at the offer price. This gives the basic equation:

   N × (rights-on price) + issue price = (N + 1)(ex-rights price)

   Alternatively, this can be written as:

   [(N + 1) × rights-on price] – (rights-on price - issue price) = (N + 1) ex-rights price

   Value of a right = right-on price – ex-rights prices = rights-on price – issue price/(N + 1)

3.5 Bonus Issue of Shares

Introduction

"Capitalisation of profits refers to the process of converting profits or reserves into paid up capital." A company may capitalise its profits or reserves which otherwise are available for distribution as dividends among the members by: (a) paying up amount unpaid on existing partly paid shares so as to make them fully paid shares, or (b) issuing fully paid bonus shares to the members. The Companies Act does not contain any specific provision regarding capitalisation of profits and consequently issue of bonus shares. However, the Companies Act permits that the

Notes

share premium amount (collected in cash only) can be used by the company in paying up unissued shares of the company to be issued to its members as fully paid bonus shares. Also the company can utilise the amount of the capital redemption reserve in paying up unissued shares of the company to be issued to its members as fully paid bonus shares. The SEBI (Disclosure and Investor Protection) Guidelines, 2000 which came into force w.e.f. 27th day of January, 2000 require that the company while issuing bonus shares shall ensure the following : (a) No company shall, pending conversion of FCDs/PCDs/ issue any by way of bonus unless similar benefit is extended to the holders of such FCDs/ through reservation of shares in proportion to such convertible part of FCDs or PCDs (b) The shares so reserved may be issued at the time of conversion(s) debentures on the same terms on which the bonus issues were made.

Definition

Bonus Share: A bonus share is a free share of stock given to current shareholders in a company, based upon the number of shares that the shareholder already owns. While the issue of bonus shares increases the total number of shares issued and owned, it does not increase the net worth of the company. Although the total number of issued shares increases, the ratio of number of shares held by each shareholder remains constant. An issue of bonus shares is referred to as a bonus issue. Depending upon the constitutional documents of the company, only certain classes of shares may be entitled to bonus issues, or may be entitled to bonus issues in preference to other classes.

Bonus Issue: A bonus issue (or scrip issue) is a stock split in which a company issues new shares without charge in order to bring its issued capital in line with its employed capital (the increased capital available to the company after profits). This usually happens after a company has made profits, thus increasing its employed capital. Therefore, a bonus issue can be seen as an alternative to dividends. No new funds are raised with a bonus issue.

Issue of Bonus Shares: Bonus shares are issued by cashing in on the free reserves of the company. The assets of a company also consist of cash reserves. A company builds up its reserves by retaining part of its profit over the years (the part that is not paid out as dividend). After a while, these free reserves increase, and the company wanting to issue bonus shares converts part of the reserves into capital.

Conditions for Bonus issue: Bonus shares are issued by **c**onverting the reserves of the company into share capital. It is nothing but capitalization of the reserves of the company. There are some conditions which need to be satisfied before issuing Bonus shares:

(a) The bonus issue is not made unless the partly-paid shares, if any, are made fully paid-up.

(b) The company has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption.

(c) The Company has sufficient reason to believe that it has not defaulted in respect of payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

(d) A company which announces its bonus issue after the approval of the Board of directors must implement the proposal within a period of six months from the date of such approval and shall not have the option of changing the decision.

    (i) The articles of association of the company shall contain a provision for capitalisation of reserves, etc.

    (ii) If there is no such provision in the articles the company shall pass a resolution at its general body meeting making provisions in the articles of association for capitalisation.

Resolution for Increased Authorised Capital: Consequent to the issue of bonus shares, if the subscribed and paid up capital exceed the authorised share capital, a resolution shall be passed by the company at its general body meeting for increasing the authorised capital.

Return of Bonus Issue: A return of bonus issue along with a copy of resolution authorising the issue of bonus shares is to be filed with the Registrar within 30 days of the allotment of such shares.

Issue of Bonus Shares by Public Sector Undertakings: It has come to the notice of the Government that a number of Central Government Public Sector Undertakings are carrying substantial reserves in their balance sheets against a relatively small paid up capital base. The question of the need for these enterprises to capitalize a portion of their reserves by issuing Bonus Shares to the existing shareholders has been under consideration of the Government. The issue of Bonus Shares helps in bringing about a proper balance between paid up capital and accumulated reserves, elicit good public response to equity issues of the public enterprises and helps in improving the market image of the company. Therefore, the Government has decided that the public enterprises, which are carrying substantial reserves in comparison to their paid up capital issue Bonus Shares to capitalize the reserves for which the certain norms/conditions and criteria may be followed and fulfilled. There are some SEBI guidelines for Bonus issue which are contained in Chapter XV of SEBI (Disclosure & Investor Protection) Guidelines, 2000 which should be followed in deciding the correct proportion of reserves to be capitalized by issuing Bonus Shares.

The amount of profit that is distributed to the shareholders in addition to dividend is called bonus. This bonus can be declared in the following conditions:

(a) ***In the condition of Excess Profit:*** If more profits are earned by a company in a year, directors of that company do not distribute the entire profit to the shareholders. If the entire profit is distributed to the shareholders, the current rate of dividend will increase. And if this profit is not earned in future and current rate to dividend is not maintained, the company's goodwill will go down. Therefore, in the case of excess profit, some profit is distributed in the form of dividend and some in the form of bonus.

(b) ***In the condition of Excess Reserves:*** If a company has accumulated more profits or reserves and directors deem it fit, excess profit or reserves can be distributed among shareholders in the form of bonus.

This bonus can be distributed in the form of cash, portly paid up shares or fully paid up shares to the shareholders. Bonus is generally not paid in cash. If it is paid in cash, the working capital of the company will be adversely affected. Mostly companies use this amount to make up the existing partly paid up shares as fully paid. This is called Bonus Issue or Bonus Shares. Generally, bonus shares are issued in the following cases:

(i) When cash is not sufficient to pay off bonus.

(ii) When there is under-capitalisation.

(iii) When there are more general reserves than necessity.

From where the bonus shares can be issued: Bonus shares can be issued from the following accounts:

(i) From the profits of the company

(ii) From general reserves

(iii) Any reserve which is made from profit

(iv) From capital reserves (in some special cases)

Notes

(v) Sinking fund account

(vi) Capital redemption reserves

(vii) Share premium

Accounting Treatment

The following general entries are recorded regarding the issue of bonus shares:

(i) When bonus is declared from accumulated profits:

Profit and Loss Account	Dr.	
General Reserve Account	Dr.	As the case may be
Share Premium Account	Dr.	
Capital Redemption Reserve A/c	Dr.	
To bonus to shareholders account		

(ii) When bonus shares are issued

Bonus to Shareholders Account	Dr.
To Share Capital Account	

(iii) If bonus shares are issued at premium:

Bonus to Shareholders Account	Dr.
To Share Capital Account	
To Share Premium Account	

(iv) If the bonus shares are issued to make up the existing partly paid up shares as fully paid:

(a) On due

Share Call Account	Dr.
To Share Capital Account	

(b) When bonus is adjusted in call

Bonus to Shareholder Account	Dr.
To Share Call Account	

Note:

Bonus shares cannot be issued unless the partly paid up share are made fully paid up.

Bonus shares are issued to the existing shareholders on a pro-rata basis.

Bonus shares are distributed free of charge.

Example 7: (Issue of Bonus Shares Out of Capital Redemption Reserve, Premium and General Reserve)

On 31st March 2006 the balance sheet of Kavita Limited stood as follows:

Notes

Liabilities	₹	Assets	₹
Share Capital:		**Fixed Assets:**	
Authorised	60,00,000	Land and Buildings	25,00,000
Issued and subscribed 3,00,000 equity shares of ₹ 10 each fully paid	30,00,000	Plant and Machinery	20,00,000
13500; 8% redeemable preference shares of ₹ 100 each fully paid.	13,50,000	Furniture and fittings	11,70,000
Reserve and surplus:		**Investments:**	
Capital reserve	37,500	Bonds of ICICI	4,35,000
Share premium	60,000	Current assets, loans and advances stock	15,00,000
General Reserve	24,91,500	Debtors	16,59,000
Profit and loss account	11,61,000	Cash in hand	53,000
Current Liabilities:		Bank balance	2,80,000
Sundry creditors	10,00,000	Unexposed Insurance	3,000
Provision:			
Provision for taxation	5,00,000		
	96,00,000		96,00,000

On 1st April, 2006, in order to redeem all of its preference shares at a premium of 5%, the company issued 60,000 equity shares of ₹ 10 each at a premium of 10% and sold all of its bonds in ICICI for ₹ 4,80,000.

After the redemption of preference shares, the company issued one fully paid equity share of ₹ 10 as bonus for every three shares held by its shareholders.

Show the journal entries for above transactions and prepare the balance sheet of the company immediately after the issue of bonus shares.

Solution:

Kavita Limited Journal

Date	Particulars		L.F.	₹	₹
August 1	8% Redeemable Preference Shares Capital Account	Dr.		13,50,000	
	Premium on Redemption Account	Dr.		67,500	
	To Preference Shareholders Account				14,17,500
	(Being amount due to preference shareholders on redemption)				
	Bank Account	Dr.		6,60,000	
	To Equity Share Capital Account				6,00,000
	To Share Premium Account				60,000
	(Being receipt of amount from the issue of new shares)				

Contd...

Notes

	Share Premium Account	Dr.		67,500	
	To Premium on Redemption Account				67,500
	(Being utilisation of share premium in writing off the premium on redemption of preference shares)				
	General Reserve Account	Dr.		7,50,000	
	To Capital Redemption Reserve Account				7,50,000
	(Being utilisation of general reserve for the redemption of preference shares)				
	Bank Account	Dr.		4,80,000	
	To Bonds of ICICI Account				4,35,000
	To Profit and Loss Account				45,000
	(Being the proceeds of sale of investments and profit transferred to P & L Account.)				
	Preference Shareholders Account	Dr.		14,17,500	
	To Bank Account				14,17,500
	(Being payment made to shareholders on redemption of preference shares)				
	Capital Redemption Reserve Account	Dr.		7,50,000	
	Share Premium Account	Dr.		52,500	
	General Reserve Account	Dr.		3,97,500	
	To Bonus to Shareholders Account				12,00,000
	(Being utilisation of Capital Redemption Reserve Share Premium and General Reserve for declaration of bonus)				
	Bonus to Shareholders Account	Dr.		12,00,000	
	To Equity Share Capital Account				12,00,000
	(Being issue of one bonus share to every three of shares)				

Balance Sheet of Kavita Limited as on 1st April, 2006

Liabilities	₹	Assets	₹
Share Capital:		**Fixed Assets:**	
Authorised	60,00,000	Land and Buildings	25,00,000
Issued and Subscribed:		Plant and Machinery	20,00,000
4,80,000 equity shares of ₹ 10 each fully paid up (of the above 60,000 equity shares are issues as fully paid up bonus shares)	48,00,000	Furniture and Fittings	11,70,000
Reserve & Surplus:		**Current Assets:**	
		Loans and Advances:	
Capital Reserve	37,500	Stock	15,00,000

Contd...

Notes

General Reserve	13,44,000	Debtors	16,59,000
Profit and Loss Account (11,61,000 + 45,000)	12,06,000	Cash in hand	53,000
Current Liabilities and Provisions:		Cash at bank	2,500
Sundry Creditors	10,00,000	Unexpired	
Provision for Taxation	5,00,000	Insurance	3,000
	88,87,500		88,87,500

Working Note:

1. Bank Balance = ₹ 2,80,000 + 6,60,000 + 480,000 – 1,41,7500 = ₹ 2,500
2. No. of Equity shares = ₹ 3,00,000 + 60,000 + 1,20,000 = ₹ 4,80,000
3. Balance in General Reserve = ₹ 24,91,500 – 3,97,500 – 7,50,000 = ₹ 13,44,000

Example 8: **(Adjustment of Bonus into Final Call)**

Abhijeet Co. Limited whose issued share capital on 31st March, 2006, consisted of 30,000; 7% redeemable preference shares of ₹ 100 each fully paid up and 1,00,000 equity shares of ₹ 100 each, ₹ 80 paid up, decided to redeem the preference shares at a premium of 5%. The balance sheet of the company as on 31st March, 2006 showed a general reserve of ₹ 45,00,000 and a capital reserve of ₹ 5,10,000. The redemption was effected partly out of profits and partly out of the proceeds of a fresh issue of 15,000 equity shares of ₹ 100 each at a premium of ₹ 30 per share.

On 1st May, 2006, the company at its general meeting resolved that all capital reserve will be applied towards the declaration of bonus at the rate of ₹ 20 per share on equity shares, for the purpose of making the said equity shares fully paid.

Pass the necessary journal entries to record the above mentioned transactions in the books of the company.

Solution:

Abhijeet Co. Limited
Journal

Date	Particulars		₹	₹
	7% Redeemable Preference Share Capital Account	Dr.	30,00,000	
	Premium on Redemption Account	Dr.	1,50,000	
	To Preference Shareholders Account			31,50,000
	(Being amount due to preference shareholder on redemption)			
	Bank Account	Dr.	19,50,000	
	To Equity Share Capital Account			15,00,000
	To Share Premium Account			4,50,000
	(Being 15,000 equity shares issued of ₹ 100 each at premium)			
	Share Premium Account	Dr.	1,50,000	
	To Premium on Redemption Account			1,50,000
	(Being utilisation of share premium in writing off the premium on redemption)			

Contd...

Notes

	General Reserve Account Dr. To Capital Redemption Reserve Account (Being utilisation of general reserve for redemption of capital)		15,00,000	15,00,000
	Preference Shareholders Account Dr. To Bank Account (Being payment made to preference shareholders on redemption)		31,50,000	31,50,000
	Equity Shares Find Call Account Dr. To Equity Share Capital Account (Being final call of ₹ 20 each due on 1,00,000 equity shares)		20,00,000	20,00,000
	Capital Reserve Account Dr. Capital Redemption Reserve Account Dr. To Bonus to Shareholders Account (Being bonus declared to make fully paid up shares)		5,10,000 14,90,000	20,00,000
	Bonus to Share-holders Account Dr. To Equity Shares Final Call Account (Being adjustment of bonus in final call of equity shares)		20,00,000	20,00,000

Self Assessment

Fill in the blanks:

10. The objective of .... is that there should be an equitable distribution of shares and the holding of shares by each shareholder should not be affected by the issue of new share.
11. The amount paid to acquire the .... should be added to the total market value of the shares.
12. After the expiry of the .... in the notice from the shareholder to whom the notice is served, the board of directors may dispose off the shares.
13. Calculating application money due on shares allotted to defaulters by multiplying the shares allotted to defaulters the result is the excess .... to adjust in allotment money.

State True or False:

14. Forfeited amount is transferred to the forfeited share account.
15. By virtue of this lien, the company has a prior right to the shares over any creditor to whom they are given as a security for a loan.

3.6 Summary

- If a company has a reputation in the market, there is a possibility that shares applied for would be more than what the company proposes to issue.
- In such a condition it is not possible for a company to allot shares to all the applicants; therefore, the company rejects some applications altogether and allots in full to some applicants
- If there is no provision to reissue the forfeited shares in the Articles of Association, Table A of Companies Act confers the power upon them to do so.

3.7 Keywords

Discount at Issues: The discount from par value at the time that a bond is issued.

Forfeiture of Shares: A share in a company that the owner loses (forfeits) by failing to meet the purchase requirements.

Share Capital Account - Funds raised by issuing shares in return for cash or other considerations.

3.8 Review Questions

1. Explain in short reissue of shares?
2. What do you mean by Right Issue of Shares.
3. What is the meaning of forfeiture of shares? How are the shares forfeited? Can forfeited shares be reissued at discount? If so, to what extent?
4. State the relevant provisions of the Companies Act regarding right issue in case of a public company. How is the value of right computed?
5. What do you mean by forfeiture of shares? How are shares forfeited? Pass journal entries regarding forfeiture and reissue of shares.
6. A Limited has a share capital of ₹ 10,00,000 divided into 10,000 equity shares of ₹ 100 each. 5,000 new shares of ₹ 100 each are issued to the existing shareholders at ₹ 140 per share in such a way that the shareholder of every two old shares will get one share in this new issue. The market value of one old share, on the commencement of the issue of right share, becomes ₹ 200 cum-right. Find out the value of right included in market price.
7. X Co. Limited issued a prospectus for 20,000 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 second and final call	₹ 2

   Applications were received for 30,000 shares and allotment made pro-rata to the applicants of 24,000 shares and remaining were rejected. Money overpaid on application was employed on account of sums due on allotment.

   Mr. Y, to whom 400 shares were allotted, failed to pay allotment money and on his subsequent failure to pay the first call, his shares were forfeited. Mr. Z, the holder of 600 shares failed to pay two calls and his shares were forfeited after the second call.

   Of the shares forfeited, 800 shares were sold to Mr. A credited as fully paid for ₹ 11 per share the whole of Mr. Y's share being included.

   Show the journal, cash book and balance sheet.
8. A company was registered with a nominal capital of ₹ 1,60,00,000 in equity shares of ₹ 100 each. 50,000 of these shares were issued to the public at a premium of ₹ 20 per share payable as to ₹ 20 on application, ₹ 45 on allotment including premium, ₹ 25 on first call and the balance on final call.

   Applications were received for 65,000 shares and allotment was made on the basis of pro-rata to the applicants of 60,000 shares. Money over paid on application was utilised on account of sums due on allotment.

Notes

Prakash holding 1,000 shares paid the whole of the amount due on first call along with the allotment but failed to pay the final call. Mr. Yeshpal holding 1,500 shares failed to pay the two calls and Mr. Rane holding 2,000 shares failed to pay only the final call. All these shares were forfeited after the final call.

Of the shares forfeited, 1,000 shares belonging to Mr. Yeshpal and 1,000 shares belonging to Mr. Rane were sold to Mr. Rajheet Singh as fully paid for ₹ 90 per share.

Show the journal entries in the banks of company.

Answers: Self Assessment

1.	Articles of Association	2.	forfeited
3.	Share premium	4.	True
5.	False	6.	True
7.	False	8.	Pro-rata
9.	Reputation	10.	Section 81
11.	right share	12.	Time specified
13.	Application money		

3.9 Further Readings

Books

Corporate Accounting - Dr. K.K. Verma

Online links

http://moneyterms.co.uk/rights-issue/

http://investmentarticle.com/why-do-companies-conduct-rights-issue.html

Unit 4: Buy Back of Securities by Private Limited and Unlisted Public Limited Companies

CONTENTS

Objectives

After studying this unit, you should be able to:

- Explain the meaning of buy back
- Understand funds for financing buy back
- Define escrow Account
- Describe the issue of bonus shares

Introduction

Share capital is a very essential part of a company, listed or unlisted. Share capital can be of two types i.e. equity share capital or preferential share capital. The share capital of a company has to be subscribed by one or more persons. After the share of a company has been allotted to the subscribing members, the subscribers have no right over the money gone as proceeds of the shares subscribed. All that the shareholder has is the right to vote at the general meetings of the company or the right to receive dividends or right to such other benefits which may have been prescribed. The only option left with the shareholder in order to realise the price of the share is to transfer the share to some other person.

But there are certain provisions in the companies act which allow the shareholders to sell their shares directly to the company and such provisions are termed as buy back of shares. Buy back of shares can be understood as the process by which a company buys its share back from its shareholder or a resort a shareholder can take in order to sell the share back to the company.

4.1 Meaning of Buy Back

Buy back of securities simply implies purchase of its own shares by the Company. Till the issue of these Rules, buy back of shares was prohibited under the law and by introducing section 77A by Companies (Amendment) Act, 1999, effective from 31.10. 1998.

Notes

The Company generally resorts to it for the following reasons:

1. to enhance the true or intrinsic value of its shares.
2. to return surplus cash to its shareholders.
3. to achieve desired capital structure.

Caution The buy-back of the shares or other specified securities, if listed on a stock exchange, shall be carried out in accordance with the Regulations framed by the SEBI.

However, in the case of securities of unlisted companies, the buy-back shall be done as per the guidelines framed by the Central Government.

Securities include:

1. shares, scrips, stocks, bonds, debentures, debentures stock or other marketable hybrid securities of a like nature in or of any incorporated company or other body corporate;
2. derivative;
3. units or any other instruments issued by any collective investment scheme to the investors in such schemes;
4. Government securities;
5. Such other instruments as may be declared by the Central Government to be securities: (not so far) and
6. Rights or interest in such securities.

"Hybrid means any security which has the character of more than one type of securities, including their derivatives".

4.2 Funds for Financing Buy Back

A Company may buy back its own shares by utilising the money only out of the following heads:

1. Free reserves;
2. The proceeds of any issue of shares or specified securities other than proceeds of an earlier issue of the same kind of shares or same kind of specified securities which are proposed to be bought back;
3. Cash reserves of the Company. However, the money borrowed from Banks/Financial Institutions can not be utilised for the same.

Notes Free reserves mean those reserves which as per the latest audited Balance Sheet are free for distribution of dividend and shall include the amount to the credit of securities premium account and balance kept in the Profit and Loss Account. The share application amount and revaluation reserve will not form part of free reserve.

Conditions to be fulfilled before buy back

Section 77A(2) provides that no Company shall purchase its own shares unless the following conditions are met:

(a) There must be a specific provision in the Articles of Association authorising the Company to buy back its own shares, otherwise the Articles must be amended by a special resolution to incorporate a suitable provision. Special resolution must also be passed in the General Meeting authorising Board of Directors to buy-back the shares of the Company or other specified securities. However no special resolution in General Meeting is required in case the buy-back is of or less than 10% of the total paid up equity capital and free reserves of the Company and the same is authorised by way of a resolution passed at a duly convened Board Meeting.

(b) The quantum of buy back could be upto 25% of paid up capital and free reserves provided the buy back of the equity shares in any financial year shall not exceed 25% of its total paid up equity capital in that financial year.

(c) The company shall after the buy-back ensure that the debt of the Company viz., the amount of secured and unsecured debts shall not be more than twice the paid up capital and free reserves. It is open, however, for the Central Government to prescribe a higher ratio of debt for any class or classes of Companies.

(d) All the shares or other specified securities involved in buy-back must be fully paid-up.

(e) The explanatory statement sent to members along with the notice for passing the special resolution referred to in clause (a) above shall, inter-alia, set out the following particulars:

  (i) A full and complete disclosure of all material facts ;

  (ii) The necessity for the buy-back ;

  (iii) The class of security proposed to be bought back ;

  (iv) The amount involved in the buy-back ;

  (v) An indication of time limit for completion of buy-back. In any case, the buy-back should be completed within 12 months from the date of passing the special resolution.

(f) The Company shall make no offer of buy-back within a period of 365 days reckoned from the date of the preceding offer of buy-back, if any. Further the Company cannot come out with a fresh issue of shares of the same class within a period of 6 months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, Stock options schemes, sweat equity or conversion of preference shares or debentures into equity shares.

Manner of making buy-back

The buy-back may be made as follows:

(a) From the existing shareholder holders on a proportionate basis through private offers.

(b) By purchasing the securities issued to employees of the Company pursuant to a scheme of stock option or sweat equity.

The buy-back under sub-section (1) may be:

(a) from the existing security-holders on a proportionate basis;

(b) from the open market

Notes

(c) from odd lots, that is to say, where the lot of securities of a public company, whose shares are listed on a recognised stock exchange, is smaller than such marketable lot, as may be specified by the stock exchange

(d) by purchasing the securities issued to employees of the company pursuant to scheme of stock option or sweat equity.

Self Assessment

Fill in the blanks:

1. .... of securities simply implies purchase of its own shares by the Company.
2. .... means any security which has the character of more than one type of securities, including their derivatives.
3. The buy-back of the shares or other specified securities, if listed on a stock exchange, shall be carried out in accordance with the Regulations framed by the ....

True or False:

4. The quantum of buy back could be upto 25% of paid up capital.
5. The Company shall make no offer of buy-back within a period of 365 days reckoned from the date of the preceding offer of buy-back.

4.3 Circumstances where Buy Back is not allowed

No Company shall directly or indirectly purchase its own shares:

(Section 77 B)

- Through any subsidiary Company or its own subsidiaries if any;
- Through any investment Company or companies;
- If the Company commits a default in the repayment of deposit or payment of interest, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of term loans or payment of interest to any financial institution which is subsisting;

The idea seems to be to stop accumulation of its shares by indirect means.

- Where a Company has not complied with the provisions of sections:
  - 159 regarding Annual Return
  - 207 regarding failure to pay dividend within 30 days of declaration; and
  - 211 regarding disclosure of true and fair view in the Balance Sheet. Section 211(3A) requires that every company's profit & Loss account and balance sheet shall comply with the accounting standards.

There should be no subsisting default by the Company in payment of:

1. any deposit or interest due thereon
2. redemption of debentures or preference shares
3. payment of dividend
4. any term loan or interest thereon to any financial institution or bank.

Securities not purchasable

Notes

(a) partly-paid securities

(b) securities which are subject to lock-in period or otherwise non-transferable.

(c) Securities held by promoters or persons in control of the company, if the buy-back is through stock exchange.

Procedural formalities

The process of Buy-back, inter-alia, includes the following steps to be taken up by the Company:

1. A Board resolution should be passed at a duly convened Board meeting authorising buy-back and approving the draft notice for convening Extraordinary General Meeting to pass the necessary resolution(s) and amending Articles of Association, if required.
2. Notice convening EGM should be sent to each and every shareholder entitled to receive and attend the general meeting along with an explanatory statement containing prescribed particulars.
3. Necessary resolution(s) should be passed at the Extraordinary General Meeting of the members of the Company authorising the Company to buy-back its own shares/securities and amending Articles of Association, if required.
4. As soon as the Company has passed the special resolution for buy-back and before making the buy-back, the Company shall file with the Registrar of Companies the following forms/documents:
   (i) Form No. 23 pursuant to Section 192 of the Act.
   (ii) Declaration of Solvency in Form No. 4A signed by two directors including the Managing Director, if any of the Company and duly verified by way of an affidavit.
   (iii) A draft letter of Offer containing prescribed particulars. On filing of the same the offer becomes irrevocable on the part of the Company.
5. Letter of offer, shall be sent to the shareholders of the Company, within 21 days of filing of draft letter of offer with the ROC.
6. The letter of offer should contain inter alia the following:
   (i) true factual and material information;
   (ii) no misleading information;
   (iii) a statement that the directors of the company accept the responsibility for the information contained in it.
7. No shares including bonus shares shall be issued till the date of the closure of the offer of buy-back of shares.
8. Confirm in the letter of offer the opening of a separate bank account testifying the availability of funds earmarked for it and also about payment of consideration only by way of cash or Bank Draft/pay order.
9. Once the draft letter of offer has been filed with the Registrar of Companies, it shall not be withdrawn.
10. Any money borrowed from Banks/Financial Institutions shall not be used for the purpose of buying back the company's shares.
11. The offer should remain open for a period not less than 15 days and not exceeding 30 days from the date of despatch of letter of offer.

Notes

12. The Company shall complete the verification of the offers received from the shareholders within 15 days from the date of closure of offer and the shares lodged shall be deemed to be accepted unless shareholders are communicated otherwise within 21 days from the closure of the offer.
13. In case of the number of shares offered by the shareholders is more than the total number of shares to be brought back by the company, see that the acceptance per shareholder is made on proportionate basis.
14. The Company should make arrangement to ensure that payment is made to the shareholders within 7 days of the time specified in clause 12, supra, by opening a special bank account, immediately after the closure of offer.
15. The share certificates should be extinguished and physically destroyed by the Company within 7 days of acceptance of shares. And a certificate to this effect shall be filed with ROC duly verified by two whole time directors including Managing Director, if any and a Company Secretary in whole time Practice within 7 days of the extinguishment and destruction of share certificates.
16. As soon as the buy-back is complete the Company shall file with the Registrar of Companies within 30 days of such completion a return containing prescribed particulars called return of buy-back.
17. The Company should maintain a Register of Shares Bought Back by the Company in the prescribed form.

Self Assessment

Fill in the blanks:

6. The money borrowed from .... cannot be utilized for the buy back.
7. There must be a specific provision in the .... authorizing the Company to buy back its own shares.

4.4 Escrow Account

Deposit in an escrow account, on or before the opening of the offer the following sum by way of security for performances of obligations by the company under the Regulations:

(a) if the consideration payable does not exceed ₹ 100 crores; 25% of the consideration payable;

(b) if the consideration payable exceeds ₹ 100 crores; 25% on 100 crores and 10% thereafter.

Mode of Payment to Escrow Account

The escrow account can consist of either cash deposited with a scheduled commercial bank or bank guarantee in favour of a merchant banker or deposit of acceptable securities with appropriate margin with the merchant banker or a combination of the above.

Did u know? If the company has deposited the specified sum in an escrow account with a scheduled commercial bank then while opening the account, empower the Merchant banker to instruct the Bank to issue a Banker's cheque or Demand Draft for the amount lying to the credit of the escrow account.

If the escrow account consist of a bank guarantee, the said bank guarantee shall be in favour of the merchant banker which will be valid until thirty days after the closure of the offer. If the escrow account consist of securities, then empower the merchant banker to realize the value of such escrow account by sale or otherwise.

Opening Special Account

A special account has to be opened with the bankers , immediately after the date of closure of the offer and deposit therein such sum due as would together with the amount lying in the escrow account make up the entire sum due and payable as consideration for buy-back in terms of Regulations and for this purpose the company may transfer the funds from the escrow account.

Make payment of consideration in cash, within 21 days from the closure of the offer, to those shareholders whose offer has been accepted.

Extinguishment of Share Certificates bought back

The certificates of shares bought back by the company must be extinguished and physically destroyed in the presence of a Company secretary or the Statutory Auditor of the company within seven days from the date of acceptance of the shares.

In case the shares offered for buy-back by the company have already been dematerialized then extinguish and destroy them in the manner specified under Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996 and the bye-laws framed therein.

The company has to furnish to the stock exchanges where shares of the company are listed, the particulars of shares certificates extinguished and destroyed within seven days of such extinguishment and destruction of the certificates.

Accounting Treatment

Transfer to capital redemption reserve account

Where a company purchases it own shares out of free reserves, then a sum equal to the nominal value of the shares purchased shall be transferred to the Capital Redemption Reserve (referred to in section 80(1) clause (d) & proviso) Account and details of such transfer will be shown in the balance sheet. (Sec.77 AA)

Effect of buy-back on Earning per share

Whenever a Company resorts to buy-back, the basic idea underlying is that its own shares represent the best investment opportunity available. Thus those who continue to hold the shares of the Company find that their percentage of holding goes up because as a result of buy-back the total number of outstanding shares, reduced. Further the Earning per share also goes up because the cake is now divided among fewer people. Thus the value of shareholders holding goes up without making any additional investment.

Section 2(22) of Income Tax Act, 1961 (as amended) defines as “Dividend” includes inter alia:

(a) any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails to release by the company to its shareholders of all or any part of the assets of the company.

(b) any distribution to its shareholders by a company of debentures etc., whether with or without interest.

Notes

(c) Any distribution made to shareholders of a company on its liquidation, to the extent to which it is attributable to the accumulated profits of the company.

(d) Any distribution to its shareholders on the reduction of its capital. to the extent to which the Company possess accumulated profits whether capitalised or not.

But "dividend" does not include:

As per section 22 (iv) of the Act (as amended), any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of section 77A of the Companies Act, 1956. Thus buy back of shares and securities does not tantamount to distribution of dividend to shareholders.

Tax on distributed profits of domestic companies

Section 115-O of the Act says that, in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way of dividends on or after the 1st April, 2003, whether out of current or accumulated profits shall be charged to additional income-tax at the rate of twelve and one-half per cent.

The Principle officer of the company shall be liable to pay the tax on distributed profits to the credit of the Central Government within fourteen days from the date of:

(a) declaration of any dividend

(b) distribution of any dividend

(c) payment of any dividend

whichever is earliest

As regards expenses incurred in the buy back process, judicial pronouncements are not clear with some holding that expenses are of revenue nature whereas others have advocated as capital nature. In fact, it is for the Company to present its stand about the usefulness of the buy back and claim the expenses as they deem best in their interest.

Once the buy back process is complete, the shares are cancelled. Buy back does not result into a transfer and hence, no stamp duty if payable. It is neither a transfer nor a release as per Indian Stamp Act.

The accounting entry is

(i) In case investment are sold for buying back of own shares:

Bank Dr

To Investment Account

(The difference if any will be credited to Profit on sale of Investment Account or debited to Loss on sale of Investment Account, which in turn will be transferred to profit & loss account)

(ii) In case the proceeds of fresh issues are used for buy-back purpose, then on fresh issue.

Bank Dr

To Debentures/other Investments Account

To Securities Premium Account (if any)

Notes

(iii) For buying back of shares:

Equity Shareholder's Account Dr

To Bank

(iv) For cancellation of shares bought back:

Equity Share Capital Account Dr (with the nominal value of shares bought Back)

Free Reserves/Securities Premium Account Dr (with the excess amount/premium Paid over nominal value)

To Equity Shareholder's Account (with the amount paid)

(v) In case the shares are bought back at a discount:

Equity Share Capital Account Dr (with the nominal vale)

To Equity Shareholders' Account (with the amount paid)

To Capital Reserve Account (with the amount of discount on buy-back

For transfer of nominal value of shares purchased out of free reserves/securities premium to Capital Redemption Reserve Account:

Free Reserves Account Dr (with the amount transferred)

Securities premium Account Dr (with the amount transferred)

To Capital Redemption Reserve Account (with the nominal value of shares bought back)

(vi) For expenses incurred in buy-back of shares:

Buy-back Expenses Dr (with the amount)

To Bank

(vii) For transfer of buy-back expenses:

Profit & Loss Account Dr

To Buy-back Expenses

The expenses incurred on the buy back formalities, e.g. Fees of advisers, filing fees, merchant bankers, cost of paper announcements etc. If these expenses are set off against the current Profit & Loss Account of the Company, it would help in claiming these expenses as revenue items for tax deduction purpose. Another alternative is to amortise over a period of 5 years this expenses and carry forward the expenditure in the Balance Sheet as a deferred revenue expenditure till it is fully written off.

Thus buy-back is a procedure, which enables the Company to go back to its shareholders and offer to purchase from them the shares that they hold. The decision to buy-back reflects management's view that the Company's future prospects are good and hence investing in its own shares is the best option. It also signals undervaluation of the Company's shares in relation to its intrinsic value. It appears that only financially sound companies should be able to resort to buy-back. Companies should follow the principles of model corporate governance and there should be transparency in buy-back deals.

The best example of such a buyback in the Indian context was the buyback of shares undertaken by the Great Eastern Shipping Company (GESCO) to protect itself from a hostile takeover bid led by the A H Dalmia group. In October 2000, the A H Dalmia group of Delhi made a hostile bid

Notes

for a 45 per cent stake in the Great Eastern Shipping Company (GESCO) at ₹ 27 a share. The price offered was less than half the book value of the company. The offer and counter offers made by the A H Dalmia group and the promoters of GESCO pushed up the bidding cost. The A H Dalmia group ultimately sold its 10.5% stake (around 3 million shares) at ₹ 54 per share for a consideration of ₹ 163 million before the year end. The A H Dalmia group had acquired the 10.5% stake in Gesco at an average cost of ₹ 24 per share for a consideration of ₹ 72 million. Hence, the A H Dalmia group was able to make a profit of ₹ 91 million through green mail transaction in less than 6 months.

Companies can also use the book building process to buy back shares. The book building process is a mechanism of price discovery which helps determine market price of securities. If the book building option is used, a draft prospectus has to be filed with SEBI. The prospectus should contain all the details of the offer, except the price at which the securities will be offered (a price band is specified). The copy of the draft prospectus is filed with SEBI and is circulated among institutional buyers by a leading merchant banker acting as the book runner. Institutional investors specify the price as well as the volume of shares they intend to buy. The book runner, on receiving the above information, determines the price at which the offer is to be made to the public.

Self Assessment

Fill in the blanks:

8. The .... can consist of either cash deposited with a scheduled commercial bank.
9. Where a company purchases it own shares out of free reserves, then a sum equal to the nominal value of the shares purchased shall be transferred to the ....

State True or False:

10. Notice convening EGM should be sent to each and every shareholder entitled to receive and attend the general meeting along with an explanatory statement.
11. If the escrow account consists of a bank guarantee, the said bank guarantee shall be in favour of the merchant banker.
12. There must be a specific provision in the Articles of Association authorising the Company to buy back its own shares.

Problem 1: K Ltd. furnishes you with the following Balance Sheet as at 31st March, 2009:

	(₹ in crores)	
Sources of Funds		
Share capital:		
Authorised		100
Issued:		
12% redeemable preference shares of ₹ 100 each fully paid	75	
Equity shares of ₹ 10 each fully paid	25	100
Reserves and surplus		
Capital Reserve	15	
Securities Premium	25	
Revenue Reserves	260	300
		400

Contd...

Notes

Funds employed in :		
Fixed assets : cost	100	
Less: Provision for depreciation	100	nil
Investments at cost (Market value ₹ 400 cr.)		100
Current assets	340	
Less : Current liabilities	40	300
		400

The company redeemed preference shares on 1st April 2009. It also bought back 50 lakh equity shares of ₹ 10 each at ₹ 50 share. The payments for the above were made out of the huge bank balances, which appeared as a part of Current assets.

You are asked to:

i. Pass journal entries to record the above

ii. Prepare Balance Sheet

iii. Value equity share on net asset basis.

Solution:

Part-I: Journal entries in the books of K Ltd.

(₹ in crore)

Particulars		Debit	Credit
a. Redemption of Preference Shares on 1st April 2009			
(i) Due Entry			
12% Preference Share capital A/c	Dr.	75	
To Preference Share Hodlers A/c			75
(ii) Payment Entry			
Preference Shareholders A/c	Dr.	75	
To Bank A/c			75
b. Shares bought back			
(i) On buy back			
Shares bought back A/c	Dr.	25	
To Bank A/c			25
(50 lakhs shares × ₹ 50 per share)			
(ii) On Cancellation			
Equity Share capital A/c (50 Lakhs × ₹ 10)	Dr.	5	
Securities premium A/c (50 Lakhs × ₹ 40)	Dr.	20	
To Shares bought back A/c			25
(iii) Transfer to Capital Redemption Reserve			
Revenue reserve A/c	Dr.	80	
To Capital Redemption Reserve A/c			80
(Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)			

Notes

Part-II: Balance Sheet of K Ltd after reconstruction:

Balance Sheet of K Ltd as at 1.4.2009

Liabilities	₹	₹	*Assets*	₹	₹
Share capital			Fixed assets		
Authorised			Cost:		
Issued, subscribed and paid up			Less : Provision for	100	
equity shares of 200 lakhs of ₹ 10 each		20	Depreciation	(100)	Nil
			Investment at Cost		
12% Redeemable preference shares were redeemed at par.			(Market Value of Investments = ₹ 400 crores)		100
Capital Redemption Reserve	80		redemption and buy back	(100)	240
		340			**340**

Part-III: Net Asset Value of Equity Shares

(₹ in crores)

Particulars		***Amount***	***Amount***
a.	(i) Fixed assets		
	(ii) Investments (at market value)	Nil	400
	(iii) Current assets	240	640
b.	Less : Current liabilities	(40)	
	Net assets available for equity share holders		600
c.	No. of equity shares outstanding (in lakhs)	2	
d.	Value per equity share of ₹ 10 each = (600÷2)	₹ 300	

Problem 2: The following was the balance sheet of Diamond Ltd. as at 31st March, 2009.

Liabilities	**₹ in lakhs**
10% Redeemable Preference Shares of ₹ 10 each, fully paid up	2,500
Equity Shares of ₹ 10 each fully paid up	8,000
Capital Redemption Reserve	1,000
Securities Premium	800
General Reserve	6,000
Profit and Loss Account	300
9% Debentures	5,000
Sundry creditors	2,300
Sundry Provisions	1,000
	26,900
Assets	**₹ in lakhs**
Fixed assets	14,000
Investments	3,000
Cash at Bank	1,650
Other Current assets	8,250
	26,900

Notes

On 1st April, 2009 the company redeemed all of its preference shares at a premium of 10% and bought back 25% of its equity shares @ ₹ 20 per share. In order to make cash available, the company sold all the investments for ₹ 3, 150 lakh and raised a bank loan amounting to ₹ 2,000 lakhs on the security of the company's plant.

Pass journal entries for all the above mentioned transactions including cash transactions and prepare the company's balance sheet immediately thereafter. The amount of securities premium has been utilized to the maximum extent allowed by law.

Solution:

Journal Entries

Particulars		Debit ₹	Credit ₹
Bank A/c To Investment A/c To Profit and Loss A/c (Being sale of investments and profit thereon)	Dr.	3,150	 3,000 150
Bank A/c To Bank Loan A/c (Being loan taken from bank)	Dr.	2,000	 2,000
10% Redeemable preference Share Capital A/c Premium on redemption of preference shareholder A/c To Preference shareholder A/c (Being redemption of preference shares)	Dr. Dr.	2,500 200	 2,750
Preference shareholders A/c To Bank A/c (Being payment of amount due to preference shareholders)	Dr.	2,750	 2,750
Securities premium A/c To Premium on redemption of preference share A/c (Being use of securities premium to provide premium on redemption of preference shares)	Dr. Dr.	250	 250
Equity Share capital A/c Securities premium A/c [800 - 250] General reserves A/c [(200x20) - 2000 - 550] To Equity shareholders A/c (being buy back of equity shares) Note: Balance of General Reserve [6000 - 1450] = ₹ 4550.	Dr. Dr. Dr.	2,000 550 1,450	 4,000
General Reserves A/ c To Capital Redemption Reserve A/c (2000 + 2500) (Being creation of capital redemption reserve to the extent of the face value of preference share redeemed and equity shares bought back).	Dr.	4,500	 4,500

Contd...

Notes

Note: Balance in General reserve as on 01.04.09 (4550 - 4500) = ₹ 50.			
Equity shareholders A/c To Bank A/c (Being payment of amount due to equity shareholders). Note: Cash at Bank [1650+3150+2000-2750-4000] = ₹ 50	Dr.	4,000	4,000

Balance Sheet of Diamond Ltd. as on 01.04.09

Liabilities	₹	Assets	₹
Share capital		Fixed assets	
Issued, subscribed and paid up equity shares of ₹ 10 each	6,000	Current asset, Loans and Advances	14,000
Reserves and surplus			
Capital Redemption Reserve	5,500	Cash at Bank	50
(1000 + 4500)		Other Current assets	8,250
General Reserves	50		
Profit and Loss A/c (300+ 150)	450		
Secured Loans			
9% Debentures	5,000		
Bank Loan	2,000		
Current liabilities and Provisions			
Sundry creditors	2,300		
Provisions	1,000		
Total	**22,300**	**Total**	**22,300**

Problem 3: XYZ Ltd. has the following capital structure as on 31st March 2009.

Particulars	₹ in crores
Equity Share capital (Shares of ₹ 10 each)	300
Reserves :	
General Reserve	270
Security Premium	100
Profit and Loss A/c	50
Export Reserve (Statutory reserve)	80
Loan Funds	800

The shareholders have on recommendation of Board of Directors approved vide special resolution at their meeting on 10th April 2009 a proposal to buy back maximum permissible equity shares considering the huge cash surplus following A/c of one of its divisions.

The market price was hovering in the range of ₹ 25 and in order to induce existing shareholders to offer their shares for buy back, it was decided to offer a price of 20% above market.

Advice the company on maximum number of shares that can be bought back and record journal entries for the same assuming the buy back has been completed in full within the next 3 months.

If borrowed funds were ₹ 1200 lakhs, and 1500 lakhs respectively would your answer change? Maximum shares that can be bought back:

Notes

	Situation I	*Situation II*	*Situation III*
Shares outstanding test (WN # 1)	7.5	7.5	7.5
Resources test (WN # 2)	6	6	6
Debt Equity ratio test (WN # 3)	10.67	4	
Maximum number of shares for	6	4	

buy back - LEAST of the above

Particulars	Situation I		Situation II	
	Debit	Credit	Debit	Credit
Shares bought back A/c Dr.	180		120	120
To Bank A/c		180		
[Being purchase of shares from public]				
Share capital A/c Dr.	60		40	
Securities premium A/c Dr.	100		80	
General reserve A/c (balancing figure) Dr.	20	180		
To Shares bought back A/c				120
[Being cancellation of shares bought on buy back]				
General Reserves A/c To Capital Redemption Reserve A/c				
[Being transfer of reserves to capital redemption reserve to the extent capital is redeemed]				

Notes Under situation III, the company does not qualify the debt equity ratio test. Therefore the company cannot perform the buy back of shares (Under section 77A of the Companies Act, 1956)

Working Notes:

WN # 1: Shares outstanding test

Particulars	Amount
No. of shares outstanding	30 crores
25% of shares outstanding	7.5 crores

WN # 2: Resources test

Particulars	(₹ in Crores) Amount
Paid up capital	300
Free reserves	420
Shareholders fund (a + b)	720
25% of shareholders fund	180
Buyback price per share	₹ 30
Number of shares that can be bought back	6 Crore

WN # 3: Debt Equity ratio test:

(₹ in crores)

Particulars	Situation I	Situation II	Situation III
Borrowed Funds	800	1,200	1,500
Minimum equity to be maintained after buy back in the ratio 2 : 1	400	600	750
Present equity	720	720	–720
Maximum possible dilution in equity	320	120	–
Maximum shares that can be bought back @ ₹ 30/- per share	10.67	4	–

Self Assessment

Fill in the blanks:

13. The amount of profit that is distributed to the shareholders in addition to dividend is called ....
14. This bonus can be distributed in the form of cash, portly paid up shares or fully paid up shares to the ....
15. Bonus is generally not paid in ....

Case Study

Minority Share Buyback

This case study is based on the experience of a business owner who owned 70 percent of his business. The balance was owned by two individuals, one of whom owned 20 percent and was causing much difficulty. The controlling shareholder wished to reacquire the shares of the troublesome stockholder, whose interest was valued at $200,000. But after working through the numbers, the business owner decided that the cost to the company would be too great. He decided to simply live with the troublesome minority shareholder.

Corporate stock redemptions are considered by company owners principally for the following reasons:

1. ***Peace:*** To silence a troublesome minority stockholder.
2. ***Obligation:*** For example, one of your executives is leaving the company and he or she has the legal right to require the company to buy the stock he or she purchased previously under a stock option plan.
3. ***Mandated Buyout:*** When a court of law orders the company to buy out a minority owner's shares.
4. ***Investment:*** Management might cause the company to buy the stock from willing sellers because they think it will provide a fair return on investment and raise the value of the shares that remain.

Contd...

Notes

5. Stay below the 500-shareholder threshold. Private firms that have 500 or more shareholders can be required to make public filings similar to public companies.

As principal owner of your business, you have to be concerned with any corporate stock redemption, for the following reasons:

- Many states restrict or prohibit the purchase of stock by the company from its stockholders, principally depending on the availability of cash and capital surplus within the company to effect the stock repurchase. Basically, you cannot "impair" the capital account and solvency of the business by repurchasing "equity" securities.
- Other stockholders may complain because of the effect on the corporation, particularly its balance sheet. The operating agreement of the company may also require that such a transaction be approved by some percentage of the shareholders.
- You may be accused of unfair dealing if you don't offer all owners the right to sell their stock back to the company at the same time, price and terms.
- Your creditors may object since the stockholders' equity account drops after a redemption. For this reason, most loan agreements prohibit or restrict a company's repurchase of equity shares or interest.
- You may be sued by the selling stockholder if you know of certain facts that affect the value of the stock and these facts are unknown to the seller (material insider information) at the time of the stock repurchase.

Effect on the Company

Below is a description of the subject business owner's analysis, with explanatory remarks. Note that this approach can be applied to companies with other forms of ownership, including S-corporations, partnerships and limited liability corporations (LLCs). Let's start with the stockholders' equity account, in which there are 100,000 shares of common stock outstanding.

Stockholders' Equity Account

Common Stock – $1 par:	
100,000 Shares Outstanding	$100,000
Capital Surplus	$120,000
Retained Earnings	$280,000
Total Stockholders' Equity	$500,000
Book Value per Share	$5.00
Net Income	$75,000
Earnings per Share	$0.75

Let's also assume that total company debt is $1 million and that of the 100,000 shares outstanding, 20,000 shares are being acquired by the company (20 percent of the outstanding common stock). The agreed-on purchase price is $10 per share (two times the company's $5 book value per share), which represents a $200,000 total purchase price. Based on these facts, here's the result:

- Corporate cash declines by $200,000 (20,000 shares times $10).

Contd...

Notes

- Stockholders' equity decreases from \$500,000 to \$300,000 — a reduction of 40 percent.
- Leverage increases from 200 percent (\$1 million total debt divided by \$500,000 equity) to 333 percent (\$1 million debt divided by \$300,000 equity). This assumes that no additional capital was borrowed to finance the stock repurchase. If that were necessary, the debt-to-equity ratio would have risen even higher.

Effect on Remaining Owners

The remaining stockholders increase their ownership percentages. Since 20,000 shares are in treasury, a stockholder owning 10,000 of the remaining 80,000 shares will now own 12.5 percent of the corporation (10,000 shares divided by 80,000). Before the purchase, this stockholder owned 10 percent (10,000 shares divided by 100,000). The percentage ownership position of all stockholders will increase by 25 percent.

Book value per share declines from \$5 to \$3.75–\$300,000 pro forma (after repurchase) stockholders' equity position divided by 80,000 shares. The proforma decline in book value occurs because the buy-back price of \$10 per share was double the previous book value per share of \$5 (\$500,000 stockholders' equity divided by 100,000 shares). That's why other minority stockholders may not be in favor of the transaction – unless they also are given the right to sell shares back to the company on the same terms.

Based on last year's net income of \$75,000, earnings per share would increase from \$0.75 to \$0.94 (\$75,000 net income divided by 80,000 shares). But note that if debt is used to finance the stock purchase, pretax income (and net income) should be adjusted downward to reflect the resulting interest expense. Company cash is being used for nonproductive purposes. This may significantly impact the company's future growth and its profitability and, as explained below, can negatively impact the company's borrowing ability.

Finally, the tax basis of each share of stock owned by the remaining shareholders remains unchanged despite the fact that the value of each share has risen due to the lower number of shares outstanding. When the remaining shareholders sell their shares, as if the entire company were sold, the taxable gain will be greater than it would have been had the buyout of the 20 percent owner been effected by a direct purchase from the shareholders. Such a purchase would have required the shareholders to use personal funds to effect the purchase, but a step-up in the basis of the stock would have occurred and the tax owed in a subsequent sale would be less.

Effect on Company's Value

Since \$200,000 is purchasing 20 percent of this company, the value placed on the business is \$1 million (\$200,000 divided by .20). In terms of fundamental valuation methods, this \$1 million value represents:

- A price-earnings multiple (P/E) of 13.3 times last year's net income of \$75,000.
- 2.0 times stockholders' equity of \$500,000 before the stock repurchase.
- 3.3 times stockholders' equity of \$300,000 after the stock repurchase.

This value analysis is presented to give you additional information to help you in deciding whether or not to effect the buyout. You also will have to determine the value of the company going forward. For example, if this company were projecting net income of \$150,000 next year, the \$1 million value would represent a P/E multiple of only 6.7. This alone could justify the stock repurchase, particularly if the company's growth continues on course.

Contd...

Notes

Access to Capital

The company redemption/purchase of common stock also has dramatic effects on the company's creditors, who now have a lower stockholders' equity account under their debt position, and a debt-to-equity ratio of 3.3 to 1 ($1 million debt divided by $300,000 stockholders' equity). In addition, the company's future borrowing capacity is substantially lower. Thus, if you are going to redeem any stock, be sure your overall cash position (today and projected) is more than adequate to finance growth and contractual debt repayments.

What If You, the Owner, Are the Seller?

If you are the owner and your common stock is being purchased by the company, read "Owner Stock Repurchase Tax Traps". Proceeds of your sale could be taxed to you at ordinary income rates rather than capital gain rates unless you completely sever your relationship with the company. Also, for liability reasons, make sure that the:

- Stock redemption price is at fair market value as established by an independent appraiser.
- Shares are purchased by the company on an arm's-length basis.
- Acquisition price and terms don't discriminate against other stockholders.
- Tax impact of the sale/purchase on both you and the company has been reviewed by your accountant.

4.5 Summary

- Buy back can be made From the existing shareholder holders on a proportionate basis through private offers.
- By purchasing the securities issued to employees of the Company pursuant to a scheme of stock option or sweat equity.
- Bonus can be distributed in the form of cash, portly paid up shares or fully paid up shares to the shareholders. Bonus is generally not paid in cash. If it is paid in cash, the working capital of the company will be adversely affected. Mostly companies use this amount to make up the existing partly paid up shares as fully paid. This is called Bonus Issue or Bonus Shares

4.6 Keywords

Buy-Back: To buy that is previously sold.

Free Reserves: Difference between borrowed reserves and excess reserves.

Subsidiary Company: Company that is completely controlled by another company.

4.7 Review Questions

1. Write a note on funds for financing buy back.
2. Explain the circumstances where buy back is not allowed.
3. Write a note on manner of making buy back.
4. Mohan Limited has an authorised capital of ₹ 40,000 in equity shares of ₹ 10 each. The issued capital of the company is ₹ 24,000 divided into shares of ₹ 10 each, with ₹ 8 per share called and paid. A sum of ₹ 12,300 was capitalised out of reserve fund and out of amount so

Notes

capitalised, the directors were so authorised to: (a) declare a bonus dividend to make the shares fully paid; (b) to issue 600 new equity shares of ₹ 10 each at a premium of ₹ 2.50 per share on the basis of one equity share for every four equity shares held. Assuming that Mohan Ltd. has passed the resolution for this purpose, pass the necessary journal entries in its books.

5. The share capital of ABC Ltd. consists 40,000 shares of ₹ 100 each, ₹ 75 called up and paid. It has ₹ 20,00,000 in general reserve. The directors recommended the following with a view to capitalise the reserve:

   (a) The existing shares to made fully paid without the shareholders having to pay anything.

   (b) Each shareholder to be given (proportionate to his holdings) bonus to the remaining amount, the shares to be valued at ₹ 125. Assuming that the recommendation is accepted and all legal formalities are completed. Pass journal entries and state in what proportion bonus shares will be distributed among the shareholders.

   A company having sufficient balance to the credit of Profit and Loss Account decided as under:

   (a) To redeem 6%, 16,000 redeemable preference shares of ₹ 10 each, fully paid at a premium of ₹ 1 share.

   (b) To apply the resultant reserve fund in paying the unissued shares of the company distributed as fully paid equity shares of ₹ 10 each by way of bonus to its members.

   Show the journal entries required to record the redemption and the bonus issue.

6. Ajanta Trading Co. Limited has an authorised capital of ₹ 8,00,000 divided into:

   10,000; 6% redeemable preference shares of ₹ 10 each.

   20,000; 7% preference shares of ₹ 100 each and 50,000 equity shares of ₹ 100 each.

   On January 1, 2006 the whole of the two classes of preference shares and 15,000 of equity shares stood in the books as fully paid. The share premium account as on that date showed a balance of ₹ 20,000. The balance of profit was ₹ 32,000.

   On July 1, 2006 it was decided to redeem the whole of 6% preference shares at a premium of ₹ 1 per share and for this specific purpose the company issued for cash 8,000 equity shares of ₹ 10 each at a premium of ₹ 2 per share, payable in full on allotment. All the above shares were taken up. The cost of issue of shares amounted to ₹ 3,000.

   On October 1, 2006 the company issued to the existing shareholders one bonus share of ₹ 10 each fully paid for each five held. It is the intension of the directors that minimum reduction should be in revenue reserve account which starts at ₹ 125,000.

   Give necessary journal entries.

7. On January 1, 1975 Shibpur Motors Ltd. issued 3,000, 7% redeemable preference shares of ₹ 10 each, all of which were taken on and fully paid. The shares were issued on condition that the same at any time after March 31, 1981 could be redeemed at a premium of ₹ 4 per share.

   On June 30, 1982, the company decided to redeem the shares. For this purpose it issued 1,800, 6% preference shares of ₹ 10 each at a premium of ₹ 1 per share on July 15, 1982. The shares were subscribed and paid for by July 31, 1982. The 7% redeemable preference shares were redeemed at the same date.

Notes

The company had a balance of ₹ 28,000 in its Profit and Loss Account on 1st September, 1982 the company decided to issue 5,000 fully paid bonus shares of ₹ 10 each for allotment to equity share-holders in the ratio of one equity share for every four shares hold. It has also a reserve of ₹ 1,10,000.

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

8. The balance sheet of P.Q. Limited on 31st December 2006 was as under:

Liabilities	₹	Assets	₹
8% Redeemable Preference Shares of ₹ 100 each fully paid.	9,00,000	Fixed Assets	20,00,000
		Current Assets	3,80,000
		Investment	2,70,000
		Bank	2,00,000
Equity Shares of ₹ 10 each fully paid	9,00,000		
General Reserve	3,60,000		
Share Premium	27,000		
Profit and Loss Account	5,40,000		
Creditors	1,23,000		
	28,50,000		28,50,000

The preferential shares were to be redeemed at 10% premium along with dividend due for 2006. The company issued 45,000 equity shares of ₹ 10 each at a premium of ₹ 5 per share. All shares were subscribed and cash fully received. The investments were sold for ₹ 3,00,000. The payment was made to the preference shareholders and therefore the directors decided to issue bonus shares in the ratio one share for every four shares held. For this purpose free reserve were utilised to the minimum extent necessary. Give journal entries with narrations and balance sheet after redemption.

9. The following is the balance sheet of Zed Ltd. as on 31st March, 2006.

Liabilities	₹	Assets	₹
50,000 Equity Shares of ₹ 10 each, ₹ 8 per share called up and paid up.	4,00,000	Fixed Assets	6,00,000
5000, 13% Redeemable Preference shares	5,00,000	Investments	2,00,000
Share Premium	98,000	Stock	2,00,000
General Reserve	90,000	Sundry Debtors	2,00,000
Profit and Loss Account	1,12,000	Cash at Bank	3,00,000
Sundry Creditors	3,00,000		
	15,00,000		15,00,000

The Company resolved:

(a) To convert the partly paid up equity shares into fully paid up on 1st April, 2006 without requiring the shareholders to pay for the same.

(b) To redeem the preference shares on 30th April, 2006 at a premium of 7.5% and for this purpose to issue 3,000; 12% preference shares of ₹ 100 each at a premium of 10% payable in full on application.

The resolutions were carried into effect. For the purpose of the above redemption, on 29th April, 2006, the company sold its fixed assets costing ₹ 3,00,000 for ₹ 3,82,500

Notes

and all the investments for ₹ 2,60,000. On 31st May 2006, all payments were made on redemption, except to the holders of 200 shares who could not be traced.

On 30th June, 2006, the directors issued fully paid bonus shares to the then shareholders at the rate 3 for 5 held at a premium of 5%.

You are required to give necessary journal entries in the books of the company to record the above transactions.

Answers: Self Assessment

1. Buy back
2. Hybrid
3. Capital Redemption Reserve
4. True
5. True
6. Banks/Financial Institutions
7. Articles of Association
8. SEBI.
9. escrow account
10. True
11. False
12. True
13. Bonus
14. Shareholders
15. cash

4.8 Further Readings

Books

Corporate Accounting - Dr. K.K. Verma

Online links

http://moneyterms.co.uk/rights-issue/

http://investmentarticle.com/why-do-companies-conduct-rights-issue.html

Unit 5: Redemption of Preference Shares

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe the Redemption of shares
- Explain Fresh issue
- Understand Redemption of capital account

Introduction

Generally, a company limited by shares is not permitted to return the share money to its shareholders except in the case of its winding up. If a company wants to return the share money to the shareholders, it must be empowered by the Articles of Association and it must secure the permission of the court as per Section 100 of Companies Act. But the court's permission is not necessary if the share money is being returned to the preference shareholders. Under Section 80 of Companies Act, a company limited by shares may, if so empowered by its Articles of Association, issue redeemable preference shares which will be redeemable at the discretion of the company, or after the expiry of a stipulated time. Along with it, section 80(5A) states that "Notwithstanding contained in this Act, no company limited by shares shall, after the commencement of the Companies (Amendment) Act 1988, issue any preference share which is irredeemable or is redeemable after the expiry of a period of ten years from the date of its issue." If a company is issuing redeemable preference shares, redemption will be according to the terms of issue but the following legal restrictions as per Section 80 relating to redemption of preference shares must be fulfilled:

(i) No share can be redeemed unless they are fully paid.

(ii) Such share can be redeemed either (a) cut off the profits which would otherwise be available for dividend or (b) out of the proceeds of the fresh issue of shares made for the purpose of redemption. Both of the sources can be used simultaneously.

(iii) Where redemption is made out of profits otherwise available for dividend, a sum equal to nominal amount of the shares so redeemed must be transferred to a reserve fund account to be called 'Capital Redemption Reserve Account.'

Notes

(iv) Capital Redemption Reserve Account can be utilised for declaring fully paid bonus shares to the shareholders of the company. Otherwise it must be maintained intact unless otherwise sanctioned by the court.

(v) If any share premium is payable on the redemption of preference, shares, such a premium must be provided out of the profits of the company, or out of the share premium account of the company.

(vi) Redemption of preference shares shall not be treated as reduction of authorised share capital. To the extent a company has redeemed or is about to redeem any preference shares, it has the power to issue upto the nominal amount of the shares redeemed or to be redeemed, as if those shares had never been issued.

(vii) If the new shares are issued for the purpose of redemption of preference shares, capital shall not be deemed to have been increased.

5.1 Purpose of Legal Restrictions

A careful analysis of the conditions of Section 80 of Companies Act regarding the redemption of preference shares reveals that the basic objective of these conditions is to protect the interest of creditors of the company. According to Section 80 of the Companies Act, redemption of preference shares can be either from out of the profits or from out of the proceeds of the fresh issue of shares. If these conditions are not followed and redemption is carried out any other manner, as from out of borrowings or by the sale of assets that will affect adversely to the interest of creditors.

If the redemption of preference shares is carried out of profits available for dividend, amount of preference share capital redemption will take place Capital Redemption Reserve Account which will be used only for one purpose namely the issue of fully paid bonus shares. Thus the interest of creditors will not be affected.

If the redemption of preference shares is carried out of fresh issue of shares, amount of fresh issue of share capital will take place the amount of preference share redeemed. This will also not affect the interest of creditors of the company. Thus, on redemption of preference shares, the amount of redemption of preference shares will be any one of the following:

1. Amount of redemption of preference shares = Amount of capital redemption reserve.
2. Amount of redemption of preference shares = proceeds of fresh issue of shares.
3. Amount of redemption of preference shares = Amount of capital redemption reserve proceeds of fresh issue of shares.

Self Assessment

True or False:

1. A company can redeem only its preference share during its lifetime.
2. There cannot be redemption of partly paid up preference shares.

Fill in the blanks:

3. Dividend on preference shares is always …………… .
4. The …………… preference shares cannot be issued by a limited company.

Choose the answer:

5. The redemption of preference shares can be from:
   (a) Capital reserve
   (b) Proceeds of issue of debentures
   (c) Development rebate reserve
   (d) General reserve

5.2 Sources of Redemption

Redeemable Preference shares are those shares, the capital of which is refunded by the company after a specified duration. The redemption of such shares is made in accordance with the provisions of section 80 of the Companies Act.

In case preference shares can be redeemed when they are fully paid up. In case a company has partly paid preference shares, it must see that they are made fully paid up before they are redeemed.

Sources of Redemption of Preference Shares

1. Fresh Issue
2. Capital Redemption Reserve

5.2.1 Explanation of Proceeds of Fresh Issue

There is a lot of controversy and confusion over the term proceeds of a fresh issue of shares. It is therefore, compulsory to understand this term properly. A closer examination of the provisions and intentions of Company Law implies the meaning of the word 'proceeds' as the amount received excluding the premium on the fresh issue and net amount received in the case of discount or at par. In other words, if the fresh shares are issued at par, 'proceeds' means the actual amount realised. If the fresh shares are issued at discount, proceeds means the net amount realised from the issue of fresh shares i.e., nominal value of shares minus discount allowed. This is done because nominal value of shares does not represent the wholly tangible assets capable of providing the real protection to the creditors (third party). This can be understood properly with the help of the following example. If a company has to redeem preference shares of ₹ 2,00,000 and decides to issue the equity shares at a discount of 10%, it will get only ₹ 1,80,000 (2,00,000 – 20,000) in cash from the cash issue. But the company will needs ₹ 2,00,000 in cash for the redemption of preference shares. On the liability side of the balance sheet, the nominal value of fresh shares will replace properly the redeemable preference shares by an equivalent sum i.e., ₹ 2,00,000. But on the assets side, there will appear two items (i) cash of ₹ 1,80,000 (ii) discount on issue of shares (loss) ₹ 20,000. Further, suppose this company goes into liquidation immediately after the redemption of preference shares and due to a bad financial position it is unable to satisfy the claims of the third party in full. Here, it would mean the repayment of capital in priority over creditors to the extent of ₹ 20,000, which is discount. This is a clear violation of Section 80.

Notes If the fresh shares are issued at premium for the redemption of redeemable preference shares, meaning of 'proceeds' will be the amount realised from the issue of fresh shares excluding the amount of premium.

Notes

Only the nominal value of shares should be taken into consideration. The reason for not including the premium in proceeds is clear that it does not provide any protection to the third party (creditors). Section 78 of Company Act clearly depicts the four uses of share premium discussed in the preceding chapter. And if premium is utilised for other than these four uses, it will be treated as reduction of capital. If the amount of premium is included in the total proceeds for redemption purpose, the amount of redeemable preference share will be replaced partly by share capital and partly by share premium. Here, the security available for third party (creditors) may be reduced at any time by the amount of premium as premium is open for four uses under Section 78.

To put in a nutshell, the proceeds of fresh issue of shares means:

(i) When shares are issued at par, the nominal value of fresh shares.

(ii) When shares are issued at discount the amount realised from the fresh issue.

(iii) When shares are issued at premium, the nominal value of shares. The amount of premium is not used for redemption of preference shares.

Profits which would otherwise be available for dividend

One of the sources of redemption of preference shares is the profit that would otherwise be available for dividend. It means general profits can be utilised for redemption. Profit should not be of capital nature. The list of such profit from which redemption can be made or can be transferred to capital redemption reserve is as follows:

(i) General Reserve Fund

(ii) Credit balance of Profit and Loss Account

(iii) Reserve Fund

(iv) Dividend Equalisation Fund

(v) Workmen's Compensation Fund

(vi) Workmen's Accident Compensation Fund

(vii) Insurance Fund

(viii) Debenture Redemption Fund/Sinking fund

(ix) Contingency Reserve

(x) Reserve for doubtful debts or taxation.

Profits which will not be available for dividend:

The following profits are of capital nature, therefore cannot be utilised for redemption of preferences shares or cannot be transferred to capital redemption reserve:

(i) Forfeited Shares Account

(ii) Share Premium Account

(iii) Profit Prior to Incorporation

(iv) Development Rebate Reserve

(v) Investment Allowable Reserve

(vi) Capital Reserve

(vii) Profit from Sale of Fixed Assets.

5.2.2 Capital Redemption Reserve Account

Caution Capital redemption reserve account is created under Section 80 which states that it should be treated as paid up capital. When redeemable preference shares are redeemed from out of those profits which are otherwise available for dividend (mentioned above), these profits are transferred to capital redemption reserve account.

Capital Redemption Reserve Account is utilised by the company in paying up unissued shares of the company to be issued to existing members of the company as fully paid bonus shares. In other words, this reserve is non-distributable and only fully paid bonus shares can be issued from this reserve. If this reserve is distributed among shareholders as profit, it will entail a reduction of capital which will adversely affect the interest of third party (creditors).

