

B.Com.

II Year

Commerce

PAPER VII
Corporate Accounting
Lesson : 1-8



SCHOOL OF OPEN LEARNING

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University of Delhi

Department of Commerce
Prepared by : K.B. Gupta

Paper VII: Corporate Accounting

Contents :

- Lesson 1 : Accounting for Shares
- Lesson 2 : Redemption of Preference Shares
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Prepared by:
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University of Delhi
5, Cavalry Lane, Delhi-110007

To 1st Call A/c	1,000
To 2nd Call A/c	1,000

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Undergraduate Course

Paper VII: Corporate Accounting

Contents :

Lesson 1 : Accounting for Shares

Lesson 2 : Cash Flow Statement

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Lesson 5 : Redemption of Preference Shares

Lesson 6 : Amalgamation and Reconciliation (I)

Lesson 7 : Amalgamation and Reconciliation (II)

Date	Particulars	Amount	Amount
	Share Capital A/c		
	Securities Premium A/c		
	To share forfeited A/c		
	To calls in Arrears A/c		

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Solution :

Share Capital A/c Dr. (No. of share forfeited X Call value per share)

To Discount on issue of shares A/c (No. of shares forfeited X amount of discount)

To share forfeited A/c (Share forfeited on previous account)

To calls in Arrears A/c (Share forfeited on current account)

Date	Particulars	Amount	Amount
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LESSON 1

ACCOUNTING FOR SHARES

Dr. Rakesh Gupta
PGDAV (Evening) College
University of Delhi

Every company should have capital in order to finance its activities. The company raises this capital by issuing shares. This capital is called 'Share Capital'. In a company limited by shares, the amount of share capital is stated in its memorandum of association. In case of an unlimited company and a company limited by guarantee it may not have any share capital. The money required by a public company for its business activities is raised by it from the public but a private company makes private arrangement for sale of shares. The persons who hold the shares of a company are called the members or shareholders of the company.

The term 'Share' is defined in section 2 (46) of the company's Act, which reads as under :-

"Share means a share in the share capital of a company, it includes stock except where a distinction between stock and share is expressed or implied".

The share capital of a company is divided into small denomination of shares. Thus if a company wants to have 10 crores as capital, it can divide it into denomination of Rs. 100 each; there will be 10 lakhs shares and every share can be separately sold. After selling all the shares, company will collect Rs. 10 crores.

ISSUE OF SHARE

ISSUE OF SHARES

For cash

For consideration other than cash

Shares Issued for Cash

At the time of issue of shares for cash by the public company, it issues prospectus and invites applications for the purchase of shares. After receiving applications, these applications are scrutinized. The issue is said to be fully subscribed if the applications properly filled up and add up to the number of shares offered by the company. When a company receives applications for more shares than the number of shares offered to the public, the issue is said to have over subscribed. In the case of over subscription, the company rejects some applications and returns their application money or adjusts the excess money towards the allotment or calls on the other side if the number of shares applied for is less than the number of shares offered to the public for issue, the issue is said to be undersubscribed. In this case all applications are accepted in full and shares are allotted to the applicants provided the amount received on application is equal to or more than the minimum subscription amount.

Journal entries for Issue of Share

1. When application money received by the company:

Bank A/C	Dr.
To Share Application A/C	

With the amount of application money received (irrespective of the number of shares allotted)

Suppose a company offers 50,000 shares of Rs. 10 each on which Rs. 2 are payable on application, and the public sends application for 60,000 shares, the entry to be passed is:

	₹		₹
Bank Account	Dr.	1,20,000	
To Share Application Account			1,20,000

(Being application money received on 60,000 shares @ ₹ 2 per share)

2. On transferring the application money received on share to share capital A/c :

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

In case of oversubscription of shares:

The excess money on application is either can be adjusted towards share allotment or may refund to the applicants if no shares are allotted:

The entry for the same will be as under:

(i) When no allotment is made then application money is to be returned to the applicant

	Dr.		
Share Application A/C			
To Bank A/C			

(ii) The excess money receives on application is adjusted against the amount due on allotment:

	Dr.		
Share Application A/C			
To Share Allotment A/C			

3. When the Amount Due on Allotment:

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

4. The Allotment money receive:

	Dr.		
Bank A/C			
To share Allotment A/C			

5. The first call money due:

	Dr.		
Share first call A/C			
To Share Capital A/C			

6. The First call money received:

	Dr.		
Bank A/C			
To Share first call A/C.			

7. The second and final call money due:

	Dr.		
Share second and final call A/C			
To Share Capital A/C			

8. The Second and final call money received:

	Dr.		
Bank A/C			
To Share second and final call A/C.			

Illustration 1: (When Public issue is fully subscribed)

Kushagr Ltd, invited applications for 1,00,000 shares of ₹ 100 each

Payable as:

₹ 20 on application; ₹ 40 on allotment; ₹ 20 on first call and ₹ 20 on final call.

Application were received for 1,00,000 shares and allotment was made in full to all applicants. Both the calls were made and the amount receives in full.

Record the Journal entries in the books of Kushagr Ltd.

Solution**In The Books of Kushagr Ltd.****JOURNAL**

Date	Particulars	L.F	Debit ₹	Credit ₹
	Bank A/c Dr. To Share application A/c (Being share application money receive on 1,00,000 share @ ₹ 20 Each)		20,00,000	20,00,000
	Share Application A/c Dr. To share capital A/c (Being share application money transferred to share capital account)		20,00,000	20,00,000
	Share Allotment A/C Dr. To Share Capital A/C (Being share allotment money due on 1,00,000 shares @ ₹ 40 per share)		40,00,000	40,00,000
	Bank A/c Dr. To share Allotment A/c (Being allotment money received on 1,00,000 shares @ ₹ 40 per share)		40,00,000	40,00,000
	Share first call A/C Dr. To Share Capital A/C (Being share first call money due on 1,00,000 shares @ ₹ 20 each)		20,00,000	20,00,000
	Bank A/C Dr. To Share first call A/C. (Being share first call money receive on 1,00,000 shares @ ₹ 20 each)		20,00,000	20,00,000
	Share final call A/C Dr.		20,00,000	20,00,000

To Share Capital A/C (Being share final call money due on 1,00,000 shares @ ₹ 20 per share)			
Bank A/C	Dr.	20,00,000	20,00,000
To Share final call A/C. (Being amount received on final call on 1,00,000 shares @ ₹ 20 per share)			

Over Subscription of shares

When the number of shares applied for is more than the number of shares offered, it is known as over subscription. In the case of over-subscription, there may be following three possibilities:

- Some applicant may not be allotted to any shares. This is known as 'Rejection of Applications'.
- Some applicants may be allotted less number of shares than they have applied for. This is known as partial or 'Pro-rata Allotment'.
- Some applicants may be allotted the full number of shares they have applied for. This is known as 'Full Allotment'.

The Directors can reject the excess applications. In such a case, application money received from such applicants is returned to them in full.

Illustration 2 : (Over Subscription of Shares) Pratishtha Ltd, offered for subscription 10,000 shares of ₹ 10 each, the amount payable as under:-

₹ 4 on application; Rs. 3 on allotment; ₹ 2 on first call and the balance on final call.

Applications were receive for 14,000 shares. The directors rejected the applications for 4,000 shares and refunded the amount received there on. The remaining shares were allotted to the applicants. The company did not make the final call rest of the amount was received in full. Pass the necessary journal entries.

Solution:

JOURNAL

Date	Particulars	L.F	Debit ₹	Credit ₹
	Bank A/c	Dr.	56,000	56,000
	To Share application A/c (Being share application money receive on 14,000 share @ ₹ 4 per share)			
	Share Application A/c	Dr.	56,000	
	To share capital A/c			40,000
	To Bank A/c (Being share application money on 10,000 shares allotted transferred to share capital account and the balance refunded)			16,000
	Share Allotment A/C	Dr.	30,000	

To Share Capital A/C (Being share allotment money due on 14,000 shares @ ₹ 3 per share)			30,000
Bank A/c Dr.		30,000	
To share Allotment A/c (Being share allotment money received on 10,000 shares @ ₹ 3 per share)			30,000
Share first call A/C Dr.		20,000	
To Share Capital A/C (Being share first call money due on 10,000 shares @ ₹ 2 per share)			20,000
Bank A/C Dr.		20,000	
To Share first call A/C (Being share first call money received on 10,000 shares @ ₹ 2 each)			20,000

Under Subscription of Shares

The Shares are said to be under-subscribed if the number of shares applied is less than the number of shares offered to public for issue.

Illustration 3

Richik Ltd. Issued 10,000 shares of ₹ 10 each. The amount was payable as under:-

Rs. 4 on application. ₹ 4 on allotment and balance on call.

Applications were received for 9000 shares. All the applicants were allotted shares in full. All money was duly received. Pass necessary journal entries.

JOURNAL

Date	Particulars	L.F	Debit ₹	Credit ₹
	Bank A/c Dr. To Share application A/c (Being share application money receive on 9,000 share @ ₹ 4 Each)		36,000	36,000
	Share Application A/c Dr. To share capital A/c (Being share application money on 9,000 shares transferred to share capital account)		36,000	36,000

Share Allotment A/C Dr. To Share Capital A/C (Being share allotment money due on 9,000 shares @ ₹ 4 per share)	36,000	36,000
Bank A/c Dr. To share Allotment A/c (Being allotment money received on 9,000 shares @ ₹ 4 each)	36,000	32,000
Share first & final call A/C Dr. To Share Capital A/C (Being call due on 9,000 shares @ ₹ 2)	18,000	18,000
Bank A/C Dr. To Share first & final call A/C. (Being call money receive)	18,000	18,000

Calls in Advance

When a company received the amount paid by some of its allottees for the calls not yet due, such amount is known as 'calls-in Advance'. Since the amount has not become due, hence it is a liability of the company. As such, it is credited to calls-in-advance account.

Journal Entry Passed to record these transactions are as under :

When call received in advance:

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

(With the amount of calls money received in advance)

When the respective call is due and made:

Calls-in-Advance A/c Dr.
To relevant call A/c

In the case of Call in advance, the company must pay interest at the rate prescribed in its articles of association. However, the provision of Table A of the company's Act will apply in the absence of interest clause in the articles of association, according to which the company will have to pay interest @ 6 % p.a. on calls-in-advance.

Accounting Treatment

(a) When interest is paid in cash

Interest on calls-in-advance A/c Dr. (with the amount of interest paid)
To Bank A/c

(b) When interest is outstanding i.e., not yet paid

Interest on call-in-advance A/c

Dr. (with the amount of interest payable)

To outstanding interest A/c

(c) On transfer to profit & loss Account at the end of Accounting period

Profit & Loss A/c

Dr. (with the total amount of interest paid or payable on calls in advance)

To Interest on calls-on-advance A/c

Calls in Arrears

When shareholders fails to pay the amount on allotment of calls, the total unpaid amount on one or more installments is known as calls-in-arrears. The company is authorized by its article to charge interest at a specified rate on calls in arrear from due date to the date of payment. But if the articles are silent the provisions of Table A would be applicable which provided for 5% per annum interest.

Accounting Treatment of Calls in Arrears

(i). For the call money not received:-

Calls in Arrears A/c

Dr.

To Relevant Call A/c

(ii). For the calls in arrear received at a subsequent date:-

Bank A/c

Dr.

To calls in Arrears A/c

(iii). For Interest due on calls in arrear:-

Sundry members A/c

Dr.

To interest on calls in arrears A/c

(iv). For the interest on calls in Arrear receive:-

Bank A/c

Dr.