No redemption of partly paid up preference shares until they are fully paid

As per Section 80(a) (mentioned above) there will be no redemption of such a redeemable preference shares which are not fully paid. The purpose of this Section is only to protect the interest of third party (creditors). Whenever a third party gives loans and advances to the company they look for security. This security is not only in existing assets but also in prospective amount of assets to be received in future. Thus, when preference shares are partly paid up, the uncalled amount of capital on partly paid up shares can always be called up by the company and by the liquidator at the time of its liquidation under conditions of the contract. If Section 80 of Companies Act allows the redemption of partly paid redeemable preference shares, it would mean the replacement of equivalent amount either by the proceeds of fresh issue of shares, or by the capital redemption reserve account. This will deceive the creditors whose calculations are based on the nominal value of shares at the time of advancing the loans or extending the credit facilities. Thus, in order to protect the interest of creditors, it was felt necessary that it is not paid up amount of redeemable preference shares, but the nominal value of shares that requires replacement. Thus, in order to protect the interest of creditors, Section 80 of the Companies Act makes it compulsory that no partly paid up preference share will be redeemed unless they are fully paid up. This will automatically replaces that amount (fully paid up) on which creditors' calculation are based.

Remedy for redemption of preference shares at the time of failure of the company

If a public company fails or is unable to redeem its redeemable preference shares by a certain date fixed for redemption, the following remedies will be available to the shareholders:

(i) If redeemable shares are issued and redeemable at the option of the company, shareholders can have no grievance.

(ii) If the shares are redeemable after the expiry of a particular period, possibly an order for liquidation may be obtained against the company on the just and equitable ground. Preference shareholders are not the creditors of the company and therefore, they cannot sue for the money due on the shares undertaken to be redeemed and cannot, as a right, claim a return of their share money except in liquidation.

Premium on Redemption of Preference Shares

If the redeemable preference shares are redeemable at a premium, the amount payable on the redemption of preference share can be provided either out of the share premium received from the fresh issue of shares, or from the profits of the company whether it is a capital profit or revenue profit.

Notes

Procedure for Solving Examination Problems

In order to solve the examination problem relating to the redemption of preference shares, the following procedure should be adopted:

Step I: First, we should see whether the redeemable preference shares are fully paid or partly paid up. If these are partly paid up, with the help of following journal entry, make them eligible for redemption, because only fully paid up shares can be redeemed.

(i) When final call money is due:

Preference Share Final Call Account Dr.

To Preference Share Capital Account

(ii) When amount of final call is received:

Bank Account Dr.

To Preference Shares Final Call Account

Step II: Now we have to determine how much money is required to pay off the preference shareholders whose shares are to be redeemed. This total amount payable will consist of face value of preference shares which are to be redeemed and, if any, share premium payable on redemption. The entry will be:

(i) When preference shares are redeemable at par:

Redeemable Preference Share Capital Account Dr.

To Preference Shareholders Account

(ii) When preference shares are redeemable at premium:

Redeemable Preference Share Capital Account Dr.

Premium on Redemption of Preference Shares Account Dr.

To Preference Shareholder Account

Premium on redemption of preference shares is a loss is therefore being debited.

Step III: In this step, we have to decide the sources from where redemption is to be made. To find out the source we have to examine the liability side of the balance sheet:

(i) How much profits which will otherwise be available for dividend, are available to need the redemption of nominal value of redeemable preferences shares.

(ii) How much other profits (capital profits) and balance in share premium account are available in order to provide for premium, if any, payable on redemption.

It will then be decided whether the new issue of shares is required for the purpose of redemption or not.

The journal entries will be:

(i) If the redemption is made by using the profits which will otherwise be available for dividends, that amount of profits which is being utilised for redemption of preference shares will be transferred to capital reserve account:

Profit and Loss Account	Dr.	As the case may be
General Reserve Account	Dr.	
Dividend Equalisation Fund a/c	Dr.	

Notes

To Capital Redemption Reserve Account

(ii) When premium on redemption of preference shares is transferred to either profit and loss account or any reserve or share premium account.

Share Premium account	Dr.	with that amount which is being paid on
Profit and Loss account	Dr.	redemption

To Premium on Redemption of Preference Shares Account

(iii) If the profits that will otherwise be available for dividend, are not sufficient to meet the redemption of nominal value of redeemable preference shares, for shortage, there will be new issue of fresh shares. This new issue of fresh shares can be at par, at discount or at premium. There will be the following journal entries:

(a) When fresh shares are issued at par

Bank Account Dr.

To Share Capital Account

(b) When fresh shares are issued at premium

Bank Account Dr.

To Share Capital Account

To Share Premium Account

(c) When fresh shares are issued at discount

Bank Account Dr.

Discount on Issue of Shares Account Dr.

To Share Capital Account

The amount required from the issue of fresh shares can be computed with the help of following equation:

$$\text{Amount of Redeemable Preference Shares} = \begin{pmatrix}\text{Capital Redemption} \\ \text{Reserve Account}\end{pmatrix} + \begin{pmatrix}\text{Amount received from} \\ \text{the issue of fresh shares}\end{pmatrix}$$

Step IV: In this step, we have to look for sums available from cash in hand and at bank in the assets side of balance sheet of the company. If the total sums available from cash in hand and at bank are not enough to meet the redemption of preference shareholders, shortage of cash will be raised by one or more of the following methods:

(i) from taking bank loan

(ii) from the sale of investment or current assets.

(iii) from the issue of new shares

For these transactions the journal entries will be as follows:

(a) when bank loan is raised

Bank account Dr.

To Bank Loan Account

(b) When current assets or investments are sold (if there is any profit or loss on the sale of assets, that will be transferred to Profit and Loss Account)

Notes

Bank Account Dr.

To Investment Account or

To other current assets (which are being sold)

(c) When new shares are issued

Bank Account Dr.

To Share Capital Account

Step V: If money available in bank is sufficient, the company will pay off the preferences shareholders for redemption by cash.

Preference Shareholders Account Dr.

To bank account

Sometimes, the redemption of preference shares is made by the conversion of some new shares; the following entry will be passed:

Preference Shareholders Account Dr.

To New Share Capital Account.

In this case no amount is required to transfer to Capital Redemption Reserve Account.

Self Assessment

Fill in the blanks:

6. In the condition of excess profits or reserves .... shares can be issued.
7. When bonus shares are issued at premium, ... account is credited.
8. If money available in bank is sufficient, the company will pay off the preference shareholders for redemption by ....

True or False:

9. Redemption of preference shares cannot be made from out of the proceeds of fresh issue of preference shares.
10. Capital redemption reserve is utilised in writing off the preliminary expenses.
11. Premium payable on redemption of preference shares must be debited to Profit and Loss Account only.

Example 1: **Determination of Minimum Amount of Fresh Issue**

Find out how much minimum fresh issue is necessary in order to comply with the provisions of Section 80 of Companies Act in the following cases:

(a) (i) Redeemable preference shares of ₹ 1,00,000 are to be redeemed at par and credit balance of P.L. Account and share premium are ₹ 20,000 and ₹ 5,000 respectively.

(ii) 7% Redeemable Preference Shares of ₹ 1,50,000 are to be redeemed at a premium of 5% and credit balance of Profit and Loss Account and balance of share premium account are ₹ 40,000 and ₹ 7,000 respectively in the balance sheet.

(iii) 10% Redeemable Preference Shares of ₹ 2,00,000 are to be redeemed at a premium of 10%. General Reserve, Share Premium and Dividend Equalisation Funds are of ₹ 20,000, ₹ 4,000 and ₹ 40,000 respectively in the balance sheet.

(b) (i) A company has to redeem its Redeemable Preference Shares of ₹ 1,00,000 at 10% premium. In its balance sheet shows profits available for dividend are ₹ 15,000, Share premium of ₹ 2,000 and new shares are to be issued at 5% premium.

(ii) The Redeemable Preference Shares of a company are of ₹ 5,00,000 which are to be redeemed at 10% premium. In its balance sheet there is credit balance of Profit and Loss account of ₹ 1,12,500, balance in Share Premium Account is ₹ 10,000. The company has to issue the new shares at 5% discount.

Solution:

The following amount from fresh issue of shares is required for redemption:

(a) (i) ₹ 80,000, because profit available of ₹ 20,000 can be utilised for redemption of preference shares and will be transferred to Capital Redemption Reserve Account. As per Section 80 the amount of premium cannot be utilised for redemption of preference shares.

(ii) ₹ 1,10,500, because after writing off the premium on redemption of preference shares, the profit available will only ₹ 39,500 which will be utilised for redemption of preference shares and will be transferred to Capital Redemption Reserve Account.

(iii) ₹ 1,56,000, because after writing off the premium on redemption of preference shares from share premium account and other profit, the profit available will only be ₹ 44,000 which will be utilised for redemption of preference shares and will be transferred to Capital Redemption Reserve Account.

(b) (i)

	(₹)
Profits available for dividend	15,000
– Premium on redemption to be paid out of profit (10,000 – 2,000)	8,000
Profits available for redemption	7,000

Amount of preference shares to be redeemed ₹ 1,00,000

Proceeds of fresh issue should be equal to ₹ 1,00,000 – 7,000 = 93,000

As the new shares are issued at 5% premium, nominal value of fresh share capital will be:

$$93,000 \times \frac{100}{105} = ₹\,88,571.4$$

(ii)

	(₹)
Credit balance of P/L A/c	1,12,500
Premium on redemption to be paid out of profit (50,000 – 10,000)	40,000
Profit available for redemption	72,500

Amount of preference shares to be redeemed is ₹ 5,00,000

Proceeds of fresh issue should be equal to ₹ 5,00,000 – 72,500 = ₹ 4,27,500

Notes

As the new shares are being issued at 5% discount, nominal value of fresh share capital will be:

$$4,27,500 \times \frac{100}{95} = ₹\ 4,50,000$$

Example 2: **Redemption of Preference Shares out of Profits**

The balance sheet of Sonex Limited as on 31 March 2006 was as under:

Liabilities	(₹)	Assets	(₹)
Share Capital:		Sundry Assets	21,25,000
5,000, 8% Preference		Bank Balance	3,75,000
Shares of ₹ 100 each fully paid	5,00,000		
1,00,000 Equity shares of ₹10 each	10,00,000		
	15,00,000		
Profit & Loss Account	3,00,000		
General Reserves	2,50,000		
Creditors	4,50,000		
	25,00,000		25,00,000

The preference shares are redeemable on April 1, 2006 at a premium of 10%. The redemption was duly carried out on the due date, assuming that the company raised the necessary loan from bank. Show the necessary journal entries in the books of Sonex Limited.

Solution:

Sonex Limited Journal

Date	Particulars		L.F.	(₹)	(₹)
April 1	8% Redeemable Preference Share Capital Account	Dr.		5,00,000	
	Premium on Redemption of Preference Share A/c	Dr.		50,000	
	To 8% Preference Shareholders Account				5,50,000
	(Being amount on redemption due to shareholders with premium)				
	Profit & Loss account	Dr.		3,00,000	
	General Reserve Account	Dr.		200,000	
	To Capital Redemption Reserve Account				5,00,000
	(Being utilisation of profit and general reserve for redemption)				
	General Reserve Account	Dr.		50,000	
	To Premium on Redemption of Preferences Shares account				50,000
	(Being utilisation of general reserve for writing off the premium on redemption of preference shares)				
	Bank Account	Dr.		1,75,000	
	To Bank Loan Account				1,75,000
	(Being raised of bank loan to pay off preference share holders)				
	8% Preference Shareholders Account	Dr.		5,50,000	
	To Bank Account				5,50,000
	(Being payment made to preference shareholders on redemption)				

Note: 8% Preference Share Capital will be replaced by capital redemption reserve account in the liability side of balance sheet.

Notes

Example 3: **Redemption of Preference Shares Out of Profit & Balance Sheet**

The following is the summarised balance sheet of Ding Dong Limited as on 31st March 2006:

Liabilities	(₹)	Assets	(₹)
Authorised Share Capital:		Plant and Machinery	10,00,000
10% Redeemable Preference Shares of ₹ 100 each.	3,20,000	Current Assets	6,00,000
Equity Shares of ₹ 10 each	10,20,000		
	13,40,000		
Issued and paid up capital:			
10% Redeemable Preference			
Shares of ₹100 each fully paid	2,80,000		
Equity shares of ₹ 10 each fully paid up	8,40,000		
Share Premium	35,000		
Profit and Loss Account	3,05,000		
Creditors	1,40,000		
	16,00,000		16,00,000

The preference shares were redeemed on 1st April, 2006 at a premium of 10%. No trace could be found of the holder of 15 preference shares.

You are required to give the journal entries in the books of the company and give its balance sheet also.

Solution:

Ding Dong Limited
Journal

Date	Particulars		L.F.	(₹)	(₹)
April 1	10% Redeemable Preferences Share Capital Account	Dr.		2,80,000	
	Premium on redemption of preference shares account	Dr.		28,000	
	To 10% Preference Shareholders Account				3,08,000
	(Being amount on redemption due to shareholders with premium)				
	Profit and Loss Account	Dr.		2,80,000	
	To Capital Redemption Reserve Account				2,80,000
	(Being utilisation of profit for the redemption of preference shares)				
	Share Premium Account	Dr.		28,000	
	To Premium on Redemption of Preferences Shares Account				28,000
	(Being utilisation of premium in writing off the premium on redemption of preference shares)				
	10% Preferences Shareholders Account	Dr.		3,06,350	
	To Bank Account				3,06,350
	(Being payment made to 2,785 Preference shareholders on redemption)				

Notes

Balance Sheet of Ding Dong Limited
as on 1st April, 2006

Liabilities	(₹)	Assets	(₹)
Authorised Shares capital:		*Fixed Assets:*	
3200, More 10% Preferences Shares of ₹ 100 each	3,20,000	Plant & Machinery	10,00,000
1,02,000 Equity Shares of ₹ 10 each.	10,20,000	Current Assets (₹ 6,00,000 – ₹ 3,06,350)	2,93,650
	13,40,000		
Issued, Subscribed, Called up and Paid up capital:			
84,000 Equity Shares of ₹ 10 each fully paid up	8,40,000		
Capital Redemption Reserve Account	2,80,000		
Share Premium Account (35,000- 28,000)	7,000		
Profit and Loss A/c (3,05,000 – 2,80,000)	25,000		
10% Preference Shareholders (15 holders could not be traced)	1,650		
Creditors	1,40,000		
	12,93,650		12,93,650

Notes:

1. Amount belonging to 15 preference shareholders who could not be traced out, will be treated as current liabilities (15 × 100 + 10%) = ₹ 1,650.
2. Inspite of being redemption of 10% preference shares, authorized share capital will not be changed because redemption of preference shares is not treated as reduction of capital as per Companies Act.

Example 4: **Redemption of Preference Shares out of the Proceeds of Fresh Issue of Shares**

The following extract of Asha Limited's balance sheet, is given below:

Liabilities	(₹)
Authorised share capital:	70,00,000
Issued and subscribed:	
3,00,000 Equity Shares of ₹ 100 each, fully paid up	30,00,000
10,000; 10% Redeemable Preference Shares of ₹ 100 each	
₹ 90 called up and paid up	9,00,000
Capital Reserve	1,50,000
Share Premium	30,000
Profit on sale of fixed assets	3,20,000
Profit and Loss Account (credit)	1,00,000

The company decides to redeem all the preferences shares at a premium of 2%. For the specific purpose of the redemption it issued 20,000, 12% preference shares of ₹ 50 each at a premium of 5%. The entire amount is being payable along with application. The whole issue is taken by public. The redemption of 10% Redeemable Preference Shares is duly completed.

Journalise the above mentioned transactions in the books of Asha Limited.

Solution:

Notes

Asha Limited
Journal

Date	Particulars		L.F.	(₹)	(₹)
	10% Redeemable Preference Share Final Call Account	Dr.		1,00,000	
	To 10% Preference Share Capital Account				1,00,000
	(Being the final call money due on preference shares for the purpose of its redemption).				
	Bank Account	Dr.		1,00,000	
	To 10% Redeemable Preference Share Final Call A/c				1,00,000
	(Being the receipt of final call money an 10,000 preference shares)				
	Bank Account	Dr.		10,50,000	
	To 12% Preference Share Capital Account				10,00,000
	To Share Premium Account				50,000
	(Being issue of 12% preference shares at a premium of 5% for redemption of preference shares)				
	10% Redeemable Preference Share Capital Account	Dr.		10,00,000	
	Premium on Redemption of Preference Shares Account	Dr.		20,000	
	To Preference Shareholders Account				10,20,000
	(Being amount due to preference shareholders on redemption)				
	Share Premium Account	Dr.		20,000	
	To Premium on Redemption of Preference Share Account				20,000
	(Being share premium utilised for writing off premium on redemption of preference shares)				
	Preference Shareholders Account	Dr.		10,50,000	
	To Bank Account				10,50,000
	(Being payment made to preference shareholders on the redemption of preference shares)				

Note: Under Section 80 preference shares cannot be redeemed until they are fully paid up. Therefore, final call of ₹ 10 is being made.

Example 5: **Redemption of Preference Shares Partly Out of Profits and Partly from the Proceeds of Fresh issue of Shares**

The following is the balance sheet of Abhimanyu Limited as on 31 December, 2005.

Liabilities	(₹)	Assets	(₹)
Share capital:		Fixed assets	12,00,000
2,500, 11% Redeemable		Stock	2,50,000
Preference Shares of ₹ 100 each	2,50,000	Debtors	25,000
5,000 Equity Shares of ₹ 100 each	5,00,000	Cash	25,000
Capital Reserve	50,000		
General Reserve	1,00,000		
Share Premium Account	50,000		
Profit and Loss Account	50,000		
Creditors	5,00,000		
	15,00,000		15,00,000

Notes

The preference shares are to be redeemed on 1st January 2006 at 10% premium.

On 1st January 2006, a fresh issue of equity shares was made to the extent it is required under the Companies Act for the purpose of redemption of preference shares.

The shortfall in cash resources for the purpose of redemption after utilising the proceeds of fresh issue was met by raising a bank loan, the cash balance ₹ 25,000 being the minimum the company requires for its trading operations.

Draft journal entries in the books of the company to record these transactions and prepare the balance sheet in the form prescribed by the Companies Act 1956, immediately after the redemption.

[Adapted from B. Com. (Hons.) Delhi 1987]

Solution:

Abhimanyu Limited
Journal

2006	Particulars		L.F.	(₹)	(₹)
Jan. 1	11% Redeemable Preference Share Capital Account	Dr.		2,50,00	
	Premium on Redemption Account	Dr.		25,000	
	To Preference Shareholders Account				2,75,000
	(Being amount due to preference shareholders on redemption with premium)				
	Profit and Loss Account	Dr.		50,000	
	General Reserve Account	Dr.		1,00,000	
	To Capital Redemption Reserve Account				1,50,000
	(Being utilisation of general reserve and profits for redemption of preference shares)				
	Share Premium Account	Dr.		25,000	
	To Premium on Redemption Account				25,000
	(Being utilisation of share premium for writing off the premium on redemption of preference shares)				
	Bank Account	Dr.		1,00,000	
	To Equity Share Capital Account				100,000
	(Being receipt the proceeds from the issue of fresh shares)				
	Bank Account	Dr.		1,75,000	
	To Bank Loan Account				1,75,000
	(Being raised of bank loan for the redemption of preference shares)				
	Preferences Shareholders Account	Dr.		2,75,000	
	To Bank Account				2,75,000
	(Being the payment made to preference shareholder on redemption of preference shares)				

Balance Sheet of Abhimanyu Limited
as on 1st January 2006

Liabilities	(₹)	Assets	(₹)
Share Capital:		Fixed Assets:	12,00,000
6,000 Equity Shares of ₹ 100		***Current Assets:***	
each fully paid up	6,00,000	Cash Balance	25,000

Contd...

Reserve & Surplus:		Stock	2,50,000
Capital Redemption Reserve	1,50,000	***Loans and Advances:***	
Capital Reserve	50,000	Debtors	25,000
Share Premium	25,000		
Secured Loans:			
Bank Loan	1,75,000		
Creditors	5,00,000		
	15,00,000		15,00,000

Working Note:

	(₹)
Total amount required for redemption	
Face value of shares	2,50,000
+ Premium to pay on redemption	25,000
Total amount required	2,75,000
- Amount received from fresh issue of shares	1,00,000
Amount required which will be	1,75,000
Taken by raising bank loan	

Example 6: On 1st August 2006, the following balances were extracted from the balance sheet of Seema Limited:

(i)	12% Redeemable Preference Share Capital:	(₹)
	12,500 shares of ₹ 100 each fully called up	12,50,000
(ii)	Calls unpaid	
	Final call on 500 shares @ ₹ 20 each	10,000
(iii)	Shares Premium	1,25,000
(iv)	General Reserve	4,00,000
(v)	Profit & Loss Account	2,96,365
(vi)	Declared Preference Dividend, not yet paid	1,44,800

The company redeemed all its preference shares at a premium of 6% and for the purpose, Company issued equity shares of ₹ 10 each at a discount of 10% for such an amount as was necessary for the purpose after utilising the available profits to the maximum possible extent. It also paid the declared preference dividend. Show the journal entries.

Solution:

Journal

Date	Particulars	L.F.	(₹)	(₹)
	Bank Account Dr.		10,000	
	To Call-in-Arrear Amount			10,000
	(Being the receipt of calls-in-arrear)			

Contd...

Notes

	12% Redeemable Preference Share Capital Account Dr.		12,50,000	
	Premium on Redemption Account Dr.		75,000	
	To Preference Sharesholders Account			13,25,000
	(Being amount due to preferences shareholders on redemption of preference share on premium)			
	General Reserve Account Dr.		4,00,000	
	Profit & Loss Account Dr.		2,96,365	
	To Capital Redemption Reserve A/c			6,96,365
	(Being profit and general reserve utilised for redemption of preference shares)			
	Share Premium Account Dr.		75,000	
	To Premium on Redemption Account			75,000
	(Being the utilisation of share premium for writing off the premium on redemption.)			
	Bank Account Dr.		5,53,680	
	Discount on Issue of Share Account Dr.		61,520	
	To Equity Shares Capital Account			6,15,200
	(Being the receipt of the proceeds from the issue of 6,152 shares of ₹ 100 each at 10% discount.)			
	Preference Shares' Dividend Account Dr.		1,44,800	
	To Bank Account			1,44,800
	(Being payment made of declared preference dividend)			
	Preference Shareholders' Account Dr.		13,25,000	
	To Bank Account			13,25,000
	(Being payment made to preference shareholders on redemption)			

Working Note:

1. It is assumed that calls-in-arrear of ₹ 10,000 on 100 shares have been received.

2. Total amount required for redemption (₹)

   Face value of preference shares 12,50,000

   Less: Divisible profits available ₹ (4,00,000 + 2,96,365) = 6,96,365

   Minimum amount of new shares

   Which will be issued at discount 5,53,635

   Face value of new shares = $\frac{5,53,635 \times 100}{90}$ = ₹ 6,15,150

   No friction of shares is allowed therefore total

   No. of shares issued will be 6,152 of ₹ 100 each.

3. It is assumed that company has sufficient cash to pay the preference dividend and to redeem the preference shares.

Example 7: **Redemption of Preference Shares with Unpaid Calls Out of Fresh Issue at Discount**

Notes

The Balance Sheet of Sanjeev Limited as on 31st December 2005 was as follows:

Liabilities		(₹)	Assets	(₹)
Share Capital:			Fixed Assets	3,25,000
25,000 Equity Shares of ₹ 10 each 2500, 10% Redeemable		2,50,000	Investments	75,000
			Stock	50,000
Preference Shares of ₹, 100 each	2,50,000		Debtors	1,25,000
Less Calls-in-Arrear 20 per share	5,000	2,45,000	Bank Balance	1,01,500
Share Premium		30,000	Misc. Exps.	20,000
Reserve Funds		74,000		
Profit and Loss Account		45,000		
Current Liabilities		52,500		
		6,96,500		6,96,500

On 1st January 2006, investments costing ₹ 50,000 were sold for ₹ 45,000.

On the same date, it was decided to redeem the preference shares at a premium of 20% by issuing sufficient number of equity shares at a discount of 10% subject to leaving a balance of ₹ 25,000 in reserve fund. All payments were made in full, except to a holder 125 shares only due to his leaving India for good.

You are required to show the journal entries and the balance sheet of the company after redemption.

Solution:

Sanjeev Limited
Journal

Date	Particulars		L.F.	(₹)	(₹)
Jan., 1	10% Redeemable Preference Share Capital Account	Dr.		2,25,000	
	Premium on Redemption Account	Dr.		45,000	
	To Preference Shareholder Account				2,70,000
	(Being amount due to preference share-holders on redemption of preference shares with 20% premium)				
	Share Premium Account	Dr.		30,000	
	Profit and Loss Account	Dr.		15,000	
	To Premium on Redemption Account				45,000
	(Being utilisation of share premium and profit in writing off the premium on redemption of preference shares)				
	Profit and Loss Account	Dr.		25,000	
	Reserve Fund Account	Dr.		49,000	
	To Capital Redemption Reserve Account				74,000
	(Profits and reserve funds utilised for the redemption of preference shares)				
	Bank Account	Dr.		1,51,002	
	Discount on Issue of Shares Account	Dr.		16,778	
	To Equity Share Capital Account				1,67,780
	(Being fresh shares issued at 10% discount for the redemption of preference shares)				

Contd...

Notes

	Bank Account	Dr.		45,000	
	Profit and Loss Account	Dr.		5,000	
	To investments account				50,000
	(Being sale of investment and loss transferred to P/L A/c)				
	Preference Shareholders Account	Dr.		2,55,000	
	To Bank Account				2,55,000
	(Being the payment of 2,125 preference shareholders)				

Balance Sheet of Sanjeev Limited as on 1st January 2006

Liabilities		(₹)	Assets	(₹)
Share Capital:			Fixed assets	3,25,000
Issued and Subscribed			Investment	25,000
41,778 shares of ₹ 10 each fully paid		4,17,780	Stock	50,000
250; 10% Preference shares of ₹ 100 each	25,000		Debtors	1,25,000
Calls in arrear ₹ 20 per share	5000	20,000	Misc. Exps.	20,000
Reserve Fund		25,000	Bank Balance	42,502
Capital Fund Redemption Reserve Account		74,000	Discount on issue of shares	16,778
Current liabilities		52,500		
Preference shareholders		15,000		
		6,04,280		6,04,280

Working Note:

1. Total amount required for redemption:

	(₹)	
Face value of preference shares	2,25,000	
+ 20% premium on redemption	45,000	
	2,75,000	

2. Sources available to write off premium on redemption:

Share premium account	30,000	
Out of profits	15,000	
	45,000	

3. Sources available for redemption of preference share capital

Profit available:

Balance of P & L Account	45,000	
—Loss on sale of investment	5,000	
	40,000	
—Amount utilised for premium on redemption	15,000	
		25,000
Reserve fund for redemption (74,000 – 25,000)		49,000
		74,000

Amount of fresh issue of shares = 2,25,000 – 74,000

= ₹ 1,51,000

No. of shares to be issued $= \dfrac{1,51,000}{9} = 1,677.7$ or 16,778

4. Bank balance = 1,01,500 + 1,51,002 + 45,000 – 2,55,000 = ₹ 42,502

Example 8: **Sale of Investments at Profit for Redemption of Shares**

The following is the summarised balance sheet of Jumbo Limited as on 31st March, 2006:

Balance Sheet of Jumbo Limited
as on 31st March, 2006

Liabilities	(₹)	Assets	(₹)
Share Capital:		Fixed Assets	9,00,000
5,000 Equity Shares of ₹ 100 each	5,00,000	Investment	2,00,000
3,000; 8% redeemable preference shares of ₹ 100 each ₹ 80 per share Called up and Paid up	2,40,000	Current Assets:	
4,000; 9% redeemable preference shares of ₹ 100 each	4,00,000	Stock	1,00,000
Reserve and surplus:		Sundry Debtors	2,00,000
Capital reserve	1,00,000	Cash at Bank	3,00,000
General reserve	1,00,000		
Share premium	60,000		
Profit and Loss Account	2,00,000		
Current Liabilities:			
Sundry creditors	1,00,000		
	17,00,000		17,00,000

On 1st April, 2006, the company redeemed the preference shares at a premium of 10%. In order to pay off the preference shareholders, the company sold the investments realising ₹ 210,000 and also issued 2,000; 7% preference shares of ₹ 100 each which were fully subscribed in cash on the same date company issued fully paid. Bonus shares in the ratio of one for every two shares held.

Show the journal entries and also prepare the balance sheet of the company after the completion of the transactions which took place on 1st April, 2006.

[ICWA, Inter, June 1986]

Solution:

Jumbo Limited
Journal

Date	Particulars		L.F.	(`)	(`)
April 1	9% Redeemable Preference Share Capital Account	Dr.		4,00,000	
	Premium on Redemption Account	Dr.		40,000	
	To Preference Shareholders Account				4,40,000
	(Being amount due to preference shareholders on redemption)				
	Share Premium Account	Dr.		40,000	

Contd...

Notes

	To Premium on Redemption Account			40,000
	(Being utilisation of share premium in writing off the premium on redemption)			
	General Reserve Account Dr.		1,00,000	
	Profit and Loss Account Dr.		1,00,000	
	To Capital Redemption Reserve A/c			2,00,000
	(Being the utilisation of general reserve and profits for redemption of preference shares)			
	Bank Account Dr.		2,10,000	
	To Investment Account			2,00,000
	To Profit and Loss Account			10,000
	(Investments sold and profit transferred to P. & L. A/c)			
	Bank Account Dr.		2,00,000	
	To 7% Preference Share Capital Account			2,00,000
	(Being receipt of amount on issue of 2,000 shares)			
	Preference Shareholders Account Dr.		4,40,000	
	To Bank Account			4,40,000
	(Being amount paid off to preference shareholders on redemption)			
	Capital Redemption Reserve Account Dr.		2,00,000	
	Profit and Loss Account Dr.		50,000	
	To Bonus to Shareholders Account			2,50,000
	(2,500 bonus shares declared to 5,000 existing equity shareholders)			
	Bonus to Shareholders Account Dr.		2,50,000	
	To Equity Share Capital Account			2,50,000
	(Being bonus shares issued)			

Balance Sheet of Jumbo Limited
as on 31st March, 2006

Liabilities	(₹)	Assets	(₹)
Share Capital:		Fixed Assets	9,00,000
Issued and Subscribed:		Investments	Nil
7,500 equity shares of ₹ 100 each fully paid up (2,500 equity shares were issued as bonus shares out of Capital Redemption Reserve and Profit and Loss A/c)	7,50,000	Current Assets:	
		Stock	1,00,000
3,000; 8% Redeemable Preference shares of ₹ 100 each, ₹ 80 paid up	2,40,000	Sundry Debtors	2,00,000
2,000; 7% Preference Shares of ₹ 100 each	2,00,000	Bank Balance	2,70,000
Reserve and Surplus:			
Share Premium	20,000		
Capital Reserve	1,00,000		
Profit and Loss Account (2,00,000 + 10,000 – 50,000 – 1,00,000)	60,000		
Current liabilities:			
Creditors	1,00,000		
	14,70,000		14,70,000

Working Note:

Notes

1. Bank Balance = 3,00,000 + 2,00,000 + 2,10,000 – 4,40,000

   = ₹ 2,70,000

2. Bonus shares can be issued by using the full amount of premium account.

Example 9: **Redemption of Preference Shares by Fresh Issue of Equity Shares or by Profits or by Both**

Pass the necessary journal entries in the books of the company in connection with redeemable preference shares in the following cases:

(i) A company issued 57,500 equity shares of ₹ 10 each, fully called up, for the redemption of 10,000; 8% Redeemable Preference Shares of ₹ 50 each at a premium of 15%.

(ii) For the redemption of 250, 10% preference shares of ₹ 200 each at a premium of 5%, a company issued 5,000 equity shares of ₹ 10 each at 5% premium all payments on these shares were duly received.

(iii) A company has to redeem 10% Redeemable Preference Shares of ₹ 5 lakhs using its profits available for dividend.

(iv) For the payment of 5,000; 9% Redeemable Preference Shares of ₹ 100 each at a premium of 10%, a company issued 4,000 equity shares of ₹ 100 each at a premium of 10% and the balance of the amount was paid out of profit. The full amount was received on this new issue.

(v) For the redemption of 5,000; 7% Redeemable Preference Shares of ₹ 500 each, a company issued 25,000 equity shares of ₹ 100 each at 10% discount and balance was payable from profits.

(vi) For the redemption of 4,00; 7% Redeemable Preference Shares of ₹ 500 each at a premium of 10%. The company utilised its profit.

Solution:

Journal

	Particulars			(₹)	(₹)
(i)	8% Redeemable Preference Share Capital Account	Dr.		5,00,000	
	Premium on Redemption Account	Dr.		75,000	
	To Preference Share Holders Account				5,75,000
	(Being amount due to preference shareholders on redemption)				
	Bank Account	Dr.		5,75,000	
	To Equity Share Capital Account				5,75,000
	(Being issue of 57,500 shares of ₹ 10 each for the redemption of preference shares)				
	Preference Shareholders Account	Dr.		5,75,000	
	To Bank Account				5,75,000
	(Being payment made to preference shareholders on redemption)				
(ii)	10% Redeemable Preference Share Capital Account	Dr.		50,000	
	Premium on Redemption Account	Dr.		250	
	To preference shareholders account				50,250
	(Being amount due to share holders on redemption with premium)				

Contd...

Notes

	Share Premium Account	Dr.	250	
	To Premium on Redemption Account			250
	(Being share premium utilised in writing off the premium on redemption)			
	Bank Account	Dr.	50,250	
	To Equity Share Capital Account			50,000
	To Share Premium Account			250
	(Being receipt of amount from the issue of shares for redemption)			
	Preference Shareholders Account	Dr.	50,250	
	To Bank Account			50,250
	(Being payment made to shareholders on redemption)			
(iii)	10% Redeemable Preference Share Capital Account	Dr.	5,00,000	
	To Preference Shareholders Account			5,00,000
	(Being amount due to shareholders on redemption of preference shares)			
	Profit and Loss Account	Dr.	5,00,000	
	To Capital Redemption Reserve A/c			5,00,000
	(Being utilisation of profit for the redemption of preference shares)			
	Preference Shareholders Account	Dr.	5,00,000	
	To Bank Account			5,00,000
	(Being payment made to shareholders on redemption of preference shares)			
(iv)	9% Redeemable Preference Share Capital Account	Dr.	5,00,000	
	Premium on Redemption Account	Dr.	50,000	
	To Preference Shareholders Account			5,50,000
	(Being amount due to shareholders on redemption of preference shares)			
	Bank Account	Dr.	4,40,000	
	To Equity Share Capital Account			4,00,000
	To Share Premium Account			40,000
	(Being receipt of amount from the issue of shares at premium)			
	Share Premium Account	Dr.	40,000	
	Profit & Loss Account	Dr.	10,000	
	To Premium on Redemption Account			50,000
	(Being the utilisation of share premium and profit in writing off premium on redemption)			
	Profit and Loss Account	Dr.	1,00,000	
	To Capital Redemption Reserve Account			1,00,000
	(Being utilisation of profit for redemption of preference shares)			
	Preference Shareholders Account	Dr.	5,50,000	
	To Bank Account			5,50,000
	(Being payment made to share holders on redemption of preference shares)			
(v)	7% Redeemable Preference Share Capital Account	Dr.	25,00,000	
	To Preference Shareholders Account			25,00,000
	(Being amount payable to preference shareholder on redemption)			

Contd...

Notes

	Bank Account	Dr.		22,50,000	
	Discount on Issue of Shares Account	Dr.		2,50,000	
	To Equity Share Capital Account				25,00,000
	(Being receipt of amount from issue of shares at discount)				
	Profit and Loss Account	Dr.		2,50,000	
	To Capital Redemption Reserve Account				2,50,000
	(Being utilisation of profit for the redemption of preference shares)				
	Preference Shareholders Account	Dr.		25,00,000	
	To Bank Account				25,00,000
	(Being payment made to shareholders on redemption of preference shares)				
(vi)	7% Redeemable Preference Shares Capital Account	Dr.		2,00,000	
	Premium on Redemption Account	Dr.		20,000	
	To Preference Shareholders Account				2,20,000
	(Being amount due to shareholders on redemption of preference shares)				
	Profit and Loss Account	Dr.		2,20,000	
	To Premium on Redemption Account				20,000
	To Capital Redemption Reserve Account				2,00,000
	(Being utilisation of profit for redemption of Pref. Capital and premium thereon)				
	Preference Shareholders Account	Dr.		2,20,000	
	To Bank Account				2,20,000
	(Being payment made to shareholders on redemption of Pref. Shares)				

Self Assessment

Fill in the blanks:

12. There is a lot of controversy and confusion over the term proceeds of a …………… .

Choose the answer:

13. Capital Redemption reserve account is created:
    (a) Voluntarily
    (b) To meet the legal requirements
    (c) Out of Capital reserve
    (d) Out of share premium

14. Bonus shares can be issued from:
    (a) Capital redemption reserve
    (b) Profit on sale of fixed assets
    (c) Development reserve
    (d) Employees' deposit

Notes

15. If a company has to redeem its 7% redeemable preference shares of ₹ 40,000 and issue 3,000 equity shares of ₹ 10 each at a premium of 10%, how much amount should be transferred to capital redemption reserve account:

    (a) ₹ 40,000

    (b) ₹ 7000

    (c) ₹ 10,000

    (d) ₹ 33,000

Case Study

OCBC Preference Shares

This preference share is currently trading in SGX under the symbol, OCBC Bk NCPS 5.1% 100. The trading symbol itself can reveal a lot of details. OCBC Bk simply stands for OCBC Bank while NCPS stands fornon-cumulative and non-convertible preference shares. Non-cumulative means the dividends that were not declared and not paid in the previous financial year will not be accumulated to the next financial year while non-convertible means there is no option for the preference shareholders to convert their preference shares to ordinary shares. The 100 at the end of the trading symbol means that the lot size is 100 shares i.e. 1 lot is equal to 100 shares as compared to the usual lot size of 1 lot is equal to 1000 shares.

The following are some of the issues that you should consider.

1. ***Perpetuity:*** One of the main issue for preference shares is that it will never mature unless the issuer which in this case, OCBC Bank decides to redeem it back. Notice that it is stated very clearly that OCBC Bank may, at its option, redeem in whole but not in part the preference shares on 29 July 2013 or on each dividend date after 29 July 2013. As compared to bonds, the issuer has the obligation to redeem it back. So what happens if you wish to cash your preference shares out after holding it for quite a long time ? Either you can wait for OCBC Bank to redeem it back or try to sell it on SGX but that brings me to my second issue.

2. ***Liquidity:*** Due to the small quantity of preference shares that are issued generally, preference shares usually have poor liquidity and that pose a problem. Firstly, there may not be buyers who wish to buy your preference shares if you need to sell it and even if there are buyers, their buying price may not be that favorable i.e. the spread which is the difference between the buying and selling price can be rather far apart. That will definitely put you at a disadvantage.

3. ***Dividends:*** Do take a closer look on how much dividends they are issuing and whether it will remain the same. For the OCBC Bk NCPS 5.1% 100, it is clearly stated that the dividend is 5.1%. However, another preference share that was also issued by OCBC Bank in August 2008 i.e. OCBC Cap 5.1% NCPS 100 has a different dividend policy. The dividend policy is such that on or before 20 September 2018, the dividend is 5.1%. However, after this date, the dividend is pegged to the 3-Month Singapore Swap Offer Rate plus 2.5% and that to me is a big difference. That would mean that the amount of dividends will fluctuate subsequently.

5.3 Summary

- The preference shareholders contribute capital to the company. According to section 85 of the Companies Act, 1956, persons holding preference shares, called preference shareholders.
- They are assured of a preferential dividend at a fixed rate during the life of the company.
- This type share holders carry preferential right over other shareholders to be paid first in case of liquidation of the company. Companies use this mode of financing as it is cheaper than raising debt.
- A company may issue redeemable type of shares on the condition that the company will repay the amount of share capital to the holders of this category of shares after the fixed period or even earlier at the discretion of the company. Section 80 of the Companies Act, 1956 deals with the redemption of preference shares.

5.4 Keywords

Fully Paid Shares: Shares in which whole amount is paid and no money is required.

Legal Restrictions: Legal limitations on activities.

Redemption: The action of saving or being saved.

Reserve Account: Funds taken out of earnings to provide for anticipated future payments.

5.5 Review Questions

1. What do you mean by preference share? Explain.
2. Distinguish between equity shares and preference shares.
3. Name the shares from where the preference shares can be redeemed.
4. What are the legal restrictions on the redemption of preference shares?
5. Explain in details the requirements for the redemption of preference shares as laid down in Section 80 of the Companies Act, 1956.
6. What is capital redemption reserve account? How is it created? How is it utilised?
7. Explain the different kinds of preference shares.

8 Explain the following terms:

   (i) Profit which would otherwise be available for dividend.

   (ii) Proceeds from the issue of fresh shares.

   (iii) Capital redemption reserve account.

9. A company has 20,000 redeemable preference shares of ₹ 100 each, fully paid. The company decides the redeem to shares on 31st March, 2006 at a premium of 8%. The company has sufficient profits but in order to augment liquid funds the following issue was made:

   12,500 equity shares of ₹ 100 each at ₹ 111.

   The issue was fully subscribed and all the amounts were received. The redemption was duly arrived out. Pass journal entries.

Notes

10. The following balances were extracted from the books of Raman Limited as on 31st Dec., 2005 3,000, 8% redeemable preference shares of ₹ 100 each fully called up ₹ 3,00,000

Less: Calls in Arrear at ₹ 20 per share on 450 shares	9,000
	2,91,000
General Reserve	75,000
Capital Reserve	15,000

The preference shares were redeemed on 1st January, 2006 at a premium of 10%. The company issued such further equity shares of ₹ 10 each as were necessary 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. (Adapted from B. Com. Mysore)

11. The summarised balance sheet of Sahitya Company Limited on 30th June 2006.

Liabilities	(₹)	Assets	(₹)
Share Capital:		Sundry Assets	80,00,000
Authorised, Issued and Paid up:		Cash Balance	32,00,000
2,00,000; 8% Redeemable Preference Shares of ₹ 10 each	20,00,000		
5,00,000 Equity Shares of ₹ 10 each	50,00,000		
Current Liabilities	30,00,000		
Profit & Loss A/c	12,00,000		
	1,12,00,000		1,12,00,000

The condition of issue of redeemable Preference Shares provided to their being redeemed on 1st July, 2006 at a premium of 5%. The profits available being not sufficient to redeem the whole issue, the company issued 10,000, 10% preference shares of ₹ 100 each at par on 1st July, 2006 which were duly taken up and paid for. The redeemable preference shares were redeemed on the due date.

Show the journal entries to record the above mentioned transactions.

12. On 31st March, 2006 the summarised balance sheet of Arti Limited stood as follows:

Liabilities	(₹)	Assets	(₹)
Share capital:		Fixed capital	15,00,000
Authorised, Issued and Subscribed		Cash at Bank	5,00,000
12,500 equity shares of ₹ 100 each fully paid up	12,50,000	Other Current Assets	7,50,000
6,250, 10% Redeemable Preference shares of ₹ 100 each, fully paid up	6,25,000		
Reserve & Surplus:			
Share premium	25,000		
Dividend equalization Reserve	2,55,000		
Profit and Loss A/c	95,000		
Current Liabilities	5,00,000		
	27,50,000		27,50,000

The company redeemed all its preference shares at a premium of 10 per cent by issuing the fresh equity shares of ₹ 100 each at a premium of 5% for minimum amount necessary, after using all its divisible profits for purpose of redemption.

Notes

First, ascertain the amount for which first equity shares were issued. Show journal entries for all transactions concerning the redemption of preference shares and prepare the balance sheet as it would appear immediately after redemption.

13. Spotlight Limited has issued share capital of 60,000, 14% Redeemable Preference Shares of ₹ 20 each and 4,00,000 Equity Shares of ₹ 10 each. The preference shares are redeemable at premium of 5 per cent on 1st April, 2006.

    As at 31 March, 2006 the company's balance sheet showed the following position:

Liabilities	(₹)	Assets	(₹)
Issued Share Capital 60,000, 14% Redeemable	12,00,000	Plant and Machinery	25,00,000
Preference shares of ₹ 20 each fully paid		Furniture	9,00,000
		Investments	3,50,000
4,00,000 equity shares of ₹ 10 each fully paid	40,00,000	Stock	15,00,000
Profit and Loss Account	7,00,000	Debtors	14,00,000
Sundry Creditors	12,00,000	Balance at Bank	4,50,000
	71,00,000		71,00,000

    In order to facilitate the redemption of preference shares it was decided:

    (a) To sell all the investments for ₹ 3,00,000.

    (b) To finance part of the redemption from company funds subject to leaving the balance in Profit and Loss Account at ₹ 2,00,000.

    (c) To issue sufficient equity shares of ₹ 10 each at premium of ₹ 2 per share to raise the balance of funds required.

Answers: Self Assessment

1. True
2. True
3. Fixed
4. Irredeemable
5. (d)
6. Bonus
7. Share Premium
8. Cash
9. False
10. False
11. False
12. fresh issue of shares.
13. (b)
14. (a)
15. (c)

5.6 Further Readings

Books

Corporate Accounting - Dr. K.K. Verma

Online links

http://moneyterms.co.uk/rights-issue/

http://investmentarticle.com/why-do-companies-conduct-rights-issue.html

Notes

Unit 6: Debentures: Concept, Types, Issue

CONTENTS

Objectives

After studying this unit, you should be able to:

- Explain the meaning of Debentures
- Define kinds of Debentures
- Explain the distinction between Share and Debenture
- Explain distinction between Debenture and Debenture Stock
- Know issue of Debentures

Introduction

A debenture is a document that either creates a debt or acknowledges it, and it is a debt without collateral. In corporate finance, the term is used for a medium- to long-term debt instrument used by large companies to borrow money. In some countries the term is used interchangeably with bond, loan stock or note. A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest and although the money raised by the debentures becomes a part of the company's capital structure, it does not become share capital. Senior debentures get paid before subordinate debentures, and there are varying rates of risk and payoff for these categories.

Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights attached to the debentures. The interest paid to them is a charge against profit in the company's financial statements.

6.1 Meaning

When a company desires to borrow a huge amount of money for a long period, it can obtain the same from financial institutions as IDBI or ICICI, or from the general public. A company can obtain a long-term loan from general public by issuing debentures. A debenture may be defined as a written instrument acknowledging a debt by a company under its carmon seal to some person or persons. It is a bond by a company and is offered to the public by means of a prospectus containing the terms and condition for repayment of the principal sum and for payment of interest at a fixed rate. It may or may not be secured by a charge on the company's assets. Section 2 (12) of the Companies Act defines the term: "debenture includes debenture stock, bonds any other securities of a company whether constituting a charge on the assets of the company or not". In fact this is no definition and hardly tells us what the term debenture really means. In simple words, a debenture is a certificate that:

1. acknowledges that company has taken a stated loan from a person/persons named in the certificate and this amount will be redeemed on a specified date or on the expiry of a stipulated period.
2. contracts to pay a fixed rate of interest periodically to the person named in the certificate.

   Usually, the rate of interest is prefixed for the debentures as 10% debentures.
3. gives the details of the security.

6.2 Kinds of Debentures

Debentures can be classified into different categories on the basis of following characteristics:

1. ***Permanence or redemption:*** On the basis of permanence or redemption, debentures can be classified into two:

   (a) *Redeemable debentures:* These are those debentures which are redeemed/repaid either at the expiry of a specific period or within a period by the company. The redemption of these debentures takes place either by annual drawings in lump sum or by purchase in the open market at any time at the prevailing rate in the market.

   (b) *Irredeemable or perpetual debentures:* In this case, the company does not fix any date for repayment of debentures. The holder of these debentures cannot demand payment from the company during its lifetime. Generally, the debentures are repayable after a long period or on liquidation of the company.

2. ***Security:*** On the basis of security, debentures can be classified into two:

   (a) *Secured or mortgage debentures:* These are those debentures which are secured by a charge on the assets or properties of the company. When the charge is of a particular assets, such as land or buildings, it is called a fixed charge. When the charge is on all the fee assets of the company, it is called general charge or floating charge. The terms of debentures or trust deed will decide the rights of the debenture-holders in the case of default of a company.

   (b) *Naked or simple debenture:* Those debentures which carry no security are unsecured. The debenture-holders of these debentures have no priority over other creations of the company. Their position is equal to that of unsecured creditors.

3. ***Priority in payment:*** On the basis of priority in payment of interest and principal amount of debenture, they can be classified into:

Notes

(a) *First debentures:* Those debentures that are to be repaid and on which interest is to be paid in priority to other debentures, are called first debentures.

(b) *Second debentures:* Those debentures that are repaid and in which interest is to be paid after the payment of first debentures, are called second debentures.

4. ***Record or Negotiability:*** On the basis of records, debentures maybe classified into:

(a) *Registered debentures:* Those debentures whose debentures-holders are registered in the books of the company. According to the provisions of the Companies Act (Sections 108 to 118), transfer of registered debentures requires a transfer deed, which has to be lodged with the company for the necessary changes to the recorded in the register of debenture-holders. The register of debenture-holders is similar to the register of shareholders containing names, addresses and holding of debentures. Interest on debenture is paid only to that person whose name appears in the register of the debenture-holders.

(b) *Bearer debentures:* Those debentures which can be transferred by mere delivery, ***because*** the company does not maintain any records of names and addresses of the debenture-holders. These are like negotiable instruments. On producing the coupons attached to the debentures, interest is paid to the bearer. The bearer is also entitled to obtain the payment of the principal sum on presenting the document at the time to its redemption.

5. ***Convertibility:*** From the point of convertibility, debentures may be classified into (i) convertible debentures and (ii) non-convertible.

(a) *Convertible debentures:* Those debentures which can be converted into shares of the company on certain dates, or during a certain period at the option of the debenture-holder according to the terms of issue. These debentures can be fully convertible (FCD) or partly convertible (PCD).

(b) *Non-convertible debentures:* Those debentures whose debenture-holders do not have a right to convert them into equity or preference debentures.

Some important points regarding issue of debentures:

1. ***Objectives of issuing debentures:*** According to the guidelines issued by the Controller of Capital Issue, the objects of issue can be one or more of the following:

(i) Setting up of new projects.

(ii) Expansion or diversification of existing projects.

(iii) Normal capital expenditure for modernisation.

(iv) Merger/amalgamation of companies in pursuance of schemes approved by banks, financial institutions and/or any legal authority.

(v) To augment the long-term resources of the company for working capital requirements.

2. Issue of fully convertible debentures (FCD) having a conversion period of more than 36 months will be permissible, unless conversion is made with "put" and "call" option.

3. Compulsory credit rating will be required if conversion is made for FCDs after 18 months.

4. Issue of debentures with maturity of 18 months or less are exempt from the requirement of appointment of debenture trustee or creating a debenture redemption reserve.

5. Any conversion in part or whole of the debentures will be optional at the hands of debenture-holders, if the conversion takes place at or after 18 months from the date of allotment, but before 36 months.
6. The premium amount at the time of conversion for PCD shall be predetermined and stated in the prospectus. The redemption amount, period of maturity, yield on redemption for the PCDs/NCDs shall be indicated in the prospectus.
7. There is no debt-equity ratio prescription now.
8. The repurchase procedure of NCDs must be stated at the time of issue itself.
9. In case one series of debentures is extinguished by another series, debenture-holders must have the right to opt out and receive the cash. There must be credit rating six months before the debentures are rolled over.

6.3 Distinction between Share and Debenture

Shares and debentures can be distinguished on the basis of the following points:

1 ***Ownership Security vs Creditors Security:*** A person having a share is called a shareholder and has ownership security while a person having a debenture is called a debenture-holder, who is creditor of the company.

2. ***Return on Investment:*** A debenture-holder will get a fixed rate of interest on debentures. This is paid in all circumstances whether there is a profit or loss. Shareholders will receive a part of the profit in the form of dividend. This dividend depends upon the profit of the company. It can be more or less; it is always declared by the directors, out of the profits.
3. ***Priority as to repayment of principal on liquidation:*** In the case of winding up of the company, the amount of debentures will be redeemed before any amount is paid to shareholder to refund share capital.
4. ***Secured by charge:*** Shares are not secured, while the debenture can be secured or mortgaged (i.e. secured by assets).
5. ***Restrictions on issue at the discount:*** There are some restrictions on the issue of shares at discount but there is no restriction on issue of debentures at discount.
6. ***Voting Right:*** A shareholder is the owner of the company and has a voting right and also takes part in the management of the company, while a debenture-holder is a creditor of the company and cannot take a part in management.
7. ***Convertibility:*** Equity shares can never be converted into debentures, while debentures can be converted into shares at the discretion of the debenture-holders.
8. ***Redemption:*** A debenture-holder may get refund during the lifetime of the company, while the equity share-holder cannot claim refund on his shares during the lifetime of the company.

Did u know? In case one series of debentures is extinguished by another series, debenture-holders must have the right to opt out and receive the cash. There must be credit rating six months before the debentures are rolled over.

Notes

6.4 Distinction between Debentures and Debenture Stock

There are three main differences between debentures and debentures stock.

1. Debenture stock are always fully paid while debentures can be partly paid up.
2. Debentures stock can be transferred in friction while debentures are transferred wholly.
3. Debentures stock are not allotted any serial number while debentures are allotted a serial number.

Stages of Debentures

There are the following three main stages of accounting for debentures:

1. Accounting at the time of issue of debentures.
2. Accounting at the time of making a provision for redemption of debentures.
3. Accounting at the time of redemption of debentures.

Note Shares are not secured, while the debenture can be secured or mortgaged (i.e. secured by assets).

6.5 Issue of Debentures

The procedure for issue of debentures is exactly similar to the procedure of issue of shares. The company prepares a prospectus and issues it in the market; applications for debentures are invited along-with some application money. After scrutiny, letters of allotment are issued and so on. The only difference is that the names of accounts are changed and the rate of interest is prefixed to debentures. For instance, if rate of interest is 10%, the name given will be 10% Debenture. Debentures may also be issued at par, at premium or at discount similar to shares.

Accounting Treatment

Accounting treatment for the issue of debentures maybe understood properly from the following points of view:

(I) Consideration

(II) Conditions for redemption

Consideration

Debentures maybe issued in the following ways:

1. Issue of debenture for cash.
2. Issue of debenture other than cash.
3. Issue of debenture as collateral security.

Issue of debentures for cash

When debentures are issued for cash, the amount of debenture maybe collected in different instalments or in lump sum and the issue of debentures maybe at par, at premium, or at discount.

Notes

1. ***Issue of debentures at par:*** When the price of the issue is equal to the face value or nominal value of debenture, it is said that debentures are issued at par e.g., the issue of a debenture of ₹ 1,000 for ₹ 1,000. The following accounting entries are adopted when debentures are issued at par:

A. If the whole value of debenture is payable in one lump sum with application.

(i) On receipt of debenture application money:

Bank Account Dr

To Debenture Application Account

(ii) On allotment of debentures

Debenture Application Account Dr

To Debentures account.

In the place of above two entries, only the following single entry can be passed Bank Account Dr

To Debentures Account.

B. If the amount of debenture is payable in different instalments:

(i) On receipt of debenture application money

Bank Account

To Debenture Application Account

(ii) When applications are accepted –

Debenture Application Account Dr.

To Debentures Account

Bank Account Dr.

To Debenture Account

(iii) When allotment money is due to debentures–

Debenture Allotment Account Dr.

To Debenture Account

Instead of opening two separate accounts-debenture application account and debenture allotment account, one combined account for application and allotment may be opened. In that case for above (ii) & (iii) entries, the following single entry will be passed:

Debenture Application & Allotment Account Dr.

To Debenture Account.

(iv) When allotment money is received-

Bank Account Dr.

To Debenture Allotment Account.

(v) When call money is due to Debenture-holders-

Debenture Call Account Dr.

Notes

To Debenture Account.

(vi) When call money is received-

Bank Account Dr.

To Debenture Call Account

Note If the issue of debentures is oversubscribed by the public, excess application money may be retained by the company for adjustment towards allotment and respective calls. If no debenture is allotted to the applicant, his money will be refunded and the following journal entry will be passed.

Debenture Application Account Dr

To Bank Account

Example 1: **Issue of Debentures at Par Payable in Installment and Lump Sum**

Sonex Co. Limited issued 5,000; 12% Debentures of ₹ 500 each payable as under:

₹ 100 on application, ₹ 200 on allotment and balance on final call.

In addition, the company offers 2,000; 10% Debentures of ₹ 100 each and the entire amount was payable with application.

In the case of 10% Debentures, the company received applications for 2,500 debentures.

The directors of the company made the allotment on a pro-rata basis and excess money was refunded to the application. All the moneys were duly received. Journalise the transactions.

Solution:

Sonex Limited Journal

		(₹)	(₹)
Bank Account	Dr.	5,00,000	
To 12% Debenture Application Account			5,00,000
(Being the receipt of application money on 5,000; 12% debenture @ ₹ 100 per debenture)			
12% Debenture Application Account	Dr.	5,00,000	
To 12% Debenture Account			5,00,000
(Being application money transferred to debenture account).			
12% Debenture Allotment Account	Dr.	10,00,000	
To 12% Debenture Account			10,00,000
(Being allotment money due on 5,000 debenture @ ₹ 200 per debenture)			
Bank Account	Dr.	10,00,000	
To 12% Debenture Allotment Account			10,00,000
(Being receipt of allotment money on debenture)			
12% Debenture Final Call Account	Dr.	10,00,000	
To 12% Debenture Account			10,00,000
(Being final call money due on 5000 debenture @ ₹ 200 per debenture)			

Contd...

Notes

Bank Account	Dr.	10,00,000	
To 12% Debenture Final Call Account			10,00,000
(Being receipt of final call money on debentures)			
Bank Account	Dr.	2,50,000	
To 10% Debenture Application Account			2,50,000
(Being receipt of when money on 2000 debenture @ ₹ 100 each in lump sum)			
10% Debenture Application Account	Dr.	2,00,000	
To 10% Debenture Account			2,00,000
(Being application money transferred to debenture accounts)			
10% Debenture Application Account	Dr.	50,000	
To Bank Account			50,000
(Being excess money refunded to the applicants)			

2. ***Issue of Debentures at Premium:*** When the issue price of a debenture is more than the face value or nominal value of the debentures, it is said that debentures are issued at premium. Take for example, the issue of a debenture of ₹ 500 for ₹ 550. Here, the excess of issue price of ₹ 50 (550-500) is termed as premium on debenture. The amount of premium is not a revenue profit. This amount is kept in a separate account known as "Debenture Premium Account." At the end of accounting period this should be transferred to Capital Reserve account. The amount of premium can be utilized for writing off capital losses and useless fictitious assets as preliminary expenses, under-writing commission, amortization of goodwill etc. The balance debenture premium is shown in the liabilities side of the balance sheet under the head of Reserve and Surplus. In the absence of any contra information, premium should be due on allotment. The journal entry will be as follows:

   Debenture allotment account Dr

   To Debenture Account

   To Debenture Premium Account

Example 2: **Issue of Debenture at Premium**

Ashutosh Company Limited issued 5,000; 10% Debenture of ₹ 100 each at a premium of 15% payable as follows: ₹ 20 on application, ₹ 40 on allotment including premium, and balance on first and final call.

The public applied for 6,000 debentures. Applications for 4,750 debentures were accepted in full, applications for 500 were allotted 250 debentures and the remaining applicants were rejected. All moneys were duly received. Pass the necessary cash book and journal entries.

Solution:

Ashutosh Co. Ltd. Journal

Date	Particulars		L.F.	(₹)	(₹)
	10% Debenture Application Account	Dr.		1,05,000	
	To 10% Debenture Account				1,00,000
	To 10% Debenture Account				5,000
	(Being utilisation of application money)				
	10% Debenture Allotment Account	Dr.		2,00,000	
	To 10% Debenture Allotment Account				1,25,000

Contd...

Notes

	To Debenture Premium Account			75,000
	(Being allotment money due with premium on 5,000 debenture @ ₹ 40)			
	10% Debenture First & Final Call Account Dr.		2,75,000	
	To 10% Debenture Account			2,75,000
	(Being first and final call money due on 5,000 debentures @ ₹ 55 per debenture)			
	Debenture Premium Account Dr.		75,000	
	To Capital Reserve Account			75,000
	(Debenture premium transferred to capital reserve account)			

Cash Book

	(₹)		(₹)
To 10% Debenture Application (6,000 × ₹ 20)	1,20,000	By 10% Debenture Application (750 × 20) Account	15,000
To 10% Debenture Allotment Account (2,00,000 – 5,000)	1,95,000	By Balance C/d	5,75,000
To 10% Debenture First and Final Call Account	2,75,000		
	5,90,000		5,90,000

Caution The procedure for issue of debentures is exactly similar to the procedure of issue of shares.

Self Assessment

Fill in the blanks:

1. Debenture-holders are entitled to get …………… at a fixed rate.
2. Debentures are shown under the heading of …………… in the liability side of the balance sheet.
3. Debenture-holders are the …………… of a public limited company.
4. Select the best alternative:

   Which of the following debentures is transferred by transfer deed only:

   (i) Bearer debenture

   (ii) Registered debenture

   (iii) Mortgage Debenture
5. The procedure for issue of …………… is exactly similar to the procedure of issue of shares.

3. ***Issue of Debentures at a Discount:*** When the issue price of the debenture is less than the face value or nominal value of the debenture, it is said that debentures are issued at discount. Take for example, the issue of a debenture of ₹ 100 at ₹ 85. Here, the deficit of price of ₹ 15 (100-85) will be termed as 'Discount on Issue of Debenture Account', which is debited due to a capital loss. There is no statutory restriction as to the maximum limit for discount on debenture as there is in the case of shares. According to the Companies Act 1956, 'Discount on Issue of Debentures' must be shown on the assets side of the Company's

Notes

Balance Sheet under the heading of Miscellaneous Expenditure, until it is written off completely. Discount on issue of debentures may be written off either out of revenue profits (credit balance of Profit and Loss Account) or out of capital profits (share premium account or debenture premium account) during the lifetime of the debentures. In the absence of any contra information in the examination question, discount should be allowed on allotment. The journal entry will be as follows –

Debenture Allotment Account Dr

Discount on Issue of Debenture Account Dr

To Debentures Account

Example 3: **Issue of Debentures at a Discount**

Surjeet Mills Limited issued 5,000 12 % Debentures of ₹ 100 each at a discount of 15% payable as below:

With application ₹ 20 per debenture

On allotment ₹ 50 per debenture

On final call the balance

The public applied for 7,000 debentures. Applications for 4500 debentures were accepted in full, the applicants for 1000 debentures were allotted 500 debentures and the remaining applicants were rejected . Show the journal entries including those for cash assuming that all the instalments were duly collected.

Solution:

Surjeet Mills Limited
Journal Entries

Date	Particulars		L.F.	(₹)	(₹)
	Bank Account	Dr.		1,40,000	
	To 12% Debenture Application Account				1,40,000
	(Being receipt of application money on 7,000 debentures @ ₹ 20 per debenture).				
	12% Debenture Application Account	Dr.		1,30,000	
	To Bank Account				30,000
	To 12% Debentures Account				1,00,000
	(Being transfer of application money to Debentures Account and amount of rejected application refunded)				
	12% Debenture Allotment Account	Dr.		1,75,000	
	Discount on Issue of Debenture Account	Dr.		75,000	
	To 12% Debenture Account				2,50,000
	(Being allotment money due on 5,000 debentures @ ₹ 50 per debenture at discount).				
	Bank Account	Dr.		1,65,000	
	12% Debenture Application account	Dr.		10,000	
	To 12% Debenture Allotment Account				1,75,000
	(Being receipt of allotment money and excess of application money adjusted in allotment)				

Contd...

Notes

	12% Debenture First and Final Call Account Dr.		1,50,000	
	To 12% Debentures Account			1,50,000
	(Being first and final call money due on 5,000 debentures @ ₹ 30 per Debenture)			
	Bank account Dr.		1,50,000	
	To 12% Debenture First and Final Call Account			1,50,000
	(Being receipt of first and final call money)			

Issue of Debentures for Consideration Other than Cash

When a company purchases some assets or services of an.otlier company., it has to pay purchase consdd.eration, which can be paid by many methods. If it paid by issue of fully paid debentures such issue of debentures is said issue of debentures for consideration other than cash.

Issue of Debentures as a Collateral Security for a Bank Loan

A collateral security means a subsidiary or secondary security_ When a company takes a loan or overdraft from a ban.k, it may give its own debenture to the bank as collateral security against the loan or overdraft, in addition to principal security_ Generally" a company delivers its own debentures as collateral security to bank only in that case,. when principal security is not sufficient for the loan. Collateral security is not utilised or realised by the bank until the company makes its payment (interest and repayment of loan). It means that this collateral security can be used by the bank in the case of default regarding the repayment of the loan_ The bank, may either keep the debentures and become a debenture-hoildE,:..r or sell them and realise money But upon the repa.yment of the loan, the bank must ret'urn these debentures and the company should then cancel them. This type of issue by the company is called issue of debenture as collateral security.

Conditions of Redemption

Sometimes, debentures are issued with specific conditions on which the redemption of debenture is made by the company. There can be the following five possibilities for redemption:

Possibility	Condition of Rssue	Condition of Redemption
1	Issued at par	Redeemable at par
2	Issued at premium	Redeemable at par
3	Issued at discount	Redeemable at par
4	Issued at par	Redeemable at premium
5	Issued at discount	Redeemable at premium

It may be noted that the debentures can be issued at par, at premium, or at discount, but redemption will be either at par or at premium. This is possible only when the condition of redemption of debentures is made in advance by the company. If a company redeems its debentures by purchasing them from the open market at a price below the par valueothe, difference (par value and purchase price) is treated as profit on redemption or redemption of debentures at discount.

6.6 Calls-in-Advance and Calls-in-Arrear on Debentures

If the Articles of Association of a company can accept calls-in-advance on debentures and will pay interest on calls-in-advance to the debenture-holders. This interest is the loss of the company and therefore, it is transferred to the debit side of Profit and Loss Account. Calls-in-advance are shown in the liabilities side of the balance sheet. When the amount of debenture is payable in

Notes

various instalments and any or some instalments are not paid by the debenture-holder, that amount which is not paid by the debenture-holder is known as calls-in-arrear. For unpaid amount on any call, no separate account is maintained in the books. The amount of calls-in-arrear is substracted from the paid-up value of debenture in the liabilities side of the balance sheet. If there is no provision regarding the interest in calls-in-arrear on debentures, interest is not calculated on arrears.

Example 4: **Calls-in-Arrear and Calls-in-Advance on Debenture**

Golu Limited issued 10,000; 12% Debentures of ₹ 100 each at premium of 5% payable as under:

With application	₹ 15 per debenture
On allotment	₹ 45 including premium
On first call	₹ 10
On final call	₹ 30

One of the conditions of issue of 12% Debentures was that the entire amount of 12% Debenture can be paid at the time of allotment of 12% Debenture and in this case interest @ 3% per annum will be paid by Golu Limited on the advance money received and this interest will be paid on the date of payment of the last call. All the debentures were subscribed. A holder of 3,000; 12% Debentures paid whole of the amount of 12% debentures on allotment in accordance with this condition. Another holder of 300; 12% Debentures could not pay the final call. The date of application and allotment was 1st November 2005 the date of first call was 1st January 2006; the date of final call was 1st May, 2006.

Pass necessary journal entries in the books of Golu Limited, assuming that all other payments were duly received.