To sundry members A/c

(v). For the interest on calls in arrear received transferred to Profit & Loss A/c at the end of account period.

Interest on calls in arrears A/c Dr.

To profit & loss A/c

Illustration 4 : (Calculation of Interest on calls in advance and calls in arrears) Mother Ltd. Issued 80,000 shares at Rs. 10 each payable as follows:-

On application ₹ 2 (01-01-2012) on allotment ₹ 3 (01-04-2012), on first call ₹ 3 (01-06-2012) and on second & final call ₹ 2 (01-08-2012).

Applications were received for 48,000 shares and the directors made allotment in full. One share holder to whom 80 shares were allotted paid the entire balance on his shareholdings with allotment money and another shareholder holding 120 shares did not pay allotment and first call money. But he paid the arrears with final call. Calculate the amount of interest paid and receive on calls in advance and calls in arrears respectively on 1st August 2012.

Solution:

Calculation of interest paid on calls in advances:

On ₹ 240 (i.e. 80X ₹ 3) for 2 months @ 6% P.A.	Rs. 2.40
On ₹ 160 (i.e. 80X ₹ 2) for 4 months @ 6% P.A.	Rs. 3.20
	<u>Rs. 5.60</u>

Calculation of interest on calls in arrears:

On ₹ 360 (i.e. 120X ₹ 3) for 4 months @ 5% P.A.	Rs. 6.00
On ₹ 160 (i.e. 120X ₹ 3) for 2 months @ 5% P.A.	Rs. 3.00
	<u>Rs. 9.00</u>

Illustration 5 : (Interest on calls-in arrears and calls-in-advance) On January, 2004, Ajay Ltd, makes on issue of 20,000 equity shares of ₹ 10 each payable as: on application ₹ 2; on allotment ₹ 3; on first and final call ₹ 6 (Three months after allotment)

Applications were received for 23,000 shares and directors made allotment in full to the applicant demanding five or more shares and returned money to the applicants for 3,000 shares. One shareholder, who was allotted 20 shares, paid first and final call with allotment money and another shareholder did not pay allotment money on his 30 shares but which he paid with first and final call. Directors have decided to charge and allow interest, as the case may be, on call in arrears and calls-in-advance respectively according to the provision of Table 'A'.

Solution**In the Book of AJAY LTD.****Journal Entries**

Date	Particulars	L.F	Debit ₹	Credit ₹
	Bank A/c Dr.		46,000	
	To equity Share application A/c (Being the application money on 23,000 shares on @ ₹ 2 per share received)			46,000
	Equity Share Application A/c Dr.		40,000	
	To equity share capital A/c (Being the application money transferred to share capital account)			40,000
	Equity Share Allotment A/C Dr.		60,000	
	To equity Share Capital A/C			40,000
	To securities premium A/C (Being the amount due on allotment on 20,000 shares @ ₹ 3 per share including premium of ₹ 1 as per resolution of the Board of director)			20,000

Equity share Application A/c To Bank A/c. (Being the application money refunded on 300 shares @ ₹ 2)	Dr.	6,000	6,000
Bank A/c Call in arrears A/c To Equity share allotment A/c To calls-in-Advance A/c (Being the allotment money received except on 30 shares and calls in advance received on 20 shares)	Dr. Dr.	60,030 90	60,000 120
Equity Share first & Final call A/c To equity share capital A/c (Being first & final call money due on 20,000 shares @ ₹ 6 per share)	Dr.	1,20,000	1,20,000
Bank A/c To Equity first & final call A/c To calls in arrears (Shares allotment) A/c (Being the amount of first & final calls received including arrears on 30 shares as allotment money)	Dr.	1,19,970	1,19,880 90
Calls in Advance A/c To equity share first & final call (Being the calls in advance transferred)	Dr.	120	120
Interest on calls in Advance A/c To sundry members A/c $6/100 \times 3/12 \times 120 = 1.80$ (Being interest allowed on calls in advance)	Dr.	1.80	1.80
Sundry Members A/c To Bank A/c (Being the interest paid)	Dr.	1.80	1.80
Sundry Members A/c To interest on calls in arrears A/c (Being the interest charged on calls-in-Arrears)	Dr.	1.13	1.13

ISSUE OF SHARES AT PREMIUM (SECTION 78)

When a company issues its shares at a price which is above its face value it is said to be an issue at a premium. Premium is the excess of issue price over face value of the security.

For example: If a share of ₹ 100 is issue at ₹ 102, it is said to be have been issued at premium of ₹ 2 or 2%.

There is no legal restriction while issuing share at a premium but premium so received is credited to a separate account called "securities Premium account" and can be utilized for the following purposes:

1. Issuing of fully paid bonus share to the members.
2. For writing off preliminary expenses.
3. For writing off the expenses of or commission paid or discount allowed on issue of share or any debenture of the company.
4. Providing for the premium payable on the redemption of any redeemable preference shares or of any debenture of the company.
5. Purchasing of its own share.

Generally premium amount is called with allotment. The journal Entry will be:

Share Allotment A/c Dr.

To share capital A/c

To securities Premium A/c

Illustration 6 : Z Ltd. Issued 10,000 share of ₹ 10 each at a Premium of ₹ 2 per share payable as follows:-

₹ 3 on application

₹ 4 on allotment along with premium ₹ 2 and the balance when required.

All the shares were applied for and duly allotted.

Solution

In the books of Y Ltd

Journal Entries

Date	Particulars	L.F	Debit ₹	Credit ₹
	Bank A/c Dr.		30,000	
	To Share application A/c (Being the application money on 10,000 shares @ ₹ 3 per share)			30,000
	Share Application A/c Dr.		30,000	
	To share capital A/c (Being Transfer of application money to share capital)			30,000
	Share Allotment A/C Dr.		40,000	

To Share Capital A/C			20,000
To securities premium A/c			20,000
(Being amount due on 10,000 @ ₹ 4 per share)			
Bank A/c	Dr.	40,000	
To share Allotment A/c			40,000
(Being allotment money received along with premium)			

ISSUE OF SHARE AT DISCOUNT (Section 79)

When a Company issues its shares at a price which is less than its face value it is said to be share issue at discount.

For example: If a share of ₹ 100 (per value) is issued at ₹ 95, it is said to be issued at discount of ₹ 5 (100-95). A company can issue its shares at a discount if it complies with the following provision of Section 79 of the Companies Act 1956.

1. The share must be of a class of share already issued. For example: if a company wants to issue preference share at a discount so it must ensure that it already issued preference share earlier if it is not so, it cannot issue preference share at discount.
2. A company cannot issue its share at discount unless it completed one year from the date of its commencement of business.
3. Company must pass a resolution in the general meeting about the maximum rate of discount.
4. A share cannot be issued at a discount for more than 10% of its face value however it can be issued at a higher discount if a resolution is passed in general meeting and sanctioned of the Central Government is obtained for this purpose (however in practice Central Government has delegated its power to Company Law Board (CLB) who provide the sanctions on behalf of Central Government in case of special circumstances.)
5. Shares must be issued within two months of receiving the sanction from Central Government. (In practice CLB by delegating power) or within extended time as Central Government may deemed fit.

In other words, it can be said that no company can issue its shares at a discount if it is a new company or it is a new class of share in case of old company.

When company issued shares at discount, the following journal entry will be passed :

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

Illustration 7- (Issues of shares at a discount):-

Yellow and white Ltd, offered 1,000 share of Rs. 10 each at discount of Rs. 1 per share payable as follows:-

₹ 3 on application

₹ 6 on allotment

The share were applied and allotted in full and all money was received in time. Pass the Journal Entries:-

Solution:

In the Book Yellow and White Ltd.

Journal Entries.

Date	Particulars	L.F	Debit ₹	Credit ₹
	Bank A/c To Equity Share application A/c (Being amount received on application)	Dr.	3,000	3,000
	Equity Share Application A/c To equity share capital A/c (Being application money transferred to share capital account)	Dr.	3,000	3,000
	Equity Share Allotment A/C Discount on shares A/C To equity share capital A/c (Being allotment money due @ ₹ 6 per share and discount @ ₹ 1 per share)	Dr.	6,000 1,000	7,000
	Bank A/c To equity share Allotment A/c (Being allotment money received)	Dr.	60,000	60,000

Point to be Remember

If it is not specify in the problem that the premium amount will be received with which call or discount is be allowed with which call it should be taken with the allotment.

FORFEITURE OF SHARES

When the shareholders are unable to pay the amount of a call, the company may have the power to forfeit those shares. Shares may be forfeited only if the articles of association allow them to be forfeited. Before forfeiture of shares the Directors have to first give a clear 14 days' notice to the concerned shareholder that unless he pays the amount due together with interest; if any, by a specified date, the shares are liable to be forfeited. After the specified date, the share holder failed to pay, the director may forfeit them by passing and appropriate resolution. The shareholder's name is removed from the register of members.

On forfeiture, the amount paid by the shareholder is not refundable to him it is forfeited, because shares were already cancelled.

The entry to be passed on forfeiture of shares will be as follows:-

Share Capital A/c Dr. (with called up amount)
 To Share forfeited A/c (With amount already received)
 To Calls in Arrears A/c (with the amount which become due but not paid for)

It should also be noted that share capital amount is debited with the called-up amount till the stage of forfeiture and not by the nominal value of share.

For example: Suppose 10,000 shares of ₹ 10 each are to be forfeited for non-payment of the first call. The amount payable was: - Rs. 3 on application, ₹ 3 on allotment, Rs. 2 on first call and the balance on 2nd & final call. The entry for forfeiture of shares will be as follows:-

Share Capital A/c	Dr.	80,000	
To share forfeited A/c		60,000	
To calls-in-arrears A/c		20,000	

Effects of Forfeiture

The effect of forfeiture on the shareholders is that, from the date of the forfeiture of shares, he ceased to be a member of the company. He loses all his privileged and rights of membership. All the money paid by him will be forfeited. The company will not refund the amount already paid, because there is no provision in the company's Act.

In Brief:

- (1) The amount already paid is to be forfeited.
- (2) The membership will be cancelled.
- (3) The defaulter remain liable for the liability incurred upto the date of his membership if the company is wound of within a year and provided other members are unable to pay.

Case- I Forfeiture of Shares originally issued at par

When share originally issued at par are forfeited for non payment of allotment money or call money. The share capital account is debited with the whole amount, i.e. called up amount on forfeited shares in respect of share capital.

The amount of the instatement, i.e. allotment and / or calls on which the shareholder has failed to pay the amount due at the time of forfeiture, is to be credited. The following journal entry made for this purpose:

Share Capital A/c	Dr.	(No. of shares forfeited X called up value)
To Share forfeiture A/c		(No. of share forfeited X amount paid on forfeited shares)
To calls in Arrears A/c		(Amount not paid on such shares)

Illustration 8: A ltd. forfeited 500 shares of Rs. 10 each which were originally issued at par for non payment of allotment Rs. 2, on 1st call Rs. 4 and Rs. 2 on final call. Pass necessary entry.

Solution :

Journal

Date	Particulars	L.F	Dr.	Cr.
			Amount	Amount
	Share Capital a/c	Dr.	5,000	
	To Share forfeiture A/c			1,000
	To Share Allotment A/c			1,000

To 1st Call A/c			2,000
To 2nd Call A/c			1,000
(Being share forfeited)			

Case-II Forfeiture of share originally issued at Premium

In case defaulting shareholder has failed to pay the share premium amount, share premium account has to be debited with the amount of premium not received. The following Journal entry has to be passed:-

Share Capital A/c	Dr.	(No. of share forfeited X called up value)
Securities Premium A/c	Dr.	(No of shares forfeited X amount of premium)
To share forfeited A/c		(Amount received on such shares)
To calls in Arrears A/c		(Amount unpaid on such shares)

Illustration 9: Laxmi Ltd. forfeited 200 shares of ₹ 10 each (originally issued at 20% premium payable with allotment) for non payment of allotment ₹ 5 including premium and 1st and final call of ₹ 3.

Solution:

Date	Particulars	L.F.	Amount	Amount
	Share capital A/c	Dr.	2,000	
	Securities Premium A/c	Dr.	400	
	To share forfeiture A/c			800
	To share allotment A/c			1,000
	To share 1st and final call A/c			600

Case-III Forfeiture of shares originally issued at discount

When the share forfeited originally issued at a discount, the discount applicable to such share must be cancelled or written off on re-issue of forfeited shares, the discount initially allowed is to be re-instated. The journal entry will be:-

Share Capital A/c	Dr.	(No. of share forfeited X Called up value per shares)
To Discount on issue of shares A/c		(No. of shares forfeited X amount of discount)
To share forfeited A/c		(Amount received on forfeited share)
To calls in Arrears A/c		(Amount due on forfeited shares)

Illustration 10: Sarika Ltd. forfeited 1,000 shares of ₹10 each, originally issued at a discount of 10%, for non payment of allotment money ₹ 3 and 1st call of ₹ 2 and final call of ₹ 2.

Solution :

Journal

Date	Particulars	L.F.	Amount	Amount
	Share capital A/c	Dr.	10,000	
	To discount on issue of shares A/c			1,000
	To share forfeiture A/c			2,000
	To share allotment A/c			3,000

To share 1st call A/c			2,000
To share final call A/c			2,000

Re-issue of forfeited shares

The forfeiture share can be re-issued in accordance with the provisions given in the articles of the company's act. Forfeited shares can be re-issued by the company at par, at premium or at discount. However the maximum discount that accompany can offer on these shares is the amount forfeited on these shares.

The forfeited share cannot be re-issued at a loss, but the amount of discount cannot be more than the amount credited to forfeited share account. When such shares issued at discount allowed on reissue of forfeited shares is debited to share forfeited account. The following entries are made for this purpose.

(i) For the reissue of forfeited shares:

Bank A/c Dr. (no. of shares reissued X issued price per share)

Share forfeited A/c Dr. (no. of shares reissued X discount allowed per share)

 To share capital A/c

Or

For the re-issue of forfeited shares which were initially issued at a discount:-

Bank A/c Dr. (no. of share re-issued X issue price per share)

Discount on shares A/c Dr. (no. of share reissued X initial discount per share)

Share forfeited A/c Dr. (no. of share reissued X additional discount per share)

 To share capital A/c

Or

For the Re-issue of forfeited shares at a premium:-

Bank A/c Dr. (no. of shares reissued X issued price per share)

 To share Capital A/c (no. of shares reissued X Face value)

 To share premium A/C

(ii) For the profit on reissue of forfeited share transferred to capital reserve Account:-

Share Forfeited A/c Dr.

 To capital reserve A/c

When all forfeited share are not-reissued

All the forfeited shares are not always re-issued, when only a part of the forfeited shares are re-issued in such a case only proportionate amount of forfeited share account relating to that part of forfeited shares which has been re-issued can be utilized towards discount to be given or the new share holders. Any balance left from this proportionate amount will be treated as net gain on re-issue of shares.

Profit on re-issue of shares is calculated as under:-

(Total amount forfeited X no. of shares re-issued) - (Amount with which forfeited

No. of shares forfeited

share A/c was debited at the time of re-issued of such shares).

The amount of profit is transferred to the capital reserve account. The amount relating to that part of forfeited shares which have not been re-issued will be shown in the forfeited shares account. The amount of

shares forfeited will be shown on the liability side of the balance sheet by way of addition to paid-up capital)

It becomes necessary to first ascertain the amount of forfeited shares which have not been re-issued. The amount will not be transferred to capital reserve. It will remain as a balance in share forfeiture account to be utilized for allowing discount as and when such shares are re-issued.

Illustration 11: Karan Ltd. forfeited 50 shares of ₹ 100 each issued at 10% premium on which allotment money of ₹ 30 per share (including premium) and first call of ₹ 30 per share were not received, the second & final call of ₹ 20 per share was not yet called. Give journal entries regarding forfeited and re-issued of shares in each of the following alternative cases:

Case I If 20 of these shares were re-issued as ₹ 80 paid-up for ₹ 90 per share

Case II If 20 of these shares were re-issued as ₹ 80 called up for ₹ 80 per share

Case III If 20 of these shares were reissued as ₹ 80 paid up for ₹ 70 per share

Case IV If 20 of these shares were re-issued as ₹ 80 paid up for ₹ 50 per share

Case V If 20 of these shares were re-issued at ₹ 70 per share as fully paid up

Solution:

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. ₹
	Entry on forfeiture of 50 shares in all cases			
	Shares Capital A/c (50 × ₹ 80) Dr.		4,000	
	Security Premium A/c [50 × ₹ 10] Dr.		500	
	To Share allotment A/c (50 × ₹ 30)			1,500
	To Share First Call A/c (50 × ₹ 30)			1,500
	To Forfeited Shares A/c (50 × ₹ 30)			1,500
	(Being 50 shares forfeited for nonpayment of first call money)			
	Entries on re-issued of 20 shares			
	Case I			
	Bank A/c (20 × ₹ 90) Dr.		1,800	
	To Share Capital A/c (20 × ₹ 80)			1,600
	To Security Premium A/c (20 × ₹ 10)			200
	(Being 20 shares re-issued as ₹ 80 paid up for ₹ 90 per share)			
	Forfeited Shares A/c (20 × ₹ 30) Dr.		600	
	To Capital Reserve A/c			600
	(being the transfer of profit on re-issue of 20 shares)			

Case II			
Bank A/c (20 × ₹ 80)	Dr.	1,600	
To share Capital A/c (20 × ₹ 80)		1,600	
(Being 20 shares re-issued at ₹ 80 paid-up for ₹ 80 per share)			
Forfeited Shares A/c (20 × ₹ 30)	Dr.	600	
To Capital Reserve A/c			600
(Being the transfer of profit on re-issued)			
Case III			
Bank A/c (20 × ₹ 70)	Dr.	1,400	
Forfeited Shares A/c (20 × ₹ 10)	Dr.	200	
To Share Capital A/c (20 × ₹ 80)			1,600
(Being 20 shares re-issued as ₹ 80 paid-up for ₹ 70 per share)			
Forfeited Shares A/c [(20 × ₹ 30) - ₹ 200]	Dr.	400	
To Capital Reserve A/c			400
(Being the transfer of profit on re-issue)			
Case IV			
Bank A/c (20 × ₹ 50)	Dr.	1,000	
Forfeited Shares A/c (20 × ₹ 30)	Dr.	600	
To Share Capital A/c (20 × ₹ 80)			1,600
(Being 20 shares re-issued as ₹ 80 paid-up for ₹ 50 per share)			
Case V			
Bank A/c (20 × ₹ 70)	Dr.	1,400	
Forfeited Shares A/c (20 × ₹ 30)	Dr.	600	
To share Capital A/c (20 ₹ 100)			2,000
(Being 20 shares re-issued as fully paid-up for ₹ 70 per share)			

Surrender of shares

Surrender of shares means the return of shares that means voluntary return of shares to the company by its registered share holders for cancellation. There is no legal provision in the companies act or in Table A is given regarding surrender of shares. However the articles of the company may allow the directors to accept surrender of shares only under cases which would justify forfeiture.

But it is admitted that surrender and forfeiture have practically the same effect with the only difference that the surrender is done with the assent of the shareholder while the forfeiture is done at the instance of the company. In surrender of shares the shareholder is willing to give up the share without any compulsion and surrender of shares is relieve the company from going through the formality of long procedure of forfeiture of share.

The surrender of shares can be made by a member to the company if the articles of association of company give the directors the power to accept a surrender of shares. But there is one condition is that shares can be surrendered only when they are liable for forfeiture.

The surrendered shares can be reissued in the same way as forfeited shares.

Issue of two classes of shares

When both the classes of shares i.e. preference and equity are issued by the company, the various account will be prefixed by the terms 'preference shares' or equity shares' as the case may be-Preference Share Application Account, Equity Share Application Account, preference share allotment account, Equity share allotment account, preference share capital account, equity share capital account etc.

Illustration 12: A company issue 2500 9% preference shares of Rs.100 each and 1000 equity share of Rs.100 each. The amount payable on preference share were as, Rs.10 on application, Rs.40 on allotment Balance in two calls of Rs.25 each. The amount payable on equity share is Rs.25 on application, Rs.25 on allotment and Rs.50 on final call. Pass the necessary entries.

Solution:

Issue of Pref. Shares

Journal

Date	Particulars	L.F.	Amount	Amount
	Bank A/c To share application A/c (being application money received on 2500 shares at ₹ 10 each)	Dr.	25,000	25,000
	Share application A/c To 9% pref. share capital A/c (share application money transferred to share capital A/c)	Dr.	25,000	25,000
	Share allotment A/c To 9%pref. share capital A/c (being share allotment money due)	Dr.	1,00,000	1,00,000
	Bank A/c To share allotment A/c (being share allotment money received)	Dr.	1,00,000	1,00,000
	Share 1st call A/c	Dr.	62,500	

	To 9% pref. share capital A/c (being share 1st call money due)			62,500
	Bank A/c	Dr.	62,500	
	To share 2nd call A/c (being share 2nd call money received)			62,500

Issue of Equity Share

Journal

Date	Particulars	L.F.	Amount	Amount
	Bank A/c	Dr.	25,000	
	To share application A/c (being application money received on 2500 shares at ₹ 10 each)			25,000
	Share application A/c	Dr.	25,000	
	To Eq. share capital A/c (share application money transferred to share capital A/c)			25,000
	Share allotment A/c	Dr.	25,000	
	To Eq. share capital A/c (being share allotment money due)			25,000
	Bank A/c	Dr.	25,000	
	To share allotment A/c (being share allotment money received)			25,000
	Share 1st call A/c	Dr.	50,000	
	To Eq. share capital A/c (being share 1st call money due)			50,000
	Bank A/c	Dr.	50,000	
	To share 1st call A/c (being share 1st call money received)			50,000

Pro-rata Allotment

When company receive applications for more shares than offered to the public or when a public issue made by a company is over subscribed, when the problem of allotment of shares arises. The company cannot allot all the shares applied by the public. The company rejects some applications altogether, allots in full some applicants and makes pro-rata allotment on remaining applicants, or there is also second option available of the company is that it may allot shares to all the applicants proportionately. So the excess money is adjusted by the company towards the amount due on the

allotment. Thus allotment of shares on proportionate basis to the applicants is called Pro-rata Allotment.

For example: If total number of shares issued are 3,000 and the shares applied for 3,600 then the proportion of share applied to allotment is 36:30 or 6:5, in other words, for every 6 shares applied for 5 shares will be allotted. This process is called Pro-rata allotment of shares.

Illustration 13 : A ltd. company offer applications for 10,000 shares of Rs.10 each payable as follows:

Application	₹ 4
Allotment	₹ 2
First call	₹ 2
Final call	₹ 2

It received applications for 13,000 shares. Application money for 1,000 shares was returned to the applicants and remaining 12,000 shares were allotted on pro-rata basis and excess money received on application was adjusted towards allotment and calls. Applicants for 8,000 shares were fully allotted; remaining 2,000 shares were allotted to Ram who applied for 4,000 shares. All the money was received on time. Pass necessary journal entries.