Solution:

Journal Entries

Date	Particulars	L.F.	(₹)	(₹)
2005				
Nov. 1	Bank Account Dr.		1,50,000	
	To 12% Debenture Application Account			1,50,000
	(Being receipt of application money in 10,000 debentures @ ₹ 15 per debenture)			
Nov. 1	12% Debenture Account Dr.		1,50,000	
	To 12% Debenture Account			1,50,000
	(Being transfer of application money to debenture account)			
Nov. 1	12% Debenture Allotment Account Dr.		4,50,000	
	To 12% Debenture Account			4,00,000
	To Premium on Debenture Account			50,000
	(Being allotment money due on 10,000 debentures @ 45 per debenture on premium)			
	Bank Account Dr.		5,70,000	
	To 12% Debenture Allotment Account			4,50,000
	To Calls-in-Advance Account			1,20,000
	(Being receipt of allotment money and also calls-in- advance on 3,000 debentures @ ₹ 40 per debenture)			

Contd...

Notes

2006				
Jan. 1	12% Debenture First Call Account Dr.		1,00,000	
	To 12% Debenture Account			1,00,000
	(Being first call money due on 10,000 debenture @ ₹ 10 each)			
	Bank Account Dr.		70,000	
	Call-in-Advance Account Dr.		30,000	
	To 12% Debenture First Call Account			1,00,000
	(Being receipt of first call money and calls-in-advance adjusted)			
May, 1	12% Debenture Second & Final Call Account Dr.		3,00,000	
	To 12% Debenture Account			3,00,000
	(Being second and final call money due on 10,000 debenture @ ₹ 30 per debenture)			
	Bank Account Dr.		2,01,000	
	Calls-in-advance Account Dr.		90,000	
	To 12% Debenture Second and Final Call Account			2,91,000
	(Being receipt of second and final call on 6,700 debenture and calls-in-advance adjusted)			
	Interest on calls in advance Account Dr.		1,500	
	To Bank Account			1,500
	(Interest on calls in advance paid to Debenture-holders)			

Working Note:

1. Total amount receivable on second and final call (₹)

    10,000 × ₹ 30 3,00,000

    Less: amount already received on 3,000 debentures

    3,000 × ₹ 30 90,000

    Amount receivable 2,10,000

    Less: Calls-in-Arrear

    300 × ₹ 30 9,000

    Amount received in second call 2,01,000

2. Interest on Calls in advance for two months

    (Nov & Dec 2005)

    $$\frac{30{,}000 \times 3}{100} \times \frac{2}{12} = 150$$

    Interest on calls-in-advance for six months
    (Nov, Dec, 2005, Jan, Feb, March, April 2006 ₹ 150)

    $$\frac{90{,}000 \times 3}{100} \times \frac{6}{12} = 1350$$

    ₹ 1500

Self Assessment

Notes

Fill in the blanks:

6. A 10% debenture of nominal value of ₹ 100 has been issued at ₹ 90 is said to be issued at …………… .
7. A 9% debenture of a nominal value of ₹ 100 has been issued at ₹ 120 debentures are said to be issued at …………… .
8. 100 8% debentures of ₹ 100 each has been issued to vendors for plant purchased the debentures are said to be issued …………… .
9. A company can issue its debentures at a discount if a provision in this regard has been made in its ....
10. If there is no provision regarding the interest in calls-in-arrear on debentures, interest is not calculated on …………… .

6.7 Issue of Debentures for Consideration Other Than Cash

When a company purchases some assets or services of another company, it has to pay purchase consideration, which can be paid by many methods. If it paid by issue of fully paid debentures such issue of debentures is said issue of debentures for consideration other than cash.

These debentures can be issued to the vender at par, at premium or at a discount. In this case following journal entries are passed:

1. On purchase of assets/business:

   Sundry Assets Account Dr.

   *Goodwill Account Dr

   To Sundry Liabilities Account

   To Vendors' Account

   **To Capital Reserve Account

   *If the value of net assets acquired is less than the value of debentures issued, the difference (value of debentures-net assets acquired) will be goodwill and will be debited.

   **If the value of net assets acquired is more than the value of debentures issued, the difference will be treated as Capital Reserve and will be credited.

2. When debentures are allotted in lieu of purchase consideration:

   (i) If the debentures are issued at par to the vendor:

   Vendors Account Dr

   To Debentures Account

   (ii) If the Debentures are issued at premium to vendor:

   Vendors' Account Dr.

   To Debentures Account

   To Debentures Premium Account

Notes

(iii) If Debentures are issued at discount to the vendor:

Vendors' account Dr.

To Discount on issue of debentures Account Dr.

To Debentures Account

Example 5: **Issue of Debentures to Vendor**

Sunder Mills Limited acquired the business of Sohan Brothers. This business consists of building of ₹ 10,00,000, Plant and Machinery of ₹ 4,00,000 and Patents of ₹ 2,00,000 and Sundry Liabilities ₹ 2,00,000. The purchase price was of ₹ 16,00,000, which will be paid by the issue of 12% debentures of ₹ 100 each. Pass necessary journal entries if these debentures are issued (i) at par (ii) at 25% premium.

Solution:

Journal Entries

Date	Particular	L.F.	(₹)	(₹)
	Building Account Dr.		10,00,000	
	Plant & Machinery Account Dr.		4,00,000	
	Patents Account Dr.		2,00,000	
	Goodwill Account Dr.		2,00,000	
	To Sohan Brothers			16,00,000
	To Sundry Liabilities Account			2,00,000
	(Being acquisition of assets and liabilities of Sohan Brothers)			
	Sohan Brothers Dr.		16,00,000	
	To 12% Debentures Account			16,00,000
	(Being debentures issued at par for consideration of purchase price)			
	Sohan Brothers Dr.		16,00,000	
	To 12% Debentures Account			12,80,000
	To Debentures Premium Account			3,20,000
	(Being debentures issued at 25% premium to Sohan Brothers)			

Working Note:

$$\text{No of debentures Issued} = \frac{\text{Purchase price}}{\text{Issue price of debenture}}$$

$$= \frac{16,00,000}{125} = 12,800$$

Face value of 12,800 debentures = 12800 × ₹ 100 = ₹ 12,80,000

Example 6: **Issue of Debentures to Vendor with part payment in cash**

AK Limited Company acquired the buildings of ₹ 25,00,000 and liabilities of ₹ 4,00,000 of G.K. & Sons. There was an agreement to pay the purchase consideration ₹ 20,00,000 by issuing the 10% Debentures of ₹ 100 each at a premium of 10%. The debentures of AK Limited are quoted in the market at ₹ 145.

You are required to give journal entries for recording the transactions in the book of AK Limited.

Solution:

Notes

Journal Entries

Date	Particulars	L.F.	(₹)	(₹)
	Buildings Account Dr.		25,00,000	
	To Sundry Liabilities Account			4,00,000
	To GK & Sons			20,00,000
	To Capital Reserve Account			1,00,000
	(Being purchase Sundry Liabilities and Buildings of GK & Sons)			
	G.K. & Sons Dr.		20,00,029	
	To 10% Debentures Account			18,18,100
	To Debenture Premium Account			1,81,810
	To Cash Account			119
	(Being debentures issued at 10% premium to G.K. & Sons for purchase consideration)			

Working Note:

$$\text{No. of debentures Issued to G.K. \& Sons} = \frac{\text{Purchase Consideration}}{\text{Issue price of debentures}}$$

$$= \frac{20,00,000}{100+10} = 18,181.818$$

As the fractional debentures cannot be issued to the vendor, AK Limited can issue only 18,181 debentures. And for fractional debenture of 0.818, payment will be made in cash. The amount payable for fractional debenture will be computed on market price and not on paid up value. The reason is that the vendor can always dispose his debentures in the market.

Therefore, the fractional value of debentures will be = 0.818 ₹ 145 = ₹ 118.61 or ₹ 116 Now, the real purchase consideration will be:

Nominal value of debentures	(₹)
18,181 × ₹ 100	18,18,100
10% Debenture Premium	1,81,810
Cash for fractional debentures	119
	20,00,029

6.8 Issue of Debentures as a Collateral Security for a Bank Loan

A collateral security means a subsidiary or secondary security. When a company takes a loan or overdraft from a bank, it may give its own debenture to the bank as collateral security against the loan or overdraft, in addition to principal security. Generally, a company delivers its own debentures as collateral security to bank only in that case, when principal security is not sufficient for the loan. Collateral security is not utilised or realised by the bank until the company makes its payment (interest and repayment of loan). It means that this collateral security can be used by the bank in the case of default regarding the repayment of the loan. The bank, may either keep the debentures and become a debenture-holder or sell them and realise money. But upon the repayment of the loan, the bank must return these debentures and the company should then cancel them. This type of issue by the company is called issue of debenture as collateral security.

Notes

Accounting Treatment

There are two methods of dealing with such debentures in the books of accounts of the company:

First Method: No accounting entry is recorded in the books of the company (as such debentures are really not alive) for such debenture. Only a note is given below the item of the loan in the liabilities side of the balance sheet that it has been secured by the issue of debentures as collateral security as under:

Balance Sheet

Liability Side only	(₹)
Secured loans:	
Loan from the State Bank of India	1,50,000
(secured by 2,000; 12% Debentures of ₹ 100 each as collateral security)	
Debentures:	
10,000; 12% Debentures of ₹ 100 each	10,00,000

Second Method: If an accounting entry for debentures issued as collateral security is to be passed in the books of accounts, the following journal entry will be made.

(i) On the issue of such debentures:

Debentures Suspense Account   Dr.   (with face value of debentures)

    To Debentures Account

Debenture suspense account will appear in the asset side and Debentures account will appear in the liabilities side of the Balance Sheet of the company.

(ii) On the repayment of bank loan such debentures will be cancelled by passing the following journal entry:

Debentures Account   Dr.

    To Debentures Suspense Account.

Note In practice this method is seldom followed.

Example 7: **Issue of Debentures as Collateral Security**

Pankaj Limited took a loan of ₹ 90,000 from Punjab National Bank by depositing 1,000; 12% Debentures of ₹ 100 each as a collateral security. How will you treat the issue of such debentures.

Solution:

First Method:

Balance Sheet of Pankaj Limited as on...

Liabilities	(₹)	Assets	(₹)
Secured loans: Loan form Punjab National Bank (secured by 1,000; 12% Debentures of ₹ 100 each as collateral security)	90,000		

Notes

Second Method:

Journal of Pankaj Limited

Date	Particulars	L.F.	(₹)	(₹)
	Debentures Suspense Account Dr.		1,00,000	
	To 12% Debentures Account			1,00,000
	(Being 1,000; 12% Debentures of ₹ 100 each issued to Punjab National Bank as collateral security)			

Balance Sheet of Pankaj Limited as on...

Liabilities	(₹)	Assets	(₹)
Secured loans:		Miscellaneous Expenditure Debenture Suspense	1,00,000
Loan from Punjab National Bank (secured by 1,000; 12% Debentures of ₹ 100 each as collateral security)	90,000		
Debentures:			
1,000; 12% Debenture of ₹. 100 each issued as collateral security.	1,00,000		

Caution There are some restrictions on the issue of shares at discount but there is no restriction on issue of debentures at discount.

Self Assessment

Name them:

11. Name the security which is issued in addition to the principal security.
12. Which account is debited while making a journal entry in the books of the company on issue of debentures as collateral security?
13. On which side of the balance sheet of a company issuing debentures as collateral security is written the Debentures Suspense A/c?
14. When does a company issue debentures as collateral security?

Did u know? Collateral security is not utilised or realised by the bank until the company makes its payment (interest and repayment of loan).

Case Study

RFU Debenture Sales

The Brief

The Rugby Football Union (RFU) issued, in 2005 debentures, ensuring that the holder had first refusal to purchase at face value, one ticket for Rugby Union events at Twickenham Stadium over a ten year period. The principle sum invested would then be returned 75 years from date of issue.

Contd...

Notes

The RFU approached Goodform to help generate sales of these debentures.

The Work

Telesales

Goodform carried out an ambitious telesales and database marketing campaign with the goal of selling all 4,000 personal debentures at £6,000 each.

Administration

Goodform looked after all areas of administration of the sales, including payment processes. Our handling of this labour-intensive work meant that the RFU could operate most effectively in this area of their business.

Database Management

Goodform established a database which was fundamental to the scheme. Our effective management gave the RFU the platform to build relationships with the sport's core enthusiasts, and by providing an established definitive database of rugby enthusiasts, were able to assist with the RFU's future marketing of the sport.

The Result

1. All 4,000 personal debentures were sold in a 4 month period generating £24 million in revenue.
2. In addition, we established a definitive database of rugby enthusiasts to aid the RFU's marketing of the sport.

Source: http://www.goodform.info/page.asp?section=177&sectionTitle=RFU

6.9 Summary

- A Debenture is a unit of loan amount issued to the lenders of the company. Debenture includes debenture stock, bond and any other security whether constituting a charge on the company's assets or not.
- ***Issue of debentures:*** Debentures can be issued for cash at par, for consideration other than cash, as collateral security debentures are said to be oversubscribed when the company receives application for number of debentures than the company has offered for subscription.
- Debenture can be issued at premium, at discount and in consideration other than cash.
- Debentures can be issued with conditions stipulated to their redemption as:
  - Issued at par redeemable at par
  - Issued at discount redeemable at par
  - Issued at premium redeemable at par
  - Issued at par redeemable at premium
  - Issued at discount redeemable at premium
- Issue of debentures as collateral security means issuing debentures to the lending agency that has given loan as additional/secondary security.
- Issue of fully convertible debentures (FCD) having a conversion period of more than 36 months will be permissible, unless conversion is made with "put" and "call" option.

Notes

- Equity shares can never be converted into debentures, while debentures can be converted into shares at the discretion of the debenture-holders.

6.10 Keywords

Collateral Security: A collateral security means a subsidiary or secondary security.

Convertible Debentures: Those debentures which can be converted into shares of the company on certain dates, or during a certain period at the option of the debenture-holder according to the terms of issue.

Debenture Holder: A person having a debenture is called a debenture-holder, who is creditor of the company.

Debenture: A debenture is a document that either creates a debt or acknowledges it, and it is a debt without collateral.

First Debentures: Those debentures that are to be repaid and on which interest is to be paid in priority to other debentures, are called first debentures.

Irredeemable or Perpetual Debentures: In this case, the company does not fix any date for repayment of debentures. The holder of these debentures cannot demand payment from the company during its lifetime.

Naked or Simple Debenture: Those debentures which carry no security are unsecured. The debenture-holders of these debentures have no priority over other creations of the company.

Non-convertible Debentures: Those debentures whose debenture-holders do not have a right to convert them into equity or preference debentures.

Redeemable Debentures: These are those debentures which are redeemed/repaid either at the expiry of a specific period or within a period by the company.

Registered Debentures: Those debentures whose debentures-holders are registered in the books of the company.

Second Debentures: Those debentures that are repaid and in which interest is to be paid after the payment of first debentures, are called second debentures.

Secured or Mortgage Debentures: These are those debentures which are secured by a charge on the assets or properties of the company. When the charge is of a particular assets, such as land or buildings, it is called a fixed charge.

Shareholder: A person having a share is called a shareholder and has ownership security.

6.11 Review Questions

1. What do you mean by a Debenture? Explain.
2. Explain the different types of Debentures.
3. Distinguish between share and debenture.
4. Explain the meaning of Issue of Debentures as Collateral Security.
5. What is a sinking fund? Explain how is it created?
6. Write the various forms in which debentures can be issued.
7. A company issued 10000 10% debentures of ₹ 100 each. ₹ 30 per debenture was to be paid along with application. Applications were received for 12000 debentures. What can the company do with the excess application money i.e. ₹ 60000 (2000 × ₹ 30).

Notes

8. A company purchased a building for ₹ 315000 and issued 10% debentures of ₹ 100 each at a premium of 5%. Calculate (i) the number of debentures issued to the vendors (ii) make journal entry for the issue.

9. Rama Company Limited issued 2000; 12% Debentures of ₹ 100 each payable as follows:

   20% on application, 30% on allotment, 30% on first call and balance on final call.

   Applications for all debentures were received and the company received all moneys except in the case of one debenture-holder of 50 debentures who failed to pay his first and final call money.

   Make the necessary journal entries and draw cash book.

10. Subhneet Ltd. issued 50,000; 15% debentures of ₹ 100 each for public subscription at a discount of 10%. Application money was ₹ 25 and the balance was payable as follows:

On allotment	₹ 30
On first call	₹ 25
On final call	₹ 20

   Applications were received for 48,000 debentures and the amount were received when due, except in the following cases:

   (i) Mr. Sohan who holds 200 debentures did not pay first and final call.

   (ii) Mr. Rohan who holds 400 debentures did not pay the final call.

   Pass journal entries to record the transaction and cash book.

11. Lohit Limited issued ₹ 4,00,000; 10% Debentures of ₹ 100 each at 25% premium, payable 15% on application, 50% on allotment (including premium), 25% on first call and balance on final call, after one month of the first call. The public applied for 4,800 debentures. Applicants for 2,800 were accepted in full; applicants for 1,500 debentures were allotted. 1,200 debentures and applications were rejected. All moneys were duly received. Pass journal entries and balance sheet of the company.

Answers: Self Assessment

1.	Interest,	2.	Secured Loans,
3.	Members,	4.	(b)
5.	debentures	6.	Discount
7.	Premium	8.	for considerations other than cash
9.	Articles of Association	10.	Arrears
11.	Collateral security	12.	Debenture suspense A/c
13.	Assets side	14.	When lender demands additional security

6.12 Further Readings

Notes

Books

Glossary: D on the Financial Industry Regulatory Authority (FINRA) website, United States

What is a debenture? Company Law Club, referring to United Kingdom usage

Chandra Gopalan (2007); Company Law in Singapore 3rd Edition; McGraw-Hill Education (Asia)

Online links

www.caclubindia.com › Articles › Accounts

www.publishyourarticles.org/.../8-main-difference-between-debentur...

www.nos.org/srsec320newe/320el26.pdf

www.mondaq.com/article.asp?articleid=102462

Notes

Unit 7: Debentures: Conditions of Issue of Debentures from Redemption Point of View

CONTENTS

Objectives

After studying this unit, you should be able to:

- Understand the discount on issue of debentures
- Explain loss on issue of debentures
- Know interest on debentures

Introduction

The issue of debentures by public limited companies is regulated by Companies Act 1956. Debenture is a document, which either creates a debt or acknowledges it. Debentures are issued through a prospectus. A debenture is issued by a company and is usually in the form of a certificate, which is an acknowledgement of indebtedness. They are issued under the company's seal. Debentures are one of a series issued to a number of lenders. The date of repayment is invariably specified in the debenture. Generally debentures are issued against a charge on the assets of the company. Debentures may, however, be issued without any such charge. Debenture holders have no right to vote in the meetings of the company.

The procedure for the issue of debentures is very much similar to that of the issue of shares. Accounting treatment for the issue of debentures is also the same as in the case of issue of shares. The only difference is that 'Debenture A/C' will be opened in place of 'Share Capital A/C'. Debenture account will be opened with prefix rate of interest, e.g. 10% Debentures.

Caution Debenture holders have no right to vote in the meetings of the company.

7.1 Meaning

Notes

Sometimes, debentures are issued with specific conditions on which the redemption of debenture is made by the company. There can be the following five possibilities for redemption:

Possibility	Condition of Issue	Condition of Redemption
1	Issued at par	Redeemable at par
2	Issued at premium	Redeemable at par
3	Issued at discount	Redeemable at par
4	Issued at par	Redeemable at premium
5	Issued at discount	Redeemable at premium

It may be noted that the debentures can be issued at par, at premium, or at discount, but redemption will be either at par or at premium. This is possible only when the condition of redemption of debentures is made in advance by the company. If a company redeems its debentures by purchasing them from the open market at a price below the par value the, difference (par value and purchase price) is treated as profit on redemption or redemption of debentures at discount.

The following journal entries are made at the time of issue of debentures for the above conditions:

1. When debentures are issued at par and redeemable at par:

   Bank Account Dr.

   (face value of debentures)

   To Debentures Account

2. When debentures are issued at premium and redeemable at par:

   Bank Account Dr.

   (amount received)

   To Debenture Account (face value of debentures)

   To Debenture Premium Account (amount of premium)

3. When debentures are issued at discount and redeemable at par:

   Bank Account Dr.

   (with amount received)

   Discount on Issue of Debentures Account Dr.

   (discount allowed)

   To Debentures Account (face value of debentures)

4. When debentures are issued at par and redeemable at premium:

   Bank Account Dr.

   (with amount received)

   Loss on Issue of Debentures Account Dr.

   (amount of premium payable in redemption)

   To Debentures Account (Face value of debentures)

   To Premium on Redemption of Debentures Account (premium on redemption)

Notes

5. When debentures are issued at discount and redeemable at premium.

Bank Account	Dr.	(with amount received)
Discount on Debentures Account	Dr.	(discount allowed)
Loss on issue of Debentures Account	Dr.	(premium on redemption)
To Debentures Account (face value of debentures)		
To Premium on Redemption of Debentures Account (premium payable on redemption)		

Alternatively, discount in issue of debentures and premium payable on redemption are the loses of the company. Therefore, a combined account for these two losses can be made. Then entry will be:

Bank Account	Dr.	(amount received)
Loss on Issue of Debentures Account	Dr.	(discount allowed and premium on redemption)
To Debentures Account (false value of debentures)		
To Premium on Redemption of Debentures Account		(premium payable on redemption)

It is to be noted that "premium on redemption of debentures account" is a personal account, because it is the liability of the company to pay the Debenture-holder at a premium as per the condition of redemption. This account will continue to appear in the liability side of the balance sheet until redemption of debentures is made. At the time of redemption, this account will be transferred to Debenture-holders.

The 'loss on issue of debentures account' is a nominal account. This is due to the promise made by the company to pay more amount (premium) at the time of redemption of debentures. This is a capital loss, tantamount to gradually writing off every year, during the life of the debentures. The unwritten off portion of this loss appears in the assets side in the balance sheet of the company under the head 'Miscellaneous Expenditure'.

Note Debentures can be issued at par, at premium, or at discount, but redemption will be either at par or at premium.

Example 1: **Issue of Debentures in Different Conditions of Redemption**

Pass the necessary journal entries in the books of B Ltd. in the following cases:

(i) 2,000, 7% Debentures of ₹ 100 each have been issued at par and are redeemable at par.

(ii) 2,000, 7% Debentures of ₹ 100 each have been issued at par and are redeemable at 4% premium.

(iii) 2,000, 7% Debentures of ₹ 100 each have been issued at 5% discount and are redeemable at par.

(iv) 2,000, 7% Debentures of ₹ 100 each are issued at 5% discount and are redeemable at 2.5% premium.

(v) 2,000, 7% Debentures of ₹ 100 each are issued at 4% premium and are redeemable at par.

(B.Com., Garhwal University, 1998)

Solution:

Notes

Journal Entries

Date	Particulars	L.F.	(₹)	(₹)
(i)	Bank Account Dr.		2,00,000	
	To 7% Debentures Account			2,00,000
	(Being the issue of 2,000, 7% Debentures at par and redeemable at par)			
(ii)	Bank Account Dr.		2,00,000	
	Loss on Issue of Debentures Account Dr.		8,000	
	To 7% Debentures Account			2,00,000
	To Premium in Redemption of Debentures Account			8,000
	(Being issue of 7% debentures at par and redeemable at premium)			
(iii)	Bank Account Dr.		1,90,000	
	Discount on Issue of Debentures Account Dr.		10,000	
	To 7% Debentures Account			2,00,000
	(Being issue of 7% debentures at discount and redeemable at par)			
(iv)	Bank Account Dr.		1,90,000	
	Loss on Issue of Debentures Accounts Dr.		15,000	
	To 7% Debentures Account			2,00,000
	To Premium on Redemption of Debentures Account			5,000
	(Being issue of 7% debentures at discount and repayable at premium)			
(v)	Bank Account Dr.		2,08,000	
	To 7% Debentures Account			2,00,000
	To Debentures premium Account			8,000
	(Being issue of 7% debentures at premium and redeemable at par).			

Example 2: **Issue of Debentures on Different Conditions of Redemption and Presentation in Balance Sheet**

Pass the necessary journal entries in the books of the companies for the following and also show how they would appear in the balance sheets of the companies:

(a) Sunita Limited issued at par 10,000; 15% Debentures of ₹ 500 each and redeemable at par.

(b) Sanjay Limited issued 15,000 Debentures of ₹ 500 each at a discount of 10% redeemable at par.

(c) Ajay Limited issued 20,000; 15% Debentures of ₹ 100 each at a premium of 10% redeemable at par.

(d) Vijay Limited issued ₹ 25,00,000; 15% Debentures of ₹ 100 each at par redeemable at ₹ 105 each.

(e) Anuj Limited issued 60,000; 15% Debentures of ₹ 100 each at a discount of 10% redeemable at a premium of 5%.

Solution:

(a) Journal of Sunita Limited

Date	Particulars	L.F.	(₹)	(₹)
	Bank Account Dr.		50,00,000	
	To 15% Debentures Account			50,00,000
	(Being issue of 15% Debentures at par and redeemable at par)			

Notes

Balance Sheet of Sunita Ltd. as on....

Liabilities	(₹)	Assets	(₹)
Secured Loans:		Current Assets:	
15% Debentures	50,00,000	Cash at Bank	50,00,000

(b) Journal of Sanjay Limited

Date	Particulars		L.F.	(`)	(`)
	Bank Account	Dr.		67,50,000	
	Discount on Issue of Debenture Account	Dr.		7,50,000	
	To 15% Debentures Account				75,00,000
	(Being issue of 15% Debentures at discount and redeemable at par)				

Balance Sheet of Sanjay Limited as on....

Liabilities	(₹)	Assets	(₹)
Secured Loans:		Current Assets:	
15% Debentures	75,00,000	Cash at Bank	67,50,000
		Miscellaneous Expenditure:	
		Discount on Issue of Debentures	7,50,000

(c) Journal of Ajay Limited

Date	Particulars		L.F.	(`)	(`)
	Bank Account	Dr.		22,00,000	
	To 15% Debentures Account				20,00,000
	To Debentures Premium Account				2,00,000
	(Being issue of 15% Debentures at premium and redeemable at par)				

Balance Sheet of Ajay Limited as on...

Liabilities	(₹)	Assets	(₹)
Reserve & Surplus:		Current Assets:	
Debentures Premium	2,00,000	Cash at Bank	22,00,000
Secured Loans:			
15% Debentures	20,00,000		

(d) Journal of Vijay Limited

Date	Particulars		L.F.	(₹)	(₹)
	Bank Account	Dr.		25,00,000	
	Loss on Issue of Debentures Account	Dr.		1,25,000	
	To 15% Debentures Account				25,00,000
	To Premium on Redemption of Debentures Account				1,25,000
	(Being issue of 15% Debentures at par and redeemable at premium)				

Balance Sheet of Vijay Limited as on...

Liabilities	(₹)	Assets	(₹)
Secured Loans:		Current Assets:	
15% Debentures	25,00,000	Cash at Bank	25,00,000
Premium on Redemption of Debentures.	1,25,000	Misc. Expenditure:	
		Loss on Issue of Debentures	1,25,000

Notes

(e) Journal of Anuj Limited

Date	Particulars		L.F.	(₹)	(₹)
	Bank Account	Dr.		54,00,000	
	Loss on Issue of Debentures Account	Dr.		9,00,000	
	To 15% Debentures Account				60,00,000
	To Premium on Redemption of Debentures Account				3,00,000
	(Being issue of 15% debentures at discount and redeemable at premium)				

Balance Sheet of Anuj Limited as on...

Liabilities	(₹)	Assets	(₹)
Secured Loans:		Current Assets:	
15% Debentures	60,00,000	Cash at Bank	54,00,000
Premium on Redemption of Debentures.	3,00,000	Miscellaneous Expenditure:	
		Loss on Issue of Debentures	9,00,000

Self Assessment

Fill in the blanks:

1. …………… can be issued at par, at premium, or at discount, but redemption will be either at par or at premium.
2. If a company …………… its debentures by purchasing them from the open market at a price below the par value the, difference (par value and purchase price) is treated as profit on redemption or redemption of debentures at discount.
3. The …………… of debentures by public limited companies is regulated by Companies Act 1956.
4. The procedure for the issue of debentures is very much similar to that of the issue of shares. …………… treatment for the issue of debentures is also the same as in the case of issue of shares.
5. Debentures are one of a series issued to a number of …………… .

Did u know? The unwritten off balance of this account should be treated as a deferred revenue expenditure and should be shown in the assets side of the balance sheet under the head “Miscellaneous Expenditure”.

7.2 Discount on Issue of Debentures

Discount on issue of debentures is a capital loss and therefore must be written off as early as possible. It can be written off against capital reserve or share premium. The unwritten off balance of this account should be treated as deferred revenue expenditure and should be shown in the assets side of the balance sheet under the head of Miscellaneous Expenditure. If a company does not have any capital reserve it must be written off against the profits of the company in an equitable basis until debentures are redeemed. The total amount of discount on the issue of debentures can be written off in the following two ways:

Notes

(i) ***When the redemption of debentures is in lump sum after specified period:*** Equal Instalment Method – When debentures are redeemable at the end of a specified period, total discount on the issue of debentures is spread over the life of debentures equally.

For example, if total discount allowed is ₹ 15,000 and debentures are redeemable at the end of fifteen years, total discount will be divided by 15 and the amount so arrived (i.e. $\frac{15,000}{15}$ = ₹ 1,000) will be transferred to Profit and Loss account every year for 15 years. Thus at the end of 15 years, the total amount of discount will be eliminated from books. This method is suitable only when debentures are redeemable at the expiry of a specified period.

(ii) ***When redemption of debentures is made in instalments:*** Proportion Method – In such case, the total amount of discount on issue of debentures should be written off in the proportion to the benefit received from the money collected by the issue of debentures or outstanding balance every year. The reason is simple: the years which enjoy the use of the larger proportion of cash should bear the larger proportion of discount.

Note It is to be noted that "premium on redemption of debentures account" is a personal account, because it is the liability of the company to pay the Debenture-holder at a premium as per the condition of redemption.

Accounting Treatment: When discount on issue of debentures is written off against the profits of the company, the following journal entry is passed:

Profit and Loss Account Dr.

To Discount on Issue of Debentures Account.

Example 3: **Debentures Discount – Proportion Method**

Suresh Co. Ltd. issued 2,00,000; 15% Debentures of ₹ 100 each at 5% discount. These debentures are redeemable in instalments of ₹ 40,00,000 every year. Open discount on issue of Debentures Account in the books of Suresh Limited. The working note will be a part of the solution.

Solution:

Discount on Issue of Debentures Account

Year	Particulars	(₹)	Year	Particulars	(₹)
	To 15% Debentures Account	10,00,000		By P&L Account	3,33,333
				By Balance c/d	6,66,667
		10,00,000			10,00,000
	To Balance b/d	6,66,667		By P&L Account	2,66,667
				By Balance c/d	4,00,000
		6,66,667			6,66,667
	To Balance b/d	4,00,000		By P&L Account	2,00,000
				By Balance c/d	2,00,000
		4,00,000			4,00,000

Contd...

Notes

	To Balance b/d	2,00,000		By P&L Account	1,33,333
				By Balance c/d	66,667
		2,00,000			2,00,000
	To Balance b/d	66,667		By P&L Account	66,667
		66,667			66,667

Working Note: Table showing Debenture Discount to be written off every year—

Year	Nominal value of Debentures used (₹)	Period of use in months	Product	Ratio (Product)	Amount of Discount to be written off every year
	2,00,00,000	12 months	24,00,00,000	5	$10,00,000 \times \frac{5}{15} = 3,33,333$
	1,60,00,000	12 months	19,20,00,000	4	$10,00,000 \times \frac{4}{15} = 2,66,667$
	1,20,00,000	12 months	14,40,00,000	3	$10,00,000 \times \frac{3}{15} = 2,00,000$
	80,00,000	12 months	9,60,00,000	2	$10,00,000 \times \frac{2}{15} = 1,33,333$
	40,00,000	12 months	4,80,00,000	1	$10,00,000 \times \frac{1}{15} = 6,66,667$
				15	

Total discount on Debentures = $\frac{200,00,000 \times 5}{100}$ = ₹ 10,00,000

Example 4: **Debentures Discount – When first redemption is made in next accounting period**

Rita Ltd. issued 12% Debentures at 94% for ₹ 2,00,000 on 1st April, 2,000 repayable by five equal annual drawings of ₹ 40,000 each. The company closes its account on a calendar year basis.

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 debentures.

Solution:

Total Discount = $\frac{2,00,000 \times 6}{100}$ = ₹ 12,000

Table showing the discount to be written off each year

Year	Nominal value of debentures (₹)	Period of use in months	Product	Equivalent amount	Ratio
1.4.2000 – 31.12.00	2,00,000	9	18,00,000	18,00,000	15
1.1.01 – 31.3.01	2,00,000	3	6,00,000		17
1.4.01 – 31.12.01	1,60,000	9	14,40,000	20,40,000	
1.1.02 – 31.3.02	1,60,000	3	4,80,000	15,60,000	13
1.4.02 – 31.12.02	1,20,000	9	10,80,000		

Contd...

1.1.03 – 31.3.03	1,20,000	3	3,60,000	10,80,000	9
1.4.03 – 31.12.03	80,000	9	7,20,000		
1.1.04 – 31.3.04	80,000	3	2,40,000	6,00,000	5
1.4.04 – 31.12.04	40,000	9	3,60,000		
1.1.05 – 31.3.05	40,000	3	1,20,000	120,000	1
					60

Amount of discount to be written off

Year	Calculation	Amount of discount to be written off (₹)
2000	$12{,}000 \times \frac{15}{60}$	3,000
2001	$12{,}000 \times \frac{17}{60}$	3,400
2002	$12{,}000 \times \frac{13}{60}$	2,600
2003	$12{,}000 \times \frac{9}{60}$	1,800
2004	$12{,}000 \times \frac{5}{60}$	1,000
2005	$12{,}000 \times \frac{1}{60}$	200
		12,000

Self Assessment

State whether the following statements are true or false:

6. If debentures are issued at par and redeemable at premium, loss on issue of debentures will be equal to the amount of premium payable on redemption.
7. If debentures are issued at discount and redeemable at premium, loss on issue of debentures will not be equal to the total of discount on issue of debentures and premium payable on redemption of debentures.
8. When debentures are redeemable at the end of a specified period, total discount on the issue of debentures is spread over the life of debentures equally.
9. The 'loss on issue of debentures account' is a nominal account.

Caution If a company does not have any capital reserve it must be written off against the profits of the company in an equitable basis until debentures are redeemed.

7.3 Loss on Issue of Debentures

The loss on issue of debentures will be computed in the following manner:

(a) If debentures are issued at par and redeemable at premium, loss on issue of debentures will be equal to the amount of premium payable on redemption.

Notes

(b) If debentures are issued at discount and redeemable at premium, loss on issue of debentures will be equal to the total of discount on issue of debentures and premium payable on redemption of debentures.

The loss on issue of debentures in both the above cases will be treated as capital loss and will be dealt with the same method as discount on issue of debentures discussed earlier.

To write off the loss on issue of debentures, the following entry will be passed:

Profit & Loss account Dr.

To Loss on Issue of Debentures Account.

Example 5: **Writing off Loss on Issue of Debentures**

On 1st January, 2001 Shubham Ltd. issued 2,000, 12% Debentures of ₹ 100 each at a discount of 5%, redeemable at a premium of 10%. Show the loss on issue of Debentures Account, if (i) such debentures are redeemable after 5 years and (ii) such debentures are redeemable by annual drawings in 5 years. Shubham Ltd. follows the calendar year as its accounting year.

Solution:

(a) When these debentures are repayable after 5 years:

(i) Amount of discount on issue of debentures

$$\frac{2,00,000 \times 5}{100} = ₹\ 10,000$$

(ii) Amount of premium payable on redemption:

$$\frac{2,00,000 \times 10}{100} = 20,000$$

(iii) Thus total loss = 10,000 + 20,000 = ₹ 30,000

$$\frac{30,000}{5} = ₹\ 6,000$$

Amount of loss to be written off every year:

Loss on Issue of Debentures Account

2001	To 12% Debentures Account	10,000	2001	By P. & L. Account	6,000
Jan. 1	To Premium on Redemption of Debentures Account	20,000	Dec. 31	By Balance c/d	24,000
		30,000			30,000
2002			2002		
Jan. 1	To balance b/d	24,000	Dec. 31	By P. & L. Account	6,000
				By Balance c/d	18,000
		24,000			24,000
2003			2003		
Jan. 1	To balance b/d	18,000	Dec. 31	By P. & L. Account	6,000
				By Balance c/d	12,000
		18,000			18,000

Contd...

Notes

2004			2004		
Jan. 1	To balance b/d	12,000	Dec. 31	By P. & L. Account	6,000
				By balance c/d	6,000
		12,000			12,000
2005			2005		
Jan. 1	To balance b/d	6,000	Dec. 31	By P. & L. Account	6,000
		6,000			6,000

(b) When such debentures are repayable by equal annual drawing in 5 years:

Year	Nominal value of debentures used (₹)	Period of Issue	Product (₹)	Ratio	Amount of loss to be w/o (₹)
2001	2,00,000	12 Months	24,00,000	5	$30,000 \times \frac{5}{15} = 10,000$
2002	1,60,000	12 Months	19,20,000	4	$30,000 \times \frac{4}{15} = 8,000$
2003	1,20,000	12 Months	14,40,000	3	$30,000 \times \frac{3}{15} = 6,000$
2004	80,000	12 Months	9,60,000	2	$30,000 \times \frac{2}{15} = 4,000$
2005	40,000	12 Months	4,80,000	1	$30,000 \times \frac{1}{15} = 2,000$
				15	30,000

Loss on Issue of Debentures Account

Date	Particulars	(₹)	Date	Particulars	(₹)
2001			2001		
Jan., 1	To 12% Debentures Account	10,000	Dec. 31	By P. & L. Account	10,000
	To Premium on Redemption of Debentures A/c	20,000		By balance c/d	20,000
		30,000			30,000
2002			2002		
Jan., 1	To balance b/d	20,000	Dec. 31	By P. & L. Account	8,000
				By balance c/d	12,000
		20,000			20,000
2003			2003		
Jan., 1	To balance b/d	12,000	Dec. 31	By P. & L. Account	6,000
				By balance c/d	6,000
		12,000			12,000
2004			2004		
Jan., 1	To balance b/d	6,000	Dec. 31	By P. & L. Account	4,000
				By balance c/d	2,000
		6,000			6,000
2005			2005		
Jan., 1	To balance b/d	2,000	Dec. 31	By P. & L. Account	2,000
		2,000			2,000

Notes

7.4 Interest on Debentures

When a company issues the debentures, it is necessary to pay interest on debentures at a fixed percentage (which is prefixed to debentures) periodically (generally half yearly) until the debentures are redeemed. Interest on debentures is a charge against the profits of the company and is payable irrespective of the fact whether there is profit or not. Interest is calculated at a fixed rate on the face value of debentures and not on issued price. Thus, issues of debentures at par, at a discount, or at a premium will not make any difference in the calculation of interest payable on debentures. In certain cases, Income Tax Act, 1961 has instructed that a company has to deduct income-tax at a prescribed rate from the gross amount of interest on debentures. The amount of tax so deducted from the gross interest is to be deposited into a government account within a prescribed time.

> *Note* When a company issues the debentures, it is necessary to pay interest on debentures at a fixed percentage (which is prefixed to debentures) periodically (generally half yearly) until the debentures are redeemed.

Accounting Treatment: Regarding the interest of on debentures, the following entries are recorded in the books of the company:

1. When interest on debentures is due:

Debentures Interest Account	Dr.	(Total interest)
To Debenture-holders account		(Net amount)
To Income tax payable account		(Tax deducted from interest)

2. When amount of interest is paid to debentures:

Debenture-holders Account	Dr.
To Bank Account.	

3. When income tax is deposited to government account:

Income tax payable Account	Dr.
To Bank Account.	

7.5 Some Points to be Noted Regarding Interest on Debentures

1. Interest is not paid on debentures issued as collateral securities.
2. If income tax deducted from interest on debentures is not paid to government, it will be shown in the liability side of balance sheet.
3. Interest on debentures for the full year is transferred to profit and loss account at the end of accounting year.
4. If interest is accrued but not paid, it will be shown in the liabilities side of the balance sheet.

Notes

Example 6: **Payment of Interest on Debentures**

Apex Limited has 20,000, 8% Debentures of ₹ 100 each on which interest is payable on 30th June and 31st December. Pass the necessary journal entries relating to debentures interest for the year 2005, assuming that income tax is deducted @ 20% on the amount of interest.

Solution:

Journal Entries

Date	Particulars		L.F.	(₹)	(₹)
2005					
June 30	Debentures Interest Account	Dr.		80,000	
	To Debenture-holders' Account				64,000
	To Income tax Payable Account				16,000
	(Being interest due for 6 months and income tax deducted @ 20%)				
June 30	Debenture-holders' Account	Dr.		64,000	
	To Bank Account				64,000
	(Being payment made to debenture-holders)				
June 30	Income Tax Payable Account	Dr.		16,000	
	To Bank Account				16,000
	(Being payment of income tax deducted from interest)				
Dec. 31	Debentures Interest Account	Dr.		80,000	
	To Debenture-holder Account				64,000
	To Income tax Payable Account.				16,000
	(Being interest due for 6 month and income tax deducted @ 20%)				
Dec. 31	Debenture-holders Account	Dr.		64,000	
	To Bank Account				64,000
	(Being payment made to Debenture-holders)				
Dec. 31	Income Tax Payable Account	Dr.		16,000	
	To Bank Account				16,000
	(Being payment of Income tax to government)				
Dec. 31	Profit & Loss Account	Dr.		1,60,000	
	To Debentures Interest Account				1,60,000
	(Being transfer of debenture interest to profit and loss account)				

Self Assessment

Fill in the blanks:

10. Under the Sinking Fund method of redemption the interest on S.F. Investment is ………… .
11. Nature of Premium a Issue of Debentures is ……….….. .
12. 'Discount on Issue of Debentures' is written off through …………… .

Notes

Select the best alternative:

13. Interest on own debentures is transferred to:
    (a) Capital reserve
    (b) Sinking fund
    (c) General reserve
14. If there is any balance in Debenture Redemption Fund, that will be transferred to:
    (a) Profit and Loss Account
    (b) General Reserve
    (c) Capital Reserve
15. The following entry is passed in the books of A company:

Bank Account	Dr.	9,000	
Loss on Issue of Debentures Account	Dr.	1,500	
To 10% Debentures Account			10,000
To Premium on Redemption of Debentures A/c			500

Here, debentures are issued at a discount of:
    (a) 10%
    (b) 5%
    (c) 15%

Case Study

Debenture Trustees can be Made to Pay

The National Commission has held that a Debenture Trustee can be held liable under the Consumer Protection Act (CPA). (Judgment dated July 4, 2008 in Revision Petition No. 1299 of 2003-Central Bank of India v/s Tadepalli Padmaja & Ors.)

Case Study

Synergy Financial Exchange Ltd, a non-banking financial company, had issued debentures with Central Bank of India as the Trustee. One of the clauses in the agreement required the company to pay all amounts of principal and interest due under the debenture by crossed account-payee cheques or bank drafts drawn on a bank in Mumbai. It was agreed and undertaken to redeem the debentures in full on the expiry of three years from the date of allotment.

The debentures carried interest of 15% per annum payable on June 30 and December 31 each year, subject to deduction of tax. Failure to pay the interest would result in an additional levy of compound interest at the same rate. All such compound interest was a charge secured by the debentures. In case of default in redemption, the company would have to pay liquidated damages of a further compound interest of 2% per annum for the period and the amount of the default, and this too would be a charge secured by the debentures.

Contd...

Notes

The financial safety of the debentures was to be ensured by the company and the trustee as creating a Debenture Redemption Reserve by transferring suitable amounts from time to time. The proof of such transfer was to be furnished by the company to the Trustee in the form of a certificate issued by the auditors.

The facts

The company failed to pay the interest or the redemption amount as agreed. So the debenture holders filed complaints before various district forums, which were allowed and the Trustee was found liable to reimburse the complainants. Appeals to the various state commissions against these orders were dismissed. The Trustee then filed revision petitions before the National Commission.

The Trustee contended that debenture holders, who have not paid any money for the services of the Trustees, are not consumers. Also, there was no privity of contract between the Trustees and the debenture holders. They claimed that their duty as Trustee ended immediately on filing a suit against the company for recovery of the debenture amounts on the basis of the Mortgage Deed. Thereafter no further proceedings would be maintainable.

Findings

The National Commission overruled the arguments of the Trustee Bank. It held that the services of the Trustee were not free but were paid for by the company to protect the interest of the debenture holders. Hence the debenture holders were consumers and entitled to approach the consumer fora.

The Commission relied on Halsbury's Laws of England which state that "a higher duty of care is due from a trust corporation which carries on specialised business of trust management and a professional corporate trustee is liable for breach of trust if loss is caused to the trust fund through neglect to exercise special care and skill which it professes to have" . The Commission found that in the present case the Trustee Bank had not done anything except merely write letters. Accordingly, the National Commission held Central Bank as the Debenture Trustee liable to compensate the complainant debenture holders for the default of Synergy Financial Exchange Ltd. The Revision Petition was thus dismissed and the orders of the District Forum and State Commission were upheld.

The National Commission further directed that its order be sent to SEBI to consider action against Central Bank as per the regulations governing the Code of Conduct of Debenture Trustees.

Impact

Debenture Trustees must realise their responsibility instead of merely collecting fat fees for services, which they fail to render. Now consumers can hold errant Trustees responsible and recover their money even if the company defaults.

Source: http://articles.timesofindia.indiatimes.com/2008-08-04/mumbai/27909882_1_debentures-interest-central-bank

7.6 Summary

A company may issue debentures at different terms and just as the issue can be made at par, at a premium or at a discount, the redemption of debentures can also be made at par, at a premium or at a discount. Combining the various conditions/terms of issue and redemption of debentures, there may be the following six possibilities:

Notes

(a) Issued at par – redeemable at par;

(b) Issued at discount – redeemable at par;

(c) Issued at premium – redeemable at par;

(d) Issued at par - redeemable at premium;

(e) Issued at a discount – redeemable at premium;

(f) Issued at premium - redeemable at premium;

It may be noted that in the above mentioned six possibilities, the debentures can be redeemed at a discount and this situation is possible only when the terms and conditions of redemption are laid down in advance. When the debentures are to be redeemed at a discount, amount payable at the time of redemption will be less than the face value of debentures resulting in a gain. However, as per the accounting convention of conservatism expected losses are to be taken into account but not expected gains. Therefore, there is no change in the journal entries passed. Thus journal entries for issue of debentures in the case of redemption at a discount are similar to journal entries for issue of debentures when redemption is at par.

7.7 Keywords

Debenture: It is a document that either creates a debt or acknowledges it, and it is a debt without collateral. In corporate finance, the term is used for a medium- to long-term debt instrument used by large companies to borrow money.

Discount on Issue of Debentures: It is a capital loss and therefore must be written off as early as possible.

Debentures Issued at Premium: Debentures are said to be issued at premium when these are issued at a value which is more than their nominal value.

Deferred Revenue Expenditure: It can be written off against capital reserve or share premium. The unwritten off balance of this account should be treated as deferred revenue expenditure.

Debentures Issued at Discount: When debentures are issued at less than their nominal value they are said to be issued at discount.

Issue of Debentures: By issuing debentures means issue of a certificate by the company under its seal which is an acknowledgement of debt taken by the company.

7.8 Review Questions

1. For how many considerations the debentures can be issued?

2. What do you mean by issue of debenture as collateral securities? Give its accounting treatment.

3. Explain the following terms:

   (a) Loss on Issue of Debentures.

   (b) Interest on own Debentures.

Practical questions:

4. Show by the means of journal entries the followings, at the time of issue on 1st January 2006.

Notes

(i) X Limited issues 10,000, 10% Debentures of ₹ 100 each at a discount of 3% to be redeemed at par at the end of 5th year.

(ii) Y Limited issues 15,000; 10% Debentures of ₹ 100 each at a discount of 4% to be redeemed at a premium of 4% at the end of 5th year.

(iii) Z Limited issues 20,000; 10% Debentures of ₹ 100 each at par to be redeemed at a premium of 4% at the end of fifth year.

(iv) XA Limited issues 25,000; 10% Debentures of ₹ 100 each at a premium of 5% to be redeemed at par at the end of 5th year.

5. Hari Mohan Limited issues 1000; 12% debentures of ₹ 500 each. Pass journal entries in the following cases:

(i) Debentures are issued at par and redeemable at par.

(ii) Debentures are issued at par and redeemable at 5% premium.

(iii) Debentures are issued at 5% discount and redeemable at par.

(iv) Debentures are issued at 5% discount and redeemable at 10% discount.

(v) Debentures are issued at 5% discount and redeemable at 2.5% premium.

(vi) Debenture are issued at 5% premium and redeemable at par.

(vii) Debentures are issued at 5% premium and redeemable at 10% premium.

6. Show by means of journal entries how will you record the following issues. Also, show how they will appear in their respective balance sheets:

(i) A Ltd. issued 10,000; 15% Debentures of ₹ 100 each at a discount of 10% redeemable at the end of 10 year at par.

(ii) B Ltd. issued 10,000; 15% Debentures of ₹ 100 each at par redeemable at the end of 10 year at a premium of 10%.

(iii) C Ltd. issued 10,000; 15% Debentures of ₹ 100 each at a premium of 10% redeemable at the end of 10 years at a premium of 10%.

(iv) D Ltd. issued 10,000; 15% Debentures of ₹ 500 each at a discount of 5% redeemable at the end of 10 years at a premium of 5%.

Answers: Self Assessment

1.	debentures	2.	redeems
3.	issue	4.	accounting
5.	lenders	6.	true
7.	false	8.	true
9.	true	10.	Also Invested,
11.	Personal,	12.	P. & L. Account.
13.	(b)	14.	(b)
15.	(a)		

7.9 Further Readings

Notes

Books

Glossary: D on the Financial Industry Regulatory Authority (FINRA) website, United States

What is a debenture?, Company Law Club, referring to United Kingdom usage

Chandra Gopalan (2007); Company Law in Singapore 3rd Edition; McGraw-Hill Education (Asia)

Online links

http://en.wikipedia.org/wiki/Debenture

http://www.nos.org/srsec320newe/320el26.pdf

http://taxguru.in/income-tax-case-laws/loss-on-sale-of-debentures-%E2%80%93-deduction-allowed-even-if-loss-was-known-at-time-of-applying-for-debentures.html

Notes

Unit 8: Methods of Redemption–I

CONTENTS

Objectives

After studying this unit, you should be able to:

- Know redemption meaning and its methods
- Explain sources of finance for redemption
- Define redemption by conversion
- Understand some important points related to debentures redemption fund
- Know non-cumulative Sinking Fund
- Understand insurance policy method

Introduction

Redemption of debentures is the process of discharging the liability on account of debentures in accordance with the terms of redemption stated in the debenture trust deed. Discharge of debenture liability is usually by paying cash to the debenture holders. But this can take other forms such as conversion or rolover. In the case of conversion debentures are converted into preference shares or equity shares. Rollover refers to the issue of new debentures, in exchange for the old ones. Both conversion and rollover are subject to detailed SEBI guidelines. When a company issues debentures it must also plan the resources required for such redemption. This can be done by setting aside profits every year and investing them wisely in investments outside, so that there will be no liquidity problem at the time of redemption. Alternatively the company can take an insurance policy by paying regular premium, so that the policy matures coinciding with the time of redemption. With the amount received on the maturity of policy the company faces no problem in carrying out the redemption.

Notes

8.1 Meaning

Redemption of debentures means repayment of the amount of debentures to debenture-holders or the discharge of the liability of debentures according to the terms of redemption given in the Trust Deed of the debentures, or in the prospectus inviting the application for the debentures. The redeemed debentures can be reissued if the conditions laid down in Section 121 of the Companies Act are satisfied.

SEBI Guidelines for the Protection of Debenture-holders' Interest

From the accounting point of view some important guidelines of SEBI are as follows:

1. All companies that raise resources through the issue of debentures must create a Debentures Redemption Reserve (DRR). This reserve must be equal to 50% of the amount of debentures issued before the redemption of debentures takes place.

   Drawal from Debentures Redemption Reserve is permissible for the purpose of redemption only after 40% of debentures liability has been actually redeemed by the company.

2. Thus, a company cannot redeem its debentures purely out of capital or out of profit.

3. There is no need to create a DRR in the following cases:

   (i) if the debentures are issued for a period of 18 months or less.

   (ii) if convertible debentures are issued by the company.

   (iii) if a company has created a sinking fund of the equivalent amount of debentures issue (but no redemption will commence unless the sinking fund accumulates a sum of 50% of the amount of debenture issue).

   (iv) if the debentures are issued for raising project finance, a moratorium upto the date of commercial production can be provided for the creation of DRR.

4. In case of convertible debentures, DRR should be created for the non-convertible component. DRR should be treated as general reserve for considering proposals of bonus issue.

5. If there is any balance in the DRR after the redemption of debentures, it is transferred to general reserve (as being the nature of undistributed profits) and will be available for the distribution of dividend.

6. For the determination of rate of interest on debentures, companies are independent.

7. There should be clear information in the prospectus regarding the premium payable and time of redemption.

8. Thus a company can not redeem its debentures purely out of capital or out of profit.

Notes Discharge of debenture liability is usually by paying cash to the debenture holders.

8.2 Sources of Finance for Redemption

In order to avoid financial difficulties when debentures become due for redemption, it is necessary to make arrangements for the accumulation of addition funds for the purpose of redemption. A company may use the following options in this regard:

1. Redemption of debentures out of capital.

2. Redemption of debentures by conversion into shares or new debentures.

Notes

3. Redemption of debentures out of profit.
4. Redemption by purchase in the open market.

8.2.1 Redemption Out of Capital

When the redemption of debentures is made out of capital, no amount is transferred from Profit and Loss Account to the Debenture Redemption Reserve Account (DRR). Its effect will be that credit balance of Profit and Loss Account will not be reduced. This might result in the payment of dividends sometime in the future. It will also indicate that redemption is being done out of that money which is not earned during the course of business. Therefore, such redemption is out of capital.

But in the SEBI guidelines, the Controller of Capital Issue has placed restrictions on this method indirectly. Every company has to create a Debenture Redemption Reserve (DRR) equivalent to 50% of the amount of debentures issue before commencement of redemption on 14.1.1987. Now it is doubtful if the debentures could be redeemed purely out of capital.

Did u know? In order to avoid financial difficulties when debentures become due for redemption, it is necessary to make arrangements for the accumulation of addition funds for the purpose of redemption?

Accounting Treatment

The following journal entries are made to record the redemption of debentures out of capital:

1. When the amount of debentures becomes due:

   (a) If the debentures are redeemable at par

Debentures Account	Dr.
To Debenture-holders' Account.	

   (b) If the debentures are redeemable at discount:

Debentures Account	Dr.
To Debentures Account	
To Profit on Redemption Account	

   (c) If the debentures are redeemable at premium:

Debentures Account	Dr.
Premium on Redemption of Debentures Account	Dr.
To Debenture-holders' Account	

2. When payment is made to debenture-holders:

Debenture-holders' Account	Dr.
To Bank Account	

Illustration 1 (Redemption Out of Capital)

Seema Ltd. issued 2000, 12% Debentures of ₹ 100 each on 1st January, 2001 at a discount of 10% redeemable at a premium of 5% out of capital. Pass journal entries both at the time of issue and redemption of debentures if (a) the Debentures are redeemable in lump sum at the end of the third year (b) the Debentures are redeemable in equal annual drawings in the fourth year. Assuming the calendar year to be the accounting year of Seema Ltd., ignore the treatment of loss on issue of debentures and interest thereon.

Solution:

(a) If the debentures are redeemed in lump sum at the end of third year:

Date	Particulars	L.F.	₹	₹
2001				
Jan. 1	Bank Account	Dr.	1,80,000	
	Loss on Issue of Debentures Account	Dr.	30,000	
	To 12% Debentures Account			2,00,000
	To Premium on Redemption of Debentures Account			10,000
	(Being issue of debentures at discount and redeemable at premium)			
2004				
Dec. 31	12% Debentures Account	Dr.	2,00,00	
	Premium on Redemption of Debentures Account	Dr.	10,000	
	To 12% Debenture-holders' Account			2,10,000
	(Being amount due to debenture-holders on redemption)			
Dec. 31	12% Debenture-holders' Account	Dr.	2,10,000	
	To Bank Account			2,10,000
	(Being payment made to Debenture-holders on redemption)			

(b) If debentures are redeemed by equal annual drawings:

Date	Particulars	L.F.	₹	₹
2001				
Jan. 1	Bank Account	Dr.	1,80,000	
	Loss on Issue of Debentures Account	Dr.	30,000	
	To 12% Debentures Account			2,00,000
	To Premium on Redemption of Debentures Account			10,000
	(Being issue of 12% debentures at discount and redeemable at premium)			
2001				
Dec. 31	12% Debentures Account	Dr.	50,000	
	Premium on Redemption of Debentures Account	Dr.	2,500	
	To Debenture-holders' Account			52,500
	(Being amount due to debenture-holders on redemption)			
	Debenture-holders' Account	Dr.	52,500	
	To Bank Account			52,500
	(Being payment made to debenture-holders)			
2002				
Dec. 31	12% Debentures Account	Dr.	50,000	
	Premium on Redemption of Debentures Account	Dr.	2,500	
	To Debenture-holders' account			52,500
	(Being amount due to debenture-holders on redemption)			
	Debenture-holders' Account	Dr.	52,500	
	To Bank Account			52,500
	(Being amount paid to debenture-holders on redemption)			
2003				
Dec. 31	12% Debentures Account	Dr.	50,000	
	Premium on Redemption of Debentures Account	Dr.	2,500	
	To Debenture-holders' Account			52,500

Notes

	(Being amount due to debenture-holders on redemption)			
	Debenture-holders' account	Dr.	52,500	
	To Bank Account			52,500
	(Being amount paid to debenture-holder)			
2004				
Dec. 31	12% Debentures Account	Dr.	50,000	
	Premium on Redemption of Debentures Account	Dr.	2,500	
	To Debenture-holders' account			52,500
	(Being amount due to debenture-holders on redemption)			
	Debenture-holders Account	Dr.	52,500	
	To Bank Account			52,500
	(Being amount paid to debenture-holders)			

Illustration 2 (Redemption Out of Capital by Drawings and Purchase of Debentures)

On 1st January 2003 Pankaj Ltd. issued 2,000, 11% Debentures of ₹ 500 each at a discount of 10%. The terms of issue provided that beginning with 2006 ₹ 2,50,000 of debentures should be redeemed either by drawings at par or by purchase in the market every year. The expenses of the issue amounted to ₹ 4,000 which were written off in 2003. The company wrote off ₹ 20,000 from the discount on debentures every year. In 2006, the debentures to be redeemed were repaid at the end of the year by drawings. In 2006, the company purchased for cancellation 500 debentures at a running rate of 480 on 31st December, the expenses being ₹ 200. Interest is payable yearly. Ignore income tax.

Pass journal entries to record the above mentioned transactions in the books of Pankaj Ltd. on 31st December 2006.

Solution:

Pankaj Ltd.
Journal Entries

Date	Particulars	L.F.	₹	₹
2003				
Jan. 1	Bank Account	Dr.	9,00,000	
	Discount on Debentures Account	Dr.	1,00,000	
	To 11% Debentures Account			10,00,000
	(Being issue of 11% Debentures at discount)			
Jan. 1	Debenture Issue Expenses Account	Dr.	4,000	
	To Bank Account			4,000
	(Being payment of expenses on issue of debentures)			
Dec. 31	Interest on Debentures Account	Dr.	1,10,000	
	To Bank Account			1,10,000
	(Being payment of interest on debentures)			
Dec. 31	Profit and Loss Account	Dr.	1,34,000	
	To Debenture Issue Expenses Account			4,000
	To Discount on Debentures Account			20,000
	To Interest on Debentures Account			1,10,000
	(Being written off of discount on debentures, debenture issue expenses and interest on debentures)			
2004				
Dec. 31	Interest on Debentures Account	Dr.	1,10,000	
	To Bank Account			1,10,000
	(Being payment of interest on debentures)			

Notes

Dec. 31	Profit and Loss Account	Dr.	1,30,000	
	To Interest on Debentures Account			1,10,000
	To Discount on Debentures Account			20,000
	(Being transfer of interest on debentures and discount on debentures)			
2005				
Dec. 31	Interest on Debentures Account	Dr.	1,10,000	
	To Bank Account			1,10,000
	(Being the payment of interest on debentures)			
Dec. 31	Profit and Loss Account	Dr.	1,30,000	
	To Interest on Debentures Account			1,10,000
	To Discount on Debentures Account			20,000
	(Being transfer of interest and discount on debentures)			
2006				
Dec. 31	11% Debentures Account	Dr.	2,50,000	
	To Profit on Redemption of Debentures Account			10,000
	To Bank Account			2,40,000
	(Being purchase of 500 debentures @ Rs. 480 per debentures from the market for cancellation)			
2006	Expenses on Redemption of Debentures Account	Dr.	200	
Dec. 31	Interest on Debentures Account	Dr.	1,10,000	
	To Bank Account			1,10,200
	(Being the payment of interest and expenses on debentures)			
	Profit and Loss Account	Dr.	1,30,200	
	To Expenses on Redemption of Debentures Account			200
	To Interest on Debentures Account			1,10,000
	To Discount on Debentures Account			20,000
	(Being written off of expenses interest and discount on debentures)			
	Profit on Redemption of Debentures Account	Dr.	10,000	
	To Profit and Loss Account			10,000
	(Being transfer of profit on redemption to P. and L. Account)			

Self Assessment

Fill in the blanks:

1. In order to avoid financial .... when debentures become due for redemption, it is necessary to make arrangements for the accumulation of addition funds for the purpose of redemption.
2. When the redemption of .... is made out of capital, no amount is transferred from Profit and Loss Account to the Debenture Redemption Reserve Account (DRR).
3. With the amount received on the .... of policy the company faces no problem in carrying out the redemption.
4. Every company has to create a ....

Notes Debenture Redemption Reserve (DRR) equivalent to 50% of the amount of debentures issue before commencement of redemption on 14.1.1987.

Notes

8.2.2 Redemption of Debentures by Conversion

When a company redeems its debentures by converting them into a new class of shares or debentures, this method is called redemption of debentures by conversion. In other words, it is an option given by a company to its debenture-holders to convert their debentures into shares or new debentures within a prescribed time. This option will be used by the debenture-holders only when they find it beneficial from their view point, or as agreed as per terms of issue. The new shares or debentures can be issued by the company either at par or at a premium or at a discount.

In the process of conversion of debentures (which were originally issued at discount) into shares, the provisions of Section 79 of Companies Act 1956 should not be violated. Only actual proceeds realised (Face value – Discount) from debentures at the time of issue should be treated as the basis for determining the number of shares to be issued in exchange. Thus, the issue price of shares must be equal to the amount actually received from the debenture-holders at the time of issue of these debentures. If this rule is not followed it will be the violation of the provision of Section 79. Under this rule, at the time of making the amount payable, due to the debenture-holders in this case, the discount on issue of debentures should be credited. But this will not be applicable where debentures (originally issued at discount) are redeemed by conversion in new debentures. Therefore, the discount on issue of debentures will not be credited.

Accounting treatment: On the redemption of debentures by conversion into shares or debentures, the following journal entries are made:

1. When new shares or debentures are issued at par:

   Old Debentures Account Dr.

   To New Shares/Debentures Account

2. When new shares/debentures are issued at discount:

   Old Debentures Account Dr.

   Discount on Issue of new Shares/Debentures Dr.

   To New Shares/Debentures Account.

3. When new shares/debentures are issued at premium:

   Old Debentures Account Dr.

   To New Shares/Debentures Account

   To Premium on Issue of New Shares/Debentures Account.

Illustration 3 (Conversion of Debentures into Preference Shares)

On 1st January 2005, Rajesh Limited issued 5,000; 15% Debentures of ₹ 100 each at 5% discount. Debenture-holders have an option to convert their holdings into 12% preference shares of ₹ 100 each at a premium of 25% at any time within three years.

On 31st December 1998, one year's interest was accrued on these debentures and remained unpaid. Mr. Om, a holder of 250 debentures notified his intention to convert his holdings in 12% preference shares. Pass the necessary journal entries in the books of Rajesh Limited and show how the items would appear in the balance sheet of the company on 31st December 2005.

Solution:

Notes

Rajesh Limited
Journal Entries

Date	Particulars	L.F.	₹	₹
2005				
Jan. 1	Bank Account	Dr.	4,75,000	
	Discount on Issue of Debentures Account	Dr.	25,000	
	To 15% Debentures Account			5,00,000
	(Being 15% Debentures issued at 5% discount)			
Dec. 31	Interest on Debentures Account	Dr.	75,000	
	To Debenture-holders Account			75,000
	(Being one year's interest due on debentures but unpaid)			
Dec. 31	15% Debentures Account	Dr.	25,000	
	To 12% Preference Shares Account			19,000
	To Share Premium Account			4,750
	To Discount on Issue of Debentures Account			1,250
	(Being 250 debentures redeemed by conversion in 12% preference shares at premium)			
	Profit and Loss Account	Dr.	75,000	
	To Interest on Debentures Account			75,000
	(Being transfer of interest to P. & L. A/c)			

Balance Sheet of Rajesh Limited as on 31st December 2008

Liabilities	₹	Assets	₹
Share Capital:		*Current Assets*	
190, 12% Preference Shares of Rs. 100 each fully paid	19,000	Cash at Bank	4,75,000
Share Premium	4,750	*Miscellaneous Expenditure*	
Secured Loans:		Discount on Issue of debentures	23,750
15% Debenture: 4,750 Debentures of Rs. 100 each	4,75,000		
Accrued Interest (Debenture-holders' Account)	75,000	Debit Balance of Profit and Loss Account	75,000
	5,73,750		5,73,750

Working Note: Calculation for number of preference shares given to Mr. Om:

Face value of debentures held by Om	₹ (250 ×100)	25,000
Less: 5% discount allowed		1,250
		23,750
Face value of preference share		100
+ premium 25%		25
Issue Price of 12% Preference Share		125
No. of shares given to Mr. Om = $\frac{23,750}{125}$		₹ 190
Face value of 12% shares 190 × 100 =		₹ 19,000
Premium 25% of face value		₹ 4,750

If the debenture-holders have a clear right, they can demand the conversion of unpaid interest into shares.

Notes

Illustration 4 (Redemption by Conversion of Shares at Premium and Discount)

Shobhit Limited redeemed, 5,000, 15% Debentures of ₹ 100 each, which were originally issued at a discount of 5%, by converting them into equity shares of ₹ 10 each. Pass the journal entries relating to redemption of debentures if (i) the new shares are issued at 25% premium, (ii) the new shares are issued at 5% discount (iii) the shares are issued at ₹ 9.50 paid up value.

Solution

Shobhit Limited
Journal

Date	Particulars		₹	₹
	15% Debentures Account	Dr.	5,00,000	
	To Discount on Issue of Debentures Account			25,000
	To Debenture-holders Account			4,75,000
	(Being the amount due to debenture-holders on redemption)			
	Debenture-holders Account	Dr.	4,75,000	
	To Equity Share Capital Account			3,80,000
	To Share Premium Account			95,000
	(Being the conversion of 5,000 debentures into share at premium)			
	15% Debenture A/c	Dr.	5,00,000	
	To Discount on Issue of Debentures Account			25,000
	To Debenture-holders Account			4,75,000
	(Being the amount due to debenture-holders on redemption)			
	Debenture-holders Account	Dr.	4,75,000	
	Discount on Issue of Shares Account	Dr.	25,000	
	To Equity Share Capital Account			5,00,000
	(Being redemption of 5,000 debentures by conversion into shares at discount)			
	15% Debentures Account	Dr.	5,00,000	
	To Discount on Issue of Debentures Account			25,000
	To Debenture-holders Account			4,75,000
	(Being amount due to debenture-holders on redemption)			
	Debenture-holders Account	Dr.	4,75,000	
	To Equity Share Capital Account			4,75,000
	(Being conversion of 5,000 debentures of ₹ 100 each in 50,000 equity shares of ₹ 10 each at ₹ 9.50 paid up)			

Did u know? Alternatively the company can take an insurance policy by paying regular premium, so that the policy matures coinciding with the time of redemption.