Solution:

Journal

Date	Particulars	L.F.	Amount	Amount
	Bank A/c	Dr.	52,000	
	To share Application A/c			52,000
	(being application money received)			
	Share application A/c	Dr.	52,000	
	To share capital A/c			40,000
	To Bank A/c			4,000
	To share allotment A/c			4,000
	To Share 1st call A/c			4,000
	(share application money adjusted to share capital)			
	Share allotment A/c	Dr.	20,000	
	To share capital A/c			20,000
	(being amount of allotment due)			
	Bank A/c	Dr.	16,000	
	To share allotment A/c			16,000

(being amount of allotment money received)			
Share 1st call A/c	Dr.	20,000	
To share capital A/c			20,000
(being amount of 1st call money due)			
Bank A/c	Dr.	16,000	
To share 1st call A/c			16,000
(being amount of share 1st call money received)			
Share final call A/c	Dr.	20,000	
To share capital A/c			20,000
(being amount of share final call due)			
Bank A/c	Dr.	20,000	
To share final call A/c			20,000
(being amount of share final call received)			

When shares belonging to Pro-rata category are forfeited

In such a case, the problem of determining the amount in arrears on allotment is arises. To solve this problem, the following procedure is recommended:-

- (i) Calculate total shares applied by the shareholder whose shares are being forfeited; the following Formula may be use:-

$$\frac{\text{Total Shares Applied}}{\text{Total Shares allotted}} \times \text{Shares allotted by the company to the defaulter shareholder.}$$

(ii) Multiply the numbers of shares as calculated by the above formula by the amount of application money. This gives total money sent by the shareholder with the applications. This amount is forfeited on default and credited to share forfeited account.

(iii) Then the amount of application money due is calculated with the help of shares allotted and it is to be deducted from the application money received. The result is the excess application money sent by the applicant in advance with the application. This money is adjusted towards allotment.

(iv) Then, calculate the amount due on allotment and deduct from it the amount sent in advance with application. The remaining amount is the outstanding amount on allotment. This amount is credited to share allotment account at the time of making entry for forfeiture.

Illustration 14: A Ltd. company offer applications for 10,000 shares of ₹ 10 each payable as follows:

Application	₹ 4
Allotment	₹ 2
First call	₹ 3
Final call	₹ 1

It received applications for 13,000 shares. Application money for 1,000 shares was returned to the

applicants and remaining 12,000 shares were allotted on pro-rata basis and excess money received on application was adjusted towards allotment and calls. Ram who holds 200 shares, fails to pay the allotment, 1st call and final call money and his shares were forfeited and subsequently reissued at Rs. 8 as fully paid up. Pass necessary journal entries for issue and forfeiture of shares.

Solution:

Journal

Date	Particulars	L.F.	Amount	Amount
	Bank A/c To share Application A/c (being application money received)	Dr.	52,000	52,000
	Share application A/c To share capital A/c To Bank A/c To share allotment A/c (share application money adjusted	Dr.	52,000	40,000 4,000 8,000
	to share capital) Share allotment A/c To share capital A/c (being amount of allotment due)	Dr.	20,000	20,000
	Bank A/c To share allotment A/c (Being amount of allotment money received) (20,000-8000-240)	Dr.	11,760	11,760
	Share 1st call A/c To share capital A/c (being amount of 1st call money due)	Dr.	30,000	30,000
	Bank A/c To share 1st call A/c (being amount of share 1st call money received . (30,000- 4000-600)	Dr.	29,400	29,400
	Share final call A/c To share capital A/c (being amount of share final call due)	Dr.	10,000	10,000
	Bank A/c To share final call A/c	Dr.	9,800	9,800

	(being amount of share final call received)(20,00-200)			
	Share capital A/c	Dr.(200 X 10)	2,000	
	To share forfeiture A/c			960
	To Share Allotment A/c			240
	To share 1st call A/c			600
	To share final call A/c			200
	(Being share forfeited)			
	Bank A/c	Dr.	1,600	
	Share Forfeiture A/c	Dr.	400	
	To Share capital A/c			2000
	(Being share reissued)			
	Share Forfeiture A/c	Dr.	560	
	To Capital Reserve A/c			560
	(Being profit on share forfeiture transfer to capital reserve a/c)			

Working Note:

$$\text{Share applied by Ram} = \frac{\text{Total shares Applied}}{\text{Total Shares Allotted}} \times \text{Share allotted to Ram}$$

$$= \frac{12,000}{10,000} \times 200 = 240$$

$$\text{Share application money paid by Ram} = 240 \times 4 = 960$$

$$\text{Less: Share application money adjusted} = 200 \times 4 = 800$$

$$\text{Excess money adjusted towards allotment} \quad \underline{160}$$

$$\text{Allotment money due on Ram} = 200 \times 2 = 400$$

$$\text{Less: money rec. with allotment} \quad \underline{= 160}$$

$$\text{Call in arrears} \quad \underline{240}$$

OVER-SUBSCRIPTION AND FORFEITURE OF SHARE ISSUED AT A PREMIUM

In such type of question, a problem arises whether securities premium account should be debited or not at the time of forfeiture. In order to solve the problem, it will have to be observed that if the premium is due on allotment, then whether the excess application money received on forfeited shares has been utilized to meet the amount of share capital due on allotment or it has been utilized to meet the premium due on allotment.

The excess application money has been utilized for the share capital due on allotment. Hence, in such type of questions where the premium is due on allotment and where the shares are forfeited for non payment of allotment money, 'securities premium account has been debited in entry for forfeiture.

Illustration 15: Mizum Ltd. Invited application for 10,000 shares of ₹ 100 each at a premium of ₹ 10 each payable as below:

₹ 50 on Application

₹ 35 on Allotment (including Premium), and

₹ 25 on call.

Applications for 15,000 shares were received. Application for 2,500 shares did not get any allotment and their money were returned. Allotment was made on pro-rata basis to the remaining applicants.

Mr. Ankit was allotted 400 shares. He failed to pay the amount due on allotment and call money. The company forfeited his shares and subsequently re-issued these share at ₹ 105 per share.

Show the journal and cash book entries in the books of the company and also prepare the balance sheet.

Solution:

Cash Book (Bank Column Only)

Particulars	₹	Particulars	₹
To share application A/c	7,50,000	By share application A/c	1,25,000
To share allotment A/c	2,16,000(1)	By Balance C/d	11,23,000
To share first and final call A/c	2,40,000		
To share capital A/c	40,000		
To securities premium A/c	2,000		
	12,48,000		12,48,000

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		₹	₹
Share application A/c	Dr.	6,25,000	
To share capital A/c			5,00,000
To share allotment A/c			1,25,000
(for application money on 10,000 shares @ ₹ Per share transferred to share capital A/c and excess money on 2,500 shares @ ₹ 50 per share to allotment A/c)			
Share allotment A/c	Dr.	3,50,000	
To share capital A/c			2,50,000
Ro securities premium A/c			1,00,000
(for allotment money, including premium due on 10,000 shares at ₹ 35 per share)			
Share first and final call A/c	Dr.	2,50,000	
To share capital A/c			2,50,000
(for first and final call due on 10,000 shares)			

at ₹ 25 per share)			
Share capital A/c	Dr.	40,000	
Securities premium A/c(2)	Dr.	4,000	
To share allotment A/c			9,000
To share first and final call A/c			10,000
To share forfeiture A/c			25,000
(for the forfeiture of 400 shares of A)			
Share forfeiture A/c	Dr.	25,000	
To capital Reserve A/c			25,000
(for the balance of share forfeiture A/c transferred to capital reserve A/c)			

Mizum Ltd.

Balance Sheet

	Particulars	Note	Figures as at the End of Current Accounting Reporting Period
I	EQUITY AND LIABILITIES		
	Shareholders' Funds		
	(a) Share Capital	1	10,00,000
	(b) Reserve and Surplus	2	1,23,000
			11,23,000
II	ASSETS:		
	Current Assets		
	Cash and cash Equivalents	3	11,23,000

Notes to Accounts

Particulars	Figures as at the End of Current Accounting Reporting Period
1. Share capital	
Issued , subscribed and fully paid up	
10,000 shares of Rs. 100 each	10,00,000
	10,00,000
2. Reserves and Surplus	
Capital Reserves	25,000
Securities Premium	98,000
	1,23,000

3. Cash and cash equivalents

Cash at Bank	11,23,000
	11,23,000

Working notes:

(1) (a) : Excess amount received from A on application:

A has been allotted 400 shares. He must have applied for more shares.

If shares allotted were 10,000, share applied for were = 12,500

If share allotted were 10,000,

$$\text{share applied for were} = \frac{12,500}{10,000} \times 400 = 500 \text{ shares}$$

Excess application money received from A:

$$500 \text{ shares} - 400 \text{ shares} = 100 \text{ shares} \times ₹ 50 = ₹ 5,000$$

(B) : Amount due from A on allotment:

$$400 \text{ shares} \times ₹ 35 = ₹ 14,000$$

$$\text{Less: excess received from A on Application} = ₹ 5,000$$

Net amount due from A on allotment, which has

$$\text{Not been received} = ₹ 9,000$$

(c) : Total amount due on allotment 10,000 shares $\times ₹ 35 = ₹ 3,50,000$

$$\text{Less: Excess amount received on applications} = ₹ 1,25,000$$

$$\text{Balance due} = ₹ 2,25,000$$

$$\text{Less: amount not received from A on allotment} = ₹ 9,000$$

$$\text{Net amount received on allotment in cash} = ₹ 2,16,000$$

(2) Since the question is silent as to be the utilization of excess application money of ₹ 5,000 (received from A) between share capital and securities premium, it has been assumed that the entire excess of Rs. 5,000 is exclusively for share capital and hence 'securities premium account' has been debited in the entry for forfeiture.

ILLUSTRATION 16.

Rahul Ltd. Invited application for issuing 50,000 equity shares of ₹ 10 each. The amount was payable as follows:

On application ₹ 3 per share

On allotment ₹ 4 per share

On first and final call ₹ 3 per share

Applications were received for 75,000 shares and pro-rata allotment was made as follows:

Applicants for 40,000 shares were allotted 30,000 share on pro-rata basic.

Applicants for 35,000 shares were allotted 20,000 shares on pro-rata basic.

Ramu, to whom 1,200 shares were allotted out of the group applying for 40,000 shares failed to pay the

allotted money. His shares were forfeited immediately after allotment.

Shamu, who had applied for 700 shares out of the group applying for 35,000 shares failed to pay the first and final call. His shares were also forfeited. Out of the forfeited shares 1,000 shares were re-issued @ Rs. per share fully paid up. The re-issued shares including all the forfeited shares of shamu.

Pass necessary journal entries to record the above transactions.