Self Assessment

State whether the following statements are true or false:

5. A company cannot purchase its own debenture.
6. Profit on sale of sinking fund investment is transferred to general reserve.
7. If a debenture is issued at a discount it cannot be redeemed at premium.
8. A company is bound to write off 'The Discount on Issue of Debentures' to profit and loss account.

Notes

9. Profit on cancellation of debentures is transferred to Debenture Redemption Fund A/c.
10. Own debentures cannot appear in the asset side of the balance sheet.

8.2.3 Redemption of Debentures Out of Profit

When a company wants to redeem its debenture out of profit, it would accumulate its divisible profits so that they maybe utilised for the redemption of debentures. For the redemption of debentures out of profit, an amount equal to that utilised for repayment of debenture-holders is transferred from the divisible profits to the D.R.R. account so that it may not be utilised for the distribution of dividend. These retained profits maybe used in the following two methods for the redemption of debentures.

(A) These accumulated profits can be retained in the business as a source of internal finance.

(B) These accumulated profits can be invested outside in the marketable securities or insurance policy.

Accounting treatment for first case: (when profit is retained in the business not invested outside):

1. When the amount of debentures becomes due to debenture-holders on redemption:

   Debentures Account Dr.

   Premium on Redemption of Debentures Account Dr. (if any)

   To Debenture-holders Account

2. When profits are transferred for redemption:

   Profit and Loss Account Dr.

   To Debenture Redemption Reserve Account.

3. When amount is paid to debenture-holders:

   Debenture-holders Account Dr.

   To Bank Account

4. After redemption of debentures the balance of D.R.R. is transferred to general reserve:

   Debenture Redemption Reserve Account Dr.

   To General Reserve Account.

Illustration 5 (Redemption Out of Profit)

Raj Shree Industries Limited issued 7,000; 12% Debentures of ₹ 100 each on 1st January 2003 at a discount of 10%, redeemable at a premium of 5% out of profits. Pass journal entries both at the time of issue and redemption of debentures if (a) the debentures are redeemable at the end of three years (b) the debentures are redeemable in three annual installments of 1,000, 2,000 and 2,000 debentures, assuming accounting year as a calendar year.

Notes

Solution:

Raj Shree Industries Limited
Journal

(a) When redemption is in lump-sum

Date	Particulars	L.F.	₹	₹
2003				
Jan. 1	Bank Account	Dr.	6,30,000	
	Loss on Issue of Debentures Account	Dr.	1,05,000	
	To 12% Debentures Account			7,00,000
	To Premium on Redemption of Debentures Account			35,000
	(Being issue of debentures at discount and redeemable at premium)			
2005				
Dec. 31	12% Debentures Account	Dr.	7,00,000	
	Premium on Redemption of Debentures Account	Dr.	35,000	
	To Debenture-holders Account			7,35,000
	(Being amount due to debenture-holders on redemption)			
	Profit and Loss Account	Dr.	7,00,000	
	To Debenture Redemption Reserve A/c			7,00,000
	(Being profit transferred from P. & L. account to DRR)			
	Debenture-holders Account	Dr.	7,35,000	
	To Bank Account			7,35,000
	(Being amount paid to debenture-holder)			
	Debenture Redemption Reserve Account	Dr.	7,00,000	
	To General Reserve Account			7,00,000
	(Being balance of DRR transferred to general reserve)			

(b) When redemption is in three annual instalments of 1000, 2,000 and 2,000 debentures.

Date	Particulars	L.F.	₹	₹
2003				
Jan. 1	Bank Account	Dr.	6,30,000	
	Loss on Issue of Debentures Account	Dr.	1,05,000	
	To 12% Debentures Account			7,00,000
	To Premium on Redemption of Debentures Account			35,000
	(Being issue of debentures at discount and redeemable at premium)			
Dec. 31	12% Debentures Account	Dr.	1,00,000	
	Premium on Redemption of Debentures Account	Dr.	5,000	
	To Debenture-holders Account			1,05,000
	(Being amount payable to debenture-holders on redemption)			
	Profit and Loss Account	Dr.	1,00,000	
	To Debenture Redemption Reserve Account			1,00,000
	(Being transfer of profits to debenture redemption reserve)			
	Debenture-holders Account	Dr.	1,05,000	
	To Bank Account			1,05,000
	(Being payment made to debenture-holders)			
2004				
Dec. 31	12% Debentures Account	Dr.	2,00,000	
	Premium on Redemption of Debentures Account	Dr.	10,000	
	To Debenture-holders Account			2,10,000
	(Being amount due to debenture-holders on redemption)			

Notes

	Profit and Loss Account	Dr.	2,00,000	
	To Debenture Redemption Reserve Account			2,00,000
	(Being transfer of profits to debenture redemption reserve)			
	Debenture-holders Account	Dr.	2,10,000	
	To Bank Account			2,10,000
	(Being payment made to debenture-holders)			
2005				
Dec. 31	12% Debentures Account	Dr.	2,00,000	
	Premium on Redemptions of Debentures Account	Dr.	10,000	
	To Debenture-holders Account			2,10,000
	(Being amount due to debenture-holder on redemption)			
	Profit & Loss Account	Dr.	2,00,000	
	To Debenture Redemption Reserve Account			2,00,000
	(Being transfer of profit to debenture redemption reserve)			
	Debenture-holders Account	Dr.	2,10,000	
	To Bank Account			2,10,000
	(Being payment made to debenture-holders)			
	Debenture Redemption Reserve Account	Dr.	7,00,000	
	To General Reserve Account			7,00,000
	(Being the balance of DRR transferred to general reserve)			

Accounting Treatment for Second Case: (when profits are invested outside in marketable securities or insurance policy)

Sinking Fund or Debenture Redemption Fund Method: A fund is created by a charge against profits of the company to redeem the debentures after a specified period. This fund is invested in some safe securities and the interest thereon is also invested. And at the end, when debentures are to be redeemed, all these investments are sold in order to enable the company to redeem the debentures without disturbing its working capital. Such a fund is called Debenture Redemption Reserve Fund/Sinking Fund Account or Cumulative S.F. Account. Here the word 'fund' indicates that the amount is invested in outside securities. The amount of annual instalment that is invested in safe securities every year by setting aside out of profits, is calculated with the help of Annuity Table or Sinking Fund Table. Sinking fund account is shown in the liability side of the balance sheet while the amount of sinking fund invested in safe securities (sinking fund investment) is shown in the assets side of the balance sheet. Sinking fund investment is the replacement of liquid assets, while sinking fund is the replacement of profits of the company.

Accounting treatment: Journal entries for making Sinking Fund/Debenture Redemption Reserve Fund for the redemption of debentures would be as under:

1. At the end of first year—

   (a) When a fixed instalment of amount is set aside from profits—

   Profit and Loss Appropriation Account Dr.

   To Debenture Redemption Fund Account.

   The fixed annual instalment is determined with the help of Annuity Table/Sinking Fund Table and total amount payable on redemption.

   (b) When the amount set aside from profits is invested in safe securities—

   Debenture Redemption Fund Investments Account Dr.

   To Bank Account

Notes

2. At the end of second and subsequent years, ascertaining last year in which redemption is to be made.

   (a) When amount of interest on Debenture Redemption Fund Investment made in the previous year is received—

   Bank Account Dr.

   To Interest on Debenture Redemption Fund Investment Account.

   (b) When the interest on Debenture Redemption Fund Investment is transferred to Debenture Redemption Fund Account—

   Interest on Debenture Redemption Fund Investment Account Dr.

   To Debenture Redemption Fund Account.

   For Entries (a) & (b); the following one combined entry can be passed:

   Bank Account Dr.

   To Debenture Redemption Fund Account.

   (c) When a fixed annual instalment is set aside from profits—

   Profit and Loss Appropriation Account Dr.

   To Debenture Redemption Fund Account.

   (d) When the amount set aside from profit is invested—

   Debenture Redemption Fund Investments Account Dr.

   To Bank Account

3. At the end of last year – (when the debentures are to be redeemed)

   (a) When the amount of interest on all previous debentures redemption reserve fund investments is received—

   Bank Account Dr.

   To Interest on Debenture Redemption Fund Investment Account.

   (b) When the interest on debenture redemption fund investments is transferred to debenture redemption fund account—

   Interest on Debenture Redemption Fund Investment Account Dr.

   To Debenture Redemption Fund Account

   (c) When a fixed annual instalment is set aside from profits—

   Profit and Loss Appropriation Account Dr.

   To Debenture Redemption Fund Account

   (d) When the proceeds from the sale of all investments at profit is received—

   Bank account Dr.

   To Debenture Redemption Fund Investment Account

   To Debenture Redemption Fund Account

   (profit on sale of investment)

Notes

Or

If investments are sold at a loss—

Bank Account Dr.

Debenture Redemption Fund Account Dr. (Loss on sale of investments)

To Debenture Redemption Fund Investments Account.

(e) When amount is due to debenture-holders for redemption—

Debentures Account Dr.

To Debenture-holders' Account

(f) When payment is made to debenture-holders—

Debenture-holders Account Dr

To Bank Account

(g) When the balance of Debenture Redemption Fund Account, after the redemption of all debentures, is transferred to General Reverse—

Debenture Redemption Fund Account Dr.

To General Reserve Account.

Some important points relating to debenture redemption fund for redemption of debentures:

1. If the debentures are redeemable at premium as per the terms of issue of debentures, total amount to be accumulated by the means of Debenture Redemption Fund must include the amount of premium payable on redemption.
2. Amount of profit to be set aside will be calculated as under:

   Amount of profit to be set aside = Amount of redeemable debentures × Present value of ₹ 1 for a given number including premium payable on redemption of years at a prescribed rate of interest.
3. Interest on investment will be calculated on the nominal value of investments not on the purchase price of investments.
4. In the last year no investment is made for another one year, because the redemption is to be made in this year.
5. If all the debentures have been repaid, the balance of Debenture Redemptions Fund should be transferred to General Reserve, because the purpose of its creation is solved by the redemption of debentures and its corresponding investments are also sold.
6. The profits on sale of investment and profit on cancellation of debentures are of capital nature. If these profits have been transferred to Debenture Redemption Fund, these should be transferred to capital reserve by the following journal entry:

   Debenture Redemption Fund Account Dr.

   To Capital Reserve Account

   and the balance should be transferred to general reserve.
7. If only some of the debentures are redeemed, only the face value of the debentures redeemed (plus any premium payable on redemption) should be transferred from Debenture Redemption Fund to General Reserve.

Notes

Illustration 6 (Debenture Redemption Fund Method)

A company issued 1,000 debentures of ₹ 100 each on 1st January, 2003 repayable after 3, years at par. It was decided to set up a Debenture Redemption Fund for the purpose of redeeming these debentures. Sinking Fund Table reveals that an amount of ₹ 0.317208 set aside every year and invested in 5% securities will yield ₹ 1 after three years.

On 31st December, 2005 the investments were sold for ₹ 60,000 and debentures were redeemed. Pass journal entries and necessary accounts.

[B. Com. Rohilkhand University 1994]

Solution:

Journal Entries

Date	Particulars	L.F.	₹	₹
2003				
Jan. 1	Bank Account	Dr.	1,00,000	
	To Debentures Account			1,00,000
	(Being issue of debentures at par redeemable at par)			
Dec. 31	Profit and Loss Appropriation Account	Dr.	31,721	
	To Debenture Redemption Fund Account			31,721
	(Being annual provision made for redemption)			
Dec. 31	Debenture Redemption Fund Investment Account	Dr.	31,721	
	To Bank Account			31,721
	(Being the amount of D.R.F. invested)			
2004				
Dec. 31	Bank Account	Dr.	1,586	
	To Interest on Debenture Redemption Fund Investment A/c			1,586
	(Being receipt of interest on investment)			
Dec. 31	Interests on Debenture Redemption Fund Investment A/c	Dr.	1,586	
	To Debenture Redemption Fund Account			1,586
	(Being interest transferred to D.R.F.)			
Dec. 31	Profit and Loss Appropriation Account	Dr.	31,721	
	To Debenture Redemption Fund Account			31,721
	(Being annual provision made for redemption)			
Dec. 31	Debenture Redemption Fund Investment Account	Dr.	33,307	
	To Bank Account			33,307
	(Being amount of debenture redemption fund invested)			
2005				
Dec. 31	Bank Account	Dr.	3,251	
	To Interest on Debenture Redemption Fund Investment A/c			3,251
	(Being receipt of Interest on investment)			
Dec. 31	Interest on Debenture Redemption Fund Investment	Dr.	3,251	
	To Debenture Redemption Fund Account			3,251
	(Being interest on investment transferred to debenture redemption fund account)			
	Profit and Loss Appropriation Account	Dr.	31,721	
" "	To Debenture Redemption Fund Account			31,721
	(Being annual provision made from profits)			
	Bank Account	Dr.	60,000	
" "	Debenture Redemption Fund Account	Dr.	5,028	
	To Debenture Redemption Fund Investment Account			65,028

Contd...

Notes

	To Debenture Redemption Fund Investment Account			65,028
	(Being investments sold for ₹ 60,000 at a loss of ₹ 6,614)			
"	" Debentures Account	Dr.	1,00,000	
	To debenture-holders' Account			1,00,000
	(Being amount due to debenture-holders on redemption)			
"	" Debenture-holders' Account	Dr.	1,00,000	
	To Bank Account			1,00,000
	(Being amount paid to debenture-holders on redemption)			
"	" Debenture Redemption Fund Account	Dr.	93,386	
	To General Reserve Account			93,386
	(Being the transfer of balance of DRF account to general reserve)			

Ledger Debenture Redemption Fund Account

Date	Particulars	₹	Date	Particulars	₹
2003			2003		
Dec. 31	To Balance c/d	31,721	Dec. 31	By P. & L. Appropriation Account	31,721
		31,721			31,721
2004			2004		
Dec. 31	To Balance c/d	65,028	Jan. 1	By Balance b/d	31,721
			Dec. 31	By P. & L. Appropriation Account	31,721
				By Interest on DRF Investment A/c	1,586
		65,028			65,028
2005			2005		
Dec. 31	To D.R.F. Investment A/c	5,028	Jan. 1	By balance b/d	65,028
Dec. 31	To General Reserve A/c	94,972	Dec. 31	By P. & L. Appropriation Account	31,721
				By Interest on DRF Investment A/c	3,251
		1,00,000			1,00,000

Debenture Redemption Fund Investment Account

Date	Particulars	₹	Date	Particulars	₹
2003			2003		
Dec. 31	To Bank Account	31,721	Dec. 31	By balance c/d	31,721
		31,721			31,721
2004			2004		
Jan. 1	To Balance b/d	31,721	Dec. 31	By balance c/d	65,028
Dec. 31	To Bank Account	33,307			
		65,028			65,028
2005			2005		
Jan. 1	To Balance b/d	65028	Dec. 31	By Bank Account	60,000
			Dec. 31	By DRF Account	5,028
		65,028			65,028

Debentures Account

2003		₹	2003		₹
Dec. 31	To Balance c/d	1,00,000	Jan.1	By Bank Account	1,00,000
		1,00,000			1,00,000
2004			2004		
Dec. 31	To Balance c/d	1,00,000	Jan. 1	By Balance b/d	1,00,000
		1,00,000			1,00,000
2005			2005		
Dec. 31	To Debenture-holders' Account	1,00,000	Jan. 1	By Balance b/d	1,00,000
		1,00,000			1,00,000

Notes

Interest on Debenture Redemption Fund Investment A/c

2004		₹	2004		₹
Dec. 31	To D.R.F. Account	1,586	Dec. 31	By Bank Account	1,586
		1,586			1,586
2005			2005		
Dec. 31	To D.R.F. Account	3,251	Dec. 31	By Bank Account	3,251
		3,251			3,251

Caution Every company has to create a Debenture Redemption Reserve (DRR) equivalent to 50% of the amount of debentures issue before commencement of redemption on 14.1.1987

Illustration 7 (Redemption of Debentures Out of Sinking Fund)

On 1st January, 2006 the following balances stood in the books of a company:

	₹
12% Mortgage Debenture	3,00,000
Debenture Redemption Fund	3,19,620
Debenture Redemption Fund Investments:	
₹ 1,05,000; 6% Haryana State Electricity Board Bonds	1,06,890
₹ 1,20,000; 8% U.P. Water Board Bonds	96,102
₹ 90,000; 6% Government of India Loan	92,565
₹ 24,000; 9% I.C.I.C.I. Bonds	24,063

On the same day investments were sold: Haryana State Electricity Board Bonds at par, 6% Government of India loan at ₹ 109, 8% U.P. Water Board Bonds at ₹ 91 and ICICI Bonds at ₹ 103. On the same day, debentures were redeemed at a premium of 5%.

Write up the accounts concerned (other than cash account) bring down the balances, if any, after the above transactions have been completed and stating how such balances should be dealt with the next balance sheet of the company.

Solution:

Debenture Redemption Fund Account

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Premium on Red. of		Jan. 1	By Balance b/d	3,19,620
	Debenture A/c	15,000			
	To General Reserve	3,04,620		By Debenture	
	To Capital Reserve	17,400		Redemption Fund Investment A/c	17,400
		3,37,020			3,37,020

Debenture-holders' Account

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Bank Account	3,15,000	Jan. 1	By 12% Mortgage Debenture Account	3,00,000
				By Premium on Redemption A/c	15,000
		3,15,000			3,15,000

12% Mortgage Debenture Account

Date			2006		₹
Jan. 1	To Debenture-holders A/c	3,00,000	Jan. 1	By Balance b/d	3,00,000
		3,00,000			3,00,000

Debenture Redemption Fund Investment Account

2006		₹	2006		₹
Jan. 1	To Balance b/d:		Jan.1	By Bank Account:	
	₹ 1,05,000 Electricity Bonds	1,06,890		₹ 1,05,000 Electricity Bonds	1,05,000
	₹ 1,20,000 UP Water Bonds	96,102		₹ 1,20,000 UP Bond @ ₹ 91	1,09,200
	₹ 90,000 G.O.I. Bonds	92,565		₹ 90,000 G.O.I. Bonds @ ₹ 109	98,100
	₹ 24,000 ICICI Bonds	24,063		₹ 24,000 ICICI Bonds @ ₹ 103	24,720
	By Debenture Redemption Fund A/c	17,400			
		3,37,020			3,37,020

Premium on Redemption of Debentures Account

2006		₹	2006		₹
Jan. 1	To Debenture-holders' A/c	15,000	Jan. 1	By Debenture Redemption Fund A/c	15,000
		15,000			15,000

Working Note:

1. In the next balance sheet 12% Mortgage Debentures and D.R.F. investment will not be shown and cash of ₹ 22,020 (3,37,020 – 3,15,000) will be shown.

2. Profit on sale of D.R.F. investment is a capital profit, therefore it is transferred to Capital Reserve.

Illustration 8 (Redemption by Sinking Fund and Calculation of Profits set aside)

Ram Chandran Company Limited issued 12,610. 12% Debentures of ₹ 100 each on 1st January 2003. They are paid at the end of three years. A sinking fund account is to be opened in the books of the company and every year on 31st December, a fixed amount is to be transferred to this account. The first investment was made on 31st December, 2003 at 5% per annum compound rate of interest. Prepare necessary account in the books of the company.

Solution:

The annually transferable amount from Profit and Loss Account to sinking fund will be calculated as follows:

	₹
In 2003 Investment of ₹ 1	1.000
In 2004 Balance of 2003	1.000
$1 \times \frac{5}{100}$	
+ Interest @ 5%	0.050
+ Investment of ₹ 1	1.000
	2.050
In 2005	
Balance of 2004	2.050
$\frac{2.05 \times 5}{100}$	
+ Interest @ 5%	0.1025

Notes

Investment of ₹ 1	1.0000
	3.1525

₹ 1 appropriated every year for three years will be accumulated ₹ 3.1525.

Total amount required for redemption of debentures ₹ 12,61,000

$$\text{Amount of each instalment} = \frac{12,61,000}{3.1525} = ₹\ 4,00,000$$

Sinking Fund Account

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To Balance c/d	4,00,000	Dec. 31	By Profit & Loss Application Account	4,00,000
		4,00,000			4,00,000
2004			2004		
Dec. 31	To Balance c/d	8,20,000	Jan. 1	By Balance b/d	4,00,000
			Dec. 31	By Interest on S.F. Investment A/c	20,000
			Dec. 31	By Profit and Loss Appropriation A/c	4,00,000
		8,20,000			8,20,000
2005			2005		
Dec. 31	To General Reserve Account	12,61,000	Jan. 1	By Balance b/d	8,20,000
			Dec. 31	By Interest on S.F. Investment A/c	41,000
			Dec. 31	By Profit and Loss Appropriation A/c	4,00,000
		12,61,000			12,61,000

Sinking Fund Investment Account

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To Bank Account	4,00,000	Dec. 31	By Balance c/d	4,00,000
		4,00,000			4,00,000
2004			2004		
Jan. 1	To Balance b/d	4,00,000	Dec. 31	By Balance c/d	8,20,000
Dec. 31	To Bank account	4,20,000			
		8,20,000			8,20,000
2005			2005		
Jan.1	To Balance b/d	8,20,000	Dec. 31	By Bank Account	8,20,000
		8,20,000			8,20,000

12% Debenture Account

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To Balance c/d	12,61,000	Jan. 1	By Bank Account	12,61,000
		12,61,000			12,61,000
2004			2004		
Dec. 31	To Balance c/d	12,61,000	Jan. 1	By Balance b/d	12,61,000
		12,61,000			12,61,000
2005			2005		
Dec. 31	To Debenture-holders account	12,61,000	Jan. 1	By Balance b/d	12,61,000
		12,61,000			12,61,000

8.2.4 Non-cumulative Sinking Fund

In a non-cumulative sinking fund, interest received on debenture redemption fund investment is neither transferred to a sinking fund nor is invested in the marketable securities. In its place,

Notes

this interest is directly transferred to profit and loss account, being treated as interest earned on general investments. In this case annual appropriation from profits will be more because interest on investments in not reinvested.

Accounting Treatment: In the case of non-cumulative sinking fund, the following entries are passed in the books of the company:

1. At the end of first year:
   (a) When annual provision is made-
   Profit and Loss Appropriation Account Dr.
   To Debenture Redemption Fund Account
   (b) When amount of sinking fund is invested—
   Debenture Redemption Fund Investment Account Dr.
   To Bank Account.
2. At end of second year and subsequent years except the last year:
   (a) When interest on investment is received—
   Bank Account Dr.
   To Interest on Debenture Redemption Fund Investment A/c
   (b) When interest on investment is transferred to profit and loss account—
   Interest on Debenture Redemption Fund Investment Account Dr.
   To Profit and Loss Account
   (c) When annual provision is made—
   Profit and Loss Account Dr.
   To Debenture Redemption Fund Account
   (d) When amount of annual installment of profit is invested—
   Debenture Redemption Fund Investment Account Dr.
   To Bank Account
3. At the end of last year:

All the same entries will be passed which were in the case of cumulative sinking fund.

Illustration 9 (Redemption by Non-Sinking Fund)

Good Fortune Ltd. issued 30,000, 8% Debentures of ₹ 100 each at a discount of on 1st January, 2003. As per term of issue, the company is required to maintain a non-cumulative sinking fund but with a provision that the company shall have the power to apply the sinking fund investments in the purchase of debentures in the open market, if below par at any time. The annual sinking fund contribution is ₹ 72,000. The followings are the relevant facts for the years 2004 & 2005:

A. Interest received by the company on investments:
   (i) 2004 ₹ 2,364
   (ii) 2005 ₹ 3,648
B. Realisation of sinking fund investments:
   (i) 31st Dec. 2004 ₹ 33,516 (original cost ₹ 33,612)
   (ii) 31st Dec., 2005 ₹ 46,800 (original cost ₹ 46,440)

Notes

C. Debentures purchased in open market:

(i) 31st December 2004 at the cost of ₹ 33,498 (paid up value ₹ 35,178)

(ii) 31st December 2005 at the cost of ₹ 46,800 (paid up value ₹ 46,980). You are required to prepare the necessary ledger accounts for two years.

[Adapted from C.A. (final) May 1973]

Solution:

Good Fortune Limited
Sinking Fund Account

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To Balance c/d	72,000	Dec. 31	By Profit and Loss Appropriation A/c	72,000
		72,000			72,000
2004			2004		
Dec. 31	To General Reserve A/c	35,178			
	To Balance c/d	1,08,822	Jan. 1	By Balance b/d	72,000
			Dec. 31	By P. & L. Appropriation A/c	72,000
		1,44,000			1,44,000
2005			2005		
Dec. 31	To General Reserve A/c	46,980	Jan.1	By Balance b/d	1,08,822
Dec. 31	To Balance c/d	1,33,842	Dec. 31	By Profit and Loss Appropriation A/c	72,000
		1,80,822			1,80,822

Sinking Fund Investments Account

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To Bank Account	72,000	Dec. 31	By Balance c/d	72,000
		72,000			72,000
2004			2004		
Jan. 1	To Balance b/d	72,000	Dec. 31	By Bank A/c	33,516
Dec. 31	To Bank A/c	72,000	Dec. 31	By Profit and Loss A/c	
				(33,516 – 33,612)	96
				By Balance c/d	1,10,388
		1,44,000			1,44,000
2005			2005		
Jan.1	To Balance b/d	1,10,388	Dec. 31	By Bank Account	46,800
Dec. 31	To Bank Account	72,000	Dec. 31	By Balance c/d	1,35,948
Dec. 31	To Capital Reserve	360			
		1,82,748			1,82,748

8% Debentures Account

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To Balance c/d	30,00,000	Jan. 1	By Bank Account	30,00,000
2004			2004		
Dec. 31	To Bank A/c	33,498	Jan. 1	By Balance b/d	30,00,000
Dec. 31	To Capital Reserve A/c	1,680			
Dec. 31	To Balance c/d	29,64,822			
		30,00,000			30,00,000
2005			2005		
Dec. 31	To Bank Account	46,800	Jan. 1	By Balance b/d	29,64,822
	To Capital Reserve	180			
	To Balance c/d	29,17,842			
		29,64,822			29,64,822

Profit and Loss Account (2004)

To Sinking Fund Investments A/c (loss)	96	By Interest on Sinking Fund Investments	2,364

Profit and Loss Account (2005)

		By Interest on Sinking Fund Investments	3,648

8.3 Insurance Policy Method

In this method too, a part of profit is set aside and is transferred to the Debenture Redemption Fund Account. Like the method of sinking fund, appropriated profits are not invested in safe or marketable securities. Instead, an insurance policy is taken by the company to get the money for redemption of debentures after a specified period of time. The premium of this insurance policy equals to profit set aside annually. At the time of redemption of debentures or on the date of maturity of policy, the amount is received from insurance company and from this amount debentures are redeemed. The period of insurance policy will be equal to the period of issue of debentures. The main differences between Sinking Fund Method and Insurance Policy Method are as below:

1. In sinking fund method profits are invested at the end of the year while premium is paid in the beginning of the year in the case of insurance policy method.
2. In last year no investment is made in sinking fund method, while in the insurance policy method, the amount of premium is paid in the beginning of the last year.
3. When money is invested in marketable securities in sinking fund method, there will be no certainty about the amount to be received from the sale of securities, due to market fluctuations. In the case of insurance policy method, there is certainty about the receipt of a fixed sum at maturity.

Notes At the time of redemption of debentures or on the date of maturity of policy, the amount is received from insurance company and from this amount debentures are redeemed.

4. Annual interest on investment is received in the case of sinking fund method, while no such annual income is received in the case of insurance policy method. But many accountants like to record the amount of interest every year which is based on expected rate of interest and they pass the following journal entry:

   Debenture Redemption Fund Policy Account Dr.

   To Debenture Redemption Fund Account

Accounting treatment: The following entries are passed in the insurance policy method—

(a) For all years (including last year) following entries are passed:

(i) When the amount of premium is paid—

Debenture Redemption Fund Policy Account Dr.

To Bank Account

(ii) When profit is set aside at the end of the year—

Profit and Loss Appropriation Account Dr.

To Debenture Redemption Fund Account

Notes

(b) In the last year, in addition to the above two entries, the following entries will also be passed-

(i) When amount is realized from insurance policy on its maturity—

Bank Account Dr.

To Debenture Redemption Fund Policy Account

(ii) When the profit on policy (difference of total instalment paid and amount received on maturity of policy) is transferred to debenture redemption fund—

Debenture Redemption Fund Policy Account Dr.

To Debenture Redemption Fund Account.

Alternatively, in the place of above (i) and (ii) entries, the following single combined entry can be passed—

Bank Account Dr.

To Debenture Redemption Fund Account

(iii) When amount is due to debenture-holders at premium—

Debenture Account Dr.

Premium on Redemption of Debenture Account Dr.

To Debenture-holders' Account.

(iv) When the premium payable on redemption of debentures is transferred to debenture redemption fund account—

Debenture Redemption Fund Account Dr.

To Premium on Redemption of Debentures Account

(v) When payment is made to debenture-holders—

Debenture-holders' Account Dr.

To Bank Account

(vi) When after the redemption of debenture, the balance of debenture redemption fund is transferred to general reserve.

Debenture Redemption Fund Account Dr.

To General Reserve Account.

Did u know? In sinking fund method profits are invested at the end of the year while premium is paid in the beginning of the year in the case of insurance policy method.

Illustration 10 (Redemption by Insurance Policy Method)

Nimish Limited issued 2,100; 12% Debentures of ₹ 100 each at par on 1st January 2003, repayable at par after three years on 31st December 2005. It was decided to take over an insurance policy for ₹ 2,10,000 to provide the necessary cash for redemption of debentures. The annual premium of the policy was ₹ 65,000.

Prepare the necessary accounts in the books of Nimish Limited relating to issue and redemption of debentures.

Notes

Solution:

Debenture Redemption Fund Account

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To Balance c/d	65,000	Dec. 31	By Profit and Loss Appropriation A/c	65,000
		65,000			65,000
2004			2004		
Dec. 31	To Balance c/d	1,30,000	Jan.1	By Balance b/d	65,000
			Dec. 31	By Profit and Loss Appropriation A/c	65,000
		1,30,000			1,30,000
2005			2005		
Dec. 31	To Bank Account	2,10,000	Jan. 1	By Balance b/d	1,30,000
			Dec. 31	By Profit and Loss Appropriation A/c	65,000
			Dec. 31	By Debenture Redemption Fund Policy Account	15,000
		2,10,000			2,10,000

Debenture Redemption Fund Policy Account

Date	Particulars	₹	Date	Particulars	₹
Jan.1	To Bank Account	65,000	Dec. 31	By Balance c/d	65,000
		65,000			65,000
2004			2004		
Jan.1	To Balance b/d	65,000	Dec. 31	By Balance c/d	1,30,000
Jan. 1	To Bank account	65,000			
					1,30,000
					1,30,000
2005			2005		
Jan. 1	To Balance b/d	1,30,000	Dec. 31	By Bank Account	2,10,000
Jan. 1	To Bank Account	65,000			
Dec. 31	By Debenture R. Fund A/c	15,000			
		2,10,000			2,10,000

12% Debentures Account

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance c/d	2,10,000	Jan. 1	To Bank Account	2,10,000
		2,10,000			2,10,000
2004			2004		
Dec. 31	To Balance c/d	210,000	Jan. 1	By Balance b/d	2,10,000
		2,10,000			2,10,000
2005			2005		
Dec. 31	To Bank Account	2,10,000	Jan.1	By Balance b/d	2,10,000
		2,10,000			2,10,000

Illustration 11 (Redemption by Insurance Policy with Interest)

Manish Mills Limited issued on 1st January, 2003 ₹ 15,00,000, 12% Debentures which are to be redeemed at the end of three years. For the redemption of 12% Debentures the company took an insurance policy on which annual premium of ₹ 4,71,160.72 is paid. The rate of interest may be estimated 3% per annum. Show Debenture Redemption Fund Account and Debenture Redemption Policy Account for 3 years in the books of the company.

Notes

Solution:

Manish Mills Limited
Debenture Redemption Fund Account

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To Balance c/d	4,85,295.52	Dec. 31	By Profit and Loss Appropriation account	4,71,160.72
			Dec. 31	By Debenture Redemption Policy Account	14,134.80
		4,85,295.52			4,85,295.52
2004			2004		
Dec. 31	To Balance c/d	9,85,149.93	Jan. 1	By Balance b/d	485,295.52
			Dec. 31	By Profit and Loss Appropriation A/c	4,71,160.72
			Dec. 31	By Debenture Redemption A/c (interest)	28,693.69
		9,85,149.93			9,85,149.93
2005			2005		
Dec. 31	To General Reserve Account	15,00,000	Jan. 1	By Balance b/d	9,85,149.93
			Dec. 31	By Profit and Loss Appropriation A/c	4,71,160.72
			Dec. 31	By Debenture Redemption Policy Account (interest)	43,689.35
		15,00,000			15,00,000

Debenture Redemption Policy Account

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Bank Account	4,71,160.72	Dec. 31	By Balance c/d	4,85,295.52
Dec. 31	To Debenture Redemption Fund Account (interest)	14,134.80			
		4,85,295.52			4,85,295.52
2004			2004		
Jan. 1	To Balance b/d	4,85,295.52	Dec. 31	By Balance c/d	9,85,149.93
Jan. 1	To Bank Account	4,71,160.72			
Dec. 31	To Debenture Redemption Fund Account (interest)	28,693.69			
		9,85,149.93			9,85,149.93
2005			2005		
Jan. 1	To Balance b/d	9,85,149.93	Dec. 31	By Bank Account	15,00,000
Jan. 1	To Bank Account	4,71,160.72			
Dec. 31	To Debenture Redemption Fund Account (Int.)	43,689.35			
		15,00,000			15,00,000

Caution At the time of redemption of debentures or on the date of maturity of policy, the amount is received from insurance company and from this amount debentures are redeemed.

Self Assessment

Notes

Fill in the blanks:

11. Profit on cancellation of debentures is transferred to .... account.
12. ……………….. is maintained for the redemption of debentures.
13. Debentures cannot be ……………….. by a company.
14. Loss on issue of debentures is a …………… loss for the company.
15. Profit on cancellation of debentures is transferred to:
    (a) Profit and Loss Account
    (b) Sinking Fund Account
    (c) Capital Reserve

8.4 Summary

- Redemption of debentures means repayment of the amount of debentures to the debenture holders or discharge of the liability on account of debentures.
- Debentures are normally redeemed at the expiry of the period for which they were originally issued. But the company may also, if so authorized by the articles of association and the terms of issue as stated in the prospectus, redeem the debentures before the expiry of the fixed period either by instalments or by purchasing them in the open market.
- Unlike shares, a company can purchase its own debentures without any conditions and then cancel them or even sell them again.
- The question of provisioning was earlier left to the discretion of company and many companies did provisioning routinely, as a matter of financial prudence.
- Now under the SEBI guidelines, the matter is no more a matter of discretion or financial prudence. SEBI guidelines provide for compulsory provisioning and also restrictions on the payment of dividends till debentures are redeemed.
- We will first deal with SEBI guidelines before proceeding with the accounting aspects of creating sinking fund for redemption of debentures.

8.5 Keywords

Redemption of Debentures: It means repayment of the amount of debentures to debenture-holders or the discharge of the liability of debentures.

Redemption of Debentures by Conversion: When a company redeems its debentures by converting them into a new class of shares or debentures, this method is called redemption of debentures by conversion.

8.6 Review Questions

1. Explain the following:
    (a) Redemption of Debentures out of Capital.
    (b) Redemption of Debentures out of Profit.

Notes

2. How are debentures redeemed? What is a sinking fund? How and why is sinking fund account prepared?

Practical Questions

3. (a) Zeba Hussain Company Limited issued 20,000; 10% Debentures of ₹ 100 each to a discount of 10% but redeemable at a discount of 5% at the end of 5 years. Give the necessary journal entries both at the time of issue and redemption of the debentures.

   (b) Akram Ltd. issued 3,000; 10% Debentures of ₹ 100 each on 1st Jan., 1990 at a discount of 10%. Redeemable at a premium of 10% in equal annual drawings in 4 years. Give journal entries both at the time of issue and redemption of debentures.

4. Ankit Mills Limited issued 12% Debentures for ₹ 50,000 on 1st January. 2002, redeemable at the end of the third year from the date of their issue. It was decided to make provision for the redemption of debentures by means of a three-year insurance policy purchased on 1st January, 2002 for an annual premium of ₹ 16,000. Pass journal entries and prepare the necessary ledger accounts to record these transactions relating to debentures in the books of Ankit Mills Limited, on the assumption that accounting year of the company ends 31st December.

Ans: Transfer from insurance policy account to debenture redemption fund account is ₹ 2,000

5. On 31st December, 2002, the following balances stood in the books of the company:

	₹
10% Mortgage Debenture Stock	3,00,000
Debenture Redemption Fund	3,19,620
Debenture Redemption Fund Investment at cost:	
₹ 1,20,000; 8% Government Loan	1,06,890
₹ 120,000; 7% Conversion Stock	96,102
₹ 90,000; 10% Corporate Stock	92,565
₹ 30,000; 8% Funding Loan	24,063

On the same day the investments were sold: Government Loan at par, Conversion Stock at 91, and Corporation Stock at 99 and Funding Loan at 93. On the following day, the debentures were redeemed at a premium of 5%.

Write up the accounts concerned, other than cash book, after the above transactions have been completed.

Ans: Transfer to General Reserve ₹ 3, 04,620.

Transfer to Capital Reserve ₹ 26,580.

Answers: Self Assessment

1.	Difficulty	2.	Debentures
3.	Maturity	4.	Debenture
5.	false	6.	false
7.	false	8.	true
9.	true	10.	false

Notes

11. Capital Reserve
12. D.R.R.
13. Forfeited
14. Capital
15. (c)

8.7 Further Readings

Books

Magazines and Journals

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Case Study

Buyback of Shares by MNCs in India

The Buyback Option

In October 2000, Royal Philips Electronics of Netherlands (Philips), the Dutch parent of Philips India Limited, announced its first offer to buyback the shares of its Indian subsidiary.

The open offer was initially made for 23% of the outstanding shares held by institutional investors, private bodies and the general public. The offer was made at ₹ 105, a premium of 46% over the then prevailing stock market price. With this, Philips became one of the first multinational companies (MNCs) in India to offer buyback option to its shareholders. Soon after, the buyback option was offered by several multinational companies (MNCs) to increase their stake in their Indian ventures. Some of these companies were Cadbury India, Otis Elevators, Carrier Aircon, Reckitt Benkiser etc. Fund managers which held these companies' stocks felt that allowing buyback of shares was one of most favorable developments in the Indian stock markets.

It provided a much needed exit option for shareholders in depressed market conditions. Buyback by the company usually indicated that the management felt that its stock was undervalued.

Contd...

Notes

This resulted in an increase in the price, bringing it closer to the intrinsic value and providing investors with a higher price for their investment in the company. However, critics of the buyback option claimed that large multinationals had utilized the buyback option to repurchase the entire floating stock from the market with the objective of delisting from the stock exchange and eliminating an investment opportunity for investors. Moreover, most MNCs that offered buyback option reported a steep decline in the trading volumes of the shares of their Indian ventures. The declining liquidity of these shares prompted critics to say that the Government of India's attempt to revive capital markets by allowing buyback of shares had failed.

The Buyback Act

The buyback ordinance was introduced by the Government of India (GOI) on October 31, 1998. The major objective of the buyback ordinance was to revive the capital markets and protect companies from hostile takeover bids.

The buy back of shares was governed by the Securities and Exchange Board of India's (SEBI) Buy Back of Securities Regulations, 1998, and Securities and Exchange Board of India's (SEBI) Substantial Acquisition of Shares and Takeover Regulations, 1997. The ordinance was issued along with a set of conditions intended to prevent its misuse by companies and protect the interests of investors. According to guidelines issued under SEBI's Buy Back of Securities Regulations, 1998, a company could buyback its shares from existing shareholders on a proportionate basis:

- From the open market, through the book building process or the stock exchange.
- From odd lot holders.

The ordinance allowed companies to buy back shares to the extent of 25 per cent of their paid up capital and free reserves in a financial year.

The buyback had to be financed only out of the company's free reserves, securities premium account, or proceeds of any earlier issue specifically made with the purpose of buying back shares. The ordinance also prevented a company that had defaulted in the repayment of deposits, redemption of debentures or preference shares, and repayment to financial institutions from buying back its shares. Moreover, a company was not allowed to buy back its shares from any person through a negotiated deal, whether through a stock exchange, spot transactions, or any private arrangement. It also allowed the promoters of a company to make an open offer (similar to an acquisition of shares) to purchase the shares of its subsidiary...

Buyback Offer By MNCs

In the financial year 2001-2002, twenty MNCs made buyback offers. Some of the well-known MNCs which offered to buy back their shares were Philips India Limited (Philips), Cadbury India Limited (Cadbury), Britannia Industries Limited (Britannia), Carrier Aircon (Carrier) and Otis Elevators (Otis).

All these companies made open offers for the non-promoter shareholding in their Indian subsidiaries. To buy back shares, Cadbury paid ₹ 9 billion, Philips ₹ 2 billion, and Carrier, Otis and Reckitt Benkiser all paid over ₹ 1 billion. According to analysts, the increased buyback activity by MNCs was due to three reasons. They felt that the share prices of most MNCs were under priced and did not reflect the true value of the company. Moreover, the buyback of shares allowed MNCs to convert their Indian ventures into wholly owned subsidiaries (WOS). It also allowed them to delist the shares of these ventures from the stock markets and thus protect them from the volatility of the stock markets (caused by scams and other market manipulations)...

Contd...

Investor Grievances

Analysts felt that the buyback option may be misused by MNCs to increase their equity stakes in their Indian ventures, escape public scrutiny and accountability and prevent them from the Indian regulatory environment.

Moreover, the option to convert their Indian ventures into wholly owned subsidiaries and delist their shares from the stock markets provided MNCs with complete control over their Indian ventures, allowed them to repatriate profits and make more independent investment decisions.

A section of investors felt that government regulations must have provided them with a choice.

However, minority shareholders claimed that they had no option and were forced to sell their shares once MNCs bought back shares from the majority shareholders...

Buy or Not to Buyback?

The dilemma that faced small investors in India was whether the buyback option, along with the SEBI guidelines, actually protected their interests and offered them an exit option at a fair price or was it a tool that provided them with no options allowing large MNCs to gain complete control of their subsidiaries.

Investors felt that the regulations framed by SEBI did not have provisions for preventing good stocks from delisting. Moreover, the buyback price, which was determined using the parameters specified in the SEBI Takeover Code, did not consider the future potential of the stock.

They felt that SEBI should have looked at various financial parameters such as future cash flows, value of brands and the value of fixed assets to determine a pricing formula for open offers which ensured that investors who had been holding the stock for several years received a fair price for their investment.

Source: http://www.icmrindia.org/casestudies/catalogue/Finance/Buyback%20of%20Shares%20by%20MNCs%20in%20 India%20-%20Finance.htm

Notes

Unit 9: Methods of Redemption-II

CONTENTS

Objectives

After studying this unit, you should be able to:

- Know redemption by purchase of debentures in open market
- Explain interest on own debentures
- Understand Cum-interest and Ex-interest Quotations

Introduction

The amount required for the redemption of debentures is usually large and as such unless adequate provision is made, the company may not have sufficient funds to repay the debentures at their maturity date.

From the legal point of view, there are no restrictions on the sources of funds for redeeming debentures – even assets can be sold for the purpose. However, in order to accumulate funds for redeeming the debentures, prudent companies try to retain sufficient profits. In this case, it is said that the debentures are redeemed out of the profits and of course, new shares or debentures may also be issued for carrying out the redemption.

It is therefore necessary to make adequate provisions for additional funds required for the redemption of debentures. For this purpose, a company may adopt any of the following methods:

(a) ***Raise fresh capital:*** A company may issue new shares or debentures and the proceeds of fresh issue of share capital and/or debentures may be utilized for redeeming the debentures.

(b) ***Utilise profits:*** A part of the profits of the company may be withheld from distribution to the shareholders and are utilized for the purpose of redemption of debentures.

(c) ***Sale of assets:*** A company may also utilize the sale proceeds of the fixed assets for redeeming the debentures

(d) ***Surplus funds:*** Apart from the above, a company may also use its surplus profits for the redemption of debentures.

Notes

Notes It is said that the debentures are redeemed out of the profits and of course, new shares or debentures may also be issued for carrying out the redemption.

9.1 Redemption by Purchase of Debentures in the Open Market

If the Articles of Association of a company empowers the directors, they can purchase the company's own debentures from the open market. Such an act of purchase of debentures can be for the following any one of the objectives:

1. Immediate cancellation of these debentures.
2. When debentures are purchased for investment, these are called own debentures and appear in the assets side until they are cancelled.

   A company purchased its own debentures from open market not only for cancellation but also for the following savings:

   (i) When debentures are purchased from the open market at a discount, it enables the company to save the money equal to the amount of discount, which could have been required to be paid by the company in case the debentures are redeemed in general.

   (ii) If the debentures are redeemable at premium and the company purchases its own debenture from the open market, it saves that amount equal to the premium which would have been payable on debentures in the ordinary course of redemption.

   (iii) Interest burden also reduces if own debenture are purchased from the open market.

Did u know? When debentures are purchased from the open market at a discount, it enables the company to save the money equal to the amount of discount, which could have been required to be paid by the company in case the debentures are redeemed in general.

Accounting treatment: When the debentures are purchased from the open market, the following entries are required to be passed.

A. When debentures are purchased for immediate cancellation, there can be two cases:

   1. If sinking fund is not maintained in the books:

      (i) when debentures are purchased for immediate cancellation—

      Debentures Account Dr.

      To Bank Account

      (ii) If there is any profit or loss on cancellation (due to difference in market price of debentures and nominal value of debentures) of debentures, that will be the capital reserve account because its nature is that of a capital item and its treatment will be as below:

         (a) when profit on cancellation of debentures is transferred to capital reserve—

         Profit on Redemption of Debentures Account Dr.

         To Capital Reserve Account

Notes

(b) when loss on cancellation of debentures is written off against capital reserve—

Capital Reserve Account Dr.

To Loss on Redemption of Debentures Account.

(iii) When debentures are purchased and cancelled, an amount equal to the nominal value of debentures cancelled is transferred from the divisible profits to general reserve account. For this, the journal entry will be:

Profit and Loss Account Dr.

To General Reserve Account

2. If a sinking fund is maintained in the books—

(i) When sinking fund investments are sold for the purchase of debentures:

Bank Account Dr.

To Sinking Fund Investment Account

Profit or loss on the sale of sinking fund investments will be transferred to the sinking fund.

(ii) When debentures are purchased for cancellation.

Debentures Account Dr.

To Bank Account

If there is any profit or loss on the cancellation of debentures, the same will be transferred to sinking fund account.

(iii) When debentures are purchased and cancelled, an equal amount to the nominal value of debentures is transferred to general reserve from the sinking fund account. For this, the entry will be:

Sinking Fund Account Dr.

To General Reserve Account

B. When debentures are purchased as investment:

1. If the sinking does not exist in the books and debentures are purchased as investment—

Own Debentures Account Dr. (value paid)

To Bank Account

2. If a sinking fund account is maintained in the books, the first sinking fund investment will be sold—

Bank Account Dr.

To Sinking Fund Investments Account.

If there is any profit or loss on the sale of sinking fund investment, the same will be transferred to the sinking fund.

3. When own debentures are cancelled—

Debentures Account Dr. (nominal value)

Loss on Redemption of Debentures Account	Dr.	(any loss)	
To Own Debentures Account		(Book value of debentures to be cancelled)	
To Profit on Redemption of Debentures Account		(any profit)	

If there is any loss or profit on redemption of debentures, that will be transferred to sinking fund account. An amount equal to the nominal value of debentures cancelled will be transferred from the divisible profit to the general reserve in case of no sinking fund is maintained. And in case sinking fund is maintained, this transfer will be from the sinking fund to the general reserve.

Illustration 1 (Redemption of Debentures by Purchase from Open Market)

On 1st January, 2004 Surjeet Company Limited made an issue of 5,000; 12% Debentures of ₹ 500 each at 5% discount. The terms of issue provided for the redemption of ₹ 50,000 debentures every year commencing from the end of 2005, either by purchase or by drawings at par at the company's discretion. ₹ 25,000 was also written off the debenture discount account in each of the years, 2004 and 2005.

On 31st December 2005 the company purchased for cancellation, debentures of the face value of ₹ 20,000 at ₹ 450 per debenture and of ₹ 38,000 at ₹ 400 per debenture, the brokerage being 2%.

Journalize the above transactions and show how the profit on redemption would be treated, ignoring the interest on debentures.

Solution:

Journal

Date	Particulars	L.F.	₹	₹
2004				
Jan. 1	Bank Account	Dr.	23,75,000	
	Discount on Issue of Debentures A/c	Dr.	1,25,000	
	To 12% Debentures Account			25,00,000
	(Being issue of 12% debentures at discount)			
Dec. 31	Profit and Loss account	Dr.	25,000	
	To Discount on Issue of Debentures Account			25,000
	(Being discount on debentures written off from P & L account)			
2005				
Dec. 31	12% Debentures Account	Dr.	20,000	
	To Bank Account			18,000
	To Profit on Redemption of Debentures Account			2,000
	(Being cancellation of 40 debentures by purchasing them @ ₹ 450 per debenture)			
	Profit on Redemption of Debenture Account	Dr.	2,000	
	To Capital Reserve Account			2,000
	(Being profit on redemption of debentures transferred to capital reserve account)			
	12% Debentures Account	Dr.	30,000	
	To Bank Account			24,000
	To Profit on Redemption of Debentures Account			6,000
	(Being cancellation of 60 debentures)			
	Profit on Redemption of Debenture Account	Dr.	6,000	
	To Capital Reserve Account			6,000
	(Being transfer of profit on cancellation of debentures)			

Contd...

Notes

Own Debentures Account	Dr.	8,000	
To Bank Account			8,000
(Being own debenture purchased as own debentures (38,000 – 30,000)			
Profit & Loss Account	Dr.	50,000	
To General Reserve Account			50,000
(An equal amount to nominal value of debentures redeemed transferred to general reserve)			
Profit and Loss Account	Dr.	20,000	
To Discount on Issue of Debentures Account			20,000
(Being discount on issue of debentures written off against profits)			

Illustration 2 (Redemption by Purchase of Debentures from Open Market)

The following information are available in the balance sheet of Sumeet Company Limited on 31st December, 2005:

(a) 15% Debentures of ₹ 100 each ₹ 14,00,000

(b) Debenture Redemption fund 59,50,000

(c) Debenture Redemption Fund Investment represented by ₹ 1,40,000 own debentures purchased at ₹ 98 each and the remaining amount by ₹ 4,90,000; 10% Government of India loan.

On the above date the directors redeemed all the debentures. For this purpose they realised 10% Government of India loan at par. They realized ₹ 2, 10,000 for redemption out of current year's profits. Pass journal entries in the books of the company.

Solution:

Journal Entries

Date	Particulars	L.F.	₹	₹
Dec. 31	Bank Account	Dr.	4,90,000	
	To Debenture Redemption Fund Investment Account			4,57,800
	To Debenture Redemption Fund Account			32,200
	(Being sale of DRF investment for redemption of debentures)			
	Profit and Loss Account	Dr.	2,10,000	
	To Debenture Redemption Fund A/c			2,10,000
	(An amount transferred from profits to D.R. fund account)			
	15% Debenture Account	Dr.	12,60,000	
	To Bank Account			12,60,000
	(Being redemption made)			
	15% Debentures Account	Dr.	1,40,000	
	To Own Debentures Account			1,37,200
	To Debenture Redemption Fund Account			2,800
	(Being cancellation of own debentures and profit thereon transferred to D.R.F.)			
	Debenture Redemption Fund Account	Dr.	8,40,000	
	To Capital Reserve Account			35,000
	To General Reserve Account			8,05,000
	(Being profit on sale of investment and profit on cancellation of debentures transferred to capital reserve and balance to general reserve account)			

Notes

Working Note:

1.	Profit on sale of investments	₹
	Total amount for D.R.F. Investment	5,95,000
	– Amount invested to purchase own debentures	1,37,200
	Amount invested in 10% Government of India loan	4,57,800
	Sale of 10% Government of India loan at par	4,90,000
	– Cost price of investments	4,57,800
	Profit on sale of investment	32,200
2.	Opening balance of Debenture Redemption Fund	5,95,000
	Add: Profit on sale of investments	32,200
	Add: Profit on cancellation of own debentures	2,800
	Add: Transfer from P & L account	2,10,000
		8,40,000
	Less: Transfer to capital reserve (profit on sale of investment + profit on cancellation of own debentures)	35,000
	Balance transferred to general reserve	8,05,000

Illustration 3 (Redemption by Cancellation of Own Debentures)

On 1st January, 2005, Shiwalik Breweries Limited had ₹ 8, 00,000; 5% debentures outstanding in its books, redeemable on 31st December, 2005.

On 1st January, 2005, the balance of sinking fund was ₹ 7, 49,000 represented by:

(i) ₹ 1, 00,000 own debentures purchased at an average price of ₹ 99 and

(ii) ₹ 6, 60,000 nominal value of 3% war loan.

The amount annually credited to the sinking fund was ₹ 28,400.

The interest on the debentures was paid by the company every year on 31st December and the interest on war loan was received also on 31st December annually.

On 31st December, 2005, the outside investments were realized at 98 per cent and all the outstanding debentures were redeemed on that date.

You are required to write up the necessary ledger accounts for the year 2005 in the books of the company.

Solution:

Ledger of Shiwalik Breweries Ltd.
Sinking Fund Account

2005		₹	2005		₹
Dec. 31	To Loss on Sale of War Loan A/c	3,200	Jan. 1	By Balance b/d	7,49,000
	To Capital Reserve Account	1,000	Dec. 31	by Profit and Loss Appropriation A/c	28,400
	To General Reserve Account	7, 99,000	Dec. 31	By Interest on Own Debentures A/c	5,000
			Dec. 31	by Interest on War Loan A/c	19,800
			Dec. 31	by Own Debentures Account (Profit on cancellation)	1,000
		8,03,200			8,03,200

Notes

Sinking Fund Investment Account
(a) 3% War Loan Account

2005			2005		
Jan. 1	To Balance b/d	6,50,000	Dec. 31	By Bank Account (98% of 6,50,000)	6,46,800
				By Sinking Fund A/c (loss on sale)	3,200
		6,50,000			6,50,000

(b) Own Debentures Account

2005			2005		
Jan. 1	To Balance b/d	99,000	Dec. 31		
Dec. 31	To Sinking Fund Account				
	(profit on cancellation)	1,000		By 5% Debentures Account	1,00,000
		1,00,000			1,00,000

5% Debentures Account

2005			2005		
Dec. 31	To Debenture-holders Account	7,00,000	Jan. 1	By Balance b/d	8,00,000
Dec. 31	To Own Debentures A/c	1,00,000			
		8,00,000			8,00,000

Debenture-holder's Account

2005			2005		
Dec. 31	To Bank Account	7,00,000	Dec. 31	By 5% Debentures Account	7,00,000
		7,00,000			7,00,000

Working Note:

	₹
Loss on sale of 3% War Loan	
Total amount available of S.F. Investment	7,49,000
Less: own debentures purchased	99,000
Cost price of 3% War Loan	6,50,000
Selling price of 3% War Loan	6,46,800
Loss on sale of 3% War Loan	3,200

Caution From the legal point of view, there are no restrictions on the sources of funds for redeeming debentures – even assets can be sold for the purpose.

Self Assessment

State whether the following statements are true or false:

1. It is compulsory to maintain D.R.R. 50% of debenture before the redemption of debentures.
2. Premium on debentures and premium on redemption of debentures carry same meaning.
3. If a company buys its own debenture at cum-interest basis, it will pay interest (in addition to purchase price) from the last date of interest payment to the date of transaction.
4. If there are same prices at cum-interest and ex-interest basis, there will be more profit on the purchase of ex-interest basis.

Notes

5. The following entry is passed in the books of a company:

12% Debentures Account	Dr.	70,000
Premium on Redemption of Debentures Account	Dr.	1,400
To Bank Account		63,000
To Profit on Cancellation of Debenture A/c		8,400

Here, debentures are redeemed:

(a) ₹ 90

(b) ₹ 91.2

(c) At discount

9.2 Interest on Own Debentures

Debentures purchased by a company, if not cancelled immediately, are retained as investment (popularly known as own debentures). These are deemed to be outstanding. Interest will be due on the total debentures (including the retained debentures by the company as investment). However, interest will be paid only on those debentures that are held by outsiders and interest on own debentures will be retained by the company itself and will be transferred to interest on own debentures account.

Accounting Treatment: The following journal entries will be passed to record the interest on own debentures:

1. When interest on debentures become due—

   Debenture Interest Account Dr.

   To Debenture-holders' Account

   To Interest on Own Debentures Account

   If any income tax is deducted at source from interest on debentures belonging to outsiders, that (income tax payable) will be credited and the balance will be given to debenture-holders.

2. When interest is paid to debenture-holders—

   Debenture-holders Account Dr.

   To Bank Account

3. When interest on debentures is transferred to Profit and Loss Account—

   Profit and Loss Account Dr.

   To Debenture Interest Account

4. There can be any one of the following treatment regarding interest on own debentures:

   (a) If the sinking fund account is not maintained by the company, it will be transferred to profit and loss Account.

   Interest on Own Debentures A/c Dr.

   To Profit and Loss Account.

   (b) If the sinking fund account is maintained by the company, interest on own debenture will be transferred to sinking fund account.

   Interest on Own Debentures Account Dr.

   To Sinking Fund Account

Notes

Notes Debentures purchased by a company, if not cancelled immediately, are retained as investment (popularly known as own debentures). These are deemed to be outstanding. Interest will be due on the total debentures (including the retained debentures by the company as investment).

Self Assessment

Fill in the blanks:

6. The amount required for the ………………… of debentures is usually large and as such unless adequate provision is made, the company may not have sufficient funds to repay the debentures at their maturity date.
7. ………………… purchased by a company, if not cancelled immediately, are retained as investment (popularly known as own debentures).
8. If the debentures are purchased exactly on the date of payment of interest by a …………………, interest of the previous period is paid to the former debenture-holder.
9. If the interest for ………………… period is included in the price of debenture, that will be the capital portion. If some extra payment is made towards the interest for expired period in addition to the price of debentures to the debenture-holder, that will be the revenue portion.
10. If the Articles of Association of a company ………………… the directors, they can purchase the company's own debentures from the open market.
11. From the ………………… point of view, there are no restrictions on the sources of funds for redeeming debentures – even assets can be sold for the purpose.

9.3 Cum-Interest and Ex-Interest Quotations

If the debentures are purchased exactly on the date of payment of interest by a company, interest of the previous period is paid to the former debenture-holder. If the debentures are purchased by the company between interest dates, it is necessary to find out whether the price paid for such debentures includes the interest of expired period or not. If the interest for expired period is included in the price of debenture, that will be the capital portion. If some extra payment is made towards the interest for expired period in addition to the price of debentures to the debenture-holder, that will be the revenue portion. The price paid depends upon the quotation. There can be two types of quotations:

(i) Cum-interest price

(ii) Ex-interest price

(i) ***Cum-interest price:*** It is the price of the debenture which includes the interest of the expired period. If cum-interest price is quoted, it means that no extra payment is to be made for interest of expired period by the company to the debenture-holder. But the interest has to be calculated from the last date of payment of interest to the date of purchase of debentures. This can be understood properly with an example. If a company buys its 100 own 10% Debentures of ₹ 100 each on 1st May, 2005 at ₹ 96 cum-interest and the dates of interest are 30th June and 31st December. Here, the expired period is four months (Jan., Feb., March & April).

And price paid for these 100; 10% Debentures is ₹ 96 × 100 = ₹ 9,600

Here, the cost portion in price is ₹ 9,600 – 333.33 = ₹ 9,266.67

And the revenue portion in price is ₹ 333.33

(a) For this cum-interest quotation purchase, the company will pass the following entry:

10% Debentures Account	Dr.	10,000
Debenture interest account	Dr.	333.33
To Bank Account		9600
To Profit on Redemption of Debenture A/c		733.33

(b) If these debentures are purchased as an investment:

Own Debentures Account	Dr.	9266.67
Debenture Interest Account	Dr.	333.33
To Bank Account		9600

In future, when these debentures are cancelled, profit on cancellation on these debentures will be transferred to the capital reserve account.

(ii) ***Ex-Interest price:*** It is the price which does not include the interest of expired period. If ex-interest price is quoted, it means the company has to make extra payment for interest for expired period in addition to the price paid for debenture. In the previous example, if a company purchases those debentures at ex-interest quotation, it has to pay ₹ 9,600 for debentures and ₹ 333.33 for interest for expired period.

(a) The following journal entry will be passed by the company:

10% Debentures Account	Dr.	10,000
Interest on Debentures Account	Dr.	333.33
To Bank Account		9,933.33
To Profit on Redemption of Debentures Account		400

(b) If these debentures are purchased as an investment:

Own Debentures Account	Dr.	9,600
Debenture Interest Account	Dr.	333.33
To Bank Account		9,933.33

The profit on cancellation of these debentures will be transferred to the capital reserve account at the time of cancellation of these debentures. If a sinking fund is maintained by the company, profit on cancellation of these debentures will go to the sinking fund.

Illustration 4 (Purchase of Own Debentures at Ex-Interest Quotation, and Interest on Own Debentures)

On 31st December, 2004, the balance sheet of Ranu Limited showed 20,000; 15% Debentures of ₹ 100 each outstanding. Interest on debentures is payable on 30th June and 31st December every year. On 1st May, 2005, the company purchased 1,000 of its own debentures as investment of ₹ 98 ex-interest. Pass the necessary journal entries for the following cases:

(a) The company cancelled all its own debentures on 1st December, 2005.

(b) The company resells all its own debentures at ₹ 108 cum-interest on 1st December, 2005.

Notes

Solution:

(a) Journal

Date	Particulars	L.F.	₹	₹
May 1	Own Debentures Account Dr.		98,000	
	Debenture Interest Account Dr.		5,000	
	To Bank Account			1,03,000
	(Being own debentures purchased at ₹ 98 each ex-interest)			
June 30	Debenture Interest Account Dr.		1,45,000	
	To Bank Account			1,42,500
	To Interest on Own Debenture Account			2,500
	(Being 6 months interest on 19,000 debenture paid and 2 months interest on 1,000 own debentures due)			
Dec. 1	15% Debentures Account Dr.		1,00,000	
	To Own Debentures Account			98,000
	To Profit on Cancellation of Own Debenture Account			2,000
	(Being cancellation of 1,000 own debentures)			
Dec. 1	Profit on Cancellation of Own Debenture Account Dr.		2,000	
	To Capital Reserve Account			2,000
	(Being transfer of profit on cancellation of own debentures to capital reserve account)			
Dec. 1	Debenture Interest Account Dr.		6,250	
	To Interest on Own Debenture Account			6,250
	[Being interest due for 5 months (from 30th June to 1st Dec. on own debentures)]			
Dec. 31	Debenture Interest Account Dr.		1,42,500	
	To Bank Account			1,42,500
	(Being payment made for 6 months' interest on 19,000 debentures)			
Dec. 31	Interest on Own Debentures Account Dr.		8,750	
	To Profit and Loss Account			8,750
	(Being interest on own debentures i.e., ₹ 6,250 + 2,500 transferred to profit and loss account)			
Dec. 31	Profit and Loss Account Dr.		2,85,000	
	To Debentures Interest Account			2,85,000
	(Being transfer of debenture interest to profit and loss account)			

(b) Journal

Date	Particulars	L.F.	₹	₹
Dec. 1	Bank Account Dr.		1,08,000	
	To Own Debentures Account			1,01,750
	To Interest on Own Debentures Account			6,250
	(Being sale of 1,000 debentures cum-interest at ₹ 108).			
Dec. 1	Own Debentures Account Dr.		3,750	
	To Profit on Resale of Own Debentures Account			3,750
	Profit on resale (1,01,750-98,000) of own debentures transferred to profit on resale of own debentures account			
Dec. 1	Interest on Own Debentures Account Dr.		6,250	
	Profit on Resale of Own Debentures Account Dr.		3,750	
	To Profit and Loss Account			10,000
	(Being transfer of interest on own debentures and profit on resale of own debentures to profit and loss account)			

Notes

Illustration 5 (Purchase of Own Debentures at Cum-interest Quotation by Sale of D.R.F. Investments)

Purohit Limited furnishes you the following information on 1st January 2005:

12% Debentures of ₹ 100 each	₹ 4,00,000
Debenture Redemption Fund	₹ 1,50,000
Debenture Redemption Fund Investment	₹ 1,50,000
(in 8% IDBI Bonds of the face value of ₹ 1,80,000)	

Interest on debentures was payable on 30th June and 31st December every year and interest on IDBI Bonds was also receivable on the same dates.

On March 1, 2005, the company purchased for immediate cancellation 480 debentures in the open market at ₹ 98 each cum-interest. The amount required for this was raised by selling 8% IDBI Bonds of the face value of ₹ 54,000.

On 31st December, 2005, ₹ 40,000 was appropriated for the Debenture Redemption Fund and on the same date, 8% IDBI Bonds were purchased for the amount plus the interest on investments. The face value of the 8% IDBI Bonds purchased was ₹ 60,000.

You are required to show the journal entries in the books of the company to record the above mentioned transactions.

Solution:

Journal Entries

2005	Particulars	L.F.	₹	₹
March 1	12% Debentures Account	Dr.	48,000	
	Debenture Interest Account	Dr.	960	
	To Bank Account (480 × ₹ 98)			47,040
	To Profit on Cancellation of Debentures Account			1,920
	(Being 480 debentures purchased cum-interest at ₹ 98 for immediate cancellation).			
March 1	Profit on Cancellation of Debentures Account	Dr.	1,920	
	To debenture redemption fund account			1,920
	(Being profit on cancellation of debentures transferred to D.R. fund)			
	Bank Account	Dr.	47,040	
	To Debenture Redemption Fund Investment Account			46,320
	To Interest on D.R. Fund Investment A/c			720
	(Being D.R.F. investments sold)			
	Debenture Redemption Fund Investment Account	Dr.	1,320	
	To Debenture Redemption Fund A/c			1,320
	(Being transfer of profit on sale of investment)			
	Profit and Loss Account	Dr.	48,000	
	To Debenture Redemption Fund Account			48,000
	(Being profit transferred to debenture redemption fund for redemption of debentures)			
June 30	Debenture Interest Account	Dr.	21,120	
	To Bank Account			21,120
	(Being payment of interest on 3,520 debentures for 6 months)			
	Bank Account	Dr.	5,040	
	To Interest on D.R. Fund Investment Account			5,040
	(Being interest received on investment of ₹ 1,26,000 @ 8% for 6 months)			

Contd...

Notes

Dec. 31	Debenture Interest Account	Dr.	21,120	
	To Bank Account			21,120
	(Being payment of interest on 3,520 debentures for 6 months)			
	Bank Account	Dr.	5,040	
	To Interest on D.R. Fund Investment A/c			5,040
	(Being interest received on investment of ₹ 1,26,000 @ 8% for 6 months)			
	Interest on D.R. Fund Investment Account	Dr.	10,800	
	To D.R. Fund Account			10,800
	(Interest on D.R.F. investment transferred to D.R. Fund account i.e., 720 + 5,040 + 5,040)			
	Profit and Loss Account	Dr.	40,000	
	To D.R. Fund Account			40,000
	(Being annual profit transferred to D.R. Fund account)			
	Debenture Redemption Fund Investment Account	Dr.	41,800	
	To Bank Account			41,800
	(Being 8% IDBI Bonds purchased with the amount of annual profits and interest i.e., 40,000 + 1,800)			
	Profit and Loss Account	Dr.	43,200	
	To Debenture Interest Account			43,200
	(Being interest on debentures transferred to P/L account i.e., 21,120 + 21,120 + 960)			
	Debenture Redemption Fund Account	Dr.	48,000	
	To General Reserve Account			48,000
	(Being an amount equal to the nominal value of debentures redeemed transferred from D.R. Fund to General Reserve)			

Illustration 6 (Sale and Purchase of Debentures at Cum-interest and Ex-interest Price)

Jaslin Company Limited issued 20,000; 12% Debentures of ₹ 100 each at par on 1st April, 2004. According to the terms of issue, interest was payable half yearly on 30th September and 31st March and the company reserved the right to buy any number of debentures in the open market to be held as an investment or to be cancelled at any time.

During the accounting year ended 31st March, 2005, the company purchased 160 of its debentures at ₹ 102 cum-interest on 31st July and 640 of its debentures at ₹ 99 ex-interest on 28th February 2005.

On 30th June, 2005, the company sold one-half of the debentures purchased on 28th February 2005 at ₹ 104 cum-interest. On 30th November 2005, the company purchased 1,200 debentures at ₹ 97.50 and on 31st December 2005 it cancelled 480 debentures purchased in 2004 and still lying with it.

Prepare important journal entries ignoring the creation of debenture redemption reserve.

Solution:

Journal Entries

Date	Particulars	L.F.	₹	₹
April 1	Bank Account	Dr.	20,00,000	
	To 12% Debentures Account			20,00,000
	(Being 20,000 debentures issued at par)			
July 31	Own Debentures Account	Dr.	15,680	
	Debenture Interest Account	Dr.	640	
	To Bank Account			16,320
	(Being 160 debentures purchased at ₹ 102 cum-interest)			

Contd...

Notes

Sep. 30	Debenture Interest Account	Dr.	1,19,360	
	To Bank Account			1,19,040
	To Interest on Own Debenture A/c			320
	(Being payment of interest on 19,840 debentures belonging to outsiders)			
2005				
Feb. 28	Own Debentures Account	Dr.	63,360	
	Debenture Interest Account	Dr.	3,200	
	To Bank Account			66,560
	(Being purchase 640 debentures at ₹ 99 ex-interest)			
March 31	Debenture Interest Account	Dr.	1,16,800	
	To Bank Account			1,15,200
	To Interest on Own Debenture A/c			1,600
	(Being payment of interest on 19,200 debentures belonging to outsiders)			
	Profit and Loss Account	Dr.	2,40,000	
	To Debenture Interest Account			2,40,000
	(Being debenture interest transferred to P & L account)			
March 31	Interest on Own Debentures A/c	Dr.	1,920	
	To Profit and Loss Account			1,920
	(Being interest on own debentures transferred to P & L account)			
June 30	Bank Account	Dr.	33,280	
	To Own Debentures Account			32,320
	To Interest on Own Debentures Account			960
	(Being sale of 320 debentures at ₹ 104 cum-interest)			
	Own Debentures Account	Dr.	640	
	To Profit on Sale of Own Debentures Account			640
	(Being profit on sale of own debentures)			
Sep. 30	Debenture Interest Account	Dr.	1,20,000	
	To Bank Account			1,17,120
	To Interest on Own Debentures Account			2,880
	(Being payment of interest on 19,520 debentures belonging to outsiders)			
Nov. 30	Own Debentures Account	Dr.	1,17,000	
	Debenture Interest Account	Dr.	2400	
	To Bank Account			1,19,400
	(Being purchase of 1,200 debentures at ₹ 97.50 ex-interest)			
Dec. 31	12% Debentures Account	Dr.	48,000	
	To Own Debentures Account			47,360
	To Profit on Cancellation of Own Debentures Account			640
	(Being cancellation of 480 debentures and profit transferred)			
Dec. 31	Profit on Cancellation Account	Dr.	640	
	To Capital Reserve Account			640
	(Being profit on cancellation transferred to capital reserve)			
Dec. 31	Debenture Interest Account	Dr.	1,440	
	To Interest on Own Debentures Account			1,440
	(Being 3 months' interest cancelled)			
March 31	Debenture Interest Account	Dr.	1,14,720	
	To bank account			1,09,920
	To interest on own debentures account			4,800
	(Being payment of interest on 18,320 debentures belonging to outsiders)			

Contd...

Notes

March 31	Profit on Sale of Own Debentures Account	Dr.	960	
	Interest on Own Debentures A/c	Dr.	10,080	
	To Profit and Loss Account			11,040
	(Being profit on sale of own debentures and interest on own debentures transferred to P & L account)			
	Profit and Loss Account	Dr.	2,38,560	
	To Debenture Interest A/c			2,38,560
	(Being debenture interest transferred)			

Illustration 7 (Purchase of Debentures as Investment and Cancellation after Some Time)

On 1st July, 2003, a company issued 1,000; 6% debentures of ₹ 100 each. The interest is payable on 30th June and 31st December every year. The company is allowed to purchase its own debentures, which may be cancelled or kept or reissued at the company's option. The company made the following purchases by cheque in the open market.

On 31st May 2004, 100 debentures @ ₹ 98 ex-interest.

On 30th September 2005, 50 debentures @ ₹ 97 cum-interest.

The debentures which were purchased on 31st May 2004 were cancelled on 31st December 2005. All payments were made on due dates.

Pass the journal entries to record the above mentioned transactions (including receipt and payments) and also the relevant items in the balance sheet as on 31st December 2005. Ignore income tax.

[Adapted from C.A. (Inter) Nov. 1975]

Solution:

Journal Entries

Date	Particulars	L.F.	₹	₹
July	Bank Account	Dr.	1,00,000	
	To 6% Debentures Account			1,00,000
	(Being issue of 1,000 debentures of ₹ 100 each)			
Dec. 31	Debenture Interest Account	Dr.	3,000	
	To Bank Account			3,000
	(Being payment of debenture interest to debenture-holders)			
Dec. 31	Profit and Loss Account	Dr.	3,000	
	To Debenture Interest A/c			3,000
	(Being debenture interest transferred to P & L accounts)			
2004				
May 31	Own Debentures Account	Dr.	9,800	
	Debenture Interest Account	Dr.	250	
	To Bank Account			10,050
	(Being 100 debentures purchased as investment @ ₹ 98 ex-interest)			
June 30	Debenture Interest Account	Dr.	2,750	
	To Bank Account			2,700
	To Interest on Own Debentures Account			50
	(Being payment of interest on 900 debentures belonging to outsiders)			
Dec. 31	Debenture Interest Account	Dr.	3,000	
	To Bank Account			2,700
	To Interest on Own Debentures A/c			300
	(Being payment of interest on debentures belonging to outsiders)			

Contd...

Dec. 31	Profit and Loss Account	Dr.	6,000	
	To Debenture Interest Account			6,000
	(Being transfer of debenture interest)			
	Interest on Own Debentures A/c	Dr.	350	
	To Profit and Loss Account			350
	(Being transfer of interest on own debentures to P & L account)			
June 30	Debenture Interest Account	Dr.	3,000	
	To Bank Account			2,700
	To Interest on Own Debentures A/c			300
	(Being payment of interest on debentures belonging to outsiders)			
Sep. 30	Own Debentures Account	Dr.	4,725	
	Debenture Interest Account	Dr.	75	
	To Bank Account			4,850
	(Being 50 debentures purchased at ₹ 97 cum-interest as investments)			
Dec. 31	Debenture Interest Account	Dr.	2,925	
	To Bank Account			2,550
	To Interest on Own Debentures A/c			375
	(Being payment of interest on debentures belonging to outsiders)			
Dec. 31	6% Debentures Account	Dr.	10,000	
	To Own Debentures Account			9,800
	To Profit on Cancellation of Debentures Account.			200
	(Being cancelled 100 debentures)			
Dec. 31	Profits on Cancellation of Debentures A/c	Dr.	200	
	To Capital Reserve Account			200
	(Being transfer of profit on cancellation to capital reserve)			
	Interest on Own Debentures Account	Dr.	675	
	To Profit and Loss Account			675
	(Being interest on own debentures transferred to P & L account)			
	Profit and Loss Account	Dr.	6,000	
	To Debenture Interest Account			6,000
	(Being debenture interest transferred to P & L account)			
	Debenture Redemption Fund Account	Dr.	10,000	
	To General Reserve Account			10,000
	(Being an amount equal to the nominal value of debentures redeemed transferred from D.R.F. to general reserve)			

Balance Sheet as on 31st December 2005

Liabilities	₹	Assets	₹
Secured Loans:			
900; 6% Debenture of ₹ 100 each	90,000	Investments:	
		Own debentures (face value ₹ 5000)	4,750
Reserve & Surplus:			
Capital reserve	200		

Notes If the debentures are redeemable at premium and the company purchases its own debenture from the open market, it saves that amount equal to the premium which would have been payable on debentures in the ordinary course of redemption.

Notes

Self Assessment

Fill in the blanks:

12. In cum ………………… price, no extra payment is to be made for interest of expired period by the company to the debenture-holder.
13. If the debentures are purchased by the company between interest dates, it is necessary to find out whether the price paid for such debentures includes the interest of ………………… period or not.
14. Interest burden also reduces if own debenture are purchased from the …………….. market.
15. If the debentures are redeemable at premium and the company ………………… its own debenture from the open market, it saves that amount equal to the premium which would have been payable on debentures in the ordinary course of redemption.

9.4 Summary

Redemption of debenture is the discharge of debenture liability. It can be done either by repaying the money to debenture holders or converting the debenture into shares. The conditions of redemption are clearly stated at the time of issue of debenture in the prospectus. Debentures can be redeemed at par, premium or discount as per the terms of issue. The period of maturity, redemption amount, yield on redemption etc. will be mentioned in the prospectus. In case the non convertible debentures proposed to be rolled over (repayment extended for an additional period), a compulsory option should be given to the debenture holders who wish to withdraw from the debenture programme, as per the guidelines issued by SEBI.

Sources of Funds for Redemption of Debentures

Redemption of debentures is an important commitment to be fulfilled by a joint stock company. Failure to redeem debentures will disqualify the directors of the company. Moreover, such a default will invite strict penalties and loss of reputation. As the redemption of debentures drains a large amount of resources, companies will make advance preparations to meet this need.

(i) Redemption of Debentures - from the proceeds of fresh issue of share capital and debentures

(ii) Redemption of Debentures - out of accumulated profits

Methods of Redemption of Debentures

(i) ***Redemption In lump-sum, at the end of stipulated period:*** Under this method the entire debentures are redeemed at the stipulated date stated in the prospectus for the issue of debentures. The drawback of this method is that the company has to arrange a large amount at the time of redemption. Usually companies prepare well advance for the redemption of debentures.

(ii) ***By Draw of Lots:*** Under this method the company does not redeem all the debentures at the same time. Instead it will call back only a portion of its debentures in the market for redemption each year. The company select the debentures of a predetermined value, by drawing lot and they are redeemed that year. This method of redemption reduces the burden of redemption. Planning is relatively easy and the impact of redemption on the finance of the company is limited.

(iii) ***By Purchasing in the Open Market:*** Debentures can be redeemed by purchasing them from the open market. If a company finds its debentures are available in the open market at cheap rate it will purchase those debentures and cancel them.

(iv) ***By Conversion into New Debentures or Shares:*** Conversion of debentures into shares is another method of redemption. When debentures are converted to shares, the company does not pay money to debenture holders. Instead the company issues share certificates in place of debentures. It may look good for the company because there is no need of cash payment. But the company is selling its shares. Selling shares is actually selling part of the ownership. Debenture holders become shareholders. Creditors become owners. It is better to pay off creditors rather than selling them part of the company. But sometimes company agree to give some shares to make the issue of debentures more attractive to buyers.

Debenture Redemption Reserve: The newly introduced Section 117C in the Companies Act, 1956 by Companies (Amendment) Act, 2000 has made a bold step in protecting the interests of debenture holders by making it mandatory for the company to create security and debenture redemption reserve. Accordingly, it shall now be mandatory for the companies to create a debenture redemption reserve for the redemption of debentures. The company shall have to credit adequate amount from out of its profits every year till such debentures are redeemed.

The debenture reserve shall be used by the company only for the redemption of debentures. Such redemption shall be in accordance with the terms and conditions of the issue of debentures. The company shall pay interest due on outstanding debentures as per the terms and conditions of the issue only.

If a company fails to redeem the debenture on due dates or on maturity, any or more than one or all the debenture holders can make an application to the Tribunal and then Tribunal on hearing all the parties concerned may direct by way of an order to redeem the debentures forthwith by payment of principal and interest due on such debentures.

If default is made in complying with the order of the Tribunal, every officer of the company who is in default shall be punishable with imprisonment which may extend to 3 years and shall also be liable to a fine of not less than ₹ 500 for every day during which such default continues.

9.5 Keywords

Cum-interest Price: It is that price of the debenture which includes the interest of the expired period.

Debentures: It is purchased by a company, if not cancelled immediately, are retained as investment (popularly known as own debentures).

Draw of Lots: Under this method the company does not redeem all the debentures at the same time.

Ex-Interest Price: It is that price which does not include the interest of expired period. If ex-interest price is quoted

Redemption in Lump-sum: Under this method the entire debentures are redeemed at the stipulated date stated in the prospectus for the issue of debentures.

9.6 Review Questions

1. What is a sinking fund? Explain how it is created.
2. What is debenture interest?
3. Explain the meaning of Ex-interest and Cum-interest.

Notes

Practical Questions:

4. A Limited had ₹ 2, 00,000; 12% Debentures on 1st January, 2005. In accordance with the power under the deed, the directors acquired from the open market for immediate cancellation of debentures as follows:

   March 1, 2005 ₹ 40,000 at ₹ 98 cum-interest. August 1, 2005 ₹ 80,000 at ₹ cum-interest. 15 December, 2005 ₹ 20,000 at ₹ Ex-interest. Debenture interest is payable half yearly i.e., 30th June and 31st December every year.

   Show the ledger accounts of (i) 12% Debentures Account (ii) Debenture Interest.

Ans: Profit on cancellation of debentures is: (i) on 1st March, ₹ 1,600 (ii) On 1st August, ₹ 600 (iii) On 15th December, ₹ 300.

5. On 31st March 2004 Varun Ltd.'s balance sheet showed 10,000 12% Debentures of ₹ 100 each outstanding. Interest on debentures is payable on 30th September; and 31st March every year. On 1st August 2004, the company purchased 500 of its own debentures as investment at ₹ 97 ex-interest.

   Pass journal entries for purchase and disposal of own debentures in each one of the following cases:

   (i) The company cancels all its own debentures on 1st March 2005.

   (ii) The company resells all its own debentures at ₹ 105 cum-interest on 1st March 2005.

   Also show journal entries relating to debenture interest and interest on own debentures as on 31st March 2005 in case (i) mentioned above.

6. (i) Swati Associates Limited has issued 10,000; 12% Debentures of ₹ 100 each on 1.1.2003. These debentures are redeemable after three years at a premium of ₹ 5 per debenture. Interest is payable annually.

   (ii) On October 1, 2004 it buys 1,500 debentures from the market at ₹ 98 per debenture. These are sold away on June 30, 2005 at ₹ 105 per debenture.

   (iii) On January 1, 2005, it buys 1,000 debentures at ₹ 104 per debenture from the open market. These are cancelled on April 1, 2005.

   (iv) On October 1, 2005 it buys 2,000 debentures of ₹ 106 per debenture from the open market. These debentures, along with other debentures, are redeemed on 31st December, 2005.

   Prepare the relevant ledger accounts, showing the above transactions. Working should form part of you answer.

Ans: Profit on cancellation of own debentures transferred to capital reserve are ₹ 1, 57,833.

Answers: Self Assessment

1.	True	2.	False
3.	False	4.	False
5.	a	6.	Redemption
7.	Debentures	8.	Company
9.	Expired	10.	Empowers
11.	Legal	12.	Interest

Notes

13. Expired
14. Open
15. Purchases

9.7 Further Readings

Books

Magazines and Journals

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Brown, Meredith, ed. *Mechanics of Global Equity Offerings: Structuring the Offering and Negotiating the Underwriting Agreement.* Cambridge, MA: Kluwer Law and Taxation Publishers, 1995.

Goldblatt, Jennifer, "Market Ho-Hum about New Revenue Limit on Securities Underwriting." *American Banker,* 26 December 1996, 20.

Invest in an IPO or DPO. Chicago: Dearborn Trade, 1998.

Johnson, Hazel J, *The Banker's Guide to Investment Banking: Securities and Underwriting Activities in Commercial Banking.* New York: McGraw-Hill Professional Book Group, 1996.

Lipman, Frederick D, *Going Public: Everything You Need to Know to Successfully Turn a Private Enterprise into a Publicly Traded Company.* Upland, PA: DIANE Publishing, 1998.

Shillinglaw, Gordon, *Accounting: A Management Approach.* 9th ed. New York: McGraw-Hill Higher Education, 1992.

Online links

http://www.articlesbase.com/college-and-university-articles/redemption-of-debentures-5644906.html

http://www.scribd.com/doc/24202747/Study-Note-7-4-Page-542-564

http://dynamictutorial.blogspot.in/2012/02/company-account-debentures.html

Case Study

18 January. For Immediate Release

THFC Bond deal breaks 5% Cost barrier!

At a time when bank pricing is once again increasing for housing associations, THFC took advantage of continued low Gilt yields to issue a £131m follow on (tap) issue of its 32 year THFC Funding (3) deal. The deal was lead managed by Royal Bank of Canada and Royal Bank of Scotland and was for ten underlying borrowers. The yield on the deal was 4.94%.

The 5% barrier is an important psychological barrier on long term deals for investors and borrowers alike. "Since 2006 out of £3.6bn of HA public bond issuance, only £180m has priced below 5% - and we had been responsible for £69m of that" said Piers Williamson, Chief Executive of THFC. THFC had to pay a credit spread on the deal of 2%, the highest it

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Notes

has paid in recent years. Williamson said "Sterling investors are no fools, they know that housing associations are increasingly looking to the capital markets as banks are no longer prepared to do long term deals. This reflects the new reality for Associations. They can still do funding deals that most banks and many sovereign nations can only dream of".

There is more HA issuance waiting in the wings, with public ratings announced for Radian, Hastoe and Midland Heartand with a significant number of larger HAs waiting in the wings to issue.

Another question in the market at the moment is whether the Bank of England will extend its Quantitative Easing (so called QE2) programme beyond the end of February. The programme is helping keep long term borrowing rates at levels last seen in Victorian Britain. The most recent sharp fall in annual Consumer Price Inflation, targeted by the Banks Monetary Policy Committee (MPC) combined with fears of a double dip recession, suggest that QE may be extended beyond February. This would help keep the cost of issuance down for HAs considering entering the capital markets later in the year.

THFC's bond had a strong regional showing with two Scottish, three Welsh and two Northern Irish Borrowers. The largest participant (£40m) was Dumfries and Galloway HA, the largest Scottish Association outside Glasgow.

Source: http://www.thfcorp.com/whatsnew/pressreleases.html

Unit 10: Underwriting of Shares

Notes

CONTENTS

Objectives

After studying this unit, you should be able to:

- Explain the meaning of underwriting
- Understand the concept of underwriting commission
- Describe types, advantages and objectives of underwriting
- Identify various underwriting agreements to be disclosed
- Define determinants of the liabilities of underwriting

Notes

Introduction

Underwriting of Shares means the contract in which underwriter agrees to take shares which will not be subscribed by public. For getting fast minimum subscription from public of his issued shares, company has to do this type of contract. With this, headache of selling and getting minimum subscription will be of underwriter not company. For this, company gives underwriting commission to underwriter which is controlled by SEBI. Still 5% on issue of shares or actual rate which is agreed in article of association which is less, is accepted to give it to underwriter.

10.1 Meaning of Underwriting

If an existing company issues its debentures or shares to the public, it is necessary to receive 90% of the issued amount (minimum amount) from the public within 120 days from the date of opening the issue. If the company does not get this amount it cannot begin the process of allotment and has to refund the amount of applications to the applicants. In the case of a new company, it cannot obtain the Certificate of Commencement of Business on the failure of receiving this amount. In order to ensure the minimum subscription from public, the companies resort to underwriting. Underwriting is an agreement whereby the underwriters give the guarantee to the company that in case the shares or debentures offered to the public are not subscribed by the public to an extent, the balance (shares not subscribed by the public) of shares or debentures will be taken up by the underwriters. The underwriters can be some individuals, firms or companies. There can be more than one underwriters. Nowadays, underwriting of shares or debentures is also done by specialized financial institutions such as Industrial Finance Corporation of India, Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Unit Trust of India (UTI) etc. Nationalised banks also have jumped into the business of underwriting.

10.2 Underwriting Commission

For this guarantee, a commission is paid to underwriters which is called underwriting commission. This commission is calculated on the issue price of shares or debentures underwritten. Underwriting commission is paid to underwriters in the whole of the issue underwritten irrespective of the fact whether shares are subscribed by the public or not, but the company should be authorized by its Articles of Association to pay this commission to underwriters. The following points should be kept in account regarding underwriting commission:

(i) Rate of commission of underwriter should not be more.

  (a) In the case of shares 5% of the issue price of shares or the amount or rate authorized by the Articles of Association whichever is less, and

  (b) In case of debentures, of the issue price of the debentures or the amount or rate authorized by the Articles of Association whichever is less.

(ii) The commission paid or to be paid must be disclosed in the Prospectus or in the Statement in lieu of prospectus.

(iii) The number of shares or debenture which the underwriters have agreed to take, should be clearly shown in the prospectus.

(iv) A copy of contract with the underwriters regarding the payment of commission should be given to the Registrar.

(v) No underwriting commission is paid on those shares or debentures which are allotted to promoters group, employees, directors, their friends and business associates.

Notes

10.3 Types of Underwriting

There can be the following three main types of underwriting agreements between the company and underwriters:

(i) ***Complete Underwriting Agreement:*** When the underwriter gives the guarantee to the company that whole issue will be subscribed by the public, it is called complete underwriting. In this case the whole issue is underwritten by one or more underwriters and collectively or individually they agree to take the entire risk.

(ii) ***Partial Underwriting Agreement:*** When only a part of issue of shares or debentures is underwritten by the underwriters, it is called partial underwriting. This underwriting can also be done by one or more persons or institutions.

(iii) ***Firm Underwriting:*** When an underwriter makes an agreement to purchase a certain number of shares or debentures of the company, in addition to the shares or debentures he has to take under the underwriting agreement, it is called firm underwriting. The underwriters under such agreement get the priority over general public in relation to allotment of shares or debentures in the conditions of oversubscription. For example, if underwriter has entered into an agreement for firm underwriting of 2,000 shares out of total 10,000 shares issued, only 8,000 shares will be available for the public even, if there are applications for 15,000 shares.

10.4 Advantages and Objectives of Underwriting

(i) ***Certainty regarding subscription on part of the public:*** If a company enters into an agreement with underwriters at the time of issue of an shares or debentures, there will be certainty that shares will be taken over by the public. In the absence of underwriting agreement, there will be uncertainty regarding its subscription by public. This uncertainty is automatically removed when underwriters give their guarantee to the company.

(ii) ***More Confidence Amongst Public:*** If a company has concluded an agreement with underwriters, the names and addresses of the underwriters are given in the prospectus. Appearance of names and addresses of the underwriters leads to more confidence amongst the public. They feel that the company has a good position which is why the underwriters have entered into an underwriting agreement with the company; which would not have been the case otherwise.

(iii) ***Underwriting creates goodwill for the company:*** Underwriting increases goodwill of the company. Generally, underwriters enter in an agreement for guaranteeing the shares and debentures with those companies which have a sound position and whose future is bright. The underwriters know that if the shares or debentures are not subscribed by the public they will have to take up these shares or debentures, hence the ultimate burden will fall on them. Due to this reason, underwriting agreement creates an impression regarding the sound status of the company.

10.5 Requirement of Disclosure of Underwriting Agreement

According to the provisions of Companies Act 1956, an underwriting agreement should be disclosed in the following:

(i) ***In the Prospectus:*** If an underwriting agreement is concluded with the underwriters by the company, their names and addresses and the opinion of the directors regarding the discharge of the obligations of the underwrites should be disclosed in the prospectus of the company. Alongwith this information, the number of shares or debentures, which the

Notes

underwriters have agreed to underwrite and to take up, and the amount or rate of commission should also be disclosed in the prospectus as per provision of Section 76 of the Companies Act.

(ii) *In Statutory Report:* The extent to which each underwriting contract, if any, has not been carried out and the reason therefore, should be stated. This is merely because the directors at the time of issuing a prospectus give a declaration that in their opinion, the underwriters have the resources to carry out their obligations.

(iii) *In the Balance Sheet:* As per the requirements of the Schedule VI of the Companies Act, all underwriting commission or brokerage payable must be shown in the assets side of the balance sheet under the heading 'Miscellaneous Expenditure'.

Distinction between Underwriter and Broker

As discussed earlier, an underwriter is that individual who agrees to take over a certain number of shares or debentures if the public does not subscribe to them. An amount for this consideration payable to the underwriter is called underwriting commission. On the other hand, a broker is a person who provides services in bringing a settlement between a seller and purchaser of the shares or debentures for a reward which is called brokerage. A broker can also procure the subscription to the shares or debentures from the public on the behalf of the company. Such a broker can only procure the subscription and does not undertake the responsibility of subscribing to the shares or debentures of the company. As per Section 76(3) of the Companies Act, a company is permitted to pay a reasonable amount of brokerage in addition to the payment of underwriting commission.

10.6 Rates of Underwriting Commission, Brokerage and Remuneration to Managers

Following the SEBI guidelines, the following rates regarding the payment of underwriting commission, brokerage and remuneration to manager to the issue were issued by the Ministry of Finance on 7th May 1985:-

1. Maximum Limit of underwriting Commission for Payment:

	On amounts developing on the underwriters (percent)	On amounts subscribed by the public (percent)
(A) Equity Shares	2.5	2.5
(B) Preference shares/Convertible & Non-Convertible debentures:		
(i) Up-to the amount of ₹ 5 Lakhs.	2.5	1.5
(ii) For months in excess of ₹ 5 Lakhs.	2.0	1.0

2. Maximum Limit of Brokerage:

   (i) Brokerage is fixed at 1.5% in respect of all types of public issue of the industrial securities whether the issue is underwritten or not.

   (ii) No company will pay any postage (mailing cost) or other cost out of pocket expenses for canvassing the public etc., to any broker.

   (iii) The listed companies are permitted to pay brokerage on private placement of capital at a maximum rate of 0.5%.

   (iv) No brokerage will be paid in respect of employees, directors, their friends and promoters quota and rights issue.

(v) No brokerage will be paid on the shares subscribed by the institutions or banks against their underwriting agreements.

3. ***Fees of Managers to the Issue:*** Companies are free to appoint one or more agencies as managers, but the total amount of fees to such persons should not exceed the following limits:

   (i) For issue up to ₹ 5 crore: 0.5%.

   (ii) For issue over ₹ 5 crore: 0.2%.

   In respect of the following, no fees shall be paid:

   (a) On the amount of shares to be taken by institutions as investors or underwriters.

   (b) Promoter's quota of shares capital.

   (c) On the amount of shares subscribed on right basis.

10.6.1 Marked and Unmarked Applications

Those applications which bear the official stamp of an underwriter or broker are called marked applications and those which do not bear the official stamp of an underwriter, are called unmarked applications. When there are more than one underwriters to underwrite the issue of a company in an agreed ratio, importance of marked application arises. In this case each of the underwriter makes an effort to sell the maximum shares or debentures through him in order to reduce his risk. The least subscription of an underwriter will count to the advantage to some other underwriter. Therefore an official seal is put on the application from each underwriter. This official seal helps the company in recognizing as to which underwriter should get the credit for that application. When applicants do not get application from any underwriter, but get the application directly from the company (means unmarked application), the advantage of such application is given to all underwriters in the ratio of gross liability of the underwriters. If there is only one underwriter, he will get the credit of all applications whether it is marked (sealed) or unmarked.

> *Notes* Those applications which bear the official stamp of an underwriter or broker are called marked applications and those which do not bear the official stamp of an underwriter, are called unmarked applications.

10.6.2 Determination of the Liabilities of the Underwriters

The liability of the underwriter is determined on the basis of the nature of the underwriting agreement. Therefore, the method of calculating the liability of the underwriters under different type of agreement is given below:

1. ***Complete Underwriter Agreements:*** Complete underwriting is discussed in the following two cases:

   (a) *When the entire issue of shares or debentures is underwritten only by one underwriter:* If the entire issue of shares or debentures is underwritten only by one underwriter, the net liability of the underwriter will be determined by deducting marked and unmarked applications received by the company from the gross liability of the underwriter. Thus, underwriter will be liable to take up only those shares or debentures which are not taken up by the public. If the issue of shares or debentures

Notes

is fully subscribed or oversubscribed, the underwriter will be free from his liability. But he is entitled to receive his commission on the total issue price of shares or debentures. Here, the issue price means the nominal value of shares or debentures in case the issue is at par. In case of discount, issue price means nominal value of shares or debentures minus discount allowed and in case of premium issue, price will be nominal value + premium on issue of shares or debentures.

10.7 Accounting Treatment

Journal entries in the books of the insured company:

(i) When underwriting commission is due to underwriters-

Underwriting Commission Account Dr.

To Underwriters Account.

(ii) When underwriting commission is paid to underwriter in cash, debentures or shares-

Underwriters Account Dr.

To Bank Account

To Share Capital Account

To Debentures Account.

(iii) When the entire issue of shares or debentures is fully subscribed and liability for shortfall in public subscription is taken by underwriters-

Underwriters Account Dr.

To Shares Capital Account.

To Debentures Account.

(iv) When the amount is received for shares or debentures taken from underwriter-

Bank Account Dr.

To Underwriters Account .

(v) When the underwriting commission is written off from the profit or shares premium account-

Profit and Loss Account Dr.

Share Premium Account Dr.

To Underwriting Commission Account.

Illustration 1 (When the Entire Issue is Underwritten by Only One Underwriter)

Sholapur Limited was formed with a capital of ₹ 1,000,000 divided into 10,000 equity shares of ₹ 100 each. All these shares were offered for subscription by prospectus to the public at par. The whole issue has been underwritten by Shabnam & Co. for a commission of 4%. The company received the applications for only 9,500 shares. All the applications were accepted by the company and the balance were taken up by the underwriter. You are required to pass the journal entries to record the above transactions in the books of Sholapur Limited and prepare the balance sheet at this stage, assuming that all amounts due have been received.

Notes

Solution:

Sholapur Limited
Journal Entries

Date	Particulars	L.F.	₹	₹
1	Bank Account	Dr.	9,50,000	
	To Equity Share Capital Account.			9,50,000
	(Being 9,500 equity shares of ₹ 100 each issued at par)			
2	Shabnam & Company (Underwriter)	Dr.	50,000	
	To Equity Share Capital Account			50,000
	(Balance of equity shares i.e., 500 shares allotted to underwriter as per commitment)			
3	Underwriting Commission Account	Dr.	40,000	
	To Shabnam & Company (underwriter)			40,000
	(Being commission due to Shabnam & Co. @ 4% on ₹ 10,00,000).			
4	Bank Account	Dr.	10,000	
	To Shabnam & Co.			10,000
	(Being receipt the balance due from Shabnam & Co. i.e., ₹ 50,000 – ₹ 40,000).			

Balance Sheet of Sholapur Ltd.

Liabilities	₹	Assets	₹
Shares Capital :		Fixed Assets:	–
Authorized, issued, Called up & Paid up capital		Current Assets:	
10,000 Equity shares of ₹ 100 each fully paid up.	10,00,000	Cash at Bank	9,60,000
		Miscellaneous Expenditure:	
		Underwriting Commission	40,000
	10,00,000		10,00,000

When the Entire Issue of Shares or Debentures is Underwritten by more than one Underwriter in an Agreed Ratio

Where the issue of shares or debentures is underwritten by more than one underwriter following procedure is adopted to determine the liability of the underwriters:

(i) Gross Liability of all underwriters is calculated on the basis of their agreed ratio.

(ii) Marked applications of all underwriters are subtracted from gross liability (which is calculated in No. 1 above).

(iii) Credit is given to all underwriters for unmarked applications in the ratio of gross liability (means unmarked application are subtracted from No. 2 above).

(iv) If some figures are in minus (surplus), that is subtracted from the liability (balance of No. 3) of other underwriters in the ratio of gross liability.

Alternatively, the credit for unmarked applications can be given to all underwriters in the ratio of gross liability as reduced by marked applications.

In this case, individual net liability of underwriters will differ from the liability calculated as for earlier procedure. Therefore, it is essential to mention the method in the underwriting agreement. Students can adopt any one of two methods in solving the examination problem but they should give a footnote regarding the method. These two methods are discussed in this illustration.

Notes

Illustration 2 (When the Entire Issue is Underwritten by More Than One Underwriter)

Sudhir Limited was incorporated on 1st January, 2006 and issued a prospectus inviting applications for 20,000 equity shares of ₹ 10 each. The whole issue was underwritten by 'A', 'B' and 'C' as follows:

'A' 10,000 shares, 'B' 6,000 share, 'C' 4,000 shares. Applications were received for 16,000 shares of which marked applications were as follows:

'A' 8,000 shares, 'B' 2,850 shares, 'C' 4,150 shares. Find out the liability of individual underwriters and pass the journal entries in the books of Sudhir Limited.

Solution:

Statement of Underwriter's Liability in Shares

Particulars	Underwriters			Total
	A	B	C	
Gross Liability as per agreement.	10,000	6,000	4,000	20,000
Less: Marked Applications	8,000	2,850	4,150	15,000
Resultant Liability	2,000	3,150	–150	5,000
Less: Credit of unmarked applications in the ratio of gross liability (i.e., 5:3:2)	500	300	–200	1,000
Resultant Liability	1,500	2,850	–350	4,000
Less: Surplus of 'C' distributed between 'A', 'B' in the ratio 5:3 (gross liability ratio)	219	131	350	—
Net Liability in shares	1,281	2,719	Nil	4,000

Alternatively, the second method can be adopted.

Statement of Underwriter's Liability in Shares

Particulars	Underwriters			Total
	A	B	C	
Gross Liability	10,000	6,000	4,000	20,000
Less: Marked Applications	8,000	2,850	4,150	15,000
Resultant Liability	2,000	3,150	–150	5000
Less: Surplus of C distributed in gross liability ratio (5:3)	94	56	150	–
Gross Liability as reduced by marked applications	1,906	3,094	Nil	5,000
Less: Credit for unmarked applications Distributed in the ratio 1906 : 3094	381	619	–	1,000
Net Liability	1,525	2,475	–	4,000

Journal Entries (Based on First Method)

Date	Particulars	L.F.	₹	₹
	Bank Account	Dr.	1,60,000	
	To Equity Share Capital Account			1,60,000
	(Being allotment of 16,000 shares of ₹ 10 each to the public)			
	'A's Account	Dr.	12,810	
	'B's Account	Dr.	27,190	
	To Equity Share Capital Account			40,000
	(Being allotment of 4,000 shares to underwriters as per agreement).			
	Underwriting Commission Account	Dr.	10,000	
	To A's account			5,000
	To B's account			3,000
	To C's account			2,000
	(Being commission due to underwriter @ 5% on ₹ 2,00,000)			

Contd...

Bank Account	Dr.	32,000	
To A's Account			7,810
To B's Account			24,190
(Being receipt of the balance from A & B)			
C's Account	Dr.	2,000	
To Bank Account			2,000
(Being payment of commission to C)			

Notes It is assumed that rate of underwriting commission is 5%.

10.7.1 Partial Underwriting Agreement

Partial underwriting means that only a portion of the issue is underwritten by the underwriter. In such case, balance of the issue of shares or debentures is treated as underwritten by the company itself. Partial underwriting can be done by one underwriter or more than one underwriter. In these cases the net liability of the underwriters will be calculated as below:

(a) When partial underwriting of the issue is done by one underwriter only

In this case the liability of the underwriter is determined as:

Net liability of the underwriter = Gross liability – Marked applications received by company.

All unmarked applications are treated as marked by the company itself and no credit is given to the underwriter regarding unmarked applications.

Thus, if marked applications exceed or are equal to the gross liability of the underwriter, he will be free from his liability. And similarly, if the issue is fully subscribed by the public, underwriter will also be free from his liability. Here, one point is to be noted that if no information is given in the question regarding marked and unmarked applications, to find out marked applications, total applications received by the company must be multiplied by the percentage of the issue underwritten.

Did u know? Net liability of the underwriter = Gross liability – Marked applications received by company.

Illustration 3 (Partial Underwriting by one Underwriter Only)

Negi Limited issued 5,00,000 equity shares of ₹ 100 each, of which 80% were underwritten by Purohit & Company.

Applications were received for 300,000 shares out of which 240,000 shares applications were marked in favour of Purohit and Company.

Determine the net liability of Purohit and Co. and pass the necessary journal entries in the books of Negi Limited.

Solution:

Calculation of Net Liability of Purohit & Co.

Gross Liability of Purohit and Co.	No. of shares
(80% as per commitment)	
500,000	4,00,000

Notes

Less: Marked applications	2,40,000
Net Liability of Purohit and Co.	1,60,000

Journal Entries in the Books of Negi Limited

Date	Particulars	L.F.	₹	₹
	Bank Account	Dr.	30,00,000	
	To Equity Share Capital Account.			30,00,000
	(Being allotment of 30,00,00 shares to the public)			
	Purohit & Company	Dr.	16,00,000	
	To Equity Share Capital Account			16,00,000
	(Being taken over the net liability of 160,000 shares by Purohit & Co. as per Commitment)			
	Underwriting Commission Account	Dr.	2,00,000	
	To Purohit & Company			2,00,000
	(Being commission due to underwriter assumed 5% of the issue)			
	Purohit & Co.	Dr.	14,00,000	
	To Bank Account			14,00,000
	(Being receipt of the balance)			

Illustration 4

XY Co. Ltd. issued 5,00,000 equity shares of ₹ 10 each at a premium of 10% and 10,000; 12% Debentures of ₹ 100 each at ₹ 95. 75% of the issue is underwritten by Apex & Company at the maximum rate of the commission allowed by Law. Applications were received for 4,00,000 shares and 6,000 debentures, which were accepted and payment for these was received in full. Pass the necessary journal entries in the books of XY Co. Ltd.

Solution:

Calculation of Net Liability of the Underwriter

Particulars	No. of shares	No. of Debentures
Total issue of the company	5,00,000	10,000
Total applications received by the company	4,00,000	6,000
Issue underwritten 75%	3,75,000	7,500
Application treated as marked by underwriter		
(75% of total applications)	3,00,000	4,500
Net Liability of Apex Company	(3,75,000 – 3,00,000)	(7,500 – 4,500)
(in form of shares & debentures)	= 75,000	= 3,000

In the absence of information it is assumed that 75% of the total applications are marked by Purohit & Company.

5% commission will be payable to underwriter on the issue price of equity shares and commission on the issue price of debentures.

Underwriting commission–

	Shares	Debentures
Issue Price (₹)	10 + 10% = 11	100 – 5% = 95
Issue Underwritten (75%)	3,75,000 shares	7500 debentures

Notes

Rate of Commission	5%	
Amount of Commission	= ₹ 2,06,250	= ₹ 35,625

Journal Entries

Date	Particulars	L.F.	₹	₹
	Bank Account	Dr.	44,00,000	
	To Equity Share Capital Account			40,00,000
	To Share Premium Account			4,00,000
	(Being allotment of 4,00,000 shares of ₹ 10 each at 10% premium)			
	Bank Account	Dr.	7,12,500	
	Discount on Issue of Debentures Account	Dr.	37,500	
	To 12% Debentures Account			7,50,000
	(Being allotment of 12% Debentures of ₹ 100 each at ₹ 95)			
	Apex & Company	Dr.	8,25,000	
	To Equity Share Capital Account			7,50,000
	To Share Premium Account			75,000
	(Being net liability of 75,000 shares taken over by underwriter as per agreement)			
	Apex % Company	Dr.	2,85,000	
	Discount on Issue of Debentures Account	Dr.	15,000	
	To 12% Debentures Account			3,00,000
	(Being net liability of 3,000 debentures taken over by the underwriter)			
	Underwriting Commission on Shares A/c	Dr.	206,250	
	Underwriting Commission on Debentures A/c	Dr.	35,625	
	To Apex & Co.			2,41,875
	(Being commission due to underwriter)			
	Bank Account	Dr.	8,68,175	
	To Apex & Company			8,68,175
	(Being receipt of the balance from Apex & Company)			

Receipt of balance of amount = ₹ 8,25,00 + ₹ 2,85,000 - ₹ 2,41,825

= ₹ 8,68,175.

Notes In the case of undersubscription, to determine the liability of underwriters, the benefit of firm underwriting can be given to all underwriters if firm underwriting is included in the unmarked application or if the benefit of firm underwriting is to be given this to individual underwriters, firm underwriting should be included in marked applications.

10.7.2 When Partial Issue is underwritten by More than One Underwriter

In this case too, only a part of the entire issue is underwritten by a number of underwriters and the rest of the issue is treated as underwritten by the company itself. The unmarked applications are treated as marked by the company and the net liability of the underwriters is determined by the same method as explained in the case of partial underwriting by one underwriter only.

Notes

Caution Partial underwriting means that only a portion of the issue is underwritten by the underwriter. In such case, balance of the issue of shares or debentures is treated as underwritten by the company itself. Partial underwriting can be done by one underwriter or more than one underwriter.

Net Liability of Underwriters = Total gross liability – Marked applications received by company.

Illustration 5 (Partial Underwriting by More than One Underwriter)

A public limited company issued 1,00,000 equity shares of ₹ 100 each at a discount of 10%. This issue was underwritten as follows:

X - 40%, Y - 20%, Z - 20%.

The company received a total number of 70,000 applications of which marked applications were as follows:

X – 30,000, Y- 15,000 Z – 17,000

Determine the Liability of each of the underwriter.

Solution:

Statement Showing the Net Liability of Underwriters in Shares

	Underwrites			Total
Particulars	***X***	***Y***	***Z***	
Liability in Percentage	40%	20%	20%	80%
Gross Liability in Shares	40,000	20,000	20,000	80,000
Less : Marked Application	30,000	15,000	17,000	62,000
Net Liability of underwriters	10,000	5,000	3,000	18,000

10.7.3 Firm Underwriting Agreements

In case of firm underwriting agreements, the underwriters agree to accept an additional liability along with the shares or debentures they have to take under the underwriting agreement. In this case, the underwriters get priority over the general public at the time of allotment of shares. In the case of under subscription the total liability of the underwriters will be the addition of net liability for unsubscribed shares on the basis of underwriting agreement and liability under firm underwriting. In the absence of information in the question, firm underwriting should be treated as included in the given marked application forms because firm underwriting shares are subscribed by the underwriters themselves under their seal.

In the case of undersubscription, to determine the liability of underwriters, the benefit of firm underwriting can be given to all underwriters if firm underwriting is included in the unmarked application or if the benefit of firm underwriting is be given this to individual underwriters, firm underwriting should be included in marked applications. Actually, this depends upon the terms of agreement with underwriters. This entire procedure can be explained in the following steps:

1. Gross liability of all underwriters is calculated in their agreed ratio:
2. Marked applications of each underwriter are deducted.
3. Then from the balance (2) above, unmarked applications from gross liability are deducted in their gross liability ratio.

4. From the balance (3) above, firm underwriting is deducted (firm underwriting can be deducted in the ratio of gross liability, or benefit may be given to individual underwriters. It depends upon the agreement).
5. If any figure comes into minus (surplus) for any underwriter, that will be transferred to other underwriters into their gross liability ratio. This will be the net liability.
6. To calculate the total liability of underwriters, firm underwriting is added to net liability.

Self Assessment

Fill in the blanks:

1. The maximum rate of underwriting commission in the case of debenture is ………………. percent.
2. When an underwriter makes an agreement to take a certain number of shares, it is called ………….
3. Brokerage is fixed at …………… in respect of all types of public issues.
4. To calculate profit or loss on underwriting, ………….. is prepared by the underwriter.
5. Sub-Underwriting Commission is shown in the ………… side of the underwriting account.

Illustration 6

A Limited was formed with a capital of ₹ 20,00,000 divided into 1,00,000 shares of ₹ 20 each. The whole amount was offered to the public. The company entered into as underwriting agreement with the following individuals who have underwritten the whole issue as under:

P-30,000; Q-25,000; R-20,000; S-7,500; T-15,000; U-2,500.

All marked forms were to go in relief of underwriters whose names they bear. Applications for 20,000 shares were received but not marked. The applications on forms marked by the underwriters were P-12,500, Q-25,000 R-10,000 S-10,000, T-7500, U-Nil. Show the ultimate liability of each underwriter in respect of his agreement in A Ltd.

[M. Com. Rohilkhand University]

Solution:

Statement Showing the Liability of Underwriters in Shares

Particulars	Underwriters						
	Total	***P***	***Q***	***R***	***S***	***T***	***U***
Gross Liability in shares	1,00,000	30,000	25000	20,000	7,500	15,000	2500
Less: Marked Applications	65,000	12,500	25,000	10,000	10,000	7,500	Nil
	35,000	17,500	Nil	10,000	–2,500	7,500	2,500
Less: Unmarked Applications in the ratio: 12:10:8:3:6:1.	20,000	6,000	5,000	4,000	–1,500	3,000	500
	15,000	11,500	–5000	6,000	–4000	4,500	2,000
Less: Surplus of 'Q'& S (divided amongst P, R, T & U. in the gross liability ratio i.e., (12:8:6:1)	–	4,000	5,000	2,667	4000	2,000	333
Net Liability	15,000	7,500	Nil	3,333	Nil	2,500	1,667

Notes

Illustration 7 (Marked Application and Firm Underwriting)

The following underwriting of shares takes place: A-3,000 shares, B-1,000 shares, C-1,000 Shares. In addition there is firm underwriting: A 100 shares, B 50 shares, C 50 shares. The issue is 5,000 shares. The total subscription including firm underwriting was 4,000 Shares and the form included the following marked forms: A-500 shares, B-600 shares, C-200 shares. Show the allocation of liability of underwriters assuming that the marked forms included the firms underwriting.

Solution:

Statement Showing the Liability of Underwriters in Shares

Particulars	Underwriters			Total
	A	*B*	*C*	
	Shares	Shares	Shares	Shares
Gross Liability	3,000	1,000	1,000	5,000
Less: Marked Applications (excluding firm underwriting)	400	550	150	1,100
Less: Unmarked Applications	26, 00	450	850	3,900
Divided into gross liability 3:1:1 (4,000-1,300)	1,620	540	540	2,700
	980	–90	310	1,200
Less: Firm Underwriting	100	-50	50	200
Less: Credit for Surplus of B divided into	880	–140	260	1000
Gross liability ratio between A & C (3:1)	105	140	35	–
Net Liability	775	Nil	225	1,000
Add: Firm Underwriting	100	50	50	200
Total liability	875	50	275	1,200

Illustration 8 (When Benefit of Firm Underwriting is given to all Underwriters)

Todi Company Limited issued prospectus inviting applications for 30,000 shares. The entire issue is underwritten by Ajay, Vijay and Sanjay in the following manner:

Ajay –18,000 shares, Vijay – 7,500 shares and Sanjay - 4,500 shares. In addition to the above, the underwriters signed a contract with the company for the following firm underwriting:

Ajay–2,550 shares; Vijay–900 shares and Sanjay–2,850 shares. The company received the applications for the purchase of 21,300 shares which included the following marked applications:

A – 3,000 shares, B-6,000 shares and C-1,500 shares.

Calculate the total liability of each underwriter treating firm applications as unmarked.

Solution:

Statement Showing the Total Liability of Underwriters in Shares

Particulars	Underwriters			Total
	Ajay shares	Vijay share	Sanjay share	
Gross Liability	18,000	7,500	4,500	30,000
Less: Marked Applications given Resultant Liability	3,000	6,000	1,500	10,500
Less: Unmarked Application in gross	15,000	1500	3000	19500
Liability Ratio (12:5:3)	6,480	2,700	1,620	10,800
	8,520	–1,200	1,380	8,700

Contd...

Less: Surplus of Vijay distributed between Ajay and Sanjay in the gross liability ratio (12:3)	–960	–1200 +	240	–
Net Liability	7,560	Nil	1,140	8,700
Add: Firm underwriting	2,550	900	2,850	6,300
Total Liability	10,110	900	3,990	15,000

Working Note:

1. Total applications received by the company 21,300

   Less: Marked applications received

Ajay	–	3,000	
Vijay	–	6,000	
Sanjay	–	1,500	10,500
Unmarked applications (including firm applications)			10,800

2. Gross Liability Ratio:

Ajay		Vijay		Sanjay
18,000	:	7,500	:	4500
180	:	75	:	45
12	:	5	:	3

Illustration 9

Sardar Limited issued to the public 1, 50,000 equity shares of ₹ 100 each at par. ₹ 60 per share was payable along with the application and the balance on allotment. The issue was underwritten equally by Ali, Bali and Charlie for a commission of 5%. Applications for 1, 40,000 shares were received as per details below:

Underwriters	**Firm Applications**	**Marked Applications**	**Total**
Ali	5,000	40,000	45,000
Bali	5,000	46,000	51,000
Charlie	3,000	34,000	37,000
Unmarked Applications			7,000
Total			140,000

It was agreed to credit unmarked applications equally to Ali & Charlie. Sardar Limited accordingly made the allotment and received the amounts due from public. The underwriters settled their accounts.

You are requited to:

(i) Prepare a statement showing the liability of underwriters

(ii) Journalize the above transactions (including cash) in the books to Sardar Limited.

Notes

Solution:

Sardar Limited

A. When the benefit of firm applications is given to individual underwriters, or when firm applications are treated as marked application.

Statement Showing the Liability of Underwriters in Shares

Particulars	Underwriters			Total
	Ali	Bali	Charlie	
Gross Liability	50,000	50,000	50,000	1,50,000
Less: Marked Applications	40,000	46,000	34,000	1,20,000
Less: Relief for Unmarked Applications	10,000	4000	16,000	30,000
	3,500	–	3,500	7,000
	6,500	4000	12,500	23,000
Less: Firm Application	5,000	5,000	3,000	13,000
	1,500	–1,000	9,500	10,000
Less: Surplus of Bali distributed to Ali and Charlie in gross				
Liability ratio	500	1000	500	–
Net Liability	1,000	Nil	9,000	10,000
Add: Firm underwriting	5,000	5,000	3,000	13,000
Total Liability	6,000	5,000	12,000	23,000

Calculation of Net amount Receivable from Underwriters

	Ali	Bali	Charlie	Total
Total liability in shares (as calculated)	6,000	5,000	12,000	23,000
Amount due @ ₹ 60 per share	3,60,000	3,00,000	7,20,000	13,80,000
Less: Commission @ 5% on the nominal value of shares	2,50,000	2,50,000	2,50,000	7,50,000
Final amount receivable	1,10,000	50,000	4,70,000	6,30,000

B. When the benefit of firm underwriting is not given to individual underwriters, or when firm applications are treated as unmarked applications.

Statement Showing the Liability of Underwriters in Shares

Particulars	Ali	Bali	Charlie	Total
Gross Liability	50,000	50,000	50,000	1,50,000
Less: Marked Applications	40,000	46,000	34,000	1,20,000
Less: Unmarked Applications	10,000	4000	16,000	30,000
(Including firm applications)	10,000	—	10,000	20,000
Net Liability	Nil	4,000	6,000	10,000
Add: Firm Underwriting	5,000	5,000	3,000	13,000
Total liability in shares	5000	9000	9000	23000

Notes

Calculation of Net Amount Receivable from Underwriters

	Ali	Bali	Charlie	Total
Total Liability in shares	5,000	9,000	9,000	23,000
Amount due @ ₹ 60 per share	3,00,000	5,40,000	5,40,000	13,80,000
Less: Commission @ 5% on the normal value of Underwritten shares	2,50,000	2,50,000	2,50,000	7,50,000
Final amount receivable	50,000	2,90,000	2,90,000	6,30,000

Journal entries in the books of Sardar Ltd.

Date	Particulars		L.F.	₹	₹
	Bank Account	Dr.		84,00,000	
	To Equity Share Application Account				84,00,000
	(Being receipt of application money on 1,40,000 shares @ ₹ 60 Per share)				
	Equity Share Application Account	Dr.		84,00,000	
	To Equity Share Capital Account				84,00,000
	(Being transfer of application money to share capital account)				
	Equity Share Allotment Account	Dr.		56,00,000	
	To Equity Share Capital Account				56,00,000
	(Being allotment money due on 1,40,000 shares @ ₹ 40 per share)				
	Bank Account	Dr.		56,00,000	
	To Equity Share Allotment Account				56,00,000
	(Being receipt of allotment money on 1,40,000 shares @ ₹ 40 Per share)				
	Underwriters' Account	Dr.		10,00,000	
	To Equity Share Capital Account				10,00,000
	(Being allotment of 10,000 shares to underwriters as per commitment)				
	Underwriting Commission Account	Dr.		7,50,000	
	To Underwriters' Account				7,50,000
	(Being underwriting commission due @ 5% on the nominal value of 1,50,000 shares)				
	Bank Account	Dr.		2,50,000	
	To Underwriters' Account				2,50,000
	(Being receipt of final amount due from underwriters)				

Illustration 10

Plentiful Ltd. comes out with a public issue of share capital on 1.1.2005 of 10, 00,000 equity shares of ₹ 10 each at a premium of 5%, ₹ 2.50 is payable on application (on or before 31.1.2005) and ₹ 3.00 on allotment (31.3.2005) including premium.

The issue is underwritten by two underwriters – Seth and Shetty – equally the commission being 5% of the issue price. Each of the underwriters underwrites 20,000 shares firm.

Subscriptions total 9,60,000 shares, the distribution of forms being:

Seth 5,20,000, Shetty 3,60,000 and unmarked forms 80,000.

Notes

One of the allottees (using forms marked with the name of the Seth) for 2,000 shares, fails to pay the amount due to allotment all other money due being received in full including any due from the share devolving upon the underwriters. The commission due is paid separately.

The shares of the indifferent allottees are finally forfeited by 30.6.2005 and are reallotted for payment in cash of ₹ 4 per share.

You are required to pass summary journal entries to record the above events and transactions (including cash).

Solution:

Statement showing the Liability Underwriters of underwriters in Shares

Particulars	Total	Underwriters	
		Seth	Shetty
Gross Liability	10,00,000	5,00,000	5,00,000
Less: Marked applications (excluding firm applications)	8,40,000	5,00,000	3,40,000
	1,60,000	Nil	1,60,000
Less: Relief of Unmarked Applications	80,000	40,000	40,000
	80,000	–40,000	1,20,000
Less: Firm underwriting	40,000	–20,000	20,000
	40,000	–60,000	1,00,000
Less: Surplus of Seth given to Shetty	–	+60,000	–60,000
Net Liability	40,000	Nil	40,000
Add: Firm Underwriting	40,000	20,000	20,000
Total Liability	80,000	20,000	60,000

Notes Firm applications are assumed to be included in marked applications.

Journal Entries in the books of Plentiful Ltd.

Date	Particulars	L.F.	₹	₹
2005				
Jan. 31	Bank Account Dr.		24,00,000	
	To Equity Share Capital Account.			24,00,000
	(Being receipt of application money on 9,60,000 shares @ ₹ 2.50 per share)			
March 31	Equity Share Allotment Account Dr.		24,00,000	
	To Equity Shares Capital Account			24,00,000
	(Being application money transferred to share Capital Account)			
March 31	Equity Share Allotment Account Dr.		28,80,000	
	To Equity Share Capital Account			24,00,000
	To Share Premium Account			4,80,000
	(Being allotment money due on 9,60,000 shares @ ₹ 3 per share including premium)			

Contd...

Notes

March 31	Bank Account	Dr.		28,74,000	
	To Equity Share Allotment Account				28,74,000
	(Being receipt allotment money on 9,60,000 shares expect 2000 shares)				
March 31	Shetty	Dr.		2,20,000	
	To Equity Shares Capital Account				2,00,000
	To Shares Premium Account				20,000
	(Being allotment of 40,000 shares to Shetty as per underwriting agreement)				
March 31	Bank Account	Dr.		2,20,000	
	To Shetty				2,20,000
	(Being receipt of the money on 40,000 shares)				
March 31	Underwriting Commission Account	Dr.		5,25,000	
	To Seth				2,62,500
	To Setty				2,62,500
	(Being commission due @ 5% in the issue price ₹ 10.50 of 10,00,000 shares distributed equally)				
March 31	Seth	Dr.		2,62,500	
	Shetty	Dr.		2,62,500	
	To Bank Account				5,25,000
	(Being payment of underwriting commission)				
June 30	Share Capital Account	Dr.		10,000	
	Share Premium Account	Dr.		1,000	
	To Share Allotment Account				6,000
	To Share Forfeited Account				5,000
	(Being forfeiture of 2,000 shares for non payment of allotment money)				
June 30	Bank Account	Dr.		8,000	
	Shares Forfeited Account	Dr.		2,000	
	To Equity Share Capital Account.				10,000
	(Being forfeited shares reissued @ ₹ 4 per share)				
June 30	Shares Forfeited Account	Dr.		3,000	
	To Capital Reserve Account				3,000
	(Being transfer of profit on sale of reissue of forfeited shares)				

10.8 Accounts of Underwriter

To determine the profit or loss on the underwriting business, the underwriters can maintain two types of accounts:

Type I – When only one account is maintained by the underwriter i.e., Underwriting Account.

Type II – When more than one account is maintained by the underwriter.

Notes

I. When Only One Account is Maintained by the Underwriter i.e. Underwriting Account

To calculate the profit or loss on underwriting of particular issue, the underwriters maintain only one account – Underwriting Account. This account is also called by the name of "Investment in Shares or Debentures of XYZ Company Limited Account." This account is practically like Profit and Loss Account. All expenses relating to the underwriting contract are debited to this account. All revenuers are credited to this account.

Accounting Treatment

1. When the underwriter has to take up the shares or debentures under agreement or firm underwriting-

   Underwriting Account Dr.

   (With amount paid for shares or debentures)

   To Bank Account

2. When payment is made by underwriter for expenses relating to the underwriting-

   Underwriting Account Dr.

   To Bank Account

3. When underwriting commission is received in cash or shares-

   Bank Account Dr.

   Shares in Co. Ltd. Dr.

   To Underwriting Commission Account.

4. When Underwriting Commission is transferred to underwriting account-

   Underwriting Commission Account Dr.

   To Underwriting Account.

5. When shares received in commission are transferred to underwriting account-

   Underwriting Account Dr.

   To Shares in Co. Ltd.

6. When shares or debentures are sold by the underwriters-

   Bank Account Dr.

   To Underwriting Account

7. At the end of the year shares or debentures in stock are valued at cost or market price which is less.

Self Assessment

State whether the following statements are true or false:

6. The maximum rates of underwriting commission on shares is 5%.
7. The minimum rates underwriting commission on debentures, is
8. The nature of underwriting account is a nominal account.
9. Only in the condition of under subscription an underwriter can take up shares.

Notes

10. If an underwriter wants to reduce his liability, he can do so by entering into another contract with sub-underwriter.

11. Commission received from a company is credited in the underwriting account.

12. Amount in shares or debentures given to sub-underwriter is debited to underwriting account.

10.9 Sub-Underwriting

In order to reduce the liability of underwriting contract, the underwriter may enter into a contract with a number of persons who we called sub-underwriters. The sub-underwriting contract is signed between the main underwriter and sub-underwriter. Sub-underwriter has nothing to do with the company. Therefore he gets his commission from the main underwriter which is called sub-underwriting commission. Sub-underwriting commission is debited to the underwriting account. In case of undersubscription, the sub-underwriter has to take shares or debentures as may fall to his share from the main underwriter. The underwriting account is credited with the allotment money on these shares.

10.10 Overall or Overriding Commission

This is an additional commission which is paid by the company to the underwriter for providing the services of sub-underwriters. This is calculated on the entire underwritten amount of shares or debentures at a fixed percentage. On account of being the income of the underwriter, this is credited to the underwriting account. When the maximum rate of underwriting commission is decided, this commission also includes in underwriting commission as per Section 76 of Companies Act.

II. When more than one account is maintained by the underwriter

In this system, the underwriter opens the following accounts in the place of underwriting account.

(i) Investment in Shares Debentures in Co. Ltd. or Underwriting Account.

(ii) Underwriting Commission Account.

(iii) Issuing Company Account.

(iv) Sub-underwriting Account.

> *Notes* In order to reduce the liability of underwriting contract, the underwriter may enter into a contract with a number of persons who we called sub-underwriters.

10.10.1 Accounting Treatment

(i) When shares or debentures are taken up under underwriting agreement –

Underwriting Account (Shares or Debentures in X Co.) Dr.

To Issuing Company.

(ii) When the amount is paid by underwriting regarding the expenses of underwriting–

Underwriting Shares or Debentures in X Co.) Dr.

To Bank Account.

Notes

(iii) When the underwriting commission is due–

Issuing Company Account Dr.

To Underwriting Commission Account.

(iv) When the amount due on shares or debentures is paid to the issuing company–

Issuing company Dr.

To Bank Account.

(v) When the underwriting commission is received in cash or shares–

Bank Account Dr.

Shares or Debentures A/c Dr.

To Issuing Company Account.

(vi) When shares or debentures are given to sub-underwriter on the basis of the sub-underwriting agreement-

Sub-Underwriter Account. Dr.

To underwriting (Shares or Debentures in X Co.)

(vii) When the sub-underwriting commission is due to the sub underwriter-

Underwriting Commission Account Dr.

To Sub-underwriters Account.

(viii) When the amount due on shares or debentures given to the sub-underwriter is received-

Bank Account Dr.

To Sub-underwriters Account.

(ix) When the sub-underwriting commission is paid to the sub-underwriter in cash or shares-

Sub-underwriters Account Dr.

To Bank Account.

To underwriting (shares or Debentures of X Co.).

(x) When the shares or debentures are sold in the market-

Bank Account. Dr.

To Underwriting Shares or Debentures in X Co.)

(xi) When the balance of underwriting commission account is transferred to underwriting (shares or debentures in X Co.) A/c-

Underwriting Commission Account Dr.

To Underwriting (shares or debentures in X Co.) A/c

(xii) Closing the shares or debentures in stock will be valued at cost or market price, whichever is less, and profit or loss on these share due to price fluctuation will be transferred to Profit and Loss Account.

In case of profit

Underwriting (Shares or Debentures in X Co.) A/c Dr.

To Profit and Loss Account.

In case of loss this entry will be reversed.

Did u know? This is an additional commission which is paid by the company to the underwriter for providing the services of sub-underwriters. This is calculated on the entire underwritten amount of shares or debentures at a fixed percentage. On account of being the income of the underwriter, this is credited to the underwriting account. When the maximum rate of underwriting commission is decided, this commission also includes in underwriting commission as per Section 76 of Companies Act.

Illustration 11 (When Only One Account is Maintained by the Underwriter)

A underwrites an issue of 10,000 shares of ₹ 10 each in consideration of a commission of 4% payable in cash, the public having subscribed for 9,500 shares only. A, under the terms of his contract, has to take up the remaining 500 shares. His expenses amount to ₹ 100 when he closes his accounts for the year no shares were sold. The market value of the shares was ₹ 6 per share. A few days after closing his above account for the year, the above mentioned underwriter sold 200 shares at the rate of ₹ 6 per share. The market value of the remaining shares at the close of the year was ₹ 5 per share. In the next year the underwriter sells all the remaining shares at the rate of ₹ 7 per share. Show the underwriting account for all the three years in the books of A.

Solution:

In the books of A Underwriting Account

Date	Particulars	Shares	Amount ₹	Date	Particulars	Shares	Amoun t ₹
I Year	To Bank (Exps.) A/c	–	100	I Year	By Bank (Underwriting commission)	–	4,000
	To Bank Account (shares taken up)	500	5,000		By Balance c/d	500	1,100
		500	5,100			500	5100
II Year	To Balance b/d	500	1,100	II Year	By Bank Account (Sale of 200 @ ₹ 6 per share)	200	1,200
	To Profit & Loss A/c (profit on sale of share)	–	100		By Balance c/d	300	–
		500	1,200			500	1,200
III Year	To Balance b/d	300	–	III Year	By Bank Account (sale of 300 share @ ₹ 7 per share)	300	2,100
	To profit and Loss A/c (Profit on sale of 300 Shares)	–	2,100				
		300	2,100			300	2,100

Illustration 12 (Underwriting with Sub-Underwriting)

A Ltd. issued 4,000 shares of ₹ 10 each and entered into an underwriting agreement with B who agreed to underwrite the whole issue at a commission of 4% and entered into sub-underwriting agreement with C for 25% of the issue at a commission of 3%. The public applied only for 75% of the issue, hence the balance was taken up by the underwriters. B sold the shares held by him @ ₹ 8 per share. Find out profit or loss on underwriting from B's point of view.

Notes

Solution:

In the books of A (Underwriter)
Underwriting Account

Particulars	₹	Particulars	₹
To Bank Account (25% of the issue taken up i.e., 1,000 shares)	10,000	By Bank Account underwriting commission	1,600
To Bank Account (3% commission given to C)	300	By Bank Account (250 shares taken up by C)	2,500
		By Bank Account (Sale of 750 shares @ ₹ 8 per share)	6,000
		By Loss	200
	10,300		10,300

Working Note:

1. Underwriting Commission = $\frac{40,000 \times 4}{100} = ₹\,1600$

2. Sub-underwriting agreement is for

   $\frac{40,000 \times 25}{100} = 1,000$ Shares.

3. Commission for C (Sub-underwriter)

   $\frac{10,000 \times 3}{100} = ₹\,300$

4. Shares taken by C (Sub-underwriter)

   $\frac{1,000 \times 25}{100} = 250$ Shares

Illustration 13

Jagdamba Limited issued 4,00,000 equity shares of ₹ 10 each. The issue was underwritten by Hanuman for a commission of 5%. Mr. Hanuman arranges with Bhima for sub-underwriting to the extent of 30% of shares for a commission of 4%. The shares were to be paid for as:

₹ 3.0 on Application

₹ 3.5 on Allotment

₹ 3.5 on First & Final call.

The public applied for 3,20,000 shares. Both Mr. Hanuman and Mr. Bhima fulfilled their obligations. After the call Mr. Hanuman sold 36,000 shares at ₹ 9. At the close of the period the market value of the shares was ₹ 9.50. Expenses of Mr. Hanuman were ₹ 13,000. Prepare the underwriting account in the books of Mr. Hanuman.