SOLUTION:

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		₹	₹
Bank A/c	Dr.	2,25,000	
To share application A/c			2,25,000
(for application money received on 75,000 shares)			
Share application A/c	Dr.	2,25,000	
To share capital A/c			1,50,000
To share allotment A/c			75,000
(for allotment money Adjusted)			
Share allotment A/c	Dr.	2,00,000	
To share capital A/c			2,00,000
(for allotment money due)			
Bank A/c	Dr.	1,21,400(1)	
To share allotment A/c			1,21,400
(for allotment money received on 48,800 shares)			
Share capital A/c	Dr.	8,400	
To share allotment A/c			3,600
To share forfeiture A/c			4,800
(for 1,200 shares forfeited for non-payment of allotment money)			
Share first and final call A/c	Dr.	1,46,000	
To share capital A/c			1,46,000
(for first and final call due on 48,800 share)			
Bank A/c	Dr.	1,45,200(2)	
To share first and final call A/c			1,45,200
(for first and final call money received on 48,400 shares)			
Share capital A/c	Dr.	4,000	
To share first an final call A/c			1,200
To share forfeiture A/c			2,800

(for 400 share forfeiture for non-payment of first and final call)		
Bank A/c	Dr.	8,000
Share forfeiture A/c	Dr.	2,000
To share capital A/c		10,000
(for the re-issue of 1.00 shares @ ₹ 8 per share as fully paid -up)		
Share forfeiture A/c		3,200(3)
To capital reserve A/c		3,200
(for the transfer of profit on re-issue)		

Working notes: (1) (A) Ramu must have applied for $\frac{40,000}{30,000} \times 1,200 = 1,600$ share

Excess amount received from Ramu on application = 1,600 shares – 1,200 shares
= 400 shares × ₹ 3 = ₹ 1,200

(b) Amount due from Ramu on Allotment

₹ 4,800

Less: Excess received on application

1,200

3,600

(c) Total amount due on allotment: 50,000 shares × ₹ 4

2,00,000

Less: Excess received on application

75,000

1,25,000

Less: Not received from Ramu on Allotment

3,600

1,21,400

(2) calculate of No. of shares allotted to shamun:

$$\frac{20,000}{35,000} \times 700 = 400 \text{ shares}$$

It means shamun has not paid first and final call money on 400 shares.

(3) Calculate of amount to be transferred to capital reserve:

Only 1,000 shares have been re-issued which include all the shares of shamun. Hence all the 400 shares of shamun and only 600 shares of Ramu have been re-issued.

Profit on 400 shares of Shamun

₹ 2,800

$$\text{Profit on 600 shares of Ramu} = \frac{\text{Rs. } 4,800}{1,200 \text{ shares}} \times 600 \text{ shares}$$

2,400

	5,200
Less: Loss on re-issued of 1.00 share @ ₹ 2 Each	2,000
	3,200

Illustration 17: Mithun Ltd. Issued a prospectus inviting application for 50,000 shares of Rs. 10 each. These shares were issued at per on the following terms:

On application ₹ 3 on allotment ₹ 4, on first call ₹ 2 and on final call the balance.

Applications were received for 60,000 shares. Allotments were made on the following basis:

- (i) to applicants for 10,000 shares - in full;
- (ii) to applicants for 20,000 shares - 15,000 shares;
- (iii) to applicants for 30,000 shares - 25,000 shares.

All excess amount paid on application is to be adjusted against amount due on allotment.

The shares were fully called and paid up except the amount of allotment, first and final call not paid by who applied for 2,000 shares of the group applying for 20,000 shares.

All the shares on which calls were not paid were forfeited by the Board of directors.

1,000 forfeited shares were re-issued as fully paid on receipt of Rs. 8 per share.

Show the journal entries in the books of Mithun Ltd.

Solution:

		₹	₹
Bank A/c	Dr.	1,80,000	
To share application A/c			1,80,000
(for application money received on 60,000 shares @ ₹ 3 per share)			
Share application A/c	Dr.	1,80,000	
To share capital A/c			1,50,000
To share allotment A/c			30,000
(for application money transferred to share capital account and the excess money to share allotment account)			
Share allotment A/c	Dr.	2,00,000	
To share capital A/c			2,00,000
(for allotment money due on 50,000 shares @ ₹ 4 per share)			
Bank A/c	Dr.	1,65,000 ⁽¹⁾	
To share allotment A/c			1,65,000
(for allotment money received, except on 1,500 share)			

LESSON 2

REDEMPTION OF PREFERENCE SHARES

Dr. Rakesh Gupta
PGDAV (Evening) College
University of Delhi

Redemption of preference share means paying back money or repayment to the preference shareholders.

Section 100 of the companies act 1956 provides that ordinarily a company is not permitted to refund any paid up share capital except with the permission of court but this section does not apply in case of preference share as no permission of court is required for the redemption of these share.

Section 80 of the companies act allows the issue of Redeemable Preference shares if articles of the company so authorize or permit. Such shares can be redeemed either at the option of the company or after the expiry of the fixed period of time stipulated at the time of issue.

Section 80 (5A) provides: notwithstanding anything contained in this Act, no company limited by shares shall, after the commencement of the Companies Amendments (1988) Act, issue any preference share which is irredeemable or is redeemable after the expiry of a period of twenty years from the date of its issue.

When an issue of redeemable preference shares has been made, the legal restrictions laid down in Section 80 must be followed most carefully when redemption is to take place. These restrictions are given as under:

- (a) no such shares shall be redeemed except out of profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of the redemption;
- (b) no such shares shall be redeemed unless they are fully paid;
- (c) the premium, if any, payable on redemption shall have been provided for out of the profits of the company or, out of the company' s share premium account, before the shares are redeemed;
- (d) where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall, out of profits which would otherwise have been available for dividend, be transferred to a reserve fund, to be called I[the capital redemption reserve account], a sum equal to the nominal amount of the shares redeemed; and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if I[the capital redemption reserve account] were paid- up share capital of the company.
- (e) The capital redemption reserve account may be applied in paying unissued shares of the company to be issued to the members as fully paid bonus shares. Otherwise this account must be maintained intact unless otherwise sanctioned by the court.

Notes:

- (i) in addition, Section 80 provides that the redemption of preference shares by a company under this section shall not be taken as reducing the amount of its authorized share capital.
- (ii) where in pursuance of this section, a company has redeemed or is about to redeem any preference shares, it shall have power to issue up to the nominal amount of the share redeemed or to be redeemed as if those shared had never been issued.

- (iii) If new shares are issued for the purpose of redemption of preference shares, the capital shall not be deemed to have been increased.
- (iv) If a company fails to comply with the provisions of this section, the company and every officer to the company who is in default shall be punishable with the fine, which may extend to one thousand rupees.

ANALYSIS OF LEGAL PROVISIONS

Maintaining of Capital Structure

One of the basic objects of the Companies Act has always been to maintain its capital structure of the company intact so that the interests of the creditors are protected. The various provisions of Section 80 outlined above do not conflict with this objective even after the redemption (i.e. paying back) of the redeemable preference shares. The reasons are:

- (i) If the redeemable preference shares are redeemed fully out of the profits which would otherwise be available for dividend, the Capital Redemption Reserve Account will take the place of Redeemable Preference Share Capital Account. In other words, the Capital Redemption Reserve Account must be equal to the Redeemable Preference Share Capital redeemed.
- (ii) If the redeemable preference shares are fully redeemed out of the proceeds of the fresh issue of its share made for the purpose of redemption, the new Share Capital Account coming into existence as a result of fresh issue would replace the redeemable preference share capital account after redemption. In other words, new share capital account (equity or preference) must be equal to the Redeemable Preference Share Capital redeemed.
- (iii) Lastly, if the redeemable preference shares are redeemed partly out of the profits of the company which would otherwise be available for dividend and partly out of the proceeds of the fresh issue of shares, the Redeemable Preference Share Capital shall be replaced after redemption by the Capital Redemption Reserve Account and New Share Capital Account (equity or preference). In other words, the total of the Capital Redemption Reserve Account and the New Share Capital Account would be equal to the Redeemable Preference share Capital redeemed.

Thus, it is clear that on the one hand Section 80 permits the paying back of the type of share capital and it has ensured on the other hand that the same is replaced by another kind of share capital. In short, there is no permanent redemption of share capital and capital structure is retained intact in order to protect interests of the creditors.

Note: The term creditors is clear in used in general sense and means any person other than a shareholder who has contributed to the assets of the company.

Profits which would otherwise be available for Dividends

As noted, one of the sources of redeeming the redeemable preference shares is the profit which would otherwise be available for dividend. The implications of the words 'which would otherwise.....dividend' is that profit of capital nature cannot be used to redeem redeemable preference shares since these cannot be utilized for dividend distribution. It means that 'redemption' can be varied out only of divisible profits or general profits which normally consist of any or all of the following items under the heading mentioned above (i.e. 'which would otherwise...')

- (i) General reserve
- (ii) Profit and Loss Account Balance (credit)

- (iii) Dividend Equalization Fund
- (iv) Reserve Fund
- (v) Insurance Fund
- (vi) Workmen Compensation Fund*
- (vii) Accident Compensation Fund*
- (viii) Contingency Reserve*
- (ix) Reserve for Doubtful Debts or Taxation*

Note: 1. In the case of items marked with asterisk "*" that part of the amount which is in excess of the required provisions only can be utilized.

2. The Balance Sheet (liabilities side) will tell us what sums stand to the credit of the items (i) to (ix).

3. Transfer to capital redemption reserve account is allowed from these profits.

The following list of items consists for profits of capital nature which cannot be utilized for dividend and hence not available for redemption of the redeemable preference shares:

- (i) Securities Premium Account
- (ii) Share Forfeited Account
- (iii) Profits Prior to Incorporation
- (iv) Capital Reserve
- (v) Development Rebate Reserve.

Notes

1. The balance sheet (liabilities side) will tell us what sums stands to the credit of these five items.

2. Transfer of Capital Redemption Reserve Account is not allowed from these items of profits.

Proceeds of Fresh Issue

The term or the phrase proceeds of a fresh issue of shares has not been defined anywhere in Section 80 or elsewhere in the Companies Act and as such there has been lot of argument, difficulty and confusion as to what constitutes proceeds especially when fresh shares have been issued at premium or at a discount. The argument centres round two points of view:

One viewpoint is that the word 'proceeds' should be interpreted in its literal sense and should be taken to mean the actual amount realized. Accordingly the issue price alone shall constitute the proceeds for the purpose of redemption.

Another viewpoint is that only nominal value should be considered for this purpose.

Still others feel that nominal value shall constitute proceeds when new shares are issued at premium or at par but if they are issued at a discount the net amount realized (nominal value less discount) should only be taken into account.

The various points of view have been critically examined below in the light of nature of the issue of shares, i.e. at par or at premium or at a discount and suggested approach is also given.

Redemption of such shares is made in accordance with the provisions of section 80 of the companies Act. 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.

When fresh issue of shares is made at par: There is no difficulty or confusion in case shares are issued at par since the literal interpretation of the word 'proceeds' is acceptable, i.e. the actual amount realized should constitute the proceeds, and it is this amount which would determine that extra amount required to be utilized from the general profits if the redeemable preference shares are to be redeemed partly out of the proceeds of the fresh issue and partly out of the profits of the company.

When fresh issue of shares is made out at premium: In such a case the confusion is as to whether actual amount realized including the amount of premium should constitute the 'proceeds' or only the nominal value of the shares issued should constitute the proceeds.

When the question is examined in the light of specific provisions of Section 78, it would be found that the Companies Act is very much clear on this point. It has already been noted in the preceding chapter that Section 78 clearly provides that when a company issues shares at premium, the amount collected as premium whether in cash or kind has to be credited to Securities Premium Account and the provisions relating to the share capital shall apply if the securities premium account is utilized for the purpose other than specified therein. But there is no provision under Section 78 for the utilization of Securities Premium Account for the purpose of redeeming the nominal amount of redeemable preference shares.