Solution:

Notes

In the books of Mr. Hanuman
Underwriting Account

Date	Particulars	Shares	Amount ₹	Date	Particulars	Shares	Amount ₹
	To Bank Account (Expenses)	–	13,000		By Bank Account (5% Commission on ₹ 40 lacs)	–	2,00,000
	To Bank Account (Payment of application money)	80,000	2,40,000		By Bank Account (Amount received from Bhima on 24,000 shares @ ₹ 6.5 per shares.	24,000	1,56,000
	To Bank Account (Payment of allotment money)	–	2,80,000				
	To Bank Account (Commission to Bhima @ 4% on ₹ 12,00,000 i.e., 30% of the issue)	–	48,000		By Bank Account (Sale of 36,000 shares @ ₹ 9 each)	36,000	3,24,000
	To Bank Account (Payment of final call on 56,000 share)	–	1,96,000		By balance c/d @ ₹ 7.5178 at cost price.	20,000	1,50,356
	To Profit and Loss A/c.	–	53,356				
		80,000	8,30,356			80,000	8,30,356

Working Note:

Calculation of cost of shares	₹	
Total amount paid on 80,000 shares @ ₹ 6.50		5,20,000
Expenses		13,000
Underwriting Commission		48,000
		5, 81,000
Less: Amount Received on 24,000 shares		
@ ₹ 6.5 per share from Bhima	1,56,000	
Underwriting Commission	2,00,000	3,56,000
		2,25,000
Add: Payment of final call on 56,000 shares @ ₹ 3.5		1,96,000
Cost of 56,000 shares		4,21,000

Cost per share = $\frac{4,21,000}{56,000}$ = ₹ 7.5178

Cost of 20,000 shares = 20,000 × ₹ 7.5178 = ₹ 1,50,356

Notes

Illustration 14 (When More Than one Account are Maintained by the Underwriter)

Shubham Limited was registered with an authorized capital of ₹ 25, 00,000 divided into 2, 50,000 shares of ₹ 10 each. It issued a prospectus inviting applications for 25, 00,000 shares. The whole issue was fully underwritten by Naranya Company Limited. The rate of underwriting commission was settled at 5% which was payable as to 80% in fully paid shares and 20% in cash. In addition to underwriting these shares Naranya Co. Ltd. made a firm application in the ordinary course for a further 50,000 shares.

The issue was not fully subscribed by the public and the underwriter was obliged to take up 25% of the issue underwritten. His expenses were ₹ 3,000. The shares in Shubham Limited were subsequently quoted at a discount of 20%.

Prepare Underwriting Commission Account, Underwriting Account, Shubham Ltd. Account and Bank Account in the books of Naranya Co. Ltd.

Solution:

In the books of Naranya Co. Ltd.
Underwriting Commission Account

Particulars	₹	Particulars	₹
To Underwriting Account (Transfer)	1,25,000	By Shubham Limited (5% on ₹ 25,00,000)	1,25,000
	1,25,000		1,25,000

Underwriting Account

Particulars	₹	Particulars	₹
To Shubham Ltd. (10,000 shares received in commission)	1,00,000	By Underwriting Commission A/c	1,25,000
To Shubham Ltd. (25% shares taken under agreement 62,500 shares)	6,25,000	By Profit and Loss Account	1,23,000
To Shubham Ltd. (firm underwriting 50,000 shares)	5,00,000	By Balance c/d (market price ₹ 8)	9,80,000
To Bank Account (Exps.)	3,000		
	12,28,000		12,28,000

Shubham Ltd.'s Account

Particulars	₹	Particulars	₹
To Underwriting Commission	1,25,000	By Underwriting Account.	1,00,000
To Bank Account	11,00,000	By Underwriting Account.	6,25,000
		By Underwriting Account.	5,00,000
	12,25,000		12,25,000

Bank Account

Particulars	₹	Particulars	₹
To Shubham Ltd.	25,000	By Underwriting Account.	3,000
		By Shubham Ltd.	11,00,000

Working Note:

1. Total no. of shares required to take up under agreement (25% of the issue) 62,500

   Firm underwriting 50,000

Notes

2. Calculation for cost price of shares.

			₹
Amount paid for	62,500	shares	6,25,000
Amount paid for	50,000	shares	5,00,000
Amount paid for (commission)	10,000	shares	Nil
Expenses	1,22,500	shares	3,000
			11,28,000
Less: Underwriting Commission Received			1,25,000
Cost of 1,22,500 shares			10,03,000

Cost of one share = $\frac{10,03,000}{1,22,500}$ = ₹ 8.188

Market value is 10 – 2 = ₹ 8.

10.10.3 Miscellaneous Illustrations

Illustration 15

The Hopeful Ltd. issued 20,000 shares which were underwritten by three different persons as follows:

A– 1,000 shares, B-6,000 shares, C-1,500 shares. In addition, there was firm underwriting by:

A –1,000 shares, B-500 shares, C-1500 shares.

The company received application for 15,200 shares including firm applications and number of marked forms were as below:

A-3,000 shares, B-4,500 shares, C-1,700 shares. Show the allocation of liability of the underwriters assuming that the underwriting agreement did not provide any relief for firm application.

Solution:

Statement Showing Underwriters' Liability in Shares

Particulars	Underwriters A	Underwriters B	Underwriters C	Total
Gross Liability	10,000	6,000	4,000	20,000
Less: Marked Applications	3,000	4,500	1,700	9,200
	7,000	1,500	2,300	10,800
Less: Unmarked Applications Including firm applications (divided in the ratio of Gross Liability) 5:3:2	4,500	2,700	1,800	9,000
Less: Surplus of 'B' distributed between A & C in the ratio of gross liability 5:2	2,500	–1,200	500	1,800
Net Liability	857	+1200	343	–
	1,643	Nil	157	1,800
Add: Firm underwriting	1,000	500	1,500	3,000
Total Liability (in Shares)	2,643	500	1,657	4,800

Notes

Working Note:

Total application received by the company.	15,200	shares
Less : Marked Applications (3,000 + 4,500 + 1,700)	9,200	shares
Unmarked Application	6,000	shares

As no relief is given on firm applications to underwriters, firm application will be treated as unmarked.

Total unmarked applications 6,000 + 3,000 = 9,000 including firm applications = 6,000 + 3,000 = 9000 shares

Illustration 16

A Ltd. has an authorized capital of ₹ 50,00,000 divided into 5,00,000 shares of ₹ 10 each. The company issued 1,00,000 shares for subscription to the public at a premium of ₹ 5 each. The entire issue was underwritten as follows:

A – 60,000 shares (Firm underwriting – 10,000 shares)

B – 30,000 shares (Firm underwriting – 4,000 shares)

C –10,000 shares (Firm underwriting – 2,000 shares)

On the total issue only 90,000 shares including.

Firm underwriting were subscribed for. Marked applications were as follows:

A – 32,000 shares

B – 20,000 shares

C – 8,000 shares

Calculate the liability of each underwriter.

Solution:

Statement Showing the Liability of Underwriter in Shares

Particulars	Underwriters			Total
	A	*B*	*C*	
Gross Liability	60,000	30,000	10,000	1,00,000
Less: Marked Applications	32,000	20,000	8,000	60,000
	28,000	10,000	2,000	40,000
Less: Unmarked applications divided in the gross liability ratio (6:3:1)	18,000	9,000	3000	30,000
	10,000	1000	–1,000	10,000
Less: Surplus of C distributed between A & B in gross liability ratio (2:1)	667	333	+1,000	–
Net liability	9,333	667	Nil	10,000
Add : Firm underwriting	10,000	4,000	2,000	16,000
Total liability	19,333	4,667	2,000	26,000

Unmarked Applications = 90,000 - (32,000 + 20,000 + 8000) = 30,000.

Did u know? RRBs are specialized rural financial institutions for catering to the credit requirements of the rural sector.

Caution RBI has also directed its own training centres and NABARD training centres to conduct training programmes for RRBs staff in keeping with the requirements of the day.

Self Assessment

Select the best alternative:

13 Underwriting agreement in made to–

(a) Collect the capital easily.

(b) Get company registered.

(c) Enter into contracts with others.

(d) Get accounts audited.

14. Underwriting commission may be paid in the issue price of shares @–

(a) 10%

(b) 5%

(c) (c)

(d) 3%

15. Maximum limit of brokerage on all type of public issues is–

(a) 0.5%

(b) 2%

(c) 1.5%

(d) 3%

16. On the debit side of the Underwriting Account, entry is made for–

(a) Price of total issue.

(b) Value of shares held.

(c) Sale of shares.

(d) Expenses in respect of underwriting.

17. Which items are not shown in the credit side of underwriting account–

(a) Value of unsold shares.

(b) Sales proceeds of the shares.

(c) Commission of the underwriter.

(d) Expenses of the underwriter.

Notes

10.11 Summary

- Underwriting involves the orderly process of security registration for the financial sourcing of a public offering through the purchase of securities for resale to the public. The underwriting may be a firm commitment to purchase the entire amount of the company's securities regardless of the ability to resell them. The underwriting of such a low-priced initial public offering (IPO) and other less-well-known stock (e.g., over-the-counter stock) may be done on a best-efforts basis where the underwriter acts only as an agent and accepts no financial liabilities.
- A successful underwriting not only sells the securities, but does so at a fair price. In addition, underwriters maintain a stable, liquid aftermarket for the trading of securities.
- Until the 1950s, underwriting was the only function performed by a number of specialty houses. Thereafter, underwriters merged their talents with retail and institutional sales in order to bolster their sagging bottom lines. Today there is little distinction between wholesale underwriting, which serves institutional clients including broker-dealers, and retail underwriting, which sells directly to individual investors.
- Most underwriting in the 1990s was handled by investment banks and brokerage firms. In 1996 the Federal Reserve Board lifted the revenue limit on securities underwriting by commercial banks and their subsidiaries from 10 to 25 percent. Although the ruling represented another falling barrier between investment banking and commercial banking, it was expected to have little effect on the underwriting industry.
- Large underwriting firms assist the largest corporations with secondary offerings and maintain a financial advisory role for the long term. As full-service houses, large firms need to handle IPOs in excess of $15 million for the fees to be profitable.
- Medium-size underwriting firms generally serve regional interests and handle offerings within the $5 to $15 million range. Although established companies, they lack the full range of services and number of personnel dedicated to underwriting and distribution. These firms are not likely to maintain a financial advisory capacity to their clients.

10.12 Keywords

Complete Underwriting Agreement: When the underwriter gives the guarantee to the company that whole issue will be subscribed by the public, it is called complete underwriting.

Firm Underwriting: When an underwriter makes an agreement to purchase a certain number of shares or debentures of the company, in addition to the shares or debentures he has to take under the underwriting agreement, it is called firm underwriting.

Investment in Shares or Debentures: To calculate the profit or loss on underwriting of particular issue, the underwriters maintain only one account – Underwriting Account. This account is also called by the name of "Investment in Shares or Debentures.

Partial Underwriting Agreement: When only a part of issue of shares or debentures is underwritten by the underwriters, it is called partial underwriting.

Underwriting of Shares: It means the contract in which underwriter agrees to take shares which will not be subscribed by public.

Underwriting Commission: A commission is paid to underwriters which is called underwriting commission.

Unmarked Applications: Those applications which bear the official stamp of an underwriter or broker are called marked applications and those which do not bear the official stamp of an underwriter, are called unmarked applications.

10.13 Review Questions

1. What do you understand by underwriting commission?
2. What are the objectives of underwriting?
3. Give the different types of underwriting.
4. Explain marked and unmarked applications.
5. What do you understand by firm underwriting?
6. Explain the meaning of sub-underwriting.
7. What restrictions are imposed by the Companies Act, on the payment of underwriting commission?
8. What do you mean by underwriting of shares and debentures? What are the various provisions in the Companies Act regarding underwriting commission? Mention accounting problems regarding underwriting.
9. What do you understand by underwriting, sub-underwriting and firm underwriting? What are the duties of the directors with regard to underwriting contracts?
10. What are the provisions regarding payment of underwriting commission on issue of share and debentures? Explain.
11. Write short notes on–
    (i) Underwriting account
    (ii) Sub-underwriting
    (iii) Overriding commission
    (iv) Marked and Unmarked Application
    (v) Firm underwriting.

Practical Questions:

1. Meerut Ltd. was formed with a capital of ₹ 1,00,000 divided into 10,000 shares of ₹ 10 each. All these shares were offered for subscription by prospectus to the public. The shares were underwritten as follows:

A	B	C
40%	30%	30%

Marked applications were received in favour of A for 1,600 shares, B for 2,800 shares C for 1,600 shares. Applications for 1,000 shares were unmarked.

Prepare a statement showing the net liability of each underwriter.

Ans: A-1,943 shares, B-nil, C-1,057 shares.

2. Chhotey Co. Limited issued 25,000 equity shares of ₹ 100 each at par and 1,250 debentures of ₹ 1,000 each at ₹ 950. The whole of the issue has been underwritten by Kashi & Co. for a consideration of 4% on shares and 2% on debentures (nominal value). The whole of the shares were applied for but applications for 1,000 debentures were received. All the applications were accepted. 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: Total of Balance Sheet ₹ 37,50,000.

Notes

3. Ranu Limited issued 75,000 equity shares of ₹ 10 each at a premium of ₹ 10 per share and 3,000 debentures of ₹ 100 each at ₹ 95. 80% of the issue is underwritten by Shalini Singh and Co. at a maximum rate of commission allowed by law. Applications were received for 60,000 equity shares and 2,250 debentures, which were accepted and the payment for these was received in full. Journalize the above transactions and show the entries in the balance sheet, assuming that the amounts due from the underwriter have been received.

Ans: Total of Balance Sheet ₹ 10,77,000.

4. Kusum Ltd. has an authorized capital of ₹ 25,00,000 divided into 1,00,000 equity shares of ₹ 25 each. The company issued for subscription, 25,000 shares at a premium of ₹ 10 each. The entire issue was underwritten as follows:

   A – 15,000 shares (Firm underwriting – 2,500 shares)

   B – 7,500 shares (Firm underwriting – 1,000 shares)

   C – 2,500 shares (Firm underwriting – 500 shares)

   Out of the total issue 22,500 shares including firm underwriting were subscribed.

   The following were the marked forms:

   A – 8,000 shares

   B – 5,000 shares

   C – 2,000 shares.

   Calculate the liability of each underwriter, assuming that marked forms include firm underwriting also.

Ans: A-4,833; B-1,176; C-500 shares.

5. J. Ltd. issued 20,000 shares which were underwritten as follows:

   A-12,000 Shares, B-5,000 Shares, and C-3,000 Shares. The underwriters made applications for firm underwriting as under:

   A-1,600 Shares, B-600 Shares, and C-2,000 Shares.

   The total subscriptions excluding firm underwriting but including marked applications were for 10,000 shares.

   The marked applications were as under:

   A-2,000 Shares, B-4,000 Shares, and C-1,000 Shares.

   You are required to show the allocation of the liability of underwriters.

Ans: Liability of underwriters in shares A-7,400, B-600 and C-2,000.

6. Shilpa Limited issued 1,20,000 Equity Shares of ₹ 10 each. The whole issue was underwritten by Yogita & Company at an agreed commission of 5% payable as to 75% in fully paid shares and 25% in cash. In addition to underwriting of these shares, Yogita & Co. also made a firm application for 30,000 equity shares. 75% of the issue was subscribed by the public and Yogita & Co. was obliged to take 25% of the shares underwritten. The shares of Shilpa Ltd., were subsequently quoted at a discount of %. Prepare the necessary accounts in the books of Yogita & Co.

Ans: Loss ₹ 20,625.

Notes

Answers: Self Assessment

1. 5%
2. Firm underwriting
3. 1.5%
4. Underwriting Account
5. Debit
6. True
7. False
8. True
9. False
10. True
11. True
12. False
13. (a)
14. (b)
15. (c)
16. (d)
17. (d)

10.14 Further Readings

Books

Magazines and Journals

Arkebauer, James, *Going Public: Everything You Need to Know to Take Your Company Public or Invest in an IPO or DPO.* Chicago: Dearborn Trade, 1998.

Barker, William W, *SEC Registration of Public Offerings under the Securities Act of 1933.* Chicago: American Bar Association, 1997.

Brown, Meredith, ed. *Mechanics of Global Equity Offerings: Structuring the Offering and Negotiating the Underwriting Agreement.* Cambridge, MA: Kluwer Law and Taxation Publishers, 1995.

Goldblatt, Jennifer, "Market Ho-Hum about New Revenue Limit on Securities Underwriting."*American Banker,* 26 December 1996, 20.

Johnson, Hazel J, *The Banker's Guide to Investment Banking: Securities and Underwriting Activities in Commercial Banking.* New York: McGraw-Hill Professional Book Group, 1996.

Lipman, Frederick D, *Going Public: Everything You Need to Know to Successfully Turn a Private Enterprise into a Publicly Traded Company.* Upland, PA: DIANE Publishing, 1998.

Shillinglaw, Gordon, *Accounting: A Management Approach.* 9th ed. New York: McGraw-Hill Higher Education, 1992.

Online links

http://www.svtuition.org/2010/10/underwriting-of-shares-and-debentures.html

http://www.enotes.com/underwriting-securities-reference/underwriting-securities

http://s3.amazonaws.com/caclubindia/cdn/forum/files/146271_945934_underwriting.pdf

Notes

Case Study

Share Capital Purchase Requires Quick Turn-Around

Lee & Priestley has clients based all over the UK. With the use of e-mail and the operation of efficient client service levels in relation to returning telephone calls Lee & Priestley can provide a first class service wherever a client's location.

A recent transaction involved an entrepeneur from Essex who was looking to purchase the share capital of a company in Suffolk. The client had used local firms in the past but was recommended to Lee & Priestley by his accountant.

The transaction timetable required a quick turn around of the documentation and regular contact with the client. The volume of paperwork involved was typical for a standard share sale.

Notwithstanding the distances involved the transaction proceeded to completion on schedule and without any location based difficulties.

The client's comments on his post-deal feedback form were "I was very pleased with all of the services provided by the team from Lee & Priestley. Over the years I have dealt with several solicitors and am finding it increasingly difficult to find effective legal firms, particularly in the South East, where at first point of contact one is told of ever increasing hourly rates only to experience an ever slower service and lack of commitment to advice given"

"The work that has been carried out has been executed in an effective and speedy manner. I have always received prompt and informative replies to my communications, some of which have been within minutes. Certainly as a client my expectations have been far exceeded when compared with the service, quality and price of other firms that I have dealt with.

Source: http://www.leepriestley.com/Case-Study/items/share-capital-purchase-requires-quick-turn-around.html

Unit 11: Profit and Loss Prior to Incorporation

Notes

CONTENTS

Objectives

After studying this unit, you should be able to:

- Explain the meaning of profit and loss prior to incorporation
- Understand the nature and use of profit and loss account
- Learn method of Ascertainment of Profit or Loss Prior to Incorporation
- Describe statutory Report

Introduction

When a running business is taken over by the promoters of a company, from a date before the company which is to manage and own is registered, the amount of profit or loss of such a business for the period prior to the date the company came into existence is referred to as pre incorporation profits or losses. Such profits or losses, though belonging to the company or payable by it, are of capital nature; it is necessary to disclose them separately from trading profits or losses.

The general practices in this concern are as follows:

1. If there is a loss.

    (a) It is either written off by debit to the Profit and Loss Account or to a special account described as Loss Prior to Incorporation and show as an asset in the Balance Sheet.

    (b) In the alternative, it is debited to the Goodwill Account.

2. On the other hand, if a profit has been earned by business prior to the same being taken over and the same is not fully absorbed by any interest payable for the period, it is credited to Capital Reserve Account or to the Goodwill Account, if any goodwill has been adjusted as an asset. The profit will not be available for distribution as a dividend among the members of the company.

Notes

11.1 Meaning of Profit or Loss Prior to Incorporation (Pre-incorporation Profit or Loss)

Generally, it is found that a newly-formed company may purchase a running business from a certain date which is prior to incorporation.

Example 1: A company incorporated or registered on 1st May, 2011 may acquire the business of a partnership firm from 31st December, 2010.

Usually it is found that this prior date coincides with the date of the Vendor's previous Balance Sheet. If this date does not coincide with the date of Vendor's previous Balance Sheet, stock taking has to be completed and balances of various assets and liabilities has to be extracted. To avoid this trouble, the business is acquired, from the date of the previous Balance Sheet. As a running business is acquired, profit or loss earned by the business from the date of purchase to the date of incorporation is called Profit or Loss Prior to Incorporation. And profit or loss made by the business from the date of incorporation to the date of closing of accounts at the end of first financial year is called Profit or Loss Subsequent to Incorporation.

11.2 Nature & Use of Profit or Loss

As per the Companies Act, a company cannot earn profit before its incorporation. Therefore, profits earned by the business from the date of acquisition to the date of its corporation cannot be treated as profit earned by the company. But due to these profits the net assets acquired by the company on its formation have been increased. Therefore, these profits cannot be treated as revenue profit but should be treated as capital profits and should be placed in a special account i.e., capital reserve. These profits will not be available for distribution as dividends to shareholders. These profits can be utilized in writing off capital losses as goodwill, preliminary expenses, discount on issue of shares and debentures, etc. In the absence of any writing off, these profits are transferred to Capital Reserve and are shown in the Liability side of the Balance Sheet under the heading 'Reserve and Surplus'. It is therefore, necessary to calculate the amount of such profits. If there is a loss during this period, it will be in the nature of a capital loss. This loss should be added to the amount of goodwill (if given). If the amount of goodwill is not given with this amount, goodwill account will be opened. Alternatively, this loss can be transferred to a suspense account and will be shown in the Assets side of Balance Sheet under the heading 'Miscellaneous Expenditure', until it is completely written off against profits.

Did u know? Usually it is found that this prior date coincides with the date of the Vendor's previous Balance Sheet. If this date does not coincide with the date of Vendor's previous Balance Sheet, stock taking has to be completed and balances of various assets and liabilities has to be extracted. To avoid this trouble, the business is acquired, from the date of the previous Balance Sheet.

In the absence of any contrary information, profit prior to incorporation in both private and public companies means the profit prior to incorporation and not to commencement of business.

> *Notes* As per the Companies Act, a company cannot earn profit before its incorporation. Therefore, profits earned by the business from the date of acquisition to the date of its corporation cannot be treated as profit earned by the company.

Notes

11.3 Method of Ascertainment of Profit or Loss Prior to Incorporation

There are two methods-

1. ***By preparation of separate profit and loss account for pre-incorporation and post-incorporation periods:*** When a running business is acquired, its separate profit and loss account can be prepared up to the date of incorporation. It will give the accurate amount of profit for pre-incorporation period and post-incorporation period. But this method is not easy, because to prepare separate profit and loss account, stocking and balancing of books is required. It would create a number of problems in the normal functioning of business and would increase cost unnecessarily. Hence this method for the determination of pre and post-incorporation profits or losses is rarely used by a company.

2. ***By apportioning the whole profits of the year into pre-incorporation period and post-incorporation period:*** Under this method, first of all trading account for the whole accounting year is prepared to find out the gross profit. Then, the following two ratios are calculated:

   (i) *Time Ratio:* This ratio is calculated on the books of time falling between the last date of the Balance Sheet and the date of incorporation or registration and the date of current final account.

Example 2: If a company acquires a business on 1st April, 2010 and is incorporated on 1st June, 2010 and final accounts are prepared on 31st March 2010, time ratio will be 2:10 or 1:5.

   (ii) *Sales Ratio or Turnover Ratio:* On the basis of pre-incorporation period sales and post-incorporation period sales this ratio is calculated.

Gross profit calculated by the preparation of profit and loss account is divided into two parts (for pre-incorporation period and post-incorporation period) on the basis of time ratio. And then a statement is prepared to find out the net profit. In this statement, all the items appearing in the debts side (expenses) and credit side (income) are shown. These items are apportioned on the basis of their characteristics. These can be as follows:

(i) ***Some expenses are distributed on the basis of Time Ratio:*** All those expenses which have fixed or standing nature, should be distributed on the basis of time ratio in pre-acquisition period and post-acquisition period e.g., salary of staff or workers, rent, depreciation, etc.

(ii) ***Some expenses are distributed on the basis of Sales/Turnover Ratio:*** All those expenses which are related to sales, are distributed on the basis of sales ratio e.g., commission on sales, discount allowed to customers, selling expenses, etc.

(iii) ***Some expenses are exclusively for prior to incorporation period:*** Some expense are exclusively incurred in the pre-incorporation period, and are therefore these are not apportioned but charged completely in the pre-incorporation period e.g., salaries payable to vendors and interest payable on purchase price for the pre-incorporation period.

Did u know? Gross profit calculated by the preparation of profit and loss account is divided into two parts (for pre-incorporation period and post-incorporation period) on the basis of time ratio.

(iv) Some expenses are exclusively for post-incorporation period: Some expenses are incurred exclusively in the post acquisition period, therefore these are not apportioned but charged completely in the post-acquisition period e.g., directors' fees, preliminary expenses, interest on debentures, etc.

Notes

Basis of Apportionment of Expenses at a Glance

	Name of Expenditure	Basis of Apportionment
1.	Gross Profit or Gross Loss	Turnover/Sales Basis Or If the sales of the respective periods are not given in the question, on the basis of direct expenses relation to sales in the respective period. Or If both the above information are not available on the basis of time.
2.	Fixed Nature Expense e.g., Salaries, Rent, General Expenses, Rates, Depreciation, Postage, Telephone, Printing and Stationery, Electricity, Audit Fees, Trade Expenses, Insurance Expenses, Bank Expenses, Interest, Repairs, Administrative Expenses etc.	On the basis of time.
3.	Variable Expenses e.g., Commission on Sales, Carriage Outwards, Discount, Advertisements, Salesman's salary, Bad Debts, Packing, Sales Expenses.	Turnover Basis.
4.	Expenses exclusively for pre-incorporation period: e.g., interest payable on purchase price to vendor for pre-incorporation period, vendor's salary, loss or gain on the sale of investment before incorporation, etc.	Not apportioned but are charged to pre-incorporation period.
5.	Expenses exclusively for post-acquisition period e.g., Preliminary Expenses, Directors' Fees, Formation, Expenses, Discount on Issue of Shares and Debentures, Underwriting Commission, Salary to Managing Director, Interest on debentures, etc.	Not apportioned but are charged to post-incorporation period.

Illustration 1 (Division of Expenses on Both Time and Turnover Basis)

Sangita Ltd. was incorporated on 1st March, 2010 and received its Certificate of Commencement of Business on 1st April, 2010. The company bought the business of M/s Sohan & Sons with effect from 1st November, 2009. From the following figures relating to the year ending October 31, 2010, find out the profit available for dividends:

(a) Sales for the year were ₹ 9,00,000 out of which sales upto 1st March were ₹ 3,75,000.

(b) Gross Profit for the year was ₹ 2,70,000.

(c) The Profit and Loss Account for the year ending October 31, 2010.

Solution:

Particulars	₹	Particulars	₹
To Rent and Rates	12,000	By Gross Profit	2,70,000
To Insurance	3,000		
To Electricity Charges	2,400		
To Salaries	36,000		
To Directors' Fees	7,200		
To Interest on Deb.	7,500		
To Audit Fees	2,250		
To Discount on Sale	5,400		

Contd...

Notes

To Depreciation	36,000		
To Advertisement	7,200		
To Stationery & Printing	27,000		
To Commission on Sales	5,400		
To Bad Debt (₹ 750 relating to pre-incorporation)	2,250		
To Interest to vendor (upto 1st May, 2010).	4,500		
To Net Profit	1,11,900		
	2,70,000		2,70,000

Solution:

Working Notes:

1. Time Ratio:

   1st November 2009 to 1st March, 2010 = 4 months

   1st March, 2010 to 31st October, 2010 = 8 months

   Time Ratio- = 4:8 or 1:2

2. Turnover Ratio:

   Turnover for prior period is ₹ 3,75,000

   Turnover for post period is ₹ 9,00,000 – 3,75,000

   = ₹ 5,25,000

   Turnover Ratio is 3,75,000:5,25,000 or 5:7

Profit and Loss Account for the year ending 31st October, 2010

Particulars	Basis of Allocation	Pre-incorporation period ₹	Post-incorporation period ₹	Particulars	Pre-incorporation period ₹	Post-incorporation period ₹
To Rent & Rates	Time	4,000	8,000	By Gross Profit	1,12,500	1,57,500
To Insurance	Time	1,000	2,000	(Turnover ratio)		
To Electricity Charges	Time	800	1,600			
To Salaries	Time	12,000	24,000			
To Directors' fees	–	–	7,200			
To Interest on Debentures	–		7,500			
To Audit fees	Time	750	1,500			
To Discount	Turnover	2,250	3,150			
To Depreciation	Time	12,000	24,000			
To Advertisement	Turnover	3,000	4,200			
To Stationery and Printing	Time	9,000	18,000			
To Commission on Sales	Turnover	2,250	3,150			
To Bad Debts	Turnover	750	1,500			
To Interest to Vendors	4:2	3,000	1,500			
To Net Profit		61,700	50,200			
		1,12,500	1,57,500		1,12,500	1,57,500

Notes

Illustration 2 (Division of Profit on Monthly Basis)

A Limited that acquires a business as on 1st April, 2010 is being incorporated on 1st August, 2010. The first account were drawn upto 31st December, 2010. The gross profit is ₹ 60,000. The general expenses are ₹ 9,000, Directors fees ₹ 30,000 per annum and Preliminary expenses ₹ 2,500. Rent to 30th September, 2010 was ₹ 1,800 per annum after which it was increased to ₹ 3,600 per annum. The salary of the manager who upon incorporation was made a Director, was ₹ 4,800 per annum (since incorporation included in Directors' fees above).

Prepare a Profit and Loss Account in the books of A Limited showing the profit for the period prior to and after incorporation. The total sales were ₹ 9,30,000 the monthly average of which for the four months of April to July, 2010 being one-fourth of that of the remaining period. The company earned a uniform profit.

(Adapted from B. Com. Rohilkhand Uni. 1995)

Solution:

Profit and Loss account for the year 2010

Particulars	Pre-incorporation period ₹	Post-incorporation period ₹	Particulars	Pre-incorporation period ₹	Post-incorporation period ₹
To General Exps.	4,000	5,000	By Gross Profit		
(Time Ratio)			(Turnover Ratio)	10,000	50,000
To Rent	600	1,200			
To Manager's Salary	1,600	–			
To Directors' fees	–	12,500			
To Preliminary Exps.	–	2,500			
To Net Profit	3,800	28,800			
	10,000	50,000		10,000	50,000

Working Note:

1. Time Ratio:

   1st April, 2010 to 1st August, 2010 = 4 months

   1st August 2010 to 31st December 2010 = 5 months.

   Therefore, Time Ratio = 4:5

2. Turnover Ratio:

   Assume the monthly average sales for first four months is ₹ 1

   ∴ Monthly average sales for the remaining five months will be ₹ 4.

   Total sales for first four months = ₹ 1 × 4 = ₹ 4

   (Pre-acquisition period)

   Total sales for next five months 4 x 5 = 20

   (Post-acquisition period)

   ∴ Turnover Ratio = 4:20 or

   1:5

3. Calculation of Rent

For first four months @ ₹ 150 p.m. or 1800 p.a. (April, May, June & July 2010)

	Pre-acquisition period Rent = ₹ 600
	For next two months @ ₹ 150 p.m. or 1800 p.a.
Post-acquisition Period]	August & September, 2010 = ₹ 300
	For next three months @ ₹ 300 p.m. or ₹ 3600 p.a.
	October, November & December, 2010 = ₹ 900
	= 300 + 900 = ₹ 1200

4. Manager's salary @ ₹ 4,800 p.a. for four months (pre-incorporation period)

5. Directors' fees @ ₹ 30,000 p.a. for five months.

Illustration 3 (Apportionment of Profit when unit cost of sales is given)

A Limited Company was incorporated on 1st January, 2010 with an authorized capital of ₹ 5,00,00 equity shares of ₹ 10 each, to take over the running business of a partnership firm as from 1st October 2009.

Solution:

The following is the summarised Profit and Loss Account for the year ended 30th September, 2010 :

	₹	₹
Sales 1.10.2009 to 31.12.2009	6,000	
1.1.2010 to 30.9.2010	19,000	25,000
Less :		
Cost of Sales	16,000	
Administrative Expenses	1,768	
Selling Commission	875	
Goodwill written off	200	
Interest paid to vendor (loan repaid on 1.2.2010)	373	
Distribution Expenses (60% variable)	1,250	
Preliminary Expenses written off	330	
Debentures Interest	320	
Depreciation	444	
Directors' fees	100	21,660
		3,340

The company deals in one type of the product.

The unit cost of sales was reduced by 10% in the post-incorporation period –

Apportion the net profit between pre-incorporation and post–incorporation period sowing the basis of apportionment.

Notes

Working Note:

1. Time Ratio:

   Pre-incorporation period (from 1.10.2009 to 31.12.2009) = 3 months.

   Post-acquisition period (1.1.2010 to 30.9.2010) = 9 months

   Time ratio = 3 : 9 or 1:3

2. Sales Ratio 6,000 : 19,000 or

   6 : 19

3. Assume ratio of cost of sales to sales in pre-acquisition period is x.

   Ratio of cost of sales to sales in post-acquisition period will be

   $$x - \frac{10x}{100} = \frac{9x}{10}$$

   According to question – The total cost of sales in the two periods will be:

   $$6{,}000x : 19{,}000 \times \frac{9x}{10}$$

   6,000x : 17,100x

   Thus, Cost of Sales Ratio will be 60 : 171

Statement showing Pre-incorporation and Post-incorporation Profit for the year 2010

Particulars	Basis of allocation	Pre-incorporation ₹	Post-incorporation ₹
Sales			
Less: Cost of sales	Actual	6,000	19,000
	(60:171)	4,156	11,844
		1,844	7,156
Less: Administration Exps	Time	442	1,326
Selling Commission	Turnover	210	665
Goodwill written off	–	–	200
Interest to vendors (Time)	3 : 1	280	93
Distribution Expenses:			
40% Fixed	Time	125	375
60% Variable	Turnover	180	570
Preliminary Expenses	–	–	330
Debenture Interest	–	–	320
Depreciation	Time	111	333
Directors' Fees	–	–	100
Net Profit		496	2,844

Did u know? RRBs are specialized rural financial institutions for catering to the credit requirements of the rural sector.

Notes

Caution RBI has also directed its own training centres and NABARD training centres to conduct training programmes for RRBs staff in keeping with the requirements of the day.

Self Assessment

Fill in the blanks:

1. Nature of pre-incorporation profits is ……………….
2. Post-incorporation profits are ready for the distribution of……………….
3. Director's fees relates to …………… incorporation period.
4. Underwriting commission relates to …………… period.
5. Depreciation is allocated on the basis of …………….
6. Sales commission is allocated on the basis of ……………
7. Pre-incorporation profit is transferred to ………… account.

Illustration 4 (Interest on Purchase Price and Profit & Loss Account for More Than 12 Months)

The partners of Maitri Agencies decided to convert the partnership into a Private Limited Company called M.A. (P) Ltd. with effect from 1st January, 2010. The consideration was agreed at ₹ 1,17,000 based on the firm's balance sheet as on 31st December, 2009. However, due to some procedural difficulties, the company could be incorporated only on 1st April, 2010. Meanwhile, the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% per annum. The same books of accounts were continued by the company, which closed its accounts for the first time on 31st March, 2011 and prepared the following summarized Profit and Loss Account:

Particulars	₹
Sales	2,34,00,000
Cost of goods sold	1,63,80,000
Salaries	11,70,000
Depreciation	1,80,000
Advertisement	7,02,000
Discount	11,70,000
Managing Directors' remuneration	90,000
Miscellaneous expenses	1,20,000
Office-cum-Show-Room rent	7,20,000
Interest	9,51,000
	2,14,83,000
Profit	19,17,000

The company's only borrowing was a loan of ₹ 50,00,000 at 12% p.a. to pay the purchase consideration due to the firm and for working capital requirements.

The company was able to double the average monthly sales of the firm, from 1st April, 2010 but the salaries trebled from that date. It had to occupy additional space from 1st July, 2010 for which rent was ₹ 30,000 per month.

Notes

Prepare a Profit and Loss Account in columnar from apportioning costs and revenue between pre-incorporation and post-incorporation periods. Also, suggest how the pre-incorporation profits are to be dealt with.

Solution:

Profit and Loss Account for 15 months ended 31st March, 2011

Particulars	Basis of Allocation	Pre-incorpo-ration ₹	Post-incorpo-ration ₹	Particulars	Pre-incorpo-ration ₹	Post-incorpo-ration ₹
To Cost of Sales	Turnover	18,20,000	1,45,60,000	By sales	26,00,000	2,08,00,000
To Salaries (1:2)	Time	90,000	10,80,000	(Turnover)	19,000	–
To Depreciation	Time	36,000	1,44,000	By Net Loss		
To Advertisement	Turnover	78,000	6,24,000			
To Discount	Turnover	1,30,000	10,40,000			
To M.D. Remuneration.	–	–	90,000			
To Misce. Office Expenses	Time	24,000	96,000			
To Rent: Old Premises	Time	90,000	3,60,000			
Add. Premises	–	–	2,70,000			
To Interest	Time	3,51,000	6,00,000			
To Net Profit	–	–	19,36,000			
		26,19,000	2,08,00,000		26,19,000	2,08,00,000

Working Note:

1. Time Ratio –

   Pre-incorporation period 1st January 2010 to 1st April 2010 = 3 months.

   Post-incorporation period 1st April 2010 to 31st March, 2011 = 12 months.

   Thus Time Ratio = 3:12 or 1:4.

2. Assume monthly sale was of ₹ 1 up to 1st April, 2010, then monthly sales would be ₹ 2 after 1st April 2010.

   Pre-incorporation sales = 1 x 3 = 3

   Post-incorporation sales = 2 x 12 = 24.

   Turnover Ratio = 3 : 24 or 1 : 8

Illustration 5 (Division of Profit and Preparation of Balance Sheet)

Ashoka Company Limited was incorporated on 1st April, 2010 to take over as from 1st January, 2010, the existing business of Bijoy Brothers. Under the takeover agreement, all profits were made from 1st January, 2010 are belong to the company. The purchase consideration was ₹ 7,00,000. The vendors received half of it in cash on 1st July, 2000 together with interest at 10% per annum. For other half of the purchase consideration they were allotted 3,500 fully paid up shares of ₹ 100 each in the company. The following balances appeared in the company's ledger as at 31st December, 2010:

Notes

Liabilities	₹	Assets	₹
Sales capital 4,500 Shares of ₹ 100 each fully paid (including vendor's shares)	4,50,000	Preliminary Expenses (These are to be fully written off)	8,000
Bank Overdraft	1,65,000	Salaries and Wages	48,000
Sundry Creditors	65,000	Rent Received	13,000
Fixed Deposit Received	35,000	Rent and Taxes	7,000
Freehold Land at Cost	50,000	Repairs to Buildings	3,000
Building at Cost	1,30,000	Miscellaneous Expenditure	22,000
Furniture & Fixtures at Cost	35,000	Directors' fees	2,400
Transport Vehicles at Cost	35,000	Interest of Vendors	17,500
Stock-in-Trade on 1st January	4,20,000	Purchases	7,70,000
Book Debits	95,000	Sales	9,10,000
Cash in hand	12,000	Goodwill	3,100

The Stock-in-Trade as on 31st December, 2010 amounted to ₹ 4,80,000.

Bad debts amounting to ₹ 1,000 out of which ₹ 500 are related to book debts taken over by the company, have to be written off and a provision of ₹ 5,000 to be made for doubtful debtors as on 31st December, 2010.

Depreciation has to be written off: Building at 5%, Furniture and Fixtures at 10% and Transport Vehicles at 20%.

You are required to prepare (a) a Profit and Loss Account for the year ending 31st December, 2010 and to compute the profit prior to incorporation. For the purpose of determining the profit prior to incorporation you should assume the turnover to be spread evenly over the year and (b) Balance Sheet as on 31st December, 2010.

Solution:

Trading and Profit & Loss Account
of Ashoka Limited for the year ending 31st Dec. 2010

Particulars	₹	Particulars	₹
To Opening Stock	4,20,000	By Sales	9,10,000
To Purchases	7,70,000	By Closing Stock	4,80,000
To Gross Profit	2,00,000		
	13,90,000		13,90,000

Particulars	Pre-incorporation period ₹	Post-incorporation period ₹	Particulars	Pre-incorporation period ₹	Post-incorporation period ₹
To Salaries (1:3)	12,000	36,000	By Gross Profit b/d (1:3)	50,000	1,50,000
To Miscellaneous Exps. (1:3)	5,500	16,500	By Rent Received (1:3)	3,250	9,750
To Rates & Taxes (1:3)	1,750	5,250			
To Repairs to Buildings	750	2,250			

Contd...

Notes

To Preliminary Exps.	–	8,000			
To Bad Debts	500	500			
To Provision for Doubtful					
Debts	–	5,000			
To Directors' fees	–	2,400			
To Interest to Vendors	8,750	8,750			
To Depreciation:					
Building	6,500	1,500			
Furniture	7,000	15,000			
Vehicles	3,750	11,250			
To Capital Reserve	20,250				
To Net Profit		63,850			
	53,250	1,59,750		53,250	1,59,750

Balance Sheet of Ashoka Limited as on 31st December, 2010

Liabilities	₹	Assets		₹
Share Capital:		**Fixed Assets:**		
Authorized, Subscribed Called up and Paid up 4,500 shares of ₹ 100 each fully paid (issued to vendor for Purchase Consideration of business)	4,50,000	Goodwill		3,100
		Freehold land		50,000
Reserve & Surplus:		Building	1,30,000	
Capital Reserve (Pre-incorporation profit)	20,250	-Depreciation	6,500	1,23,500
Profit and Loss A/c. (Post-acquisition profit)	63,850	Furniture & Fixture	15,000	
Secured Loans	Nil	Less Dep.	1,500	13,500
Unsecured Loans:		Transport vehicles	35,000	
Bank overdraft	1,65,000	– Dep.	7,000	28,000
Fixed Deposit	35,000	Investments		Nil
Current Liabilities:		**Current Assets:**		
Sundry Creditors	65,000	Stock		4,80,000
		Debtors	94,000	
		-D/D Provision	5,000	89,000
		Cash in hand		12,000
		Miscellaneous Exps.		Nil
	7,99,100			7,99,100

Working Note:

1. Time Ratio 3:9 or 1:3
2. Turnover Ratio will also be the same because sales are spread evenly over the year i.e., 1:3.

Self Assessment

State whether the following statements are true or false:

8. Loss prior to incorporation must be transferred to goodwill account.
9. Profit prior to incorporation must be available for dividend.

Notes

10. Gross profit must be apportioned between prior to incorporation period and post-incorporation period in the Ratio of Turnover.
11. Directors' fees are apportioned on time basis to pre-incorporation and post-incorporation period.
12. Statutory meeting of a public limited company is held only once in the life of the company.
13. Statutory report must be signed and certified by at least two directors of the company.

Illustration 6

Dehra Udyog Ltd. incorporated on 1st May, 2010 received the Certificate to Commence the Business on 31st May 2010. It had acquired a running business from M/s. Vohra & Co. with effect from 1st January, 2010. The purchase consideration was ₹ 2,500,000 of which ₹ 500,000 was to be paid in cash and ₹ 2,000,000 in form of fully paid shares. The company also issued shares for ₹ 2,000,000 for cash. Machinery costing ₹ 12,50,000 was then installed. The assets acquired from the vendor were:

Machinery ₹ 15,00,000, Stock ₹ 300,000, Patents ₹ 2,00,000.

During the year 2010 the total sale was ₹ 90,00,000. The sale per months in the first half year was one half of what was in the later half year. The net profit of the company after charging the following expenses was ₹ 5,00,000.

Depreciation ₹ 2,70,000. Audit fees ₹ 37,500 Directors' fees ₹ 1,25,000, Preliminary Exps. ₹ 30,000, Office Expenses ₹ 1,95,000, Selling Expenses ₹ 1,80,000. Interest to vendor upto 31st May 2010 ₹ 12,500. Ascertain the pre-incorporation and post-incorporation amount of profits and prepare the Balance Sheet as on 31st December, 2010. Closing stock was valued at ₹ 3,50,000

Solution:

1. Calculation of Goodwill

	₹
Machinery	15,00,000
Stock	3,00,000
Patents	2,00,000
	20,00,000
Less: Purchase Price	25,00,000
Goodwill	5,00,000

2. Calculation of Gross Profit:

Net Profit (given)	5,00,000
Add: Expenses –	
Depreciation	2,70,000
Audit Fees	37,500
Directors' Fees	1,25,000
Preliminary Expenses.	30,000
Office Expenses	1,95,000
Selling Expenses	1,80,000

Notes

Interest to Vendor	12,500	8,50,000
Gross Profit		13,50,000

3. Time Ratio:

   Pre-incorporation Period (1st Jan., 2010 to 30th April 2010) = 4 months

   Post-incorporation Period (1st May to 31st December 2010) = 8 months

   Time Ratio 4:8 or 1:2.

4. Sales Ratio: Assume monthly sales in first half is Re 1 hence sales in the second half will be ₹ 2. Sales will be

Jan.	Feb.	March	April	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.
1	1	1	1	1	1	2	2	2	2	2	2

   Sales in pre-incorporation period ₹ 4

   sales in post-incorporation period ₹ 14.

   Sales Ratio 4:14 or 2:7

   Statement for pre-incorporation profit and post-incorporation profit.

Particulars	Pre-incorporation ₹	Post-incorporation ₹
Gross Profit (2:7)	3,00,000	10,50,000
Less: Expenses–		
Depreciation 1:2	90,000	1,80,000
Audit fees	–	37,500
Director's fees	––	1,25,000
Preliminary Exps.		30,000
Office Exps. (1:2)	65,000	1,30,000
Selling Exps. (2:7)	40,000	1,40,000
Interest to vendors (4:1)	10,000	2,500
	2,05,000	6,45,000
Net Profit	95,000	4,05,000

Balance Sheet as on 31st December, 2010

Liabilities	₹	Assets		₹
Share Capital Subscribed & Paid up Capital	40,00,000	**Fixed Assets:**		
Reserve & Surplus:		Goodwill		
		(₹ 5,00,000 – ₹ 95,000)		4,05,000
Profit and Loss A/c.	4,05,000	Machinery	27,50,000	
		– Deb.	2,70,000	24,80,000
		Patents		2,00,000
		Current Assets:		
		Stock		3,50,000
		Cash		9,70,000
	44,05,000			44,05,000

Cash Account

Particulars	₹	Particulars	₹
To Share Capital	20,00,000	By Vendor	5,00,000
To Sales	90,00,000	By Machinery	12,50,000
		By Purchases (calculated as below)	77,00,000
		To Expenses (except expenses)	5,80,000
		To Balance c/d.	9,70,000
	1,10,00,000		1,10,00,000

Trading Account (to find out purchases)

Particulars	₹	Particulars	₹
To Opening Stock	3,00,000	By Sales	90,00,000
To Purchases (Balancing figure)	77,00,000	By Closing Stock	3,50,000
To Gross Profit	13,50,000		
	93,50,000		93,50,000

Notes It is assumed that all transactions are cash transaction therefore there is no debtor and creditor.

Illustration 7

On 1st June, 2011 Sushil & Co. sold their business to Sushil Company Limited as on 1st April, 2011 for a total consideration of ₹ 5,00,000: for Goodwill ₹ 1,50,000, Building ₹ 1,50,000, Machinery ₹ 75,000 and Stock ₹ 1,25,000

Sushil Company Limited was incorporated on 1st June, 2011 and the purchase consideration was met by the issue of shares. The business was carried on by the vendors on the behalf of the company from 1st April and the same set of account books was maintained till 30th June, 2011 when the following Trial Balance was prepared:

Particulars	Dr. ₹	Cr. ₹
Capital Account - Sushil		1,80,000
Capital account - Mohan		1,50,000
Sundry creditors (including for June purchase of ₹ 25,000)		50,000
Sales		5,00,000
Salaries and Wages (including ₹ 5000 being sitting fees to Directors)	60,000	
Rent	7,500	
Purchases	1,80,000	
Sushil Company Limited	50,000	
Expenses	25,000	
Bank	17,500	
Goodwill	1,25,000	
Buildings	1,00,000	
Machinery (purchases after 1.4.2006 were ₹ 50,000)	1,25,000	
Stock on 31.3.2006	1,25,000	
Sundry Debtors (including sales of ₹ 40,000 in June)	65,000	
	8,80,000	8,80,000

Notes

Stock on hand on 30th June, 2011, were ₹ 90,000. Sushil & Co. paid ₹ 50,000 for additional shares and out of this account, the company incurred preliminary expenses of ₹ 30,000 and purchased a typewriter for ₹ 15,000. Debtors and Creditors prior to 1st June, 2011, were to be taken over by Sushil & Co.

Prepare the Profit and Loss Account of Sushil Company Limited for the period ended 30th June, 2011 and a Balance Sheet as on that date. All workings are to form part of your answer.

Solution:

Sushil Company Limited
Profit and Loss Account
from 1st April, 2011 to 30th June, 2011

Particulars	₹	Particulars	₹
To Opening Stock	1,25,000	By Sales	5,00,000
To Purchases	1,80,000	By Closing Stock	90,000
To Salaries & Wages	55,000		
To Rent	7,500		
To Expenses	25,000		
To Profit	1,97,500		
	5,90,000		5,90,000

Alternatively, the first trading account can be made to find out gross profit and then gross profit and all above expenses can be separated in pre-incorporation and post-incorporation periods into time ratio i.e., 2:1. The result will be the same.

Particulars	Pre-incorporation ₹	Post-incorporation ₹	Particulars	Pre-incorporation ₹	Post-incorporation ₹
To Director's fees	–	5,000	By Profit		
To Capital Reserve	–	60,833	(2:1)	1,31,667	65,833
To Net Profit	1,31,667	–			
	1,31,667	65,833		1,31,667	65,833

Balance Sheet of Sushil Co. Limited as on 30th June, 2011

Liabilities	₹	Assets	₹
Share Capital:		**Fixed Assets:**	
Issued & Paid up.		Goodwill (₹ 1,50,000 – ₹ 60,833)	89,167
55,000 Equity shares of ₹ 10 each fully paid up	5,50,000	Buildings	1,50,000
Reserve & Surplus:		Plant and Machinery	1,25,000
Profit and Loss A/c	1,31,667	Type-writer	15,000
Current Liabilities:		**Current Assets, Loans & Advances:**	
Sundry Creditors	25,000	Sundry Debtors	40,000
		Stock (closing)	90,000
		Due from vendor	1,62,500
		Bank	5,000
		Miscellaneous Expenditure:	
		Preliminary Expenditure	30,000
	7,06,667		7,06,667

Working Note:

Notes

1. Bank Account

Liabilities	₹	Assets	₹
To Vendors (amount received for shares)	50,000	By Preliminary Exps.	30,000
		By Typewriter	15,000
		By Balance c/d	5,000
	50,000		50,000

2. Adjustment Journal Entries

Date	Particulars		L.F.	₹	₹
	Goodwill Account	Dr.		25,000	
	Building Account	Dr.		50,000	
	To Vendor's Account				75,000
	(Being revaluation of assets)				
	Sushil's Company Account	Dr.		1,80,000	
	Mohan's Capital Account	Dr.		1,50,000	
	To Vendor's Account				3,30,000
	(Being the transfer of balance of capital accounts)				
	Vendor's Account	Dr.		50,000	
	To Shares in Sushil Company Limited				50,000
	(Being allotment of shares)				
	Creditors Account	Dr.		25,000	
	To Vendor's Account				25,000
	(Being the transfer of creditor prior to June 2006)				
	Vendor's Account	Dr.		25,000	
	To Debtors Account				25,000
	(Being the transfer of debtors prior to June 2006)				
	Vendor's Account	Dr.		5,00,000	
	To Share Capital Account				5,00,000
	(Being issue of shares for the payment of purchase consideration)				

Vendor's Account

Liabilities	₹	Assets	₹
To Shares in Sushil Co. Limited	50,000	By Goodwill A/c.	25,000
To Sundry Debtors	25,000	By Buildings A/c.	50,000
To Share Capital A/c.	5,00,000	By Creditors A/c.	25,000
To Bank (balance given)	17,500	By Sushil's Capital A/c.	1,80,000
		By Mohan's Capital A/c.	1,50,000
		By Balance c/d	1,62,500
	5,92,500		5,92,500

Notes

11.4 Statutory Report

Under Section 165 of the Companies Act, 1956 a public limited company must convene a general meeting of its members not less than one month nor more than six months from the date of its certificate to commence the business. This meeting is called a statutory meeting. This is the first meeting of the company and is convened once in its life. This meeting is called to provide an early opportunity of meeting the directors and to discuss the formation and prospects of the company and terms of any contract mentioned in the prospectus. Under Section 165(2) the Board of Directors has to send a copy of the statutory report to every member at least 21 days before the date of holding the statutory meeting. Under Section 165(3), the Statutory Report must contain the followings:

1. Total number of shares allotted distinguishing the shares allotted as fully paid or partly paid up.
2. Total amount of cash received by the company on the allotted shares.
3. An abstract of receipt and payment.
4. Names, addresses and occupations of the directors, auditors, manager and secretary of the company.
5. Particulars of any contracts which are to be submitted to the meeting for its approval.
6. The extent to which each underwriting contract, if any, has not been carried out and the reason therefore.
7. The arrears due to calls from every director and from the manager.
8. The particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares to any director or manager.

Notes Under Section 165 of the Companies Act, 1956 a public limited company must convene a general meeting of its members not less than one month nor more than six months from the date of its certificate to commence the business.

The statutory report shall be certified as correct by at least two directors of the company and of these, one must be managing director.

After the certification of the directors regarding the correctness of the statutory report, the auditor of the company must also certify it as correct in regarding the total allotment of shares, receipt of cash on allotted shares and abstract of receipts and payment. A copy of the certified statutory report is dispatched to the Registrar for registration after sending the copies of the report to the members of the company.

Caution After the certification of the directors regarding the correctness of the statutory report, the auditor of the company must also certify it as correct in regarding the total allotment of shares, receipt of cash on allotted shares and abstract of receipts and payments.

Self Assessment

Notes

Select the best alternative:

14. Pre-incorporation loss must be transferred to:

    (a) Capital reserve

    (b) Goodwill

    (c) General reserve

    (d) Dividends to members

15. On the sale of business, if a partner wants a preference in return of capital he must get:

    (a) Cash

    (b) Preference shares

    (c) Equity shares

    (d) Right shares

16. Pre-incorporation profit of a company is transferred to:

    (a) General Reserve

    (b) Capital Reserve

    (c) P. & L. Account

    (d) P. & L. Appropriation Account

17. For what purpose the pre-incorporation profits are used:

    (a) To distribute dividend

    (b) To write off goodwill

    (c) To write off discount on issue of shares

    (d) To make a reserve

16. Depreciation is allocated between pre- and post-incorporation period on the basis of:

    (a) Turnover Ratio

    (b) Time Ratio

    (c) Both the above

    (d) None of these.

Caution The statutory report shall be certified as correct by at least two directors of the company and of these, one must be managing director.

Notes

11.5 Summary

- Profit or loss of a business for the period to the date company came into existence is referred to as Pre-Incorporation Profits or Losses.
- Generally, there are two methods of computing Profit & Loss prior to incorporation.
- One is to close off old books and open new books with the assets and liabilities as they existed all the date of incorporation. In this way, automatically the result to that date will be adjusted.
- Other is to split up the profit of the year of the transfer of the business to the company between pre- and post-incorporation periods. This is done either on the time basis or on the turnover basis or by a method which combines the two.
- A company taking over a running business may also agree to collect its debts as an agent for the vendor and may further undertake to pay the creditor on behalf of the vendors. In such a case, the debtors and creditors of the vendors will be included in the accounts for the company by debit or credit to separate total accounts in the General Ledger to distinguish them from the debtors and creditors of the business and contra entries will be made in corresponding Suspense Accounts. Also details of debtors and creditors balance will be kept in separate ledger.
- The vendor is treated as a creditors for the cash received by the purchasing company in respect of the debts due to the vendor, just as if he has himself collected cash from his debtors and remitted the proceeds to the purchasing company.
- The vendor is considered a debtor in respect of cash paid to his creditors by the purchasing company. The balance of the cash collected, less paid, will represent the amount due to or by the vendor, arising from debtors and creditors balances which have been taken over, subject to any collection expenses.
- The balance in the suspense accounts will be always equal to the amount of debtors and creditors taken over remaining unadjusted at any time.

11.6 Keywords

Balance Sheet: A balance sheet is often described as a "snapshot of a company's financial condition". Of the four basic financial statements, the balance sheet is the only statement which applies to a single point in time of a business calendar year.

Capital Reserve: A type of account on a municipality's or company's balance sheet that is reserved for long-term capital investment projects or any other large and anticipated expense(s) that will be incurred in the future.

Loss: The harm or suffering caused by losing or being lost.

Pre Incorporation Profits or Losses: When a running business is taken over by the promoters of a company, from a date before the company which is to manage and own is registered, the amount of profit or loss of such a business for the period prior to the date the company came into existence is referred to as pre-incorporation profits or losses.

Profit: Profit is the difference between the purchase price and the component costs of delivered goods and/or services and any operating or other expenses.

11.7 Review Questions

1. What do you mean by Profit or Loss pre-incorporation?
2. Why is it necessary to compute profit or loss pre and post-incorporation?
3. How are the different expenses allocated between pre- and post-incorporation periods? Explain.
4. Which items are distributed between pre- and post-incorporation period on the basis of time ratio?
5. Which items distributed between pre- and post-incorporation period on the basis of turnover ratio?
6. Describe the method of finding out profit or loss prior and after incorporation.
7. How are "Profits prior to incorporation" dealt with? How will you ascertain such profit?
8. Why is it necessary to find out profit prior and after incorporation? Explain it in detail.
9. Why and how are pre- and post-incorporation profits and losses calculated?

Practical Questions:

A. Pre-incorporation profits

1. Sethi Ltd. was incorporated on 30th June, 2010 to acquire the business of Mr. X as from 1st January, 2010. The accounts for the year ended 31st December, 2010 disclosed the following:

   (i) There was a gross profit of ₹ 4,80,000.

   (ii) The sales for the year amounted to ₹ 24,00,000 of which ₹ 10,80,000 were for the first six months.

   (iii) The expense debits to Profit and Loss Account included Director's fees ₹ 30,000, Bad Debts ₹ 7,200, Advertising ₹ 24,000 (under a contract amounting to ₹ 2,000 per month), Salaries and General Expenses ₹ 1,28,000, Preliminary expenses written off ₹ 10,000. Donation to political parties given by the company ₹ 10,000.

   Prepare a statement showing the amount of profit made before and after incorporation in the books of Sethi Ltd.

Ans: Profit pre-incorporation period ₹ 1,36,760.

Profit after incorporation period ₹ 1,34,040.

B. Division of profit on monthly basis

2. A company acquires a business on 1st January, 2010; it is being incorporated on 1st May, 2010. The first accounts are drawn upto 30th September 2010. The gross profit for the period is ₹ 56,000.

   The General Expenses are ₹ 14,220, Director's fees ₹ 12,000 per annum, formation expenses ₹ 1,500.

   Rent to 30th June was ₹ 1,200 per annum after which it was increased to ₹ 3,000 per annum. The salary of the manager who upto incorporation of the company, was made a director, was ₹ 6000 per annum (since incorporation included in the director's fees above).

Notes

Show Profit and Loss Account assuming that the net sales were ₹ 8,20,000, the monthly average of which for the first four months of 2010 being one-half of that of the remaining period, the company earned a uniform profit. Interest and Taxation maybe ignored:

(B.Com. Rohilkhand 1992)

Ans: Pre-incorporation profit ₹ 7,280

Post-incorporation profit ₹ 24,650.

3. Bhaba Limited was incorporated on 30th June, 2010 to take over the business of R. Kumar as from 1st January 2010. The financial accounts of the business for the year ended. 31.12.2010 disclosed the following information:

Particulars		₹	₹
Sales –	January to June	1,20,000	
	July to December	1,80,000	3,00,000
Less: Purchases–			
	January to June	75,000	
	July to December	1,20,000	1,95,000
Gross Profit		1,05,000	
Less: Salaries		15,000	
	Selling Expenses	3,000	
	Depreciation	1,500	
	Director's Remuneration	750	
	Debenture Interest	90	
	Administrative Exps. (Rent, Rates, etc.)	4,500	24,840
	Profit for the year		80,160

You are required to prepare a statement apportioning the balances between periods prior to and since incorporation and show the Profit & Loss Appropriation Account for the year ended 31st December, 2010.

[Adapted from I.C.W.A. (Final) June, 1981]

Ans: Pre-incorporation profit ₹ 33,300

Post-incorporation profit ₹ 46,860.

D. Calculation of Sales Ratio

4. Mittal Rolling Mills Limited was registered on 1st April, 2010 to take over the business of Mittal Brothers from 1st January, 2010 From the following information given to you. You are required to calculate the profit earned by the company in pre- and post-incorporation periods.

(a) Sales during the period January-December 2010 ₹ 4,80,000. The trend of the sales was as under:

January and February	:	Half the average sales in each month.
May, June, July	:	Average sales in each month.
October	:	Average sales.
November & December	:	Half the average sales in each month.

(b) Cost of goods sold ₹ 1,20,000

(c) Salary and other administrative charges ₹ 12,000

(d) Bad Debts ₹ 4,800

(e) Interest on purchase price paid by the company to Mittal Brothers on 1st August, 2010 ₹ 4,200.

(f) Expenses exclusively related to the company ₹ 17,800.

Ans: Pre-incorporation profit ₹ 69,200.

Post-incorporation profit ₹ 252,000.

5. Sundir Ltd. is incorporated on 1st May, 2010. From January 1, 2010 it purchased the business of Priyanka Limited for ₹ 4,00,000 out of which ₹ 3,20,000 was paid up fully paid equity shares and the balance was paid in cash. The company also issued equity shares ₹ 3,00,000 for cash to public. Stock ₹ 40,000, Machinery ₹ 3,00,000 and Debtors ₹ 25,000 were acquired from vendors.

   The purchasing company installed a new machine of ₹ 2,00,000. During the year 2010 total cash sales were ₹ 10,00,000. The sales per month in the first half of the year were one-half of what they were in the later half year. The net profit of the company after charging the following expenses was ₹ 90,000. The directors' fees ₹ 20,000, Office exps. ₹ 7,500, Preliminary expenses. ₹ 6,500, Depreciation ₹ 36,000, Selling expenses. ₹ 18,000, Interest to vendor upto 31st May, 2010 is ₹ 2,000, Closing stock is valued at ₹ 40,000. Find out profit before and after incorporation and prepare a Balance Sheet of Purchasing Company as on 31st December, 2010.

Ans: Pre-incorporation profit ₹ 19,900.

Post-incorporation profit ₹ 70,100.

Answers to Self Assessment

1. Capital
2. Divided
3. Post
4. Post-Incorporation
5. Time Ratio
6. Turnover Ratio
7. Goodwill
8. True
9. False
10. False
11. True
12. True
13. False
14. (b)
15. (b)
16. (b)
17. (b)
18. (b)

11.8 Further Readings

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http://220.227.161.86/19668ipcc_acc_vol1_chapter-3.pdf

http://www.investopedia.com/terms/c/capitalreserve.asp#ixzz1xlZehyWb

Case Study

Law Firm Profit and Growth Strategy Facilitated by Law Business Management System™ (LBMS™)

Situation: Law firm had objective of increased revenue and profitability. The key strategy was diversification, both geographically and into new practice areas. The approach involved utilization of mergers & acquisitions that enabled this diversification.

Critical Issues: The firm's strategy involved strategic placement of additional offices dispersed throughout the United States on an accelerated timeframe. To achieve full and fast recognition of increased revenues that translated to bottom-line profit, the firm had to ensure the following issues were addressed:

- Acquired firms' book of business had to be quickly integrated into the firm's total book of business. This meant clearing all lateral hire conflicts quickly and pulling all client and matter information into the firm's centralized accounting system.
- New offices had to be quickly assimilated into adherence into the firm's policies and procedures to ensure effective loss prevention, thereby ensuring profits were protected.
- The firm wanted to grow its legal services delivery base without an increase in staffing for new business intake, conflicts or billing, this way driving profitability up significantly as revenue increased, but administrative overhead expense stayed steady.
- Real-time analysis of effectiveness of mergers and acquisitions on overall practice and geographic diversification required technology capable of supplying analytics and sophisticated reporting.

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Reasons: The firm was over-committed to service of a particular market segment, which had strict demands of legal service providers (and historically mandated very low rates).

- Firm revenues and profitability were below the norm.
- Firm was at high risk if the market segment they serviced changed dramatically due to over-specialisation.
- Required Capabilities:
- Globally consistent processes for New Business Intake and Client/Matter Change Management
- Fast inclusion of new offices/users into the firm's standard processes without overhead of rollout/training
- Positive adoption of new processes by users to minimize resistance to change
- Targeted, high-value automation, to ensure that existing operational infrastructure (personnel) could handle the substantially increased load without the need for hiring new personnel.

Elegrity (the firm) delivered the following:

- Business process re-engineering and optimization consulting, focused on helping the firm determine how to leverage the new capabilities automation affords to meet their objectives.
- *Law Business Management System (LBMS)* – The only comprehensive cradle-to-grave client/matter management business process automation platform specifically built to accommodate all the sophisticated business process needs of the legal industry.

LBMS provides all of the technology capabilities required to meet the following functional capability requirements:

- Automation to enable the same number of people and their teams to do significantly more!
- Risk mitigation through the enforcement of consistent, codified firm business processes and business rules.
- Visibility for all levels of users, secured appropriately.
- Flexibility for the organization as a whole through the ability to quickly add offices/ users, and make immediate adjustments to firm business process and business rules as strategies or needs changed.
- System Integrity for automation of system interfaces and aggregation and distribution of information to/from the appropriate system of record.
- Agility through the leveraging of active decision support in combination with business process execution, decision-makers at all levels of the organization were provided the ability to make better, more informed decisions faster.
- Reporting and Business Intelligence to provide information to various levels of the organization, as needed.
- Process Development, User Interface Development & Customization and Business Systems Integration Services to leverage the technology provided by LBMS to meet the specific requirements of the firm's unique business processes.

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Notes

End-User Training and Floor Support to ensure positive and fast adoption rate Results:

- Significantly increased speed of new business intake (accelerating revenue generation, recognition & cash flow).
- Increased billing accuracy and speed due to comprehensive billing guidelines collection as part of the intake process.
- Enhanced conflicts management and clearing processes to process mass intakes and lateral hires.
- Substantially improved loss prevention through the consistent and audited application of firm policies and completed approval cycles.
- Streamlined client/matter lifecycle processes and automated many associated manual and paper-intensive tasks.
- The firm has grown from approximately 10 offices at the time Elegrity's LBMS®was implemented to now 19 offices across 32 different practice areas.
- The firm has become one of the top AmLaw 200 law firms.
- The firm has enjoyed a substantial increase in revenue and achieved higher profitability as a result of its leveraging of LBMS.

Source: http://www.elegrity.com/Portals/15318/docs/elegrity%20case%20study%20-%20lbms%20provides%20 foundation%20for%20law%20firm%20profit%20and%20growth.pdf

Manpreet Kaur, Lovely Professional University

Unit 12: Divisible Profits and Managerial Remuneration

Notes

CONTENTS

Objectives

After studying this unit, you should be able to:

- Know principles of divisible profits
- Explain meaning of managerial remuneration
- Define provisions
- Understand remuneration to the directors

Introduction

The management and administration of a company is delegated to the managerial personnel as per the provisions of the Companies Act.

Divisible Profits: According to Black and White Publishing Company (1901) profit available for dividend means net profits after making any deduction which the directors can duly make profit which can be distributed legally in the form of dividends to the shareholders of the company are called divisible profits.

Caution There is no any particular rule about the determination of profit. By company law has laid down the following rules or a principle which guides us to determine the divisible profits.

12.1 Principles of Divisible Profit

Following are the important principles of divisible profits :

1. ***According the Company Rules:*** The articles of association are the rules of the company. The directors are entitled to distribute the profits under rules. They also follow the company law. The dividend can be paid out of revenue profit.

Notes

2. ***Follow the court cases:*** While calculating the divisible profits, the court cases must be kept in mind. The auditors must know the decisions of the courts announced time to time.
3. ***Profit not out of capital:*** The capital cannot be used to pay dividend. The revenue profits can be used for the payment of dividend.
4. ***Approval of Shareholders:*** In the annual general meeting, shareholders may approve the rate of profit recommended by the directors. So divisible profits can be used to pay as dividend after approval.
5. ***Right of Proposal:*** The directors can propose the rate of dividend out of divisible profits. After completing the legal formalities the directors can decide the dividend.
6. ***Undistributed Profit:*** It is the right of the directors to use such profit for the payment of dividend at the end of a year. It is a revenue of the provision year.
7. ***Depreciation:*** Before declaring revenue profits, the depreciation on fixed assets must be charged. In manufacturing company it is compulsory to charge depreciation before the declaration of profits.
8. ***Secrete Reserves:*** If according the articles association it is allowed to create and use the such reserves then these can be used for the payment of dividends.
9. ***Capital profits:*** Under certain conditions the capital profit can be used to pay dividend but articles of association should allow the distribution of capital profit as dividend.
10. ***Capital loss:*** In spite of capital loss, the dividend can be paid out of revenue profits. The capital profit must be used to eliminate capital loss first and then surplus can be used to pay dividends.
11. ***Loss of provision year:*** If a company suffers a loss in one year but earns profit next year, such loss can be adjusted by the company from benefit of the current year.
12. ***Revaluation of assets:*** After the revaluation of asset, if it becomes surplus then it can be used after realization and profit may be paid after selling the assets.
13. ***Revenue profits:*** According the principle of divisible profit dividend must be paid out of revenue profit but it is essential that calculation should be correct.
14. ***Asset goodwill written down & up:*** If a company has written down good will out of profits, it may also write up this asset, with the appreciation. But the value written up should not excess than the true value.

Self Assessment

True or False:

1. According the principle of divisible profit dividend must be profit
2. If a company does not have written down good will out of profits, it may also write up this asset paid out of revenue.

Fill in the blanks:

3. In case there is only one whole-time director in a company, maximum remuneration payable to director will be .... of the net profit calculated u/s 349.
4. A .... cannot be the manager of the company.

12.2 Meaning of Managerial Remuneration

The managerial personnel include the following personnel:

(a) ***Director:*** Directors are the representatives of the company. They manage and control the company. Directors are also the trustees for the company's property. Therefore, it is their duty to use company's property for its benefit alone. It is compulsory for every company to have a board of directors. Board of directors is a group of directors. A contract signed by the directors on the behalf of the company is binding on the company and the concerned third party. If the directors use their reasonable care and skill to perform their duties and yet the company suffers a loss, the directors will not be responsible for such a loss. But if the loss is due to the negligence of directors and breach of trust, they must have to compensate the loss suffered by the company. There can be two types of directors in a company i.e. full-time director and part-time directors. A whole-time director is not a new category of managerial personnel. But a director who is in the whole-time employment of the company is called a whole-time director. Managing directors are also called the whole-time directors. Part-time directors are those who devote part of their time in the affairs of the company. There can be more than one part-time director in a company.

(b) ***Managing director:*** A company can have one or more than one managing director. The board of directors may appoint one of themselves as the managing director of the company by giving more powers to manage the company. According to section 2(26) of the Companies Act, a managing director is a director who (i) by virtue of an agreement with the company, or (ii) of a resolution passed by the company in general meeting, or (iii) by its board of directors, or (iv) 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. Without unanimous approval of the board of directors, a managing director cannot manage more than one company at a time.

(c) ***Manager:*** There cannot be a manager and a managing director both in a company. Like managing director, a manager is also appointed by board of directors. His tenure cannot be more than five years at a time. According section 2(24) of the Companies Act, a manager means a person who, subject to the superintendence, controls and manages the company according to the direction of the board of directors, has the management of the whole or substantially the whole of the affairs of a 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. A company cannot have more than one manager at a time. The same disqualifications and restrictions will be applicable for the manager which exist for a managing director.

The remuneration which is paid to the managerial personnel (directors, managing directors and managers) by the company is called managerial remuneration. This remuneration is shown in the debit side of profit and loss account of the company. Besides salary, dearness allowance perquisites, commission and other allowances, the managerial remuneration includes the following as per section 198:

(a) Expenditure incurred by the company in providing any rent-free accommodation, or any other benefits or amenity in respect of accommodation free of charge,

(b) Expenditure incurred by the company in providing any other benefit or amenity free of charge or at a concessional rate,

Notes

(c) Expenditure incurred by the company in respect of any obligation or service which but for such expenditure by the company, would have been incurred by them, and

(d) Expenditure incurred by the company to effect any insurance on the life of, or to provide any pension, annuity, or gratuity for any of the managerial personnel, or his spouse or child.

12.3 Provisions Regarding Overall Maximum and Minimum Limits

As per section 198 of the Companies Act 1956, these are several restrictions on the managerial remuneration. These are as below:

Maximum Limit

Did u know? The managerial remuneration of the managerial personnel (as director, manager and managing director) should not more than 11% of the net profit of that company as per section 198 of the Companies Act 1956.

Any fees payable to the directors for attending the meeting of board of directors will not be included in the above ceiling of the remuneration for this purpose the profit of the company will be calculated as per sections 349, 350 and 351 of the Companies Act.

Minimum Limit

In case a company has no profit or its profits are inadequate in any financial year, the company will pay the minimum amount of remuneration to the director, managing director, manager or whole-time director. This minimum amount will vary from ₹ 75,000 to ₹ 2,00,000 p.m., which will depend on the effective capital of the company as specified in part ii of schedule xiii of the Companies Act as given below.

Schedule XIII, Part II

Section I - Remuneration payable by companies having profits-

Notes Subject to the provisions of sections 198 and 309, a company having profits in a financial year may pay any remuneration by way of salary, dearness allowance, perquisites, commission and other allowances, which shall not exceed 5% of its net profit for one such managerial person and if there is more than one such managerial person, 10% for all of them together.

Section II - Remuneration payable by companies having no profit or inadequate profit-

1. Notwithstanding anything contained in this part, wherein any financial year during the currency of tenure of the managerial person, a company has no profits or its profits are adequate, it may pay remuneration to a managerial person, by way of salary, dearness allowance, perquisites and any other allowance, as per scale prescribed in part II which have been revised vide Notification GSR no. 215(e) dated 2-3-2000. These revised scales are as below:

Notes

Where the effective capital of the company is		Monthly salary payable shall not exceed
(i)	less than ₹ 1 crore.	₹ 75,000
(ii)	rupees 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

Explanation I: For the purpose of section II of this part, "effective capital" means the aggregate of:

(i) Paid up share capital (excluding share application money or advances against shares).

(ii) Credit balance of share premium account.

(iii) Reserve and surplus (excluding revaluation reserve).

(iv) 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) as reduced by:

(a) Aggregate of any investments (except in the case of investment by an investment company whose principal business is acquisition of shares, stock, debentures, or other securities).

(b) Accumulated losses not written off.

(c) Preliminary expenses not written off.

Explanation II:

(a) Where the appointment of the managerial person is made in the year in which the company has been incorporated, the effective capital shall be calculated as on the date of such appointment.

(b) In any other cases, the effective capital shall be calculated as on the last date of the financial year preceding the financial year in which the appointment of managerial person is made.

Perquisites

2. A managerial person shall be eligible to the following perquisites which shall not be included in the computation of the ceiling on the remuneration specified in the paragraph 1 of this section:

(i) Contribution to provident fund, superannuation fund or annuity fund to the extent these either single or put together are not taxable under the Income Tax Act 1961.

(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

3. In addition to the perquisites specified in paragraph 2 of this section, an expatriate managerial person (including Non-resident Indians) shall be eligible to the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in paragraph 1 of this section:

(a) *Children's education allowance:* In case of children studying in or outside India, an allowance limited to a maximum of ₹ 5,000 per month per child or actual expenses incurred whichever is less. Such allowance is admissible upto a maximum of two children.

(b) *Holiday passage of children studying outside India or family studying abroad:* return holiday passage once in a year by economy class or once in two years by first class to children and to the members of the family from the place of their study or stay outside India, if they are not residing in India with the managerial person.

(c) *Leave travel concession:* Return passage for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead; anywhere in India.

Explanation: For the purpose of this part, family means the spouse, dependent children and dependent parents of the managerial person.

Formula for computation of effective capital			₹
Paid up share capital			----------------------
+ Credit balance of premium a/c. (securities)			----------------------
+ Reserve & surplus (excluding revaluation reserve)			----------------------
+ Long-term loans and deposit repayable after one year			----------------------
	Total	₹	
–Investments	----------------------		----------------------
Accumulated losses		----------------------	----------------------
Preliminary expenses		----------------------	----------------------
	Effective Capital		

12.4 Remuneration to Directors

Notes Remuneration to directors including managing directors, is determined either by the articles of association or by a resolution or, if the articles so required, by a special resolution, passed by the company in general meeting subject to the provisions of the section 309 of the Companies Act.

Section 309 governs the remuneration of directors, including managing directors or whole-time director of a public company and a private company which is a subsidiary of a public company. Provisions of this section are as under:

(a) ***Remuneration to whole-time director or managing director:*** As per the provision of section 309(3), a whole-time director or 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 by one way and partly by the other. But except with the approval of the central government, such remuneration shall not exceed:

(i) 5% of the net profit for one whole-time or managing director,

(ii) 10% of the net profit for more than one whole-time director.

Notes

(b) ***Remuneration of part-time directors:*** As per the provision of section 309(4) a part-time director (who is neither whole-time nor managing director) may receive monthly, quarterly or annual payment of remuneration with the approval of Central Government or by way of commission, if a special resolution of the company authorizes such payment. But except with the approval of the Central Government, total remuneration shall not exceed:

(i) 1% of the net profit of the company if the company has managing directors or whole-time directors or;

(ii) 3% of net profit of the company if the company has no manager, managing directors or whole-time director.

It is to be noted that these rates of 1% and 3% respectively can be increased by the company by a special resolution in a general meeting with the approval of the Central Government. This special resolution will be valid for a period of five years.

(c) ***Director's fees:*** In addition, a director may receive remuneration by the way of a fee for each meeting of board of directors or a committee thereof attended by him according to the Companies Act, but the government has decided that in case of whole-time directors or managing directors, no sitting fee will be payable. As per notification of the Central Government dated, 27.8.1993 a company can pay fees upto ₹ 2, 000 to its each director for attending the meeting of board of directors or a committee thereof. As stated earlier, director's fees a not included in the managerial remuneration for the purpose of overall limit.

(d) ***Whole-time director or managing director shall not get any remuneration or commission from subsidiary company:*** As per section 309(6) a whole-time or managing director who is in receipt of any commission from a company is not entitled to receive any commission or remuneration from the subsidiary company of such company.

(e) as per section 309(1) remuneration to a director will include any remuneration paid to him for services rendered by him in any capacity except when-

(i) The services rendered by him are of a professional nature.

(ii) In the opinion of the Central Government, the director possesses the requisite qualifications for the practice of the profession.

(f) The above-mentioned provision of section 309 regarding the remuneration of the managerial personnel will not be applicable to a private company unless it is a subsidiary company of a public company.

(g) As per section 310 of the Companies Act, if a public company or a private company, which is the subsidiary of a public company, increases the remuneration payable to directors, such an increase requires the approval of Central Government, except in the following cases–

(i) if schedule XIII is applicable and the increase is in accordance with the conditions specified in that schedule and

(ii) if the increase is in the fee payable for attending each meeting of the board of directors or a committee thereof and the increased rate does not exceed such sum as may be prescribed.

(h) The net profit of the company for the purpose of calculating director's remuneration would be computed as per the provisions of sections 349 and 350 of the Companies Act.

(i) As per section 200, no company will pay its officers or employees any remuneration free of any tax.

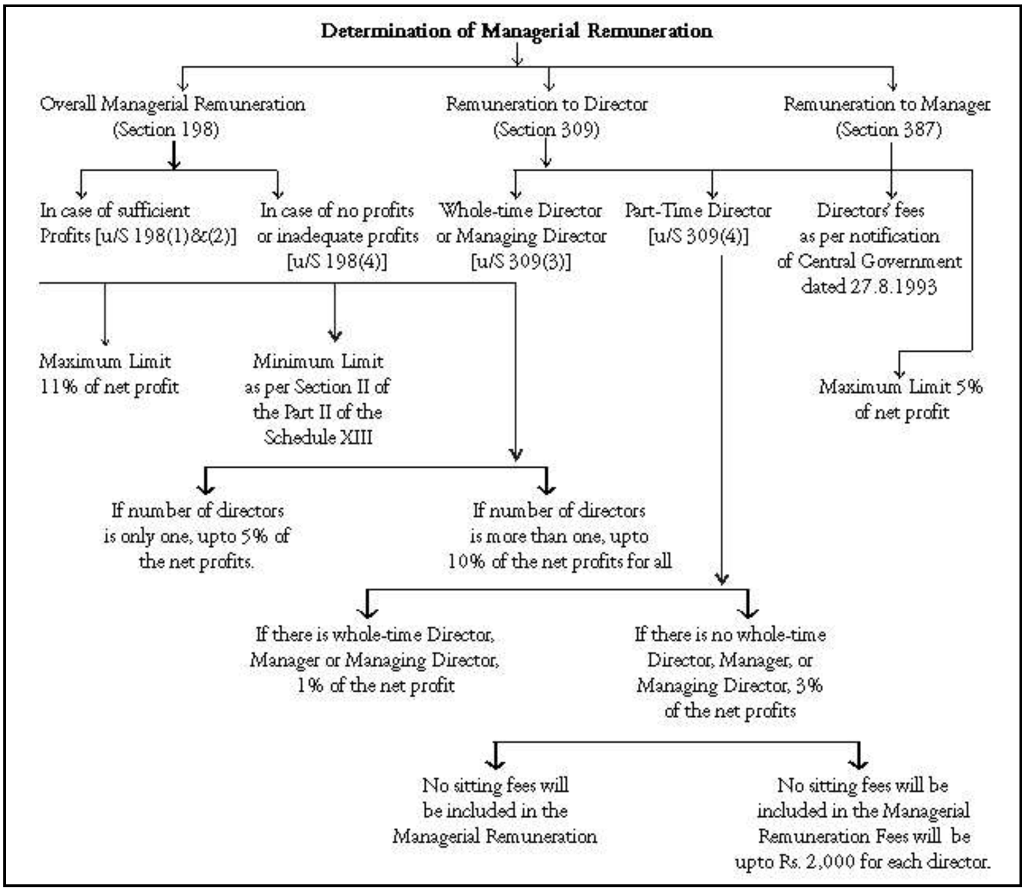
Notes

Remuneration to Manager

Provisions regarding remuneration to manager are given in the section 387 of the Companies Act 1956. According to this section, a company can pay the remuneration to a manager by the way of a monthly payment or by way of a specific percentage of the net profits of the company or partly by way of monthly payment and partly by way of specific percentage of the net profits. The net profit of the company is calculated according to sections 349 and 350 of the Companies Act.

Caution The total remuneration to the manager cannot exceed 5% of the net profit of the company, except with the approval of the Central Government.

Determination of net profit for managerial remuneration



Determination of net profit of a public company for the purpose of calculating the managerial remuneration will be as per the provision of the section 349 and section 350 of Indian Companies Act. These provisions are summarized as under:

1. ***The following items are added to the gross profit of the company:*** Bounties and subsidies received from any government or any public authority constituted or authorized in this behalf, by any government, unless and except in so far as the Central Government otherwise directs.

2. The following items are not considered to calculate the net profit of the company:

   (a) Profit by way of premium on the issue of shares or debentures of the company.

Notes

(b) Profits on the sale of forfeited shares.

(c) Profits in capital nature.

(d) Profit arising from the sale of immovable property or fixed assets, if company's business is not the sale and purchase of such type of assets. In other words, if the company is engaged in buying and selling of any assets of capital nature, profit arising from such a sale is added to for gross profit of the company.

Under section 350 if amount of sale of any such assets exceeds the written down value thereof, credit shall be given for so much of the excess as is not higher than the difference between the original cost of the fixed assets and its written down value. For example- Gujarat ltd., acquired fixed assets for ₹ 80,000 two years ago and now its written down value is ₹ 60,000. The company sold these assets for ₹ 85,000. In this case, total profit is ₹ 25,000 (₹ 85,000–₹ 60,000) profit of ₹ 20,000 (difference of original cost and written down value of the assets) will be added to gross profit and the excess of profit of ₹ 5,000 (₹ 25,000 – ₹ 20,000) will be excluded in computing the net profit for the purpose of remuneration.

3. The following items shall be deducted from the gross profit of the company:

(a) all the usual working charges.

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

(c) Any tax notified by the central government as being in the nature of a tax on the excess or abnormal profits.

(d) Any tax on business profits imposed for special reason or in special circumstances and notified by central government in this behalf.

(e) Interest on debentures issued by the company.

(f) Interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets.

(g) Interest on secured loans and advances.

(h) Expenses on repairs if the repairs are not of capital nature.

(i) Outgoings inclusive of contribution made to charitable and other funds not directly relating to the business of the company or welfare of its employees.

(j) Depreciation as per section 350 of the Companies Act. Under this section, the amount of depreciation is calculated as per rates specified in the schedule XIV (which is discussed in the chapter of final a/cs) on the written down value of the assets. The amount of depreciation includes normal depreciation, which includes extra and multiple shift allowance but excludes special depreciation, initial depreciation and any development rebate. If any assets are sold, discarded, demolished or destroyed before the expiry date of the assets, excess of w.d.v. of the assets over the sales proceeds of the assets or scrap value of the assets as the case may be, is written off in that financial year in which the assets are sold, discarded or demolished. This excess of w.d.v. will be computed as below:

Excess of w.d.v. = w.d.v. – sale proceeds – scrap value.

(k) The excess of expenditure over income which had arisen in computing the net profit in accordance with the section 349 of the Companies Act in any year which begins at or after the commencement of this Act insofar as such excess has not been deducted in any subsequent year preceding the year in which the net profits have to be ascertained.

Notes

(l) Any compensation or damages to be paid by virtue of any legal liability including a liability arising from a breach of contract.

(m) Any sum paid by way of insurance against the risk of meeting any liability such as referred to in clause (l).

(n) Debts considered bad and written off or adjusted during the year of account.

4. But the following items shall not be deducted from the gross profits of the company:

(a) The income tax and super tax payable by the company under the Indian Income Tax Act, 1961 or any other tax on the income of the company not covered under clauses (c) and (d) above.

(b) Any compensation or damage paid by the company voluntarily.

(c) Loss of capital nature including loss on sale of undertaking or any part thereof not including any excess of written down value over its sale proceeds or scrap value of any excess of written down value of any assets sold, discarded, demolished or destroyed as this excess is written off against p & l a/c.

Notes The profit calculated as per above provision is considered profits for the purpose of remuneration to directors, managing directors and manager. On the basis of this profit, the managerial remuneration is computed.

Self Assessment

Fill in the blanks:

5. The provisions regarding the manager's remuneration are found in section .... of the Companies Act.

6. Net profit for the purpose of managerial remuneration is calculated u/s ....

7. Minimum amount of overall remuneration is determined on the bases of ....

True or False:

8. Overall managerial remuneration is calculated u/s 198.

9. There can be more than one whole-time directors simultaneously in a company.

10. The managing director of the company must be a shareholder.

11. The maximum limit of manager's remuneration is 15% of profit u/s 387.

12. Section 209 relates to the provisions of managing director's remuneration.

13. If there is no whole-time director or managing director or manager in a company, part-time director's maximum remuneration can be paid 5% of the profit of the company.

14. Net profit for the purpose of managerial remuneration is calculated u/ss 349 & 350.

15. Managerial remuneration is always calculated on the profit before tax.

Example 1: Determine the maximum remuneration available to the part-time directors and managers of Babli and Bunty ltd. under sections 309 and 387 of the Companies Act, 1956 from the following particulars:

Before charging any such remuneration the profit and loss a/c, showed a credit balance of ₹ 57,75,000 for the year ended 31st march, 2006 after taking into account of following balances:

		₹
(i)	capital expenditure	13,12,500
(ii)	subsidiary received from government	10,50,000
(iii)	special depreciation	1,75,000
(iv)	multiple shift allowance	2,62,500
(v)	bonus to foreign technicians	7,87,500
(vi)	provision for taxation	70,00,000
(vii)	compensation paid to an injured workman	1,75,000
(viii)	ex-gratia payment to an employee	87,500
(ix)	loss on sale of fixed assets	1,75,000
(x)	profit on sale of investment	5,25,000

company is providing depreciation as per section 350 of the companies act, 1956.

Solution:

Calculation of net profit for managerial Remuneration u/s 349

Particulars	₹	₹
Credit balance of profit & loss (given)	57,75,000	
Add: Inadmissible items:		
(a) Capital expenditure	13,12,500	
(b) Special depreciation	1,75,000	
(c) Provision for depreciation	70,00,000	
(d) Ex-gratia payment to an employee	87,500	85,75,000
		1,43,50,000
Less: Non-trading profits:		
Profit on sale of investment		5,25,000
Net profit for managerial remuneration u/s 349.		1,38,25,000

Calculation of Managerial Remuneration

(i) Maximum remuneration for part-time directors @ 1% = $\frac{1,38,25,000 \times 1}{100}$ = 1,38,250

(ii) Net profit for the purpose of remuneration to manager = ₹ 1,38,25,000 – ₹ 1,38,500

= ₹ 1,36,86,750

Remuneration for manager @ 5% = $\frac{1,36,86,750 \times 5}{100}$ = ₹ 6,84,337.5

Example 2: Following is the profit and loss a/c of Puneet manufacturing company limited for the year ending 31st December 2005. You are required to calculate the maximum remuneration permissible to part-time directors. The company does not employ a manager or managing director or whole-time director. Also calculate overall managerial remuneration under section 198.

Notes

Particulars	₹	Particulars		₹
To salaries & wages	70,000	By gross profit		31,10,000
To director's fees	40,000	By profit on sale of building:		
To repairs	40,000		₹	
To general expenses	17,000	Cost	6,40,000	
To compensation for breach of contact	10,000	W.D.V.	3,00,000	3,40,000
To depreciation (including development rebate of ₹ 20,000 and initial depreciation of ₹ 10,000)	2,00,000	By subsidy from Central Government		60,000
To loss on sale of vehicle (w.d.v. ₹ 5,500)	3,000			
To loss on sale of investment	15,000			
To scientific research (new laboratory)	2,00,000			
To donation to charitable institutions	20,000			
To interest on debentures	40,000			
To interest on secured loans	10,000			
To debenture trustee remuneration	10,000			
To investment revaluation reserve	5,000			
To brought forward trading losses	30,000			
To income tax	10,00,000			
To proposed dividend	10,00,000			
To balance c/d.	8,00,000			
	35,10,000			35,10,000

Solution:

Calculation of net profit for managerial remuneration u/s 349

Particulars	₹	₹
Net profit as per p.& l. a/c (given)		8,00,000
Add: inadmissible items:		
(a) Development rebate	20,000	
(b) Initial depreciation	10,000	
(c) Loss on sale of investment	15,000	
(d) Scientific research	2,00,000	
(e) Investment revaluation reserve	5,000	
(f) Income tax	10,00,000	
(g) Proposed dividend	10,00,000	22,50,000
		30,50,000
Less: Capital profits on sale of building		40,000
Net profit for the purpose of managerial remuneration		30,10,000

alternatively, net profit for managerial remuneration may be calculated by taking gross profit of the company.

Notes

Particulars		₹	₹
Gross profit as per p. & l. A/c			31,10,000
Add: subsidy from Central Government.		60,000	
Revenue profit on the sale of buildings			
Sale (3,00,000 + 3,40,000)	6,40,000		
Less: cost	6,00,000		
Capital profit on sale of building	40,000		
Revenue profit = (3,40,000 – 40,000)		3,00,000	3,60,000
			34,70,000
Less: permissible items:			
Salaries and wages		70,000	
Director's fees		40,000	
Repairs		40,000	
General expenses		17,000	
Compensation on the breach of contact		10,000	
Depreciation (2,00,000 – 20,000 – 10,000)		1,70,000	
Loss on sale of vehicles		3,000	
Donation to charitable institution		20,000	
Interest on debentures		40,000	
Interest on secured loans		10,000	
Debenture trustee's remuneration		10,000	
Brought forward trading loss		30,000	4,60,000
Net profit for the purpose of managerial remuneration			30,10,000

Calculation of managerial remuneration

(i) Maximum remuneration for part-time directors @ 3% = $\frac{30,10,000 \times 3}{100} = ₹ 90,300$

(ii) Maximum overall remuneration @ 11% = $\frac{30,10,000 \times 11}{100} = ₹ 3,31,100$

Example 3: Calculate the managerial remuneration from the following particulars of Jag Mohan & Co. Ltd. due to the managing director of the company. Remuneration is paid at the rate of 5% of the profits. Also, determine the excess remuneration paid, if any:

		₹
Net profits		7,00,000
Net profit is calculated after considering the following:		
(i)	Depreciation	1,40,000
(ii)	Preliminary expenses	35,000
(iii)	Tax provision	10,85,000
(iv)	Director's fees	28,000
(v)	Bonus	52,500
(vi)	Profit on sale of fixed assets (original cost ₹ 70,000; written down value ₹ 38,500)	54,250
(vii)	Provision for doubtful debts	31,500

Notes

(viii) Scientific research expenditure (for setting up new machinery) 70,000

(ix) Managing director's remuneration paid 1,05,000

Other information:

(i) Depreciation allowable under schedule XIV of the Companies Act 1,22,500

(ii) Bonus liability as per payment of bonus act 63,000

Solution:

Calculation of net profit for managerial remuneration u/s 349

Particulars		₹	₹
Net profits			7,00,000
Add: inadmissible items:			
(a) excess of depreciation (₹ 1,40,000 – ₹ 1,22,500)		17,500	
(b) preliminary expenses		35,000	
(c) provision for doubtful debts		31,500	
(d) scientific research expenditures		70,000	
(e) managing director's remuneration		1,05,000	
(f) tax provision		10,85,000	13,44,000
			20,44,000
Less: deductible items			
Liability of bonus under Payment of Bonus Act.	₹ 63,000		
- bonus already debited	₹ 52,500	10,500	
Profit on sale of fixed assets			
Sales proceeds (38,500 + 54,250)	92,750		
- Original cost of assets	70,000	22,750	33,250
Net profit for managerial remuneration			20,10,750

Calculation of managerial remuneration

	₹
Remuneration @ 5% on ₹ 20,10,750	1,00,537.50
–Managing director's remuneration already paid	1,05,000.00
Excess remuneration paid	4,462.50

Example 4: The manager of XYZ Ltd. is entitled to get a salary of ₹ 5,000 per month plus 1% commission on the net profit of the company. After such salary and commission. The following is the profit and loss account of the company for the year ended 31st December, 2005:

Profit and Loss A/c.

Particulars	₹	Particulars	₹
To salaries, wages & bonus	3,85,000	By gross profit b/d	18,00,000
To general expenses	1,48,000	By subsidy from govt.	1,20,000
To depreciation	1,64,000	By profit on sale of assets	
To expenditure on scientific research		₹	
(Cost of apparatus)	28,000	Cost price 5,00,000	

Contd...

Notes

To manager's salary	60,000	W.D.V.	3,60,000	2,00,000
To commission to manager	12,000			
To provision for bad & doubtful debts	35,000			
To provision for income tax	4,80,000			
To proposed divided	2,00,000			
To balance c/d	6,08,000			
	21,20,000			21,20,000

Depreciation as per income tax rules amounts to ₹ 1,62,000. Calculate the remuneration payable to the manager.

Solution:

Calculation of Net Profit for Managerial Remuneration u/s 349

Particulars	₹	₹
Net profit as per p. & l. A/c		6,08,000
Add: inadmissible items excess depreciation (1,64,000 – 1,62,000)	2,000	
Expenditure on scientific research	28,000	
Manager's salary	60,000	
Manager's commission	12,000	
Provision for bad & doubtful debts	35,000	
Provision for income tax	4,80,000	
Proposed dividend	2,00,000	8,17,000
		14,25,000
Less: non-trading profits:		
Capital profit on the sale of assets (₹ 3,60,000 + ₹ 2,00,000 – ₹ 5,00,000)	60,000	60,000
Net profit for the purpose of managerial remuneration		13,65,000

Calculation of Managerial Remuneration

Net profit before manager's salary & commission =	₹ 13, 65,000
- Manager's salary (12× ₹ 5000)	60,000
Net profit before manager's remuneration	13,05,000
Manager's remuneration @ 1% = $\frac{13,05,000 \times 1}{100+1}$ =	₹ 12,920

As the manager has already withdrawn ₹ 12,000 as commission,

Now the commission payable to manager will be ₹ (12,920 – 12,000) = 920

Total remuneration of manager (₹ 60,000 + ₹ 12,920) =	₹ 72,920
Maximum remuneration to manager @ 5% = $\frac{13,65,000 \times 5}{100+5}$ =	₹ 65,000
Excess remuneration paid to manager	7,920

Notes

Notes As per the Companies Act, a company cannot pay commission to its managerial staff on the profit left after charging such commission. But in this illustration, commission to the manager is paid after charging his commission. Therefore, his commission is calculated by the following formula:

Example 5: From the following profit and loss a/c of Slow and Steady Ltd., for the year ended 31st December, 2005, calculate the commission payable to the managing director and other directors of the company whose commission was fixed @ 5% and 2% respectively on the profit of the company before charging their commission:

Particulars	₹	Particulars	₹
To salaries & wages	10,00,000	By gross profit	25,50,000
To rent, rates & taxes	2,25,000	By bounties and subsidies	
		Received from government	50,000
To repairs & renewals	30,000		
To miscellaneous expenses.	70,000	By profit on sale of fixed assets	40,000
To workmen compensation including		By premium on issues of shares	10,000
₹ 5,000, legal compensation	12,500		
To interest on bank overdraft.	20,000	By profit on sale of forfeited shares	5,000
To interest on debentures	25,000		
To director's fees	9,000		
To donation	17,500		
To depreciation on fixed assets	50,000		
To loss on sale of investment	12,500		
To reserve for redemption of redeemable			
Pref. Shares	75,000		
To development rebate reserve	50,000		
To provision for taxation	5,00,000		
To balance c/d	5,58,500		
	26,55,000		26,55,000

Notes

		₹
1.	Original cost of fixed assets sold	95,000
	Written down value of fixed assets sold	70,000
	Sale proceeds of fixed assets	1,10,000
2.	Donation allowable under Income Tax Act	12,500
3.	Depreciation allowable for income tax purpose	40,000

Solution:

Notes

Calculation of Net Profit for Managerial Remuneration u/s 349

Particulars	₹	₹
Net profit as per p. & l. A/c.		5,58,500
Less: non–trading incomes		
(i) Capital profit on sale of fixed assets (₹ 40,000 – ₹ 25,000)	15,000	
(ii) Premium on issue of shares	10,000	
(iii) Profit on sale of forfeited shares	5,000	30,000
		5,28,500
Add: inadmissible items:		
Workmen compensation voluntary (₹ 12,500 – ₹ 5,000)	7,500	
Excess depreciation on fixed asset (₹ 50,000 – ₹ 40,000)	10,000	
Donations (₹ 17,500 – ₹ 12,500)	5,000	
Loss on sale of investment	12,500	
Reserve for redemption of preference shares	75,000	
Development rebate reserve	50,000	
Provision for taxation	5,00,000	6,60,000
Net profit for the purpose of managerial remuneration		11,88,500

Calculation of Managerial Remuneration

As per section 309 of the Companies Act, if a company has a managing director, other part-time directors will be entitled to get a commission @ 1%. Only with the approval of the Central Government, a higher rate of remuneration can be given to the other directors.

Commission payable to managing director @ 5% on 11,88,500 ₹ 59,425

Commission payable to other directors @ 2% (given) on ₹ 11,88,500 ₹ 23,770

Example 6: Titu Tyres Limited, having three whole-time directors on its board, the others being part-time directors earned profits during the year ended 31st march, 2005 to the tune of ₹ 7,50,000 after taking into consideration the following:

	₹
Depreciation on Fixed Assets (depreciation admissible as per Income Tax Rules ₹ 98,400)	1,43,400
Provision of Income Tax	3,67,500
capital expenditure included in general expenses charged to	
Profit and Loss Account	37,500

Calculate the maximum remuneration payable to the whole-time directors, assuming that the remuneration payable to the whole-time directors to be calculated on net profits remaining after payment of commission to part-time directors, is to be calculated on net profits remaining after payment of remuneration to whole-time directors.

Notes

Solution:

Calculation of Net Profits for Managerial Remuneration U/S 349

Particulars	₹	₹
Net profit as per p. & l. A/c		7,50,000
Add: inadmissible items:		
Excess depreciation on fixed assets (₹ 1,43,400 – ₹ 98,400)	45,000	
Provision for taxation	3,67,500	
Capital expenditure included in general expenses	37,500	4,50,000
Net profit for the purpose of managerial remuneration		12,00,000

Calculation of Managerial Remuneration

10% will be the maximum remuneration payable to the whole-time director. This will be calculated on that profit which is left after charging the commission to part-time directors.

1% will be the maximum remuneration payable to the part–time director and that will be calculated on the profit left after charging the commission to the whole-time directors.

To compute both remunerations, we assume that the whole-time director's remuneration is x and part-time director's remuneration is y.

$\therefore \quad x = 10\%$ of (₹ 12,00,000 – y) and

$y = 1\%$ of (₹ 12,00,000 – x)

Now we find the following two equations–

$$10x + y = 12,00,000 \qquad \ldots(i)$$

$$100y + x = 12,00,000 \qquad \ldots(ii)$$

On multiplying the (ii) equation by 10 and then subtracting it from (i)

$$10x + y = 12,00,000 \qquad \ldots(i)$$

$$10x \pm 1000y = 120,00,000$$

$$-999y = -108,00,000$$

$$y = \frac{108,00,000}{999} = 1,811 \text{ (approx).}$$

On substituting the value of y in the (i) equation –

$$10x + 10,811 = 12,00,000$$

$$10x = 12,00,000 - 10,811$$

$$x = \frac{12,00,000 - 108,11}{10}$$

$$x = 1,18,919 \text{ (approx).}$$

	₹
Thus, remuneration to whole-time directors	1,18,919

Remuneration to part-time directors	10,811
Total managerial remuneration	1,29,730

Task The manager of Shanti Ltd., is entitled to annual salary of ₹ 35,000 and also a commission of 5% on the profits available for dividend. Their profit and loss account for the year ended 31st march, 2006 is as under:

Particulars	₹	Particulars	₹
To salaries & wages	2,80,000	By gross profit b/d	15,40,000
To general exps.	1,92,500		
To director's fees	17,500		
To manager's salary	35,000		
To depreciation (including development Rebate ₹ 35,000)	1,75,000		
To interest on debentures	70,000		
To general reserve	2,10,000		
To taxation	3,15,000		
To balance c/d	2,45,000		
	15,40,000		15,40,000

Assuming that general expenses are all admissible for tax purpose, income tax and super tax are to be taken at 50% of the company profits (except capital gains of 30%). Calculate the manager's remuneration.

Self Assessment

State whether the following statements are "true" or "false":

16. Maximum amount of director's fees can be ₹ 2,000 per head as per notification of central government dated 27-8-1993.
17. Director's fees is a part of managerial remuneration.

Select the right alternative:

18. Which section of the Companies Act contains the provisions regarding overall managerial remuneration?
    (a) Section 349
    (b) Section 198
    (c) Section 387
    (d) Section 79.
19. Which section of the Companies Act contains the provision regarding part-time director?
    (a) Section 198
    (b) Section 387
    (c) Section 309(3)
    (d) Section 309(4)

Notes

20. Which one of the following items is not included in the managerial remuneration?
    (a) Dearness allowance
    (b) Salary
    (c) Commission
    (d) Encashment of leaves

Case Study

Managerial Remuneration/Incentives

The Company

A medium sized mortgage broker with 10 sales staff and 4 administration staff - two of which handle complaints.

Current Practice

Currently the firm's consultants earn commission for reaching sales targets, and bonuses on top when certain milestones are passed. No other incentive system operates, but staff are required to follow FSA Rules on complaint turnaround times.

The TCF Problem

As a result of the sales incentive programme, consultants are encouraged to complete as many sales as possible in a given timeframe. The risk to customers is that, in their eagerness to meet targets, advisers may be tempted to sell a suitable product with which they are familiar when there are others equally or more suitable available for the particular individual in question. As a result customer choice – and therefore fair treatment - may be compromised.

At the same time, opportunities to encourage other staff members to implement TCF are being lost. For example, as things stand staff who deal with customer complaints have no incentives to spot and report opportunities to improve service and reduce future complaints. Their only incentive is to turn complaints around within the FSA timeframes.

TCF Solution

Sales

To encourage a more balanced approach to sales, the firm could include risk and service performance targets in its rewards programme and make it known that it monitors sales of individual product type against each adviser.

The additional targets might require the consultant to document the range of suitable products discussed with the client and the reason for the final choice out of these. Consultants would only qualify for commission on satisfactory completion of these details - which will be open to scrutiny during file checks and/or if sale statistics suggest undue emphasis of a broker selling one product type. By making consultants aware that MI will monitor sales of individual product by consultant the firm will further encourage them to consider a wider range of similar products and be ready to justify the final choices they make.

Contd...

Complaints

On the complaints side, a simple reward programme to encourage staff to suggest ways to prevent complaints reoccurring would benefit both customers and the broker. The reward programme could include points for the number of recommendations made and a financial reward where a recommendation is implemented and shown through MI to reduce complaints and improve service in that area.

12.5 Summary

- Profits available for the distribution among the shareholders of a company as dividend are called divisible profits.
- The profits are calculated by comparing the income and expense of one year.
- The necessary adjustments are made before calculating the profit of a business concern.
- The accounting principles are followed.
- The directors have the right to create provisions, reserves and funds out of business profits under the articles of association and the Companies Ordinance 1984.
- The remuneration which is paid to the managerial personnel (directors, managing directors and managers) by the company is called managerial remuneration.

12.6 Keywords

Breach of Contract: Breaking rules of a legal duty.

Preliminary Expenses: All the costs that are incurred when a company is formed.

Remuneration: Money paid for service.

12.7 Review Questions

1. Who can be appointed a managing director of a company?
2. What do you mean by managerial remuneration?
3. How is net profit determined for managerial remuneration u/s 349?
4. What are the provisions of remuneration of a part-time director of a public company?
5. What are the provisions regarding the remuneration of a whole-time director u/s 309?
6. What do you mean by managerial remuneration? Describe the provisions relating to maximum and minimum remuneration.
7. What is the meaning of managerial remuneration? How is the profit calculated for managerial remuneration? Describe in detail.
8. What provisions have been made in the Companies Act in connection with depreciation and remuneration of whole-time director? Describe.
9. Describe the provisions of the Companies Act, 1956 as amended up to date relating to the ascertainment of remuneration of the members of managerial staff.
10. Give the main provisions of company law regarding managerial remuneration.

Notes

11. Net profit to Akash Ltd. is ₹ 7,00,000 for the year ending on 31st December, 2005. The following amounts have also been recorded in the profit and loss a/c:

		₹
(a)	Bounties received from government	1,00,000
(b)	Bonus paid to foreign technicians	75,000
(c)	Repair of capital nature	1,25,000
(d)	Depreciation (extra shift allowance of ₹ 32,500 is included in it)	1,12,500
(e)	Provision for taxation	10,00,000
(f)	Investment allowance reserve	1,25,000
(g)	Compensation paid to an injured employee	20,000
(h)	Terminal depreciation of a machine	12,500
(i)	profit on sale of investment	20,000

Now find out:

(i) Manager and directors are in the company. Find out maximum remuneration payable to directors.

(ii) if there is one manager and three other directors in the company, what will be their maximum remuneration?

12. Following is the profit and loss a/c of Sanjna Ltd. for the year ending 31st December, 2005:

Particulars	₹	Particulars	₹
To salaries	4,25,000	By gross profit	6,50,000
To discount	20,000	By profit on sale of machinery	75,000
To carriage outward	10,000		
To general expenses	25,000		
To interest on unsecured loans	25,000		
To provision for tax	45,000		
To net profit	1,75,000		
	7,25,000		7,25,000

Written down value of that machinery whose profit is given in the above p. & l. A/c is ₹ 1,00,000. Its cost is ₹ 1, 25,000. Find out the maximum remuneration payable to directors when the company has a whole-time director or managing director or manager.

13. The manager of XYZ Ltd. is entitled to get a salary of ₹ 6,250 per month plus 1% commission on the net profit of the company after such salary and commission. The following is the profit and loss A/c of the company for the year ended 31st march, 2005:

Particulars	₹	Particulars	₹
To salaries, wages & bonus	4,81,250	By gross profit	22,50,000
To general exps.	1,85,000	By subsidy from government	1,50,000
To expenditure on	2,05,000	By profit on sale of assets (cost price of ₹ 6,25,000 and written down value ₹ 4,50,000).	2,50,000

Contd...

Notes

Scientific research (cost of an apparatus)	35,000		
To manager's salary	75,000		
To commission to manager	15,000		
To reserve for b/d.	43,750		
To provision for income tax	6,00,000		
To proposed dividend	2,50,000		
To balance c/d	7,60,000		
	26,50,000		26,50,000

Depreciation as per Income Tax Rules amounts to ₹ 2,02,000. Calculate the managerial remuneration.

14. Following are the relevant balances taken from the books of Shashi Ltd. You are required to calculate the remuneration of the managing director at 5% of the profit ascertained according to the Companies Act. Find out the excess amount, if any, paid to him.

Net profit		₹ 69,279
Items considered for arriving at the above net profit:		
(a)	provision for taxation	₹ 1,05,455
(b)	managing director's remuneration	₹ 13,552
(c)	preliminary expenses	₹ 10,500
(d)	director's fees	₹ 7,000
(e)	provision for doubtful debts	₹ 21,000
(f)	depreciation	₹ 33,810
(g)	depreciation allowed as per schedule XIV	₹ 31,500
(h)	donation to sister concerns	₹ 10,500
(i)	ex-gratia payment to employees	₹ 3,500

15. Determine the maximum remuneration available to the part-time director and manager of the Ankit Tyres Co. Ltd., (a manufacturing company) under sections 309 and 387 of the Companies Act, 1956, from the following particulars:

Before charging any such remuneration the profit and loss account showed a credit balance of ₹ 9,90,000 for the year ended 31st December, 2005 after taking into account the following matters:

		₹
(a)	capital expenditure	2,25,000
(b)	subsidiary received from central government	1,80,000
(c)	special depreciation	30,000
(d)	multiple allowance	45,000
(e)	bonus to foreign technicians	1,35,000
(f)	provision for taxation	12,00,000
(g)	compensation paid to injured worker	30,000
(h)	ex-gratia payment to an employee	15,000

Notes

(i) loss on sale of fixed assets 30,000

(j) profit on sale of investment 90,000

16. Calculate the managerial remuneration from the following particulars of Radha Krishna & Company Ltd. due to the managing directors of the company at the rate of 5% of the profits. Also determine the excess remuneration paid, if any:

	₹
Net profits	7,00,000
Net profit is determined after considering the following:	
(i) depreciation	1,20,000
(ii) preliminary exps.	35,000
(iii) tax provision	10,85,000
(iv) director's fees	28,000
(v) bonus	52,500
(vi) profit on sale of fixed assets	
(original cost: ₹ 70,000, written down value: ₹ 38,500)	54,250
(vii) provision for doubtful debts	31,500
(viii) scientific research expenditure (for setting up new machinery)	70,000
(ix) managing director's remuneration paid	1,05,000
Other Information :	
(i) depreciation allowable under schedule XIV of the companies act, 1956	1,22,500
(ii) bonus liability as per Payment of Bonus Act, 1965.	63,000

17. Following is the profit and loss a/c of Lakshmikant & Company Limited for the year ending 31st march, 2005:

Particulars	₹	Particulars		₹
To salaries	63,875	By gross profit		8,75,000
To income-tax	67,375			
To depreciation (including ₹ 8,750 terminal depreciation)	96,250	By subsidy received form government		2,10,000
To compensation for breach of contract.	14,000	By profit on sale of machinery		
To provision for b/d.	3,500	Cost	₹ 3,85,000	
To general reserve	10,500	Depreciation value	₹ 1,22,500	
To general expenses	7,000	Sale price	₹ 4,37,500	3,15,000
To proposed dividend	43,750			
To director's fees	26,250			
To loss on sale of investment	17,500			
To net profit	10,50,000			
	14,00,000			14,00,000

Find out the permissible maximum commission payable for directors from the above information when:

(a) there is a manager to assist the directors.

(b) there is none other out of the manager, managing director and whole-time director to assist the directors.

18. Babita Ltd. has 3 whole-time directors on its board, the others being part-time directors. From the following particulars of the company, calculate the maximum remuneration payable to the whole-time directors and the part-time directors, assuming that the remuneration payable to the whole-time directors is to be calculated on net profits remaining after payment of commission to part-time directors, and the commission to part-time directors is to be calculated on net profits remaining after payment of remuneration to whole-time directors.

Profit earned by the company ₹ 10,00,000

The above profits have been ascertained after taking into account the following:

Depreciation on fixed assets ₹ 1,91,200

Provision for income-tax made ₹ 4,90,000

Capital expenditure relating to cost of a showroom has been included in general

Expenses charged to profit and loss a/c ₹ 50,000.

You are informed that the depreciation admissible as

Per schedule XIV amounts to ₹ 1,31,200.

19. The following was the profit and loss account of Anand & Company Limited as on 31st March, 2005:

Particulars	₹	Particulars	₹
To salaries	1,80,000	By gross profit	9,00,000
To manager's salary	24,000		
To director's fees	12,000		
To depreciation	1,20,000		
To general charges	1,26,000		
To general reserve	90,000		
To interest on debentures	45,000		
To taxation	2,10,000		
To net profit	93,000		
	9,00,000		9,00,000

All the expenses are allowable for taxation. Calculate income tax on company's profit @ 40%. The annual salary of the manager of the company is ₹ 24,000. He also gets 3% commission on divisible profits arrived at after deducting his salary and taxation. Depreciation includes ₹ 30,000 for development rebate. Find out the manager's remuneration and income tax.

20. Babli and Company Ltd. employs a manager and three whole-time directors. It pays 5% commission to the manager and 2% to each whole-time director. The commission payable to the manager is calculated on the profit left after charging his commission and the commissions of whole-time directors and the commission payable to the whole-time directors are calculated on profit left after charging their commission and commission of manager as per Companies Act after taking into consideration the following information:

Notes

Particulars	₹	Particulars	₹
To administrative & selling expenses	3,25,000	By gross profit	15,00,000
To bad debts	27,000	By subsidy from central bank	2,00,000
To salary & bonus	1,50,000	By profit on sale of plant	1,50,000
To development rebate reserve	40,000	Cost ₹ 6,00,000	
To income-tax	30,000	Realised ₹ 7,00,000	
To tax on abnormal profits	5,000		
To managerial remuneration	75,000		
To provision for depreciation	2,50,000		
To net profit	9,48,000		
	18,50,000		18,50,000

Answers: Self Assessment

1.	True	2.	False
3.	5%	4.	Shareholder
5.	387	6.	349
7.	Effective capital	8.	True
9.	True	10.	True
11.	False	12.	False
13.	False	14.	True
15.	False	16.	True
17.	True	18.	B
19.	D	20.	D

12.8 Further Readings

Books

Corporate Accounting - Dr. K.K. Verma

Online links

http://moneyterms.co.uk/rights-issue/

http://investmentarticle.com/why-do-companies-conduct-rights-issue.html

Notes

Unit 13: Final Accounts for Companies

CONTENTS

Objectives

After studying this unit, you should be able to:

- Explain meaning of final accounts
- Understand form and content of Balance Sheet
- Explain different Schedules of Balance Sheet
- Understand explanations of content items of Balance Sheet
- Explain limitations of Financial Statements

Introduction

It is quite natural that the businessman is interested in knowing whether his business is running on Profit or Loss and also the true financial position of his business. The main aim of Bookkeeping is to inform the Proprietor, about the business progress and the financial position at the right time and in the right way.

In the present unit, you will study about the final accounts of the company. After studying this unit, you will be able to understand the preparation of profit & loss account and balance sheet of the company. The unit also discussed about the requirements of Schedule VI concerning the P&L a/c and balance sheet. Financial statements of companies mean: (i) Profit and Loss Account, and (ii) Balance Sheet. According to Section 209 of the Indian Companies Act, 1956, it is compulsory for each and every company to prepare its profit and loss account as well as Balance Sheet. It is also essential to maintain both the accounts in a proper form which is given in the Schedule VI Part I and II of the Companies Act.

Notes

Example 1: A company ABC Ltd. is a non-banking financial company. During the financial year 2009-2010 the company made some expenditure and earned revenue from its business activities. The company took a loan of ₹ 100 crore from a bank for its new project during the same year. In the financial year 2008-2009 the company earned a good amount of profit so the company decides to hike the salary of its staff by 5% from the financial year 2009-2010. At the end of the financial year 2009-2010 the company wants to calculate its net earnings/losses and financial position. The accounts which are prepared to know the net profit/loss and financial position of the business are called final accounts.

In the present unit, you will study about the final accounts of the company. After studying this unit, you should be able to understand the preparation of profit & loss account and balance sheet of the company. The unit also discussed about the requirements of Schedule VI concerning the P&L a/c and balance sheet. Financial statements of companies mean: (i) Profit and Loss Account, and (ii) Balance Sheet. According to Section 209 of the Indian Companies Act, 1956, it is compulsory for each and every company to prepare its profit and loss account as well as Balance Sheet. It is also essential to maintain both the accounts in a proper form which is given in the Schedule VI Parts I and II of the Companies Act.

13.1 Meaning

To prepare final account by the sole trader or partnership firm is not a statutory obligation. But as per Section 210 of the Companies Act, it is compulsory for every registered company to prepare the final accounts. Final account of company includes Profit and Loss A/c, and Balance Sheet. Profit and Loss Account is a combined account of Trading Account Profit and Loss Account and Profit and Loss Appropriation Account. The general principles of preparing sheet of a company are the same as used in the case sole trader or partnership firm. But in addition to these principles, a company must conform to legal provisions in the Indian Companies Act, 1956 relating to the preparation of final accounts. The provision relating to the maintenance, publication, form and contents of final accounts are given in the Sections 209 to 233 of the Companies Act, 1956. A brief description of these sections is given below:

As per Section 209 of Indian Companies Act 1956, a company has to keep proper accounts regarding (i) all receipts and disbursements of money (ii) all sales and purchases of goods (iii) all assets and liabilities (iv) particulars relating to the utilization of material and labour, etc. (in case of a manufacturing concern).

Section 210 is relating with the preparation and presentation of final account of a company. As per this section-

1. "At every annual general meeting of company held in pursuance of Section 166, the Board of Directors of the Company shall lay before the company:
   (i) The balance sheet as at the end of the period specified in sub-section (3) and
   (ii) A profit and loss account of that period.
2. In case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting instead of profit and loss account, and all references to 'profit and loss' in this section and elsewhere in this Act, shall be construed, in relation to such a company, as reference respectively to the 'income and expenditure account', and the 'excess of expenditure over income'.
3. The profit and loss account shall relate to–
   (i) The meeting of a company, to the period beginning with the incorporation of the company and ending with a day which shall not precede the day of meeting by more than nine months, and

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(ii) In 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 cases where an extension of the meeting under the second proviso to the sub-section (1) of Section 166, by more than six months and the extension so granted.

4. 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 fifteen months:

   Provided that it may extend to eighteen months, where special permission has been granted in that behalf by the Registrar.

As per Section 211 every profit and loss account and balance sheet of a company must show 'true and fair' picture of the state of affairs of the company. For this, the balance sheet must be in the form set out in the Part I of the Schedule VI and the requirements for the preparation of Profit and Loss account given in the Part II of this Schedule must be followed.

Caution To prepare final account by the sole trader or partnership firm is not a statutory obligation. But as per Section 210 of the Companies Act, it is compulsory for every registered company to prepare the final accounts.

As per Section 212 of the Companies Act if any company is a holding of another company, the holding company has to attach with its balance sheet the following documents relating to its subsidiary company.

(a) A copy of balance sheet and profit and loss account of the subsidiary company.

(b) A copy of Director's Report.

(c) A copy of Auditor's Report

(d) A statement of the holding company's interest in the subsidiary company.

Section 213 deals the extension of the financial year of the holding company and its subsidiary company.

The provisions of Section 214 relate to the rights of holding company's representative and members to inspect the books of accounts of the subsidiary company.

Section 215 relates to the authentication of balance sheet and the profit and loss account of a company. As per the provisions of this section the final accounts of a company shall be signed on the behalf of the board of directors by its manager or the secretary, if any, and by not less than two directors of the company, one of whom shall be a managing director, where there is one.

As per the Section 216 of the Companies Act, the profit and loss account shall be treated as an annexure to the balance sheet the auditor's report as an enclosure thereto.

Section 217 provides that Auditor's Report and Director's Report shall be attached to the Balance Sheet laid before the shareholders in the general meeting.

As per Section 218 there would be a penalty for improper issue, circulation or publication of Balance Sheet or Profit and Loss account.

Section 219 deals with the right of the member to obtain copies of Balance Sheet and Profit and Loss Account, Auditor's Report and every other document required by law to be annexed or attached to the Balance Sheet which is to be presented in the general meeting.

Section 220 is relating with the filing of accounts with register. As per this section three copies of Balance Sheet, Profit and Loss A/c, and all other documents which are attached with the Balance Sheet shall to be filed with the Registrar within thirty days after the annual general meeting.

Did u know? As per Section 212 of the Companies Act if any company is a holding of another company, the holding company has to attach with its balance sheet the following documents relating to its subsidiary company.

Task Discuss the rulings of different sections come under this final accounts of a company.

13.2 Form and Contents of Balance Sheet

Meaning of Balance Sheet

The balance sheet of a company is a statement which shows the total value of assets owned and total of the company's liabilities owed by of trading on a particular date or at the end of trading period. Balance Sheet is also called the statement of assets and liabilities and net worth. Section 211 of the Companies Act provides that the Balance Sheet of the company shall give true and fair view of the state of affairs of the company as at the end of the financial year. True and fair view means that there should be no window-dressing on any item of the balance sheet. For the true and fair view of the state of affairs of the company, assets and liabilities should be correctly given, provisions should be shown in the sufficient amount, contingent assets and contingent liabilities should be given as notes of the Balance Sheet and stock should be valued on the basis of accounting principles.

According to Section 211(1) every balance sheet of the company shall be prepared in the form set out in Part I of Schedule VI or as near thereto as circumstances permit, or in such other form as may be laid down by the Central Government either generally or in a particular case. This Part further states that 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 the Part. Provisions of this Section do not apply to Banking. Insurance and Electricity Generation and Supplying Companies because the Form of Balance Sheets of these companies are given in the Act governing such class of companies. There are given two alternative formats of the Balance Sheet in Part I of Schedule VI. These are the Horizontal form and the Vertical Form. Companies are free to choose any one of these forms. Mostly, companies adopt the Horizontal Form of Balance Sheet. These forms of Balance Sheet are given in Part I of Schedule VI of the Companies Act given below:

13.2.1 Schedule VI – Part I (see Section 211) Form of Balance Sheet – A Horizontal Form

(The balance sheet of a company shall be in Horizontal form or Vertical form)

Balance Sheet of .... (Here, enter the name of company) as at .... (Here, enter the date at which the balance sheet in made out.)

Notes

Figures for the previous year ₹	Liabilities	Figures of the current year ₹	Figures for the previous year ₹	Assets	Figures for the current year ₹
	Share Capital Authorised ...... shares of ₹ each. Issued: (distinguishing between the various classes of capital and stating the particular specified below, in respect of each class.) — — shares of ₹ — — — each. Subscribed: (distinguishing between the various classes of capital and stating the particular specified below, in respect of each class) — shares of ₹ — each ₹ — — called up. (Of the above shares — shares are allotted as fully paid up pursuant without payments being received in cash). (Of the above shares — — shares are allotted as fully paid up pursuant to a contract without payments being received in cash). (Of the above shares — — shares are allotted as fully paid up by way of bonus shares). Specify the source from which bonus shares are issued e.g. capitalization of profits or Reserve or from shares Premium Account. Less: Calls unpaid (i) By directors. (ii) By others. Add: Forfeited shares: (Amount originally paid up) (Any capital profit on reissue of forfeited shares should be transferred to Capital Reserve) Notes: 1. Terms of redemption or conversion (if any) of any redeemable preference capital are to be stated together with earliest date of redemption or conversion. 2. Particulars of any option on unissued share capital are to be specified. 3. Particulars of the different classes of preference shares are to be given. These particulars are to be given along with shares capital In the case of subsidiary companies, the number of shares held of the holding company as well as by the ultimate holding company and its subsidiaries shall be separately stated in			**Fixed Assets** Distinguishing as far as possible between expenditure upon: (a) goodwill (b) land (c) buildings (d) leaseholds (e) railways sidings (f) plant and machinery (g) furniture and fittings (h) development of property (i) patents, trade marks and designs (j) livestock and (k) vehicles, etc. Under each head the original cost and the additions thereto and deductions therefrom during the year, and the total depreciation written off or provided up to the end of the year is be stated. Depreciation written off or provided shall be allotted under the different assets heads and deducted in arriving at the value of Fixed Assets. [Also see note (11)] In every case where the original cost cannot be ascertained, without unreasonable expenses or delay, the valuation shown by the books is to be given. For the purpose of this paragraph such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation of diminution in value, and where any asset is sold, the amounts of sale proceeds shall be shown as deduction. Where sums have been written off on a reduction of capital or a revaluation of assets, every balance sheet, (after the first balance sheet) subsequent to the reduction or revaluation shall show the reduced figures with the date of the reduction in 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 written up the assets, every balance sheet subsequent to such writing up	

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respect of subscribed share capital. The auditor is not required to certify the correctness of such share holding as certified by the management.			shall show the increased figure with the date of the increased in place of the original cost. Each balance sheet for the first five years subsequent to the date of the written up shall also show the amount of increase made. Explanation: Nothing contained in the preceding two paragraphs shall apply to any adjustment made in accordance with the second paragraph.
Reserve and Surplus: (1) Capital Reserve. (2) Capital Redemption Reserve. (3) Shares Premium Account (showing details of its utilization in the manner provided in Section 78 in the year of utilization). (4) Other Reserve specifying the nature of each Reserve and the amount in respect thereof. Less: Debit balance in profit and loss account (if any). (The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserve, if any). (5) Surplus, i.e. balance in profit and loss account after providing for proposed allocations namely: Dividend Bonus or Reserve. (6) Proposed additions to Reserves. (7) Sinking Funds (Additions and deductions 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).			**Investment:** Showing nature of investment and mode of valuation, for example, cost or market value and distinguishing between- (1) Investment in Government or Trust Securities (2) Investment in shares, debentures or bonds. (Showing separate shares fully paid up and partly paid up and also distinguishing the different classes of shares and showing also in similar detail, investment in shares, debentures or bonds details of subsidiary companies). (3) Immovable properties (4) Balance of the investments in the capital partnership firm. (5) Balance of unutilized monies raised by issue. (Aggregate amount of the company's quoted investment and also the market value thereof shall be shown). (Aggregate amount of the company's unquoted investments shall also be shown). (All unutilized monies out of issue must be separately disclosed in the Balance Sheet of the company) indicating the manner in which such unutilized funds have been invested.
Secured Loans: (1) Debentures (2) Loans and Advance from Banks (3) Loans and Advance from Subsidiaries. (4) Other Loans and Advance (Loans from directors and/or 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 security to be specified in each case. Where loans have been guaranteed by manager and/or directors, a mountain thereof, shall also be made and also the			**Current Assets' Loans and Advance:** **(A) Current Assets** (1) Interest accrued in Investment (2) Store and spare paid (3) Loose Tools (4) Stock-in-Trade (5) Work-in-Progress [In respect of (2) and (4), mode of valuation of stock shall be stated and the amount in respect of raw materials shall also be stated separately where practicable. Mode of valuation of work-in-progress shall be stated]. (6) Sundry Debtors–(a) Debts outstanding for a period exceeding six months. (b) Other debts Less: Provision (The amounts to be shown under Sundry Debtors shall include the amount due in respect of

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aggregate amount of such loans under each head. In case of Debentures, terms of redemption or conversion (if any) are to be stated together with earliest date of redemption or conversion.

Unsecured Loans:

1. Fixed Deposits

(2) Loans and Advance from Subsidiaries.

(3) Short-term Loans and Advance.

(a) From Banks (b) From Others

(Short-term loans include those which are due for repayment not late than one year as at the date of the balance sheet).

(4) Other Loans and Advance

(a) From Banks (b) From Others

(Loans from directors and/or manager should be shown separately).

Interest accrued and due on Unsecured Loans should be included under the appropriate sub-head "Unsecured Loans" where Loans have been guaranteed by manager and/or directors, a mention thereof shall be made together with the aggregate amount of such loans under each head.

Current Liabilities and

Provisions:

(A) Current Liabilities

1. Acceptance

2. Sundry Creditors

3. Subsidiary Companies

4. Advance Payments and unexpired discounts for the portions for which value has still to be given e.g. in the case of the following classes of companies: Newspaper's Fire Insurance, Theatres, Clubs, Banking, Steamship Companies etc.

5. Unclaimed Dividends

6. Other Liabilities (if any)

7. Interest accrued but not due on loans.

(B) Provision

1. Provision for Taxation

2. Proposed Dividend

3. For Contingencies

4. For Provident Fund Scheme.

5. For Insurance, Pension and similar staff benefit schemes.

6. Other Provision: 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 dividend. (The period for which

goods sold or service rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances).

In regard to Sundry Debtors particulars to be given separately of-

(a) Debts considered good and in respect of which the company is fully secured.

(b) Debts considered good for which the company holds no security other than the debtor's personal security; and

(c) Debts considered doubtful or bad. Debts due by directors or other officers of the company any of 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.

Debts due from other companies under the same management within the meaning of sub-section (IB) of Section 370 to be disclosed with the names of the companies. 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 provision to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such provision, if already created, should be shown at every closing under "Reserve and Surplus" (in the Liabilities side) under a separate sub- head "Reserve for Doubtful or Bad Debts." (7A) Cash balance on hand. (7B) Bank balance-(a) with Scheduled Banks and (b) with other. In regard to bank balance, particulars to be given separately of- (i) the balance lying with scheduled Banks on current account, call accounts and deposit account. (ii) the names of the bankers other than scheduled Banks and the balance lying with each such banker on current accounts, call account and deposit accounts and the maximum amount outstanding at any time during the year with each such bankers; and (iii) the nature of the interest, if any, of any director or his relative in each of the bankers [other than Scheduled Bankers referred in (ii) above.] (iv) all unutilized monies out of the issue must be separately

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	the dividend are in arrear or if there is more than one class of shares, the dividend on each such class that are in arrear, shall be stated. The amount shall be stated before deduction of income tax, except that in the case of tax and free dividends the amount shall be shown free of income tax; the fact that is it is so shown shall be stated). 4. Estimated amount of contract remaining to be executed on capital account and not provided for. 5. Other moneys for which the company is contingently liable. (The amount of any guarantee given by the company on behalf of directors or other officers for the company shall be stated and where practicable the general nature and amount of each such contingent liabilities, if material, shall also be specified).			disclosed in the Balance Sheet of the company indicating the manner in which such unutilized funds have been invested. **(B) Loans and Advance** (8) (a) Advances and loans to subsidiaries. (b) Advances and loans to partnership firms in which the company or any subsidiaries is a partner (9) Bills of Exchange (10) Advance recoverable in cash or in kind or for value to be received. e.g. Rates, Taxes, Insurance etc. (11) Balance with customs, Port Trust etc. (where payable on demand). The instructions regarding Sundry Debtors apply to "Loans and Advance" too. The amounts due form other companies under the same management; within the meaning of sub-section (IB) of Section 370 should also be given with the name of companies the maximum amounts due from every one of these at any time during the year must be shown. **Miscellaneous Expenditure** (To the extent not written off 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 sums (specifying nature) **Profit and Loss Account** (Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserve, if any).	

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1. Paise can also be given in addition to Rupees, if desired.
2. Dividend declared by subsidiary companies after the date of the balance sheet should not be included, unless they are in respect of a period which closed on or before the date of the balance sheet.
3. Any reference to benefit expected from contracts to the extent not executed shall be not made in the balance sheet but shall be made in the Board's report.
4. Particulars of any redeemed debentures which the company has power to issue should be given.

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5. Where any of the company's redeemed 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.
6. A statement of investment (whether shown under: "Investment" or "Current Assets" as Stock-in-trade) separately classifying trade investment and other investments should be annexed to the balance sheet, showing the names of the bodies corporate (including separately the name 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 on which the previous balance sheet was made out); and the nature and extent of the investment so made in each body corporate: provided that in the case of an investments 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 on which the balance sheet has been made out. In regard to the investment in the capital of partnership firm, 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.
7. If, in the opinion the Board, any of the current assets, loans and advances do not have a value on realization in that ordinary course 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.
8. Except in the case of the first balance sheet laid before the company after the commencement of the Act, the corresponding amounts of the immediately preceding financial year for all items shown in the balance sheet shall be also given in the balance sheet. The requirements in this behalf shall, in case of companies preparing quarterly or half yearly account, etc., relate to the balance sheet for the corresponding date in the previous year.
9. Current account with Directors and Manager, whether they are in credit or debit, shall be shown separately.
10. The information required to be given under any of the items or sub-items in the Form, if cannot be conveniently included in the balance sheet itself, shall be furnished in a separate Schedule or Schedule to be annexed to any form part of the balance sheet. This is recommenced when the items are numerous.
11. Where the original coat (of fixed assets) and additions and deduction thereto, relate to any fixed assets which have been acquired from a country outside India, and in consequence of a charge in the rate of exchange at any time after the acquisition of such assets, there has been an increase or reduction on 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, or for repayment of the whole or a part of monies borrowed by the company from any person, directly, in any foreign currency specifically for the purpose of acquiring the asset (being in either cause the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liabilities are so increased or reduced during the year, shall be added to, or as the case may be, deducted from the cost, and amount arrived at after such addition or deduction shall be taken to the cost of the fixed assets.

Caution According to Section 211(1) every balance sheet of the company shall be prepared in the form set out in Part I of Schedule VI or as near thereto as circumstances permit, or in such other form as may be laid down by the Central Government either generally or in a particular case.

Explanation 1: This paragraph shall apply in relation to all balance sheets that may be made out as on the 6th day of June, 1966 or any day thereafter and where, at the date of issue of the

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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 the paragraph applies has already been made in the first balance sheet made out and laid before the company in its annual general meeting, the adjustment referred to in this paragraph may be made out after the issue of the said notification.

Explanation 2: In this paragraph unless the context otherwise requires, the expression "rate of exchange", "Foreign currency" and "Indian currency" shall have the meanings respectively assigned to them under sub-section (1) of Section 43A of the Income Tax Act (XLII of 1961) and Explanation 2 and Explanation 3 of the said sub-section shall as far as may apply in relation to the said paragraph, as they apply to the said sub-section (1).

Did u know? Except in the case of the first balance sheet laid before the company after the commencement of the Act, the corresponding amounts of the immediately preceding financial year for all items shown in the balance sheet shall be also given in the balance sheet.

13.2.2 Vertical Form of Balance Sheet

Name of Company ....

Balance Sheet as at ....

Schedule No.	Figures as at the end of the current year	Figures as at the end of the previous financial year
I Sources of Fund		
1. Shareholder's Funds		
(a) Capital	....	....
(b) Reserve and Surplus	....	....
2. Loan Funds		
(a) Secured loans..	....	....
(b) Unsecured loans..	....	....
Total		
II Applications of Funds		
1. Fixed Assets		
(a) Gross Block	....	....
(b) Less Depreciation......................................	....	....
(c) Net Block...		
(d) Capital Work-in-Progress		
2. Investment		
3. Current Assets, Loans and Advances		
(a) Inventories	....	....
(b) Sundry Debtors	....	....
(c) Cash and Bank Balance	....	....
(d) Other current Assets	....	....
(e) Loans and Advance	....	....
Less: Current liabilities And provisions		
(a) Liabilities	....	....
(b) Provision	....	....
Net Current Assets		
4. (a) Miscellaneous expenditure to the extent not written off or adjusted	....	....
(b) Profit and loss Account	....	....
Total	....	....