Thus, it is clear from the foregoing discussion that the amount collected as premium would be excluded from the total amount realized when the shares are issued at premium; only the nominal value of the shares should be taken into consideration for determining the additional amount to be utilized from the profits when the shares are to be redeemed fully out of fresh issue to shares, only nominal value of the shares constitutes the source of redemption since the use of premium money for any purpose other than for purposes stated in Section 78(2) would amount to reduction of capital.

When the fresh issue of shares is made at a discount: In such a case the controversy is whether.

- (i) the net amount realized (i.e. nominal value of the shares less the amount of discount) should constitute the proceeds; or
- (ii) the nominal value of the shares issued constitute the proceeds.

Although the company law does not assist on this point, it is suggested that only the net amount realized that is the nominal value of the shares less the discount should constitute the proceeds. The reason is that, when shares are issued at a discount the nominal value of shares does not represent the wholly tangible assets capable of providing real protection to the third party, i.e. creditors.

Suppose a company is to redeem preference shares of the nominal value of ₹ 5,00,000. Now if the company issues the shares at a discount of 10% for a nominal value of ₹ 5,00,000, it would get only ₹ 4,50,000 in cash after deducting a discount of ₹ 50,000 being 10% of ₹ 5,00,000. But it will need ₹ 5,00,000 in cash on redemption. It is true that the nominal value of the fresh shares replaces the redeemable preference shares by an equivalent sum (i.e. ₹ 5,00,000), it does not amount to replacement of assets utilized in the redemption of the redeemable preference shares. The assets side has two items (i) Bank ₹ 4,50,000 and (ii) Discount on the issue of shares ₹ 50,000. Let us assume that due to unforeseen circumstances the company is unable to satisfy the claims of the third parties in full. In such a case it would mean the repayment of capital in priority over the creditors to the extent of the amount of discount, i.e. ₹ 50,000. This procedure seems to be violative of Section 80. The net amount received represents tangible assets while the amount of discount is a tangible loss since it does not represent tangible assets.

To conclude, it may be stated that when shares are issued at discount: (i) the net amount realized should be taken into consideration while calculating the additional amount to be used from the general profits when the shares are partly redeemed out of the 'proceeds' of the fresh issue and partly out of

general profits, and (ii) when the redemption is to be carried out fully from the 'proceeds' of fresh shares, the total amount to be raised must be divided by the net value of the shares (Nominal value of the shares minus the amount of discount) or as to arrive at the total number of shares to be issued or total amount of the nominal value to be raised.

In short proceeds of fresh issue of share means:

- (i) The nominal value of the shares when shares are issued at par.
- (ii) The nominal value of the shares when shares are issued at a premium. The amount of premium cannot be used for redemption in view of restrictions imposed by Section 78.
- (iii) The net amount realized when the share are issued at a discount.

Notes:

1. If new shares have been issued as partly paid, only the paid up nominal amount when the shares are issued at par and premium and net realized amount when shares issued at discount should be considered. This is in line with the spirit of the Section 80 and according to the letter of the rule.
2. Where the preference shares are redeemed by conversion into ordinary or preference shares, it is not necessary to transfer an equivalent amount out of divisible profits to capital redemption reserve account in view of the fact that this also amount to issue of new shares no actual amount us realized.

No Redemption unless the Redeemable Preference Shares are fully Paid

As stated above, Section 80 requires that the redeemable preference shares cannot be redeemed unless they are fully paid. The purpose of this provision is to protect the radiators who advance credit or advance loans to be received in future. The uncalled capital on the partly paid up shares can always be called up by the company during its lifetime and even by the liquidator when the company is wound up. It is because of this feature of the limited companies that the creditors count of this item (i.e. uncalled capital) while dealing with the company. Now coming to redemption, if the Companies Act or Section 80, to be more specific, were to allow the redemption of partly paid redeemable preference shares, it would mean the replacement of equivalent amount (i.e. partly paid up amount) either by the proceeds of fresh issue of shares or by capital redemption reserve account. This would upset the calculation of the creditors who depend upon the face value or nominal value of the shares while advancing the loans, or extending credit facilities. In view of this, it was deemed necessary that it is not the paid up amount but the nominal or face value of the shares which requires replacement. Thus, Section 80 makes it compulsory that that partly paid up shares must be made up fully paid up before redemption takes place. It is a positive step in the right direction since it ensures that there is automatic replacement of the amount on which the creditors might have based their calculations.

Premium on Redemption

When the redeemable preference shares are to be redeemed at premium, the amount of premium payable on redemption can be provided either out of the Securities Premium Account or from the profits of the company. The term used in Section 80 is profits without any qualification as to the nature of the profits. It means capital profits could also be utilized for premium, if any, payable on redemption of preference shares.

Notes:

1. In the examination problem if the redeemable preference shares are given as partly paid up and no instruction is given, it should be presumed that they have been made fully paid up before redemption. The necessary entries for the final call due and received must be made.
2. If there are two categories of redeemable preference shares in the examination problem— one partly paid and another fully paid—and there is no instruction to the contrary, then only fully paid redeemable preference share should be redeemed.

Capital Redemption Reserve Account

The capital redemption reserve account is a statutory capital reserve and Section 80 expressly states that it is to be treated as the paid up capital of the company and is to be preserved with the same sanctity as the company's share capital and can be reduced only in the like manner. The amount to be credited to this account is arrived as follows:

1. Where the shares (Nominal value only) are redeemed wholly out of the profits which would otherwise be available for dividends (i.e. divisible profits), the amount by which the company's issued share capital is diminished, shall be transferred to the Capital Redemption Reserve Account.
2. Where the shares are redeemed partly out of the proceeds of a fresh issue made for the purpose of redemption, the amount of the difference between the nominal value of the shares redeemed and the proceeds of fresh issue shall be transferred to the Capital Redemption Reserve Account.

Transfers to capital redemption reserve are frozen except for the purpose of issuing fully paid bonus shares. Hence the reserve is non-distributable. The objective is to safeguard the interest of the creditors from the effects of a reduction in capital.

How to Solve the Examination Problem

In order to deal with examination problems relating to redemption of preference shares, the following procedure is suggested:

Step I: Determine How Much Money is needed, i.e. The Resources

The first step is to calculate on a rough sheet the total amount required to pay off the preference shareholders are to be redeemed. The total amount needed will consist of:

1. The nominal or face value of the preference shares to be redeemed;
2. Any premium to be paid on redemption

Note: If the redeemable preference shares are partly paid, they should be made fully paid before initiated to redeem them. The necessary journal entries would be made accordingly.

Step II: Decide the Sources of Redemption (i.e. what is to be made available for the redemption)

The order to decide about this part of the problem we will have to be clear in our mind on the following points: Provisions of the Companies Act as regards the sources of redemption and the Non-reduction of the effective issued capital. This means we will have to examine the liabilities side to find out:

- (i) What is available in the form of profits which otherwise be available for dividend for the purpose of redeeming the nominal value of the redeemable preference shares.

- (ii) What is available in the form of all types of profits and Securities Premium Account in order to provide for the premium, if any, payable on redemption.
- (iii) It is only then it will be determined whether the new issue of shares is required for the purpose of redemption.

Notes: 1. In case the examination problem states that the redemption is to be carried out by the fresh issue of shares at premium alone, point nos. (i) and (ii) are unnecessary.

2. In case the redemption of preference shares to be done partly by the issue of shares and partly out of profits, there may be two possibilities, namely:

- (i) the examination problem may specify the amount of fresh issue, or
- (ii) the amount of fresh issue may have to be determined by the student. In such a case what is available in the form of divisible profits will be determined first.

Step III: Take Steps to Raise the Money

The assets side of the Balance Sheet would disclose the sums available from cash in hand and at Bank. In case cash in hand and the Bank balance are not sufficient to meet the claims of the preference shareholders, the additional or extra cash will normally be raised by one or more of the following methods:

- (i) By the sale of investments, if any. Any profit or loss on the sale of investments must be transferred to the Profit and Loss Account this closing off the Investment Account.
- (ii) By a new issue of shares, if the examination problem so requires.
- (iii) By taking bank loan. This will have to be presumed if the examination problem is silent on the sale of investments and issue of new shares provided the cash in hand and at Bank are found to be insufficient in the given balance sheet.

Notes: In case no balance sheet is given, it will be presumed that the company has sufficient cash and the student is not required to make journal entries in respect of bank loan.

Step IV: Pay Off the Preference Shareholders

Since the money available in the bank would be sufficient as outlined in Step III above, the company is in a position to pay off the preference shareholders and thus redeem the preference shares.

Step V: Maintain the Issued Capital Intact

When the redemption of the preference shares actually takes place, the assets, (i.e. cash) of the company are diminished by the amount of payment. At the same time the 'liabilities' of the company are also diminished by an equal amount, that is, the preference share capital is eliminated from the Balance Sheet. But as stated earlier, Section 80 of the Companies Act does not permit a reduction of the effective issued capital of the company. It is, therefore, important to note that:

- (i) If the redemption has been completely achieved by a fresh issue of capital, i.e. if all the money required from that source, the capital simply cancels out the capital which is being redeemed and both assets and liabilities remain in total as same as before. And of course, the issued also remains, in total, at the same figure as before thus confirming to the requirements of Section 80.
- (ii) If part of the redemption (or the whole of it for that matter) is to be achieved by using divisible profits which have been set aside to reserves, then an amount equivalent to the divisible profits so appropriated must be transferred from General Reserve Account (or some other similar fund) to an account called Capital Redemption Reserve Account. In this way, past profits become

frozen or capitalized and can never be used in the future, except for the purpose of issuing fully paid bonus shares. Thus they become a part of effective capital.

Notes: It is relevant to mention that though Section 80 has provided for the replacement of the nominal or face value of the share redeemed, there is no provision for the replacement of premium, if any, payable on redemption. It means that on payment of premium, the divisible profits are never capitalized. Instead the premium paid on redemption is written off by a transfer to either divisible profits (or capital profits) or Securities Premium Account or both as the case may be.

ACCOUNTING TREATMENT

- When preference shares are redeemed out of proceeds of a fresh issue made for the purpose of redemption, the question usually states that the full amount of cash is available on application or at the most on allotment. This means only application or/ and allotment account will have to be opened. Suppose a fresh issue is made for Rs. 1,00,000 being the nominal value, say (i) at par (ii) at a discount of 10% or (iii) at a premium of 20%. Assuming the full amount is payable along with application and further there is no over-or-under-subscription, the journal entries in each case would be:

A. When issued at par

		₹	₹
(i) Bank Account	Dr.	1,00,000	
	To Share Application and Allotment Account		1,00,000
(ii) Share Application and Allotment Account	Dr.	1,00,000	
	To Share Capital Account		1,00,000

B. When issued at a discount of 10%

		₹	₹
(i) Bank Account	Dr.	90,000	
	To Share Application and Allotment Account		90,000
(ii) Share Application and Allotment Account	Dr.	90,000	
	Discount on Issue of Shares Account	10,000	
	To Share Capital Account		1,00,000

C. When issued at a premium of 20%

		₹	₹
(i) Bank Account	Dr.	1,20,000	
	To Share Application and Allotment Account		1,20,000

(ii) Share Application and Allotment Account	Dr.	1,20,000	
To Share Capital Account			1,00,000
To Securities Premium Account			20,000

2. When current assets are realized to provide cash for redemption of preference shares, the book-keeping presents no difficulty; the journal entry is:

Bank Account	Dr.		
To Respective Assets Accounts (e.g. Investment Account)			

The amount realized from the assets is not likely to be same at which the asset appears in the books. In other words, there will be either profits or loss on the sale. Any such profit or loss must be transferred to the Profit and Loss Account, thus closing off the asset account.

Example: Investment of the face value of ₹ 30,000 carried in the books at a cost of ₹ 34,000 were sold at 105% of their face value:

The journal entry is:

Bank Account	Dr.	31,500	
Profit and Loss Account	Dr.	2,500	
To Investment Account			34,000

(Investment of ₹ 30,000 face value sold at ₹ 105

Against the cost of ₹ 34,000, loss on sale debited to

Profit and Loss Account)

Note: Section 80 of the companies Act provide that the redemption should be achieved either (i) out of the profits otherwise available for dividend or (ii) out of proceeds of the fresh issue of shares made for the purpose of redemption but not out of the proceeds of the property. The intention of the Act can be inferred from the fact that the words 'or out of the sale proceeds of any property of the company' appearing in Section 105B (I) (a) of the Act of 1913 have been deleted from Section 80(I) (a) of the present Act. The impact of the deletion is that if a company has sufficient profits for redemption of redeemable preference shares but does not have sufficient cash or/and bank balance to pay off preference share-holders account, the company in that case can increase its resources either by borrowing money or by selling current assets but not disposing of its fixed assets.

3. On transfer of redeemable preference share capital to be redeemed to the preference shareholders accounts, the journal entry is:

Redeemable Preference Share Capital Account	Dr.	
To Preference Shareholders Account		

Note: this entry will be made with the nominal value of the shares to be redeemed.

4. When the preference shares are redeemable at premium, enter the amount of premium payable as follows:

Premium on Redemption of Preference Shares Account Dr.
 To Preference Shareholders Account

This entry will be made with the amount of premium payable of redemption.

Note: Entry Nos. 3 and 4 can be combined together.

5. On redemption of preference shares, i.e. on making the payment to preference shareholders:

Preference Shareholders Account Dr.
 To Bank Account

This entry is made with the total amount paid to preference shareholders including the amount of premium, if any.

6. If redemption has been achieved by using profits which would otherwise be available for dividend (i.e. divisible profit), an amount of profit so used for redeeming nominal value would be transferred to capital redemption reserve account. The entry is:

Profit and Loss Account Dr.
 General Reserve Account Dr. As the case may be
 Reserve Fund Account Dr.
 Dividend Equalization Fund Account etc. Dr.
 To Capital Redemption Reserve Account

7. When premium on redemption of preference shares is written off:

Securities Premium Account Dr. With the amount of premium
 Or paid on redemption
 Profit and Loss Account Dr.
 To Premium on Redemption
 Of Preference Shares Account

Note: 1. If redeemable preference shares are redeemed out of the proceeds of the fresh issue, the new share capital account (preference or equity) replaces the redeemable preference share capital account.

2. When redeemable preference shares are redeemed out of the divisible profits, Capital Redemption Reserve Account replaces the Redeemable Preference Share Capital Account.

3. If redeemable preference shares are redeemed partly out of the proceeds of fresh issue of shares

made for the purpose and partly out of profits which would otherwise be available for dividend. New Share Capital Account and Capital Redemption Reserve Account will jointly replace the Redeemable Preference Share Capital Account.

Illustration 1: Ridhi Co. Ltd. had issued 50,000 redeemable preference shares of ₹ 10/- each ₹ 8/- paid. In order to redeem these shares now being redeemable, the company issued for cash 30,000 equity shares of ₹ 10/- each at a Premium of ₹ 2/- per share. Out of the cash proceeds the redeemable share were paid and the balance was met out of Reserve fund which stood at ₹ 2,50,000/- show the Journal entries books of the company.

Solution:

Journal Entries

		₹	₹
(i) Redeemable Preference Share Final Call A/c	Dr.	100,000	
To Redeemable preference share capital A/c			100,000
Final call on 50,000 Pref. Shares (50,000*2)			
<hr/>			
(ii) Bank A/c	Dr.	100,000	
To Redeemable Preference Share Final all A/c			100,000
Final call on 50,000 Pref. Shares received			
<hr/>			
(iii) Bank A/c	Dr.	360,000	
To Equity Share Capital A/c			300,000
To Securities Premium A/c			60,000
Cash received on 30,000 equity shares of Rs.10 each issued at a premium of Rs. 2/- per share.			
<hr/>			
(iv) Redeemable Preference share Capital A/c	Dr.	500,000	
To Bank			500,000
50,000 Redeemable preference Shares of Rs. 10/- each redeemed			
<hr/>			
(v) Reserve Fund A/c Dr.		200,000	
To Capital Redemption Reserve Account			200,000
Amount equal to share redeemed out of profit transferred to capital redemption reserve Account.			

Illustration 2: Aryan Ltd. company had issued 2,000 6% Redeemable Preference Shares of Rs.100 each. These share had to be redeemed on 31st December, 2002 at Rs. 105. The company had earned good profit but also made the following issue of shares and debentures for the purpose or redemption.

1,000 equity shares of Rs. 100 each at a premium of Rs. 10 per share.

6% Debentures of the face value of Rs. 1,00,000 at par.

Journalise the redemption and the above-noted transactions.

Solution:

Journal

2002			Rs.	Rs.
Dec. 31	Bank Account	Dr.	2,10,000	2,10,000
	To Equity Share Capital A/c			1,00,000
	To Securities Premium A/c			10,000
	To 6% Debentures A/c			1,00,000
	(Issue of 1,000 Equity shares of Rs. 100 each @ Rs. 110 and 6% Debentures for Rs. 1,00,000)			
<hr/>				
2002				
Dec.31	Redeemable Preference Share Capital A/c	Dr.	2,00,000	
	Premium on Redemption of Preference Share A/c	Dr.	10,000	
	To R. Pref. Shareholders A/c			2,10,000
	(Amount due to Preference Shareholders in respect Of shares and premium on them)			
	R. Pref. Shareholder A/c	Dr.	2,10,000	
	To Bank Account			2,10,000
	(Payment to Redeemable Preference Shareholders)			
	Share Premium A/c	Dr.	10,000	
	To Premium Redemption of Pref. Share A/c			10,000
	(Transfer of premium redemption to share premium A/c)			

As a result of redemption what happens is that money is paid to redeemable preference shareholders. But the money must have been collected either by profits or, by issue of new shares. That means that one set of shareholders is replaced by another or a suitable portion of funds is permanently kept back out of profits (by transfer to capital Redemption Reserve Account.)

Illustration 3: Priya Ltd. Co. decides to redeem at par 2,00,000 redeemable preference shares of Rs. 10 each. A general reserve of Rs. 12,50,000 had already been, built up. For the purpose of redemption of 75,000 equity shares of Rs. 10 were effected to the public at a premium of Rs.5/- each, payable or full on application. The new issue was fully subscribed and preference share were redeemed.

Journalise the above

Redeemable Pref. Share Capital A/c	Dr.	10,00,000	
Premium on redemption A/c	Dr.	1,00,000	
To Redeemable Preference Shareholders			11,00,000
(Money due on redemption of 10,000 shares at a Premium of ₹ 10/- per share transferred to Pref. Shareholders Account)			
<hr/>			
Profit and Loss Appropriation Account	Dr.	80,000	
Securities Premium A/c	Dr.	20,000	
To Premium on Redemption Account			1,00,000
(Premium on redemption taken partly from share premium A/c and balance from profit and loss appropriation Account)			
<hr/>			
Redeemable Preference Shareholders Account	Dr.	11,00,000	
To Bank Account			11,00,000
(Amount paid to shareholders on redemption of 10,000 shares)			
<hr/>			
Profit and Loss Appropriation A/c	Dr.	6,00,000	
To Capital Redemption Reserve Account			6,00,000
(Transfer of amount utilized out of profits for redemption to capital redemption reserve account as per requirements of the companies Act)			

Illustration 5: (When preference shares are redeemed out of the proceeds of the fresh issue of shares made for the redemption)

Suryanarayan Limited issues on 1.1.1999 10,000, 8% Redeemable Preference Shares of ₹ 100 each redeemable on January 1, 2002 at a premium of ₹ 10 each.

In order to meet this obligation, the company decides to issue 50,000 fresh equity shares of ₹ 10 each at ₹ 15 and 5,000 9% preference shares of ₹ 100 each at ₹110. The whole amount is received in cash and the 8% preference shares are redeemed.

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

Solution:

Bank A/c	Dr.	11,25,000	
Equity Share Application and Allotment A/c			11,25,000
(Receipt of 75,000 application of equity shares of Rs. 10 each at premium of ₹ 5/-)			
Equity Share Application and Allotment A/c	Dr.	11,25,000	
To Share Capital A/c			7,50,000
To Securities Premium A/c			3,75,000
(Transfer of share application to share capital)			
Redeemable Pref. shares Capital A/c	Dr.	20,00,000	
To Pref. share holders			20,00,000
(Transfer of Pref. share capital to shareholders).			
Preference Shareholders A/c	Dr.	20,00,000	
To Bank A/c			20,00,000
(Payments to the Preference shareholders on Redemption)			
General Reserve A/c	Dr.	12,50,000	
To Capital Redemption Reserve A/c			12,50,000
(Transfer of General Reserve to Capital Redemption Reserve A/c)			

Illustration 4: In Pooja Ltd. Company, on 1st January, 2002 10,000, 6% Redeemable Preference Share of Rs.100 each fully paid up, are outstanding. These share are redeemable at ₹110 each. 8,000 Equity shares of ₹50 each are issued at ₹52.50 for cash or redemption of preference shares. The balance of Profit and Loss Appropriation Account is ₹15,20,000.

Pass the entries in the books of Pooja Ltd. Company to record redemption of preference shares.

Solution:**Pooja CO.LTD.****Journal Entries**

Date	Particulars	L.F	Dr. Amount	Cr. Amount
2002				Rs.
Jan.1	Bank Account	Dr.	4,20,000	
	To Equity Share Capital A/c			4,00,000
	To Securities Premium A/c			20,000
	(Issue of 8,000 shares of ₹50/- each at a premium of ₹ 2.50 each)			

Redeemable Pref. Share Capital A/c	Dr.	10,00,000	
Premium on redemption A/c	Dr.	1,00,000	
To Redeemable Preference Shareholders			11,00,000
(Money due on redemption of 10,000 shares at a Premium of ₹ 10/- per share transferred to Pref. Shareholders Account)			
<hr/>			
Profit and Loss Appropriation Account	Dr.	80,000	
Securities Premium A/c	Dr.	20,000	
To Premium on Redemption Account			1,00,000
(Premium on redemption taken partly from share premium A/c and balance from profit and loss appropriation Account)			
<hr/>			
Redeemable Preference Shareholders Account	Dr.	11,00,000	
To Bank Account			11,00,000
(Amount paid to shareholders on redemption of 10,000 shares)			
<hr/>			
Profit and Loss Appropriation A/c	Dr.	6,00,000	
To Capital Redemption Reserve Account			6,00,000
(Transfer of amount utilized out of profits for redemption to capital redemption reserve account as per requirements of the companies Act)			

Illustration 5: (When preference shares are redeemed out of the proceeds of the fresh issue of shares made for the redemption)

Suryanarayan Limited issues on 1.1.1999 10,000, 8% Redeemable Preference Shares of ₹ 100 each redeemable on January 1, 2002 at a premium of ₹ 10 each.

In order to meet this obligation, the company decides to issue 50,000 fresh equity shares of ₹ 10 each at ₹ 15 and 5,000 9% preference shares of ₹ 100 each at ₹110. The whole amount is received in cash and the 8% preference shares are redeemed.