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1. Details under each of the above items shall be given in separate Schedule. The Schedules shall incorporate all the information required to be given under Part IA of the Schedule VI read with Notes containing General Instructions for preparation of Balance Sheet.
2. The Schedules referred to above, according polices and explanatory notes that may be attached shall form an integral part of the balance sheet.
3. The figures in the balance sheet may be rounded to the nearest "000" or "00" as may be convenient or may be expressed in terms of decimals of thousands.
4. A footnote to the balance sheet may be added to show separately contingent liabilities.

   By notification No. GSR 388(E) dated May 15, 1995; the Central Government has inserted Part IV in the Schedule VI to the Act.

Self Assessment

Fill in the blanks:

1. The Board of Directors is required to present its Profit and Loss Account and Balance Sheet in every ………………… of the company.
2. The first Profit and Loss Account can be prepared from the date of incorporation upto a period which initially cannot be more than ………………… after closing the accounts.
3. Preparation of balance sheet in the prescribed format is required u/s .... of the Companies Act.
4. If the rate of proposed divided does not exceed .... no transfer of profit to reserve will be compulsory.
5. Capital Redemption Reserve and .... can be utilized only for the issue of fully paid bonus shares and not meeting the partly paid equity shares into ....

13.3 Explanation of Major Items of Liabilities Side of the Balance Sheet

1. ***Share Capital:*** Under the heading of Shares Capital, Authorised, Issued, Subscribed, Called up and Paid up Capital are disclosed. If the company has issued the preference shares, Preference Capital is also showed separately under this heading. These capital are given stating the number and nominal value of the shares. Shares allotted for consideration other than cash, shares issued as bonus shares and calls in advance are also shown separately. Calls in arrear (the unpaid calls) are disclosed as deduction from the amount of called up capital.
2. ***Reserve & Surplus:*** Under this heading, the following items are shown separately:

   (i) Capital Reserve

   (ii) Capital Redemption Reserve

   (iii) Securities Premium

   (iv) Other Reserve

Notes

(v) Sinking Fund

(vi) Surplus of Profit and Loss A/c.

Increase and decrease in the above reserves during the previous year should be shown clearly. There is a difference between reserve and fund. When a reserve is invested in the outside investment, that reserve is called fund.

3. ***Secured Loans:*** The loans which are secured against some tangible assets of the company are called secured loans. If some secured loans are taken by directors, managing directors and manager, those should be shown separately. Debentures are always secured because they have floating charge or fixed charge on the assets of the company. Therefore these are shown under this heading. If the company has taken a secured loans from a bank or subsidiary company etc. that also should be disclosed under this heading. The nature of security of the loan should also be given in each case. Interest accrued and due on the secured loans is also shown under this head, but interest accrued but not due is not shown here. Interest accrued but due is shown under current liabilities of this side of the balance sheet. If the loans have been guaranteed by the manager or directors, this fact should also mentioned in the Balance Sheet.

4. ***Unsecured Loans:*** The loans which do not carry any charge an the assets are called unsecured loans. Fixed deposits and loans and advances from banks are included in the unsecured loans. Unsecured loans are divided into two – (i) Long-term loans (ii) Short-term loans. Loans which are taken for one year or less than one year, are called short-term loans. The loans for more than one year are called long-term loans. Long-term loans and short-term loans are shown separately; loans given by directors or manager should be shown separately. 'Interest accrued and due' should be shown with the respective loans but "interest accrued and not due" is shown in the current liabilities.

5. ***Current Liabilities & Provision:*** The following two sub-headings are included under this head-

   (a) Current liabilities; and

   (b) Provision

   Current liabilities are those which are payable within one year. These liabilities include Bills Payable, Sundry Creditors, Advance Payments, Unclaimed Dividend etc. All these are shown separately. In part (b) of this heading, Provision for Taxation, Proposed Dividends, Provision for Contingencies. Provision for Employees Provident Fund and Insurance Plans are shown separately.

13.4 Profit and Loss Account

Any standard form of profit and loss account or income statement is not prescribed in the Companies Act, 1956. In the case of a company only one account (known as Profit and Loss A/c), is maintained to calculate profit or loss. This account is divided into three parts. Its first part contains all items of trading account, the second part profit and loss account and the third part profit and loss appropriation account. As per Section 211(2) in every profit and loss account a company shall give true and fair view of the profit and loss of the company for the financial year and comply with the requirement of Part II of Schedule VI so far as they are applicable thereto and disclose information accordingly. The requirement of this part does not apply to banking, insurance and electricity-supplying companies as the forms of profit and loss account of these companies are specified in the separate Acts governing such class of companies.

Notes

The student should note that there is no fundamental difference between the preparation of Trading and Profit and Loss A/c, for a sole trader, partnership firm or a company. The same principles are adopted as all the expenses to earn an income in the concerned period are debited in the Profit and Loss Account. Similarly, all the incomes in the revenue nature of the concerned period are credited. And all the losses due to accident or depreciation in the value of assets due to wear and tear and passage of time should be debited.

In spite of there being so many similarities, there are some difference which are listed below-

(a) Sole traders or partnership firms give the heading Trading and Profit and Loss A/c., while companies give the heading Profit and Loss A/c, only.

(b) A company divides its profit and loss account into two i.e., profit and loss account proper and profit and loss appropriation account, while in case of sale trader or partnership firm it is not done so.

(c) Some special items such as interest on debentures, director's fees etc., also appear in the profit and loss account of a company while these do not appear in the case of profit and loss account of a firm or sole trader.

(d) Income tax on profit is assumed an expenses in the case of a company, while it is not so in the case of a firm or sole trader.

(e) Profit or losses of a non-corporate body are transferred to the capital account (or current account of partners) while in the case of a company these are kept in a separate account.

(f) Part II of Schedule VI of the Companies Act, governs all the requirement of a profit and loss account of a company. The profit and loss account should also be prepared as per guidance of AS-1 Disclosure of Accounting Policies, AS-4 Contingencies and Events Occurring after the Balance Sheet date and AS-5 Prior Period and Extraordinary Items and Changes in Accounting Policies.

Contents of Profit and Loss Account

As per Part II of Schedule VI of the Companies Act, 1956, the following are the requirements as to profit and loss account:

Requirements as to Profit and Loss Account

1. The provision of this part shall apply to the income and expenditure account referred to in sub section (2) of Section 210 of the Act, in a likewise manner as they apply to a profit and loss account, but subject to the modification of reference as specified in that sub-section.

2. The profit and loss account (a) shall be so made out as to clearly disclose the result of the working of the company during the period covered by the account, and (b) shall disclose every material feature 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:

   (i) (a) The turnover, that is, the aggregate amount for which sales are effected 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.

Notes

(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.

(ii) (a) In the case of manufacturing companies :

(1) The value of the raw material consumed, giving items-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 of 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 to 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 stock 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 therein, if the total amounts are shown in respect of the opening and closing stocks, purchase, 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.

Notes

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.

2. For the purpose of the items (ii) (a), (ii) (b), (ii) (d) the items for which the company is holding separate industrial licenses, shall be treated as separate classes of goods, but where a company has more than one industrial license for production of items covered, or the same items at different places or for expansion of the licensed capacity, the items covered by all such licenses 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 Export in granting the import licenses.

Contd...

Notes

3. In giving the break-up of purchase stock 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 purchase, stock or turnover, as the case may be, are shown as separate and distinct items with quantities thereof in the breakup.

(iii) In the case of all concerns having work in progress the amounts for which such works have been completed at the commencement and at the end of accounting period.

(iv) The amount provided for is not made by means of a depreciation, renewals or diminution in the value of fixed assets.

If such provision is not made by means of a depreciation charge, the method adopted in making such provision.

If no provision is made for depreciation, the fact that no provision has been made shall be stated 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 assets periods, stating separately the amount of interest, if any, paid or payable to the managing director and the manger, 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 transaction proposed elsewhere to the extent of the relief, if any, from Indian income tax and distinguishing, where practicable, between income tax other taxation.

(vii) The amounts reserved for:

(a) repayment of shares capital, and

(b) repayment of loans.

(viii) (a) the aggregate, if material, of any amount set aside or proposed to be set aside to reserves but not including made to meet any specific liability contingency, or commitment known to exist at the date as on 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 amount set aside to provision made for meeting specific liabilities, contingencies, or commitment.

(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 on stores and spare parts

(b) Power and fuel

(c) Rent

(d) Repairs to building

(e) Repairs to machinery

(f) (1) Salaries, wages and bonus.

(2) Contribution to provident and other funds.

(3) Workmen and staff welfare expenses to the extent not adjusted from any pervious or provision reserve.

> *Notes* Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account.

(g) Insurance

(h) Rates, and taxes, excluding taxes on income

(i) Miscellaneous expenses, provided that any item under which the expenses exceed 1% 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 items to be shown under 'Miscellaneous Expenses'.

(xi) (a) The amount of income from investment distinguishing between trade investment and other investment.

(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 showing distinctly the extent of the profit and losses earned or incurred on account of membership of a partnership firm, to the extent not adjusted from any previous provision or reserve.

> *Notes* 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 transaction 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) Dividend from subsidiary companies.

(b) Provision for issues of subsidiary companies.

(xiv) The aggregate amount of the dividend paid and proposed and stating whether such amounts are subject to deduction of income tax or not.

(xv) Amount, if material by which any items shown in the profit and loss account are affected by any change in the basis of accounting.

4. 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) or manager, if any, by the company, the subsidiaries of the company and any other person:

(i) managerial remuneration under Section 198 of the Act paid or payable during the financial year to the directors (including managing directors) or manager, if any;

Notes

(ii) other allowances and commission including guarantee commission (details to be given);

(iii) any other perquisites and benefits in cash or in kind (stating approximately money value where practicable);

(iv) Pension, etc.,

(a) pension,

(b) gratuities,

(c) payment from provident funds, in excess of own subscriptions and interest thereon,

(d) compensation for loss of office,

(e) consideration in 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 the relevant details of the calculation of the commission payable by way percentage of such profit to the directors (including managing directors) or manager, if any.

4B. The profit and loss account shall further contain to give by way of a note detailed information in regard to amounts paid to the auditor, whether as fees, expenses or otherwise for services rendered.

(a) as auditor, and

(b) as adviser in any other capacity in respect of:

(i) taxation matters,

(ii) company law matters,

(iii) management services; and

(c) in any other manner.

[The Institute of Chartered Accountants of India has stated, in its statement styled 'Payment to Auditors for other Services', that the remuneration to the auditor for other services should be classified as follows:

(1) for tax representations;

(2) for company law matters;

(3) for management services;

(4) for internal auditing; and

(5) for other services.]

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 license is in force);

(b) the installed capacity; and

(c) the actual production.

Notes

Notes

1. The licensed capacity and installed capacity of the company as on the last date of the year to which to profit and loss account relates, shall be mentioned against items (a) and (b) above, respectively.
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.
3. For the purpose of this paragraph, the items for which the company is holding separate industrial license shall be treated as separated classes of goods, but where a company has more than one industrial license for production of the same item at different places, or for expansion of the licensed capacity, the items covered by all such licenses 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:

(i) raw material;

(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, spares and components similarly consumed and the percentage of each of the total consumption.

(d) the amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividend related.

(e) earnings in foreign exchange classified under the following heads, namely:

(i) export of goods calculated on F.B.O. basis,

(ii) royalty, professional know-how 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 amounts set aside to provision, other than those relating to depreciation, renewal or diminution in value of 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 side as such, the provision shall be so formed or marked as to indicate that fact.

6. (1) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amount for 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 ended on the corresponding date of the previous year.

   At the time to preparation of Profit and Loss A/c of the company, the following guidelines should also be kept in mind.

Self Assessment

Choose the best alternative:

6. Which one of the following does not relate to Profit and Loss Appropriation A/c?
   (a) Contribution to General Reserve
   (b) Proposed Dividend
   (c) Provision for Depreciation
   (d) Interim Dividend
7. Which of the following does not include the divisible profits?
   (a) Revenue reserve
   (b) General reserve
   (c) Capital reserve
   (d) Subsidies and credit balance of P./L. A/c
8. Advance payment of tax is shown:
   (a) P. & L. A/c.
   (b) Below the line
   (c) Liabilities side of balance sheet
   (d) Assets side of balance sheet
9. Employee provident fund is a:
   (a) Liability
   (b) Provision
   (c) Loan
   (d) None for the above
10. Dividend is calculated on:
    (a) Called up capital
    (b) Paid up capital
    (c) Paid up capital & calls in advance
    (d) Subscribed capital

Notes

13.5 Limitations of Financial Statements

Following of main limitations of financial statement analysis:

1. It is just study of interim reports.
2. It check just monetary aspect of company's performance and position but it ignores non-monetary aspect of company.
3. It does not analyze the changes in price level of different items of financial statements.
4. Many accounting concepts and conventions are used for preparing financial statement and these concepts and conventions are accepted for analysis. So, analysis is totally affected with these accounting concepts.
5. Analysis of financial statements are just source but not decision or result because person who write its interpretation, may also affect the analysis. So, different interpretation by different person may become its limitation.
6. LIFO vs FIFO and different depreciation methods usage may bring difference in result and performance of financial statement, so it is also limitation of financial statement analysis.
7. If one company's accounting period completes at 31^{st} Dec. and other company's accounting period completes at 31^{st} march, we will unable to compare both company's financial statement and it will be the limitation of financial statement analysis.

Task Discuss the various contents of the Balance Sheet.

Self Assessment

True or False:

11. As per Section 209 of the Companies Act, it is compulsory for every limited company to prepare the final accounts.
12. The rate of dividend which is recommended by the board of directors can be increased by the shareholders if they think it is too low.
13. Provision is made for any known liability of which the amount can not be determined with accuracy in advance.
14. When the rate of proposed dividend is more than 20%, 10% of profit must be transferred to revenue reserves.
15. No dividend will be payable on calls in advance.

13.6 Summary

- Balance Sheet as we have seen is one of the most important financial statements.
- It is a periodic summary of the position of the business.
- It is the statement of assets, liabilities and owners' capital as of a particular point in time.
- This statement in itself does not reveal anything about the details of operations of the business.
- However, a comparison of two balance sheets could reveal the changes in business position.

Notes

- A realistic understanding of the operations of the business would require two other statements - Profit and Loss Account and Funds Flow Statement.

13.7 Keywords

Asset: Anything, tangible or intangible, of monetary value to a business entity.

Contingent Liability: A liability which has not been recognised as such by the entity. It becomes a liability only on the happening of a certain future event. An example could be the liability which may arise out of a pending law suit.

Current Assets: All of the assets held by a firm with the objective of conversion to cash within the operating cycle or within one year whichever is longer. Current Assets include items such as cash, receivables, inventory and prepayments.

Current Liabilities: All those claims against the assets of the firm to be met out of cash or other current assets within one year or within the operating cycle, whichever is longer. Usually include items such as accounts payable, tax or other claims payable, and accrued expenses.

Fixed Asset: Tangible long-lived asset. Usually having a life of more than one year. Includes items such as land, building, plant, machinery, motor vehicles, furniture and fixtures.

Intangible Assets: Any long-term assets useful to the business and having no physical characteristics. Include items such as goodwill, patents, franchises, formation expenses and copyrights.

Liability: Any amount owed by one person (the debtor) to another (the creditor). In a balance sheet all those claims against the assets of the entity, other than those of the owners.

Owner's Equity: It is the owner's claim against the assets of a business entity. It could be expressed as total assets of an entity less claims of outsiders or liabilities, includes both contributed capital and retained earnings.

13.8 Review Questions

1. What are the legal requirements regarding the transfer of profit to the reserves?
2. What is the difference between final dividend and interim dividend?
3. Mention the various sources of dividend.
4. Explain the different methods of capitalization of profit.
5. What are the different types of balance sheets?
6. What are the statutory provisions relating to transfer of profit to reserve?

Answers: Self Assessment

1.	Annual General Meeting	2.	9 months
3.	211	4.	10%
5.	Share Premium A/c and fully paid equity shares,		
6.	c	7.	c
8.	d	9.	a
10.	b	11.	True

Notes

12. False
13. True
14. True
15. True

13.9 Further Readings

Books

Magazines and Journals

Horngren C.T. and Harrison, 01/23/2003, Financial Accounting, Prentice Hall : New Delhi (Chapter 1)

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Glantier M. W. E., Underdown B. and A.C. Clark, 1979, Basic Accounting Practice, Arnold Hieneman: Vikas Publishing House, New Delhi (Chapter 5, Section 2)

Bhattacharya, S. K. and John Dearden, 1984. Accounting For Management: Text and Cases (2nd Ed.) Vani: New Delhi. (Chapters 3, 10 and 11)

Hingorani, N.L. and A. R. Ramanathan, 1986, Management Accounting, Sultan Chand: New Delhi. (Chapter 3)

Online links

http://220.227.161.86/19685ipcc_acc_vol2_chapter3.pdf

http://220.227.161.86/19668ipcc_acc_vol1_chapter-3.pdf

http://www.investopedia.com/terms/c/capitalreserve.asp#ixzz1xlZehyWb

Case Study

IXIS Accelerates Profit and Loss Analysis

October 23, 2006

Commentary by Damien Le Marchand, Project Manager, IXIS CIB

For the investment bank IXIS CIB, a subsidiary of the third largest banking group in France, the process of calculating its profit and loss (P&L) on a daily basis involves analyzing 300 million transaction lines.

Until recently, IXIS CIB used a reporting system designed solely for trading floor operators. This system relied on both a production database and an information database. Both of these were transactional management databases.

"We carried out batch loading from the production database to the information database. Requests from traders were made alongside this transaction processing, which could cause performance problems. With the growing complexity of analysis required by traders, loading times increased to four hours. Due to these constraints, background history was gradually reduced to a period of no more than six months in the production database and 15 consecutive days in the information database," explains Damien Le Marchand, project manager at IXIS CIB. The huge volume of processing together with peak loadings caused bottlenecks and affected response times. Complex requests could take up to three hours.

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To better support the activities of its risk managers, the bank realized it needed a more efficient and scalable system—a system that would enable it to reconcile P&L accounts. The new system would have to combine P&L lines, the dynamic risk parameters in each portfolio, and cash flow, which meant the target system would need the capacity to handle much larger data volumes and a constantly increasing number of requests.

Evaluating Alternatives

IXIS CIB identified two ways to address this challenge. One involved reviewing working patterns and changing operational procedures. The second involved consolidating all transaction data into a central information database, isolating reporting and analysis from transaction processing. The key to making this second method work was the ability to deploy a robust, high-performance data management system with the capacity to scale as data storage requirements increased, and to expedite loading and response times regardless of the number of users and the complexity of requests.

IXIS CIB chose the second way and found its data management solution in the Sybase IQ analytics server. After achieving positive results in testing, the bank began to integrate P&L lines and the dynamic performance indicators coming from front-office trading applications, namely Summit for fixed-income and foreign-exchange business, and Calypso for credit derivatives and complex rates, in total representing 300 million lines.

The project went live within a month thanks to support from Sybase Professional Services, which facilitated the porting of the previous central information database to Sybase IQ and the transfer of skills to the P&L IT team.

A future phase will integrate two other front-office applications: Sophis for shares and ACBS for financial accounting and cash flow lines. All data will be available through Business Objects reporting tools via an intranet.

Sybase IQ Delivers in Real Time

Thanks to Sybase IQ, transactions from the previous day are available to trading operators and risk managers before the markets open, with load times reduced to 30 minutes. Sybase IQ provides risk managers with both the speed and the detail to allow them to complete their tasks successfully by zooming right in on the minute details of each transaction. This has all been achieved without impacting database availability or performance.

"By separating out the transaction processing database, we've achieved response times that are between 10 and 20 times faster than our earlier system. Responses do not exceed four minutes, even for the most complex cases," says Le Marchand. The speed of processing calculations that are linked with the central information base, which consolidates all transactions and cash flow lines, now provides full visibility of trading results the following day. Moreover, daily consolidation gives the accounts department access to data following the close of each day's trading, allowing it to meet the reduced 15-day reporting cycle required to comply with the IFRS standard.

The bank has also realized IT cost reductions, which by themselves constitute an impressive ROI.

Source: http://tdwi.org/Articles/2006/10/23/IXIS-Accelerates-PL-Analysis.aspx?Page=2

Notes

Unit 14: Preparation of Final Accounts

CONTENTS

Objectives

After studying this unit, you should be able to:

- Understand meaning and preparation of final accounts
- Explain treatment of special items
- Know requirements of Schedule VI
- Understand preparation of Balance Sheet

Introduction

All business transactions are first recorded in Journal or Subsidiary Books. They are transferred to Ledger and balanced it. The main object of keeping the books of accounts is to ascertain the profit or loss of business and to assess the financial position of the business at the end of the year. The object is better served if the businessman first satisfies himself that the accounts written up during the year are correct or at least arithmetically accurate. When the transactions are recorded under double entry system, there is a credit for every debit, when on a/c is debited; another a/c is credited with equal amount. If a Statement is prepared with debit balances on one side and credit balances on the other side, the totals of the two sides will be equal. Such a Statement is called Trial Balance.

14.1 Preparation of Final Accounts

Though there is no prescribed form of Profit and Loss Account as per law, but all such information are to be given which can help in presenting a true and fair view of the activities of the company. According to section 211 of the Companies Act, Schedule 6 Part II (1) Every Profit and Loss Account must disclose the result of the concerned period, and (2) Every expenses or item, which is of debit or credit must be disclosed properly. Information relating to past year must also be given along with the present year’s result in the form of figures.

Every profit and Loss Account is divided into two parts: (1) Profit and Loss Account, and (2) Profit and Loss (Appropriation) Account.

14.1.1 Treatment of Special Items

Notes

1. ***Interest on debentures:*** If interest on debentures is not paid then provision of interest for the full year should be made. This provision of interest is not only for that interest which has become due but also for that interest which is not due but has been earned. Interest on debentures is generally paid half yearly.

2. ***Deduction of tax from interest on debentures:*** As per Income Tax Rules, income tax is deducted from such interest and deposited with the Central Government, if security is Government. Tax free securities or where Income Tax Officer is informed that the income of the assesse is not taxable, then income tax should not be deducted. How much tax is to be deducted is decided as per Finance Act every year. At present, income tax is deducted at source. During 2006-07, it was a 10% + Education cess 2% if listed/Govt., otherwise 20% + 2% education cess.

3. Discount on the issue of debentures to be shown in the balance sheet but a reasonable amount is written off every year from the Profit & Loss a/c.

4. ***Transfer to Reserves [Statutory requirement before dividend is proposed]:*** According to Section 205 of the Companies Act, Companies are required to transfer a certain percentage of profits not exceeding 10% to Reserves before declaring any dividend. Following are the rates:

   (a) 2.5% if the dividend proposed exceeds 10% but not 12.5%

   (b) 5% if the dividend proposed exceeds 12.5% but not 15%

   (c) 7.5% if the dividend proposed exceeds 15% but not 20%

   (d) 10% if it exceeds 20%.

Task Analyse the profit and loss account of HDFC bank for FY 2009-10.

Notes As per Income tax Rules, income tax is deducted from such interest and deposited with the Central Government, if security is Government. Tax free securities or where Income Tax Officer is informed that the income of the assesse is not taxable, then income tax should not be deducted.

14.1.2 Requirements of Schedule VI Concerning Profit and Loss Accounts

A company shall disclose the following notes to their accounts :

1. ***Revenues from operations:*** Revenue from operations shall be classified as:

   (a) Sale of products;

   (b) Sale of Services;

   (c) Other operating revenues (specify nature);

   Less:

   (d) Discounts, allowances, and returns;

   (e) Excise duty/service tax.

Notes

These shall include sales or service charges to customers for the goods and/or services provided during the period. This section shall include information about duties, taxes, discounts, allowances and returns in order to determine net sales or net revenues.

2. ***Cost of sales/services:*** These are costs directly associated with generating revenues and shall include (to be disclosed separately):
   (a) *Change in inventories* – Opening (less closing) inventories of finished goods and work-in-process;
   (b) Cost of direct materials consumed arrived at by adding net purchases (purchases less discounts, returns and allowances plus freight-in) to beginning inventory to obtain direct materials available. From the cost of direct materials available, the ending inventory is deducted;
   (c) Other external charges (such as the hire of plant and machinery or the cost of casual labour used in the productive process);
   (d) Direct labour (ESOP and ESPP expenses to be disclosed separately);
   (e) All direct production overheads;
   (f) Depreciation and amortization that can reasonably be allocated to the production function;
   (g) Indirect overheads that can reasonably be allocated to the production function;
   (h) Product development expenditure not qualifying for recognition as an intangible asset and amortization of development expenditure recognized as an intangible asset;
   (i) Inventory write downs/reversals;
   (j) All direct overheads in providing services;
   (k) All allocable indirect overheads in providing services;
   (l) Cost of goods traded-in arrived at by adding net purchases (purchases less discounts, returns, and allowances plus freight-in) to beginning inventory to obtain the cost of goods available for sale. From the cost of goods available for sale amount, the ending inventory is deducted;
   (m) Other cost of sales.
3. ***Operating expenses:*** Operating expenses are those that are incurred in order to generate sales. Operating expenses shall be classified as:
   (a) Selling and marketing expenses;
   (b) Administrative expenses;
   (c) Depreciation and amortization of assets;
   (d) Foreign currency exchange gains/(losses), net.
   (a) *Selling and marketing expenses* are those expenses that are directly related to the company's efforts to generate sales. These items shall include (to be disclosed separately):
      (i) Payroll costs of sales, marketing and distribution functions (ESOP and ESPP expenses to be disclosed separately);
      (ii) Advertising;

Notes

(iii) Sales persons' travel and entertaining;

(iv) Warehouse costs for finished goods;

(v) Transport costs arising on the distribution of finished goods;

(vi) All costs of maintaining sales outlets;

(vii) Agents commission payable;

(viii) Other selling and marketing expenses.

(b) *Administrative expenses* are expenses related to the general administration of the company's operations. These items shall include (to be disclosed separately):

(i) Payroll costs of office and administrative staff (ESOP and ESPP expenses to be disclosed separately);

(ii) All costs of maintaining the administration buildings;

(iii) Bad debts;

(iv) Professional costs;

(v) Amount paid to the auditor, whether as fees, expenses or otherwise for services

(vi) Directors remuneration;

(vii) Insurance expense;

(viii) Utilities expense;

(ix) Other administrative expenses.

(c) *Depreciation and amortization of assets* other than used in the production process and included in cost of sales.

4. ***Other income:*** This shall include (to be disclosed separately):

(a) Interest income;

(b) Dividend income;

(c) Rental on investment properties;

(d) Increase (decrease) in carrying amounts of investments;

(e) Gains and losses on trading derivatives;

(f) Amounts withdrawn, as no longer required, from provisions created previously for meeting specific liabilities;

(g) Other miscellaneous income.

5. ***Other expenses:*** These shall be classified as:

(a) Finance costs.

(b) Others.

(a) *Finance costs* shall include (to be disclosed separately):

(i) Interest expense.

(ii) Dividends on preference shares classified as debt.

(b) *Others* shall include costs related to 'other income'.

Notes

6. ***Tax Expense – Others***

   Others shall be specified separately.

7. Any item for which the expense exceeds one percent of the revenues from operations of the Company or ₹ 1,00,000 whichever is higher, shall be shown as a separate and distinct item under the appropriate head of expense in the notes to accounts and shall not be combined with any other item.

8. Results from discontinued operations included in the statement of profit and loss i.e. income (loss) from activities and gain (loss) from disposal of assets/settlement of liabilities shall be disclosed separately in the notes to accounts.

Self Assessment

Fill in the blanks:

1. ……………… account enables the trader to find out Gross Profit or Loss.
2. ……………… account enables the trader to find out the Net Profit or Loss.
3. Direct Expenses appears on ……………… side of ……………… account.
4. Indirect Expenses appears on ……………… side of ……………… account.
5. If the Trial Balance contains both Trade Expenses and Office Expenses, the Trade Expenses.
6. Posted to ……………… account and office expenses posted to ……………… account.

14.2 Preparation of Balance Sheet

According to Institute of Chartered Accountants of India Balance Sheet as a statement of the financial position of an enterprise at a given gate which exhibits its assets liabilities capital, reserves and other account balances at their respective book values. The balance sheet of a company is prepared on the same principles, which are followed as for the balance sheet of a sole proprietor or a partnership firm. The only difference is that in case of a company, the balance sheet is prepared in a prescribed form so that it can exhibit a true and fair view of the financial position of the company at a point of time. The assets and liabilities must be shown at the proper figures neither more or less. There should not be any secret reserve as per law. The most important function of a balance sheet is to provide full and sufficient information to enable the reader to judge the financial state of affairs (position) correctly and completely.

> *Task* Analyse the balance sheet of HDFC bank for FY 2009-10.

Requirements of Schedule VI of Indian Companies Act

The balance sheet of a company must be in accordance with the proforma given in Schedule VI Part I of the Indian Companies Act. This is as per section 211 of the Indian Companies Act, 1956. Sub-sections (3A), (3B) and (3C) of section 211 have made it compulsory that Profit and Loss account and Balance Sheet of a Company are prepared in accordance with Accounting Standards prescribed by the Central Government in consolation with National Advisory Committee on Accounting Standards (NACAS).

The Act has laid down two forms of Balance Sheet. The two forms are generally known as:

1. Horizontal Form
2. Vertical Form

Notes

The Balance Sheet must give a true and fair view of the company activities. This form may be in any other form with the consent of the Central Government.

Did u know? According to Institute of Chartered Accountants of India Balance Sheet as a statement of the financial position of an enterprise at a given gate which exhibits its assets liabilities capital, reserves and other account balances at their respective book values.

Form of Balance Sheet [Horizontal]
Balance Sheet of ………………………… Co. Ltd.
as on ……………..………

Figures for the previous year	Liabilities	Figures for the current year	Figures for the previous year	Assets	Figures for the previous year
	Share capital Reserves and surplus Secured loans Unsecured loans Current liabilities and provisions (a) Current liabilities (b) Provisions			Fixed assets Investments Current assets. Loan and advances (a) Current assets (b) Loans and advances Miscellaneous expenditure Profit and loss account	

As it is clear from the above form of Balance Sheet, that Assets are shown on right hand side whereas liabilities are put up on left hand side and relevant figures for the previous year as well as for the current year are given but in case of Balance Sheet which is shown in vertical form liabilities are put under one head i.e. 'Sources of funds' which is immediately followed by assets under the head 'Application of Funds'. This would be clear from the following exhibit of Balance Sheet in vertical form.

Form of Balance Sheet [Vertical Form]
Balance Sheet of ………………………… Co. Ltd.
as on …………………………

Particulars	Schedule No.	Figures for the Current Year	Figures for the Previous Year
1	2	3	4
I. Sources of Funds			
1. Share Holders Funds			
Share Capital + 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			

Contd...

Notes

(d) Capital work in progress			
2. Investments			
3. Current Assets, Loans and Advances			
(a) Inventories			
(b) Sundry debtors			
(c) Cash and Bank Balances			
(d) Other Current Assets			
(e) Loans and Advances			
Less			
Current Liabilities and Provisions			
(a) Current Liabilities			
(b) Provisions			
Net Current Assets			
4. Miscellaneous Expenditure (to the extent not written off)			
5. Profit and Loss Account			
Total			

Notes Details are given by way of schedules.

Statutory Contents of Liabilities Side of Balance Sheet

There are two types of items shown on the liabilities side of the Balance sheet.

1. The items relating to owners equity and
2. The items relating to borrowers' capital

The main items relating to owner's capital: The main item are as follows:

1. Share capital
2. Reserves and surplus

1. ***Share Capital:*** It means the share of the owner's in the company. There are different types of capital.
   (a) *Authorized Share Capital:* This is the amount of capital which the company is authorized to raise from the public. Generally authorized capital is given in the memorandum of association, popularly known as M/A at the time of incorporation of the company. There are two types of share capital – (i) Equity share capital, and (ii) Preference share capital. It is given by way of information in the balance sheet. It is not added to the liabilities of the company, unless the entire share capital is issued, subscribed, called up and received in full.
   (b) *Issued Share Capital:* It is that part of issued share capital, which is offered for the public to subscribe till the date of Balance Sheet. Various types of share capital along with classes and face value etc. are given.
   (c) *Subscribed Capital:*
      (i) It is that part of issued share capital which is actually, subscribed by the public alongwith share value called up.

Notes

(ii) Shares, which are issued other than cash for different consideration and issued, as bonus shares must also be given.

(iii) Shares on which calls are in arrear must also be shown by way of deduction from called up capital.

(iv) Shares which are forfeited on account of non-payment must be shown separately.

(v) If forfeited shares are re-issued in full or in part, in case of profit must be transferred to capital reserve account only.

> *Notes* There are two types of share capital – (i) Equity share capital, and (ii) Preference share capital.

2. ***Reserves and Surplus:*** As per Companies Act, 1956 the following are the Reserves and Surplus:

   (a) Capital Reserves

   (b) Capital Redemption Reserve Account

   (c) Securities Premium Account

   (d) Other Reserves such as – General Reserve, Reserve for depreciation, etc.

   (e) Surplus – The net profit, as per profit and loss account, is to be given.

   (f) Proposed Addition to Reserves

   (g) Sinking Fund

Borrowers Capital Fund: There are the following types of loan capital:

1. ***Secured loans:*** If any security is given by way of a mortgage or charge on all or any of its property, the loan is termed as secured loan and shown in the following order:

   (i) Debentures: Types of debentures, redeemable and non-redeemable etc.

   (ii) Loans and Advances from Banks

   (iii) Loans and Advances from subsidiary company

   (iv) Other Loans and Advances if any

2. ***Unsecured loans:*** If a company borrows loans without giving any security, then such loans are termed as unsecured loans. Following are:

   (i) Fixed deposits

   (ii) Loans and Advances from Subsidiaries

   (iii) Loans and Advances from the banks

   (iv) Loans and Advances from others

3. ***Current Liabilities and Provisions:***

   (a) ***Current Liabilities:*** Which are payable within one year are shown in this such as

   - Acceptances
   - Sundry creditors

Notes

- Investor Education and Protection Fund
- Advance payments
- unclaimed dividends
- Interest Accrued but not due
- Tax payable
- Tax deducted at source (TDS).

(b) ***Provisions:*** are shown separately such as

- Provision for taxation
- Proposed dividend
- Provision for contingencies
- Provision for provident fund
- Other provisions

Contingent liabilities are such liabilities which may exist or may not exist subject to happening or not happening the event. It is given as a foot note in the Balance Sheet. Amount of such liabilities is not included in the total liabilities.

The following are the examples of contingent liabilities:

1. Claims against company, which are still not accepted by the company.
2. Liability for amount uncalled on partly paid shares.
3. Arrears of fixed cumulative dividends.
4. Estimated amount of incomplete contracts.
5. Other contingent liability.

Investor Education and Protection Fund

According to section 205A of the Companies (Amendment) Act, 1999, any amount transferred to unpaid dividend account of company which will remain unpaid or unclaimed in the said accounts for a period of seven years from the date of such transfer is required to be transferred by the company to Investor Education and Protection Fund. Such payment are:

1. Unpaid dividends
2. Matured deposit with companies for seven year
3. Matured debentures
4. Interest accrued on the above
5. Donations or Grants from Government

Did u know? According to section 205 A of the Companies (Amendment) Act, 1999, any amount transferred to unpaid dividend account of company which will remain unpaid or unclaimed in the said accounts for a period of seven years from the date of such transfer is required to be transferred by the company to Investor Education and Protection Fund.

Notes

Statutory Contents of Assets Side of Balance Sheet

1. ***Fixed Assets:*** Fixed assets are those assets, which are used for long-term in the business. Different assets are shown separately at their original cost and addition to and deductions for depreciation provided for. Fixed Assets include:
   (a) Goodwill
   (b) Land and Building
   (c) Lease hold
   (d) Railway sidings
   (e) Plant & Machinery
   (f) Furniture & Fixture
   (g) Patents, Trade Marks and Designs
   (h) Development of property
   (i) Copyrights
   (j) Live stock
   (k) Vehicles
2. ***Investments:*** Investments are shown after fixed assets. It is necessary to disclose nature and mode of its valuation of every investment. Market price or cost price, at which investments are valued, must be disclosed. All investments must be shown separately such as Govt., shares, debentures, etc.
3. ***Current Assets, loans and advances:***
   (a) Current assets are such assets which are likely to be converted into cash within one year from one balance sheet. Such assets are. 1. Loose tools 2. Stock in trade 3. Work in progress 4. Sundry debtors 5. Cash and Bank balance
   (b) Loans and advances – it includes loans and advances against purchase of goods and various expenses.
4. ***Miscellaneous Expenditure:*** Expenses not written off– 1. Preliminary Expenses 2. Discount on issue of shares and debentures 3. Expenses including commission or brokerage on underwriting 4. Interest paid out of capital 5. Other sums.
5. ***Profit and Loss Account:*** If there is any debit balance in profit and loss account, it will be shown on the assets side of the balance sheet.

Form of Balance Sheet
(Horizontal Form)
Balance sheet of …………… as at …………
(Form of Balance Sheet as Per Schedule VI and Part I)

Figures for the previous year (₹)	Liabilities	Figures for the Current year (₹)	Figures for the previous year (₹)	Assets	Figures for the current year (₹)
	1. Share Capital Authorized …………shares of ₹…………each			1. Fixed Assets (1) Goodwill (2) Land (3) Buildings	

Contd...

Notes

Issued……………….share of ₹…………each Subscribed and paid up……… shares of ₹……………each Less: Called unpaid Add: Forfeited shares			(4) Leaseholds (5) Railway Sidings (6) Plant & Machinery (7) Furniture and Fittings (8) Development of Property (9) Patents, Trade Marks and Designs (10) Live Stock (11) Vehicles etc.	
2. Reserves and Surplus (1) Capital Reserve (2) Capital Redemption Reserve (3) Securities Premium Account (4) Other Reserves Less: Debit Balance of P&L Account (5) Surplus, i.e., Balance of P&L Account (6) Proposed additions to Reserves (7) Sinking Funds			2. Investments (1) Investments in Govt. or Trust securities (2) Investments in Shares, Debentures and Bonds (3) Immovable Properties (4) Investment in the Capital of Partnership Firms	
3. Secured Loans (1) Debentures (2) Loans and Advances from Banks (3) Loans and advances from Subsidiaries (4) Other Loans & Advances			3. Current Assets, Loans and Advances A. Current Assets (1) Interest accrued on Investments (2) Stores and spare parts (3) Loose Tools (4) Stock in Trade (5) Work in Progress (6) Sundry Debtors (a) Debt outstanding for a period exceeding six months. (b) Other Debts Less: Provision (7) Cash and Bank Balances B. Loans & Advances: (1) Acceptances & Loans to Subsidiaries (2) Exchange	

Contd...

Notes

			(3) Advances recoverable for value to be received by Rates, Taxes, Insurance etc. (4) Balance with Customs, Port Trust etc.	
4. Unsecured Loans (1) Fixed Deposit (2) Loans and advances from subsidiaries (3) Short-term Loans & Advances (a) From Banks (b) From Others			4. Miscellaneous Expenditure (1) Preliminary Expenditure (2) Expenses including commission and brokerage of shares and debentures (3) Discount allowed on issue of shares and debentures (4) Interest paid out of capital during construction (also state the rate of interest) (5) Development Expenditure not adjusted. (6) Other Items (specifying nature)	
5. Current Liabilities & Provisions A. Current Liabilities (1) Acceptance (2) Sundry Creditors (3) Advances payments & unexpired discounts for the portion for which value has still to be given (4) Unclaimed Dividend (5) Other liabilities but not due on Loans (6) Interest Accrued B. Provisions (1) Provisions for taxation (2) Proposed Dividends, (3) For Contingencies (4) For Provident Fund scheme			5. Profit and Loss A/c. (1) Claims against the company not acknowledged as debts. (2) Uncalled liabilities on shares partly paid up (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 company is contingently liable.	

Contd...

Notes

	(5) Fire Insurance, Pension and similar staff benefits scheme (6) Other Provisions [A footnote to the balance sheet may be added to show separately]				

Form of Balance Sheet
(Vertical Form)
Balance Sheet of …………….Company
(As on…………………..)

Particulars	Schedule No.	Figures as at the end of the Current Year	Figures as at the end of the Previous Year
1	2	3	4
1. Sources of Funds			
(1) Share holders funds			
(a) Capital			
(b) Reserves and Surplus			
(2) Loan Funds			
(a) Secured Loans			
(b) Unsecured Loans			
Total			
2. 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 Balance			
(d) Other current Assets			
(e) Loans and Advances			
Less: current liabilities provisions			
(a) Liabilities			
(b) Provisions			
Net Current Assets			
(4) (a) Miscellaneous Expenditure to the extent not written off or adjusted.			
(b) Profit and Loss Account			
Total			

Self Assessment

Notes

State whether the following statements are true or false:

7. Proposed dividend is shown under the heading of current liabilities.
8. Unpaid dividend is shown under the heading of current liabilities.
9. Advance payment of income tax is shown under the heading of Advance in the assets side of the balance sheet.
10. Goodwill appears under the heading of fixed assets of the balance sheet of a company.

Illustration 1:

Mention the major heads in the required serial order under which various assets of a company are to be presented as per the requirements of the Companies Act.

Solution:

Various assets to be shown under the following heads.

1. Fixed Assets
2. Investments
3. Current Assets, Loans and Advances
   (a) Current Assets
   (b) Loans and Advances
4. Miscellaneous Expenditure (to the extent not written off)
5. Profit and Loss Account- Dr. Balance

Illustration 2:

Under what headings will you show the following items in the Balance Sheet of the Company.

1. Goodwill
2. Unclaimed Dividends
3. Provision for Tax
4. Securities Premium A/c.
5. Loose Tools

Solution:

Items	Heading	Sub-heading (if any)
Goodwill	Fixed Assets	–
Unclaimed Dividends	Current Liabilities and Provisions	Current Liabilities
Provision for tax	Current Liabilities and Provisions	Provisions
Securities Premium A/c	Reserve and Surplus	–
Loose Tools	Current Assets, Loans and Advances	Current Assets

Notes

Illustration 3:

The following balances appear in the books of Excel books:

Particulars	₹
Goodwill	20,000
Plant and machinery	1,60,000
Building	1,45,000
Cash in hand	10,000
Stock in trade	70,000
Share Capital	
1000 equity shares of 100 each is issued at par, Rs. 80 per share called up and paid up	80,000
8% Debentures	2,50,000
Preliminary Expenses	5,000
Creditors	55,000
Dividends Payable	25,000

Showing the above items under the major heads in accordance with section 211 and Part I of Schedule VI of the Companies Act, 1956. Prepare a Balance Sheet of the company.

Solution:

Balance sheet of Excel Books as on................

Liabilities	₹	Assets	₹
Share Capital		Fixed Assets	
Authorized Capital		Goodwill	20,000
1,000 Shares of ₹ 100 each	1,00,000	Plant & Machinery	1,60,000
Issued & Subscribed & paid up		Building	1,45,000
1,000 Shares of ₹ 100 each	80,000	Investments	–
₹ 80 per share called up & paid up	–	Current Assets, loans & Advances	
Reserve & Surplus		Current Assets	
Secured loans 8% debentures	2,50,000	Cash in hand	10,000
Unsecured loans – Current liabilities & Provision Current Liabilities		Stock in Trade	70,000
Dividend payable	25,000	Loan & Advances	–
Creditors	55,000	Miscellaneous Expenses	
Provisions		Preliminary Expenses	5,000
		Profit & Loss A/c	–
	4,10,000		4,10,000

Illustration 4:

The following ledger balances were extracted from the goods of Varun Ltd. as on 31[st] March 2006. Land and building ₹ 2,00,000, 12 % debentures ₹ 2,00,000, share capital ₹ 10,00,000 (equity shares of ₹ 10 each fully paid up) Plant and Machinery ₹ 8,00,000, Goodwill ₹ 2,00,000, Investments in shares of Raja Ltd. ₹ 2,00,000, General Reserve ₹ 2,00,000, Stock in trade ₹ 1,00,000, Bill receivable ₹ 1,00,000, Debtors ₹ 1,50,000, Creditors ₹ 1,00,000, Bank loans (Unsecured) ₹ 1,00,000, Provision for taxation ₹ 55,000, Discount on issue 12% debentures ₹ 5,000, Proposed dividends ₹ 1,00,000. You are required to prepare the balance sheet of company as per Schedule-VI Part-I of the Companies Act 1956.

Notes

Solution:

Balance Sheet of Varun Ltd. 31st March, 2006

Liabilities	₹	Assets	₹
Authorized Share Capital 1,00,000 equity shares of ₹ 10 each	10,00,000	Fixed Assets Goodwill	2,00,000
Issued Share Capital 1,00,000 equity shares of ₹10 each.	10,00,000	Land & Building	2,00,000
		Plant & Machinery	8,00,000
Subscribed Share Capital 1,00,000 equity shares of ₹ 10 each fully Paid up	10,00,000	Investments	
		in shares of Raja Ltd.	2,00,000
Reserves and surplus	2,00,000	Current Assets, Loans and Advances	
General Reserves			
Secured Loans	2,00,000	(a) Current Assets	1,00,000
12% Debentures		Stock in Trade	1,50,000
Unsecured Loans	1,00,000	Debtors	
Bank Loan		(a) Loans & Advances	1,00,000
Current Liabilities and Provision	1,00,000	Bill Receivable	
(A) Current liabilities creditors		Miscellaneous Expenditure	
(B) Provision	55,000	Discount on Issue	
Provision for taxation	1,00,000	of 12% debentures	5,000
Proposed Dividends			
	17,55,000		17,55,000

Illustration 5:

The following is the Profit and Loss Account of ABC Limited for the year ended 31st December, 2006, before providing for the following:

1. Directors' Commission of 1 per cent on the Net Profit.
2. Managerial Commission of 10 per cent on Net Profit.

Particulars	₹	Particulars	₹
To Depreciation	30,000	By Gross Profit	5,00,000
To Compensatuion (Voluntary)	5,000	By Profit on Investment Sold	
To Other Expenses	3,40,000	(Non-Trading)	20,000
To Net Profit	1,45,000		
	5,20,000		5,20,000

Notes Depreciation allowable as per rules amount to ₹ 25,000.

Redraft the profit and loss account after providing for the amounts of Managerial Commission on net profit due in accordance with provisions of the Companies Act and show the Computation of such amount of commission.

Solution:

1. Calculation of commission ₹ ₹

   Net Profit as per profit & Loss Account 1,45,000

   (+) Expenses not allowed

Notes

(i) Excess depreciation	5,000	
(ii) Compensation value	5,000	10,000
		1,55,000
(–) Income other than business income		20,000
Net profit before charging commission		1,35,000

2. Commission of 1% + 10% on net profit comes to ₹, 13,378 calculated below:

$$\frac{11}{111}\times 135,000 = ₹13,348$$

If segregated then for Director's Remuneration is ₹, 1,216 and

For managerial commission is ₹ 12,162.

Notes Profit on sale of investment is excluded for calculation of commission as per Companies Act.

Redrafted Profit and Loss A/c
(For the year ended on 31st Dec. 2006)

Particulars	₹	Particulars	₹
To Depreciation	30,000	By Gross Profit b/d	5,00,000
To Compensation	5,000	By Profit on sale of Investment	20,000
To Other Expenses	3,40,000		
To Director's commission 1% of Net Profit	1,216		
To Managerial Commission 10% of Net Profit	12,162		
To Net Profit	1,31,622		
	5,20,000		5,20,000

Illustration 6:

E.H. Ltd. carried forward a balance of ₹ 4,25,000 in the profit and loss a/c from the year ended 31st March, 2006. During the year ending 31 March 2007 the company made a profit of ₹ 15,75,000 before charging Income Tax. Prepare the Profit and Loss Appropriation a/c taking into consideration the following:

1. Provide ₹ 8,00,000 for Income Tax.
2. Transfer ₹ 1,00,000 to Dividend Equalization Account
3. Provide for dividend on 10% Preference Shares of ₹ 25,00,000.
4. Provide for dividend at 12.5% on 4,00,000 Equity Shares of ₹ 10 each.
5. Transfer ₹ 1,00,000 to Development Rebate Reserve.
6. Transfer ₹ 50,000 to General Reserve.

Solution:

Notes

Profit & Loss Appropriation Account
(For the year ended on 31st March 2007)

Particulars	₹	Particulars	₹
To Income Tax	8,00,000	By Balance b/f	4,25,000
To Dividend Equalization Fund	1,00,000	By net profit as per	
To Dividend on Preference shares	2,50,000	Profit & loss a/c	15,75,000
To Dividend on Equity Shares	5,00,000		
To Development Rebate Reserve	1,00,000		
To Transfer to General reserve	50,000		
To Balance c/d	2,00,000		
	20,00,000		20,00,000

Notes

(a) Dividend on preference shares 10% on ₹ 25,00,000 = 2,50,000

(b) Dividend on equity shares 12.5% on ₹ 40,00,000 = 5,00,000

Illustration 7:

The Balance sheet of P. Ltd. as on 31st March 07 is given below:

Liabilities	₹ (in lacs)	Assets	₹ (in lacs)
Issued and Paid up Capital 20 lacs equity shares of ₹ 10 each	200	Freehold Property	200
Profit and Loss a/c	180	Stock in Trade	120
12% Debentures	120	Sundry Debtors	100
Sundry Creditors	100	Cash and Bank	180
	600		600

It was resolved in the Annual General Meeting:

1. to pay a dividend of 10% and corporate dividend tax @ 10%.
2. to issue one bonus share for every four shares held.
3. to give existing shareholders the option to buy one ₹ 10 shares @ ₹ 14 for every four shares held prior to the bonus distribution.
4. to repay the debentures at a premium of 4%

All the shareholders who took up the option in (iii) above pass Journal entries and draw up the Balance sheet after the above transactions have been given effect to (Ignore tax on income), also prepare Profit and Loss Appropriation Account.

Notes

Solution:

Journal Entries in the books of P Ltd.

S. No.	Particulars		LF.	Dr. ₹	Cr. ₹
1.	Profit and loss Appropriation a/c	Dr.		22,00,000	
	To Dividend Payable a/c			20,00,000	
	" Corporate Tax on Dividend payable a/c				2,00,000
	Appropriation of profits				
2.	Dividend Bank a/c	Dr.		20,00,000	
	To Bank a/c				20,00,000
	Transfer of dividend to a separate dividend Bank a/c				
3.	Dividend Payable a/c	Dr.		20,00,000	
	To Dividend Bank a/c				20,00.000
	Dividend from a separate bank a/c				
4.	Corporate dividend Tax Payable	Dr.		2,00,000	
	To Bank a/c				2,00,000
	Payment of corporate dividend tax				
5.	Profit and Loss a/c	Dr.		50,00,000	
	To Bonus Issue a/c				50,00,000
	Bonus declared				
6.	Bonus Issue a/c	Dr.		50,00,000	
	To equity share capital a/c				50,00,000
	Bonus shares issued				
7.	Bank a/c	Dr.			70,00,000
	To Equity Share Application & Allotment a/c				70,00,000
	Right shares issued @ ₹ 14 per share				
8.	Equity share Application & Allotment a/c	Dr.		70,00,000	
	To Equity share capital a/c				50,00,000
	" Securities Premium a/c				20,00,000
	Balance Transferred				
9.	12% Debentures a/c	Dr.		1,20,00,000	
	Premium on Redemption a/c	Dr.		4,80,000	
	To Debenture holders a/c				1,24,80,000
	Amount payable to debenture holders				
10.	Debenture holders a/c	Dr.		1,24,80,000	
	To Bank a/c				1,24,80,000
	Paid off				
11.	Securities Premium a/c	Dr.		4,80,000	
	To Premium of Redemption of debentures a/c				480,000
	Balance Transferred				

Notes

Profit and Loss Appropriation Account

Particulars	₹	Particulars	₹
To Dividend Payable a/c	20,00,000	By Balance b/d	1,80,00,000
" Corporate Dividend Tax a/c	2,00,000		
" Bonus Issue a/c	50,00,000		
" Balance c/d	1,08,00,000		
(To be shown in Balance Sheet)			
	1,80,00,000		1,80,00,000

Balance Sheet of P Ltd. after Bonus and Repayment of debentures

Liabilities	₹ (in lacs)	Assets	₹ (in lacs)
Issued & Paid up Cap.		Freehold Property	200
30 lacs equity shares	300	Stock in trade	120
of ₹ 10 each		Sundry Debtors	100
Profit & Loss a/c	108	Cash in hand (1)	103.2
Securities Premium a/c	15.2		
Sundry creditors	100		
	523.2		523.2

Working Notes:

(1) Cash and Bank A/C

Particulars	₹	Particulars	₹
To Balance b/d	1,80,00,000	By Dividend Bank a/c	20,00,000
		" Corporate Dividend Tax a/c	2,00,000
" Share Application &			
Allotment a/c	70,00,000	" Debenture holders a/c	1,24,80,000
		" Balance c/d	1,03,20,000
	2,50,00,000		2,50,00,000

Illustration 8:

The following are the extracts from the trial balance of a Neha Beauty Products Limited on 31st March 2007:

Particulars	Debit (₹)	Credit (₹)
Provision for tax 2005-06		20,000
Advance Tax paid for 2005-06	18,000	
Advance Tax paid for 2006-07	10,000	
Tax deducted at source 06-07	1,000	
Profit and loss Account		
Balance 2005-06	–	20,000

Assessment for the year 2005-06 was finalized during the year 2006-07. The total tax liability for that year was fixed at ₹ 22,000. The net profit earned by the company during 2006-07 before tax amounts to ₹ 40,000. The company is in 35% tax bracket.

Pass Journal Entries and show how the various items will appear in the Company's Balance sheet.

Notes

Solution:

Journal Entries

S. No.	Particulars		LF.	Dr. ₹	Cr. ₹
1.	Profit and loss Appropriation a/c	Dr.		2,000	
	To Provision for tax a/c				2,000
	Additional provision made				
2.	Provision for tax a/c	Dr.		22,000	
	To Advance Tax paid a/c 2005-06				18,000
	" Bank a/c				4,000
	Balance Tax paid				
3.	Profit and Loss a/c	Dr.		14,000	
	To Provision for tax a/c				14,000
	Additional provision for tax @ 35% on 40,000 = 14,000				

Balance Sheet as on 31.03.2007

Liabilities		₹	Assets	₹
Reserves & Surplus			Loan & Advances	
Profit & Loss a/c		20,000	Advance Tax Paid	10,000
– Prov. for Tax		2,000	Tax deducted at source	1,000
+ Current year's Profit		18,000		
	40,000			
– Provision for tax	14,000	26,000		
Current Liabilities & Provision				
Provision for Tax		14,000		

Illustration 9:

The following are the balances of Modern Dress Bhandar Ltd. as on 31st March, 2007.

Credit	₹	Debit	₹
Share Capital	40,00,000	Premises	30,72,000
12% Debentures	30,00,000	Plant	33,00,000
Profit and Loss a/c	2,62,500	Stock	7,50,000
Bills Payable	3,70,000	Debtors	8,70,000
Creditors	4,00,000	Goodwill	2,50,000
Sales	41,50,000	Cash and Bank	4,06,500
General Reserve	2,50,000	Calls in Arrear	75,000
Provision for Bad debt	35,000	Interim Dividend paid	3,92,500
as on 1.4.06		Purchases	18,50,000
		Preliminary Expenses	50,000
		Wages	9,79,800
		General Expenses	68,350
		Salaries	2,02,250
		Bad debts	21,100
		Debenture Interest paid	1,80,000
	1,24,67,500		1,24,67,500

Additional Information:

Notes

1. Depreciate plant by 15%
2. Write off ₹ 5,000 from Preliminary Expenses.
3. Half year's Debenture Interest Due.
4. Create 5% Provision on Debtors for doubtful debts.
5. Provide for income tax @ 50%.
6. Stock on 31st March, 07 was ₹ 9,50,000.

Prepare Final Accounts of the company.

Solution:

Profit and Loss Account
for the year ended on 31st March, 07

Particulars		₹	Particulars	₹
To Stock		7,50,000	By Sales	41,50,000
" Purchases		18,50,000	" Stock	950,000
" Wages		9,79,800		
" Preliminary Expenses		5,000		
" General Expenses		68,350		
" Salaries		2,02,250		
Paid	1,80,000			
+ due	1,80,000	3,60,000		
" Bad debts		21,100		
" Provision for doubtful debts		8,500		
" Depreciation on plant		4,95,000		
" Provision for tax		180,000		
" Profit & Loss Appropriation a/c				
(Net profit)		1,80,000		
		51,00,000		51,00,000

Profit and Loss Appropriation Account

Particulars	₹	Particulars	₹
To Interim Dividend	3,92,500	By Balance b/d	2,62,500
" Balance c/d	50,000	" Profit & Loss a/c	1,80,000
		(Net profit)	
	4,42,500		4,42,500

Balance Sheet
as on 31.3.2007

Liabilities		₹	Assets		₹
Share Capital			Fixed Assets		
Called up Capital			Goodwill		2,50,000
	40,00,000		Premises		30,72,000
Less calls in arrear	75,000	39,25,000	Plant	33,00,000	
Reserves & Surplus			Less: Provision	4,95,000	28,05,000

Contd...

Notes

General Reserve		2,50,000	Current Assets, Loans and Advances		
Profit & Loss a/c		50,000			
Secured Loans			Current Assets:		
12% Debentures	30,00,000		Stock		9,50,000
O/s Interest	1,80,000	31,80,000	Debtors	8,70,000	
Current liabilities and Provisions			Provision	43,500	8,26,500
			Cash & Bank		4,06,500
Current Liabilities			Miscellaneous Expenditure:		
Creditors		4,00,000	Preliminary Expenses		45,000
Bills Payable		3,70,000			
Provision					
Provision for tax		1,80,000			
		83,55,000			83,55,000

Illustration 10:

From the under mentioned Trial Balance of Gopal Oil Co. Limited, prepare a Trading and profit and loss account for the year ended December 31, 2006 and the Balance sheet as on that date:

Particulars	₹	Particulars	₹
Opening Stock	30,000	Equity share capital	1,00,000
Rates and Taxes	6,000	(1,000 shares of ₹ 100 each)	
Purchases	60,900	5% debentures	25,000
Wages	55,200	Sales	1,75,000
Discount	1,500	Creditors	8,000
Fuel	2,570	Bank overdraft	12,000
Building	70,000	Discount	2,200
Carriage Inward	1,175	Transfer fee	100
Sundry Debtors	20,000	Returns outward	100
Goodwill	28,000		
Plant & Machinery	25,000		
Loose Tools	6,000		
Advertisement	3,000		
General Expenses	4,400		
Bad Debts	1,030		
Debenture Interest	625		
(Half year upto 30.06.2006)			
Insurance	3,000		
Miscellaneous Expenses	1,000		
Cash & Bank Balances	3,000		
	3,22,400		3,22,400

1. The Authorized Capital of the company is ₹ 2,00,000.
2. Stock on December 31, 2006 is ₹ 35,000.
3. Depreciate Plant & Machinery @9% and revalue loose tools at ₹ 4,100.
4. Allow 2.5% discount on Debtors and 2% as bad debt reserve.

Notes

Solution:

Trading and Profit & Loss Account of Gopal Oil Company
(For the year ending December 31, 2006)

Particulars	₹	Particulars	₹
To Opening Stock	30,000	By Sales	1,75,000
To Purchases		By Closing Stock	35,000
(–) Returns Outward	60,800	By Discount	2,200
To Wages	55,200	By Transfer Fee	100
To Fuel	2,570		
To Carriage Inwards	1,175		
To Advertisement	3,000		
To Rent and Rates	6,000		
To Debenture Interest			
(+) Outstanding	1,250		
To Discount	1,500		
To General Expenses	4,400		
To Bad Debts	1,030		
To Provision for Bad Debts	400		
To Provision for Discount on Debtors	490		
To Miscellaneous Expenses	3,000		
To Insurance	1,000		
To Depreciation on Plant & Machinery	2,250		
To Loose Tools	1,900		
To Net Profit	36,335		
	2,12,300		2,12,300

Balance Sheet of Gopal Oil Co. Ltd.
As on December 31, 2006

Liabilities	₹	Assets		₹
Share Capital		Fixed Assets		
Authorized Capital		Goodwill		28,000
2000 Shares of ₹ 100 each	2,00,000	Building at Cost		70,000
Issued and Subscribed Capital		Plant & Machinery	25,000	
1000 equity shares of		Less: Depreciation	2,250	22,750
₹ 100 each fully paid up	1,00,000	Investments		
Reserves and Surplus:		Current Assets and Loans Advances:		
Profit and Loss Account	36,335	Current Assets:		
Secured Loans				
5% Debentures	25,000	Loose Tools		4,100
Outstanding Interest:	625	Stock in Trade		35,000
Unsecured Loans:		Sundry Debtors	20,000	
Current Liabilities and Provisions:		Less: Provision for debts	400	
Creditors	8,000		19,600	
Bank Overdraft	12,000	Less: Provision for Discount on Debtors	490	19,110
		Cash in hand and Bank		3,000
	1,81,960			1,81,960

Notes

Self Assessment

11. Section .... of the Companies Act governs the preparation of final account of a company.
12. Interim dividend is declared between two..................
13. The difference between dividend received and dividend receivable is debited..................
14. 30 days after the declaration of dividend the amount of unpaid dividend is deposited in a..................
15. Interest out of .... may be paid u/s 208 of the Companies Act.

Task Discuss the importance of profit and loss A/c and explain the terms Gross Profit and Net Profit.

14.3 Summary

- Final accounts include the Trading and Profit & Loss Account and Balance Sheet. Trading and Profit and Loss Account is prepared to calculate the net profit earned by business during a period. Balance Sheet of a business is prepared to disclose the financial picture of the business.
- The Trading Account shows the gross profit difference of sales receipts and cost of sales. Profit & Loss Account shows the net profit which is computed by matching the total revenues and expenses of the business. Balance Sheet is a statement which has two sides – Liability side and Assets side.
- According to Section 209 of the Indian Companies Act, 1956, it is compulsory for each and every company to prepare its profit and loss account as well as Balance Sheet.
- It is also essential to maintain both the accounts in a proper form which is given in the Schedule VI Parts (I and II) of the Companies Act.
- Final accounts of a business comprise of trading account, which shows gross profit.
- It includes profit and loss account which shows net profit.
- Then further it includes balance sheet which shows the assets and liabilities of the business at the year end.
- The starting point for the preparation of final accounts is the summary of the information from the accounting records contained in the book keepers trial balance.

14.4 Keywords

Gross Profit: It is calculated by comparing the sales and cost of sales. It is the excess of sales over cost of sales.

Net Profit: It is the excess of revenues over expenses. It is depicted by P. & L. A/c.

Net Loss: Excess of expenditures over revenues is called net loss.

Trial Balance: It is the list of accounts taken from the ledger.

14.5 Review Questions

1. Explain the key books of accounts of a company.
2. State the preparation of profit and loss account.
3. What are the key requirements of Schedule VI of Companies Act concerning the profit and loss account?
4. Prepare Profit and Loss Account as per Companies Act (take imaginary figures).
5. Explain the contingent liabilities. Give three examples of it.
6. What are the different provisions regarding depreciation?
7. Classify the following items under different heading of the balance sheet:

   (a) Share Premium Account　　(b) Bank Overdraft

   (c) Unclaimed Dividend　　(d) Proposed Dividend
8. Give the different forms of the balance sheet
9. Prepare the vertical form of balance sheet.
10. Give the items of Profit & Loss Appropriation A/c.
11. Give a specimen form of Balance Sheet and Profit and Loss A/c as per Companies Act.
12. Prepare Profit and Loss A/c and Profit and Loss Appropriation Account of a company with loss Appropriation Account of a company with imaginary figures.
13. What are the rules regarding the preparation and presentation of the final account of a company under the Companies Act? Explain.
14. Prepare a Proforma of Balance Sheet in horizontal form as per requirement of the Schedule VI of the Companies Act, 1956.
15. Mention the requirement of Schedule VI (Parts I and II) of the Companies Act, 1956 in respect of-

    (i) Fixed Assets

    (ii) Investments

    (iii) Turnover

    (iv) Contingent Liabilities

    (v) Debtors
16. What do you mean by 'Divisible profit'? How are they calculated? Explain.
17. Explain the term 'Dividend'. Give the various provisions of Indian Companies Act governing the declaration and payment of dividend.
18. What is interim dividend? Under what circumstances will it be given?

Practical Questions:

1. Calculate the maximum account that can be distributed as dividend for the year 2005 according to Companies (Declaration of Dividend out of Reserve) Rules, 1975 from the following data:

Notes

	₹
Paid up Capital	45 lakhs
Free Reserve	22.5 lakhs
Loss in 2005	2.25 lakhs

Dividend declared in 2000, 2001, 2002, 2003 and 2004 are 13.5%, 12.5%, 16%, 15 & 13%.

Ans: Maximum amount can be distributed as dividend ₹ 450,000 and the maximum rate of dividend, 10%).

2. Calculate the amount of divisible profits for year 2005 from the information given below:

		2003 ₹ in lakhs	2004 ₹ in lakhs	2005 ₹ in lakhs
I	Profit or Loss before depreciation	-60	-30	+50
II	Depreciation provided in the book.	6	6	9
III	Depreciation as prescribed under Section 205	48	42	36

Ans: Divisible profits are ₹ 24,00,000(150-48-42-36)

3. On 31st December, 2005 the paid up capital of XYZ Company Limited was as under:

		₹
(a)	2,500 8% Tax Free Preference Shares ₹ 100 each issued before 1st April, 1960	2,50,000
(b)	2,500 9% Tax Free Preference Shares of ₹ 100 each issued after 1st April, 1960	2,50,000
(c)	5,000 10% Taxable Preference Shares of ₹ 100 each issued before 1st April, 1960	5,00,000
(d)	5,000 10% Taxable Preference Shares ₹ 100 each issued after 1st April, 1960	5,00,000
(e)	12,500 Equity Share of ₹ 100 each issued before 1st April, 1960	12,50,000
(f)	12,500 Equity Shares of ₹ 100 each issued, as right shares on 1st April, 2005 to rank for dividend from 1st May, 2005 fully paid up less ₹ 50,000 call in arrears.	12,00,000

Calculate the amount of profits that should be available so that directors may (i) transfer ₹ 2,50,000 to General Reserve, (ii) recommend the dividend due to preference shares and a dividend of 10% equity shares for the year 2005, any carry forward 20% of profits.

Ans: Profit should be available ₹ 7,61,250

Answers: Self Assessment

1. Trading
2. Profit & Loss
3. Debit, Trading
4. Debit, Profit & Loss
5. Trading
6. Trading, P & L A/c
7. False
8. True
9. True
10. True

Notes

11. 210,
12. Annual General Meetings,
13. T.D.S A/c,
14. Unpaid Dividend A/c,
15. Capital,

14.6 Further Readings

Books

Magazines and Journals

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Brown, Meredith, ed. *Mechanics of Global Equity Offerings: Structuring the Offering and Negotiating the Underwriting Agreement.* Cambridge, MA: Kluwer Law and Taxation Publishers, 1995.

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Shillinglaw, Gordon. *Accounting: A Management Approach.* 9th ed. New York: McGraw-Hill Higher Education, 1992.

Online links

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http://220.227.161.86/19668ipcc_acc_vol1_chapter-3.pdf

http://www.investopedia.com/terms/c/capitalreserve.asp#ixzz1xlZehyWb

Case Study

Trial Balance of Alfa Limited

The following is the trial balance of Alfa Ltd. for the year ended 30th June, 2006.

Particulars	₹	₹
Stock 1st July 2005	85,000	
Land & Buildings	3,00,000	–
Plant & Machinery	4,50,000	–
Furniture & Fittings	40,000	–
Goodwill	60,000	–
Sundry Debtors	60,000	–

Contd...