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

Solution:**Journal Entries**

		₹	₹
1. Bank Account	Dr.	13,00,000	
	To Equity Share Application Account		7,50,000
	To 9% Preference Share Application Account		5,50,000
(Application money received on 50,000 equity shares @ Rs.15 and on 5,000 9% preference shares @ Rs.110 per share)			
<hr/>			
2. Equity Share Application Account	Dr.	7,50,000	
9% Preference Share Application Account	Dr.	5,50,000	
	To Equity Share Capital Account		5,00,000
	To 9% Preference Share Capital Account		5,00,000
	To Securities Premium Account		3,00,000
(Allotment of 50,000 equity shares of Rs. 10 each issued at a premium of Rs.5 and 5,000 9% preference shares of Rs.100 each issued at a Premium of Rs. 10 vide Board's resolution dated....)			
<hr/>			
3. 8% Preference Share Capital Account	Dr.	10,00,000	
Premium on Redemption of Preference Shares Account	Dr.	1,00,000	
	To 8% Preference Shareholders Account		11,00,000
(Amount due on 8% preference shareholders on redemption of 8% preference shares at a premium of 10%)			
<hr/>			
4. 8% Preference Shareholders Account	Dr.	11,00,000	
	To Bank Account		11,00,000
(Amount paid to 8% preference shareholders on redemption)			
<hr/>			
5. Securities Premium Account	Dr.	1,00,000	
	To Premium on Redemption of Preference Shares Account		1,00,000

Note: In the foregoing illustration it would be observed that Equity Share Capital and 9% Preference Share Capital replace the 8% Redeemable Preference Shares thus maintaining the capital structure of the company.

Illustration 6: (Redemption of preference shares partly out of profit and partly from the fresh proceeds)

The following is the Balance Sheet of Kushagr Limited as on 31 December 2011.

	₹		₹
Share capital:			
5,000 12% Redeemable Preference Shares of Rs. 100 each	5,00,000	Fixed Assets	24,00,000
10,000 Equity Shares of Rs. 100 each	10,00,000	Stock	5,00,000
Capital Reserve	1,00,000	Debtors	50,000
Securities Premium Account	1,00,000	Cash	50,000
General Reserve	2,00,000		
Profit and Loss Account	1,00,000		
Current Liabilities	10,00,000		
	-----		-----
	30,00,000		30,00,000

The Preference Shares are to be redeemed on 1 January, 2012 at 10% premium.

On 1 January, 2012 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 unitizing the proceeds of fresh issue was met by raising a bank loan, the cash balance of Rs.50,000 being the minimum to company requires for its trading operations.

Draft journal entries in the books of the company to record the transaction.

Journal Entries

2012		₹	₹
Jan.1	12% Redemption 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 on redemption)		
Jan.1	Bank Account	Dr. 2,00,000	
	To Share Application and Allotment Account		2,00,000
	(Fresh issue of 2,000 shares for the purpose of redemption)		
Jan.1	Share Application and Allotment Account	Dr. 2,00,000	
	To Equity share Capital Account	2,00,000	
	(Allotment of 2,000 equity shares)		
Jan.1	Bank Account	Dr. 3,50,000	
	To Bank Loan Account		3,50,000
	(Raising of bank loan of Rs.3,50,000 for redemption of 5,000 (preference shares at 10% premium.)		

Jan.1	Preference Shareholders Account	Dr.	5,50,000	
	To Bank			5,50,000
	(Payment to preference shareholders on redemption)			
Jan.1	General Reserve Account	Dr.	2,00,000	
	Profit and Loss Account	Dr.	1,00,000	
	To Capital Redemption Reserve Account			3,00,000
	(Balance of accumulated profits and general reserve transferred to Capital Redemption Reserve Account)			
Jan.1	Securities Premium Account	Dr.	50,000	
	To Premium for Redemption Account			50,000
	(Premium paid on redemption taken from Share Premium Account)			

Illustration 7: A company has 4,000 6% redeemable preference shares of Rs.100 each fully paid. The company decided to redeem the shares on December 31, 2012 at a premium of 5%. The Company makes the following issues:

- 1,000 equity shares of Rs. 100 each at a premium of 10%.
- 1,000 9% debentures of Rs. 100 each

The issue was fully subscribed and all the amounts were received. The redemption was duly carried out.

The company has sufficient profits. Give journal entries.

Solution:

Journal

		₹	₹
2012			
Dec.31	Bank A/c	Dr.	1,10,000
	To Equity Share Application & Allotment A/c		1,10,000
	(Receipt of application money on 1,000 shares @ Rs. 110 each)		
Dec.31	Equity Share Application & Allotment A/c	Dr.	1,10,000
	To Equity Share Capital A/c		1,00,000
	To Securities Premium A/c		10,000
	(Transfer of application money on issue of 1,000 shares of Rs. 100 each at a premium of 10%)		
Dec.31	Bank A/c	Dr.	1,00,000
	To 9% Debenture Application & Allotment A/c		1,00,000

	(Receipt of application money on 1,000 debentures of Rs. 100 each)		
Dec.31	9% Debentures Application & Allotment A/c	Dr.	1,00,000
	To 9% Debenture A/c		1,00,000
	(Transfer of application money on issue of 1,000 debentures of Rs. 100 each)		
Dec.31	Securities Premium A/c	Dr.	10,000
	Profit & Loss A/c	Dr.	10,000
	To Premium on Redemption A/c		20,000
	(Premium on redemption provided partly out of Securities premium and partly out of profit)		
Dec.31	Profit & Loss Appropriation A/c	Dr.	3,00,000(1)
	To Capital Redemption Reserve A/c		3,00,000
	(Amount transferred, being the amount uncovered by fresh issue of shares)		
Dec.31	Redeemable Preference Share Capital A/c	Dr.	4,00,000
	Premium on Redemption A/c	Dr.	20,000
	To Redeemable Preference Shareholder's A/c		4,20,000
	(Amount due on redemption of Preference Shares at 5% premium)		
Dec.31	Redeemable Preference Shareholder's A/c	Dr.	4,20,000
	To Bank A/c		4,20,000
	(Payment made)		

Note: Preference shares cannot be redeemed out of the proceeds of issue of debentures because the Act lays down that such share can be redeemed either out of the profits of the Company or out of the proceeds of fresh issue of shares. As such, the amount transferred of Capital Redemption Reserve is:

	₹
Nominal value of Redeemable Preference Shares	4,00,000
Less: Nominal Value of fresh issue of Equity Shares	1,00,000
	3,00,000

Illustration 8: Rudra Ltd. has an issued share capital of 650, 7% redeemable preference shares of Rs. 100 each and 4,500 equity shares of Rs. 50 each. The preference shares are redeemable at a premium of 7.5 % on April, 2012. The company's balance sheet as on March 31, 2012 was as follows:

Liabilities	Amount	Assets	Amount
Share Capital:		Fixed Assets	3,45,000
Issued:650,7% Redeemable Preference Shares of Rs. 100 each fully paid		Investments	18,500
4,500 Equity Shares of Rs. 50 each fully	65,000	Balance at Bank	31,000
	2,25,000		
Profit and Loss Account	2,90,000		
Sundry Creditors	48,000		
	56,500		
	3,94,500		3,94,500

In order to facilitate the redemption of the preference shares, the company decided:

- to sell all the investment for Rs. 16,000
- to finance part of the redemption from company funds, subject to leaving a balance of Rs. 12,000 in the profit and loss account and,
- to issue sufficient equity shares of Rs. 50 each at a premium of Rs 13 per share to raise the balance of funds required.

The preference shares were redeemed on the due date and the issue of equity shares was fully subscribed. You are required to prepare: (i) the necessary journal entries to record the above transactions (including Cash) and (ii) the balance sheet as on completion.

Solution:

Rudra Ltd.

Journal Entries

Date	Particulars	Debit	Credit
		Amount	Amount
	Bank Account Dr.	16,000	
	Profit and Loss Account Dr.	2,500	
	To Investment Account		18,500
	(Sale of investment for Rs. 16,500; loss debited to P& L A/c)		
	Bank A/c Dr.	39,690	
	To Share Application and Allotment Account		39,690
	(Application money received for 630 equity shares of Rs. 50 each at a premium of Rs. 13)		
	Share Application and Allotment Account Dr.	39,690	
	To Equity Share Capital Account		31,500
	To Securities Premium Account		8,190

(Allotment of 630 equity shares of Rs. 50 each at a premium of Rs. 13 per share)			
7% Redeemable Preference Share Capital Account	Dr.	65,000	
Premium on Redemption Account	Dr.	4,875	
To Preference Shareholder Account			69,875
(Amount payable on redemption)			
Preference Shareholder Account	Dr.	69,875	
To Bank Account			69,875
(Payment to preference shareholders on redemption at a premium of 7.5%)			
Surplus Account	Dr.	33,500	
To Capital Redemption Reserve Account			33,500
(Transfer out of profit an amount equal to nominal value of shares redeemed out of divisible profits)			
Securities Premium Account	Dr.	4,875	
To Premium on redemption Account			4,875
(Premium payable on redemption charged to securities premium account)			

Balance Sheet of Rudra Ltd. As At.....

Particulars	Note	₹	₹
I Equity AND LIABILITIES			
1. Shareholders' Fund			
(a) Share Capital	1	2,56,500	
(b) Reserves and Surplus	2	48,815	
			3,05,315
2. Current Liabilities			
Trade Payables (Creditors for goods)		56,500	56,500
Total Equity and Liabilities			3,61,815
II ASSETS			
1. Non-Current Assets			

(a) Fixed Assets		
Tangible Assets		3,45,000
2. Current Assets		
Cash and Cash Equivalents	3	16,815
		3,61,815

Notes to Accounts

Particulars	₹	₹
1. Share capital		
Issued , subscribed and fully paid up		
5,130 Equity shares of Rs. 50 each		2,56,500
Reconciliation		
Balance As per last Balance sheet:		
4,500 Equity Shares of Rs. 50 each Fully Paid	2,25,000	
630 Equity Shares Issued for the purpose of redemption of 7% Redeemable Preference Shares 5,130 Equity Shares of Rs. 50 each	31,500	
	2,56,500	
7% Preference Share capital		
Balance as per Last Balance Sheet	65,000	
Less: Redeemed	65,000	

2. Reserves and Surplus		
(a) Capital Redemption Reserves (Redemption out of divisible profit)		33,500
(b) Securities Premium (From issue of fresh Equity share for the purpose of redemption)		3,315
(c) Surplus		
Balance As per Last Balance Sheet	48,000	
Less: Loss on sale of Investment	(2,500)	
Transfer to Capital Redemption Reserve	(33,500)	12,000
		48,815
3. Cash and cash equivalents		

Cash at Bank	31,000
Balance as per Last balance sheet	16,000
Sale of investment(for redemption purpose)	39,690
From Issue of Fresh shares	86,690
Less: Provision to Preference shareholders	69,875
[65,000+ 4,875 (Premium on Redemption)]	16,815

Working Notes

(i) Amount of Equity share to be issued	₹
Surplus A/c	48,000
Less: Loss on sale of Investment	2,500
	45,500
Less: Amount to be retained	12,000
	33,500
(ii) Nominal value of Equity Shares to be Issued	
(65,000 – 33,500)	31,500

Illustration 9: The following is the balance Sheet of Basanti Ltd. as on March 31, 2012:

Liabilities	Amount	Assets	Amount
Authorized Capital			
70,000 Equity Shares of Rs. 10 each	7,00,000	Fixed Assets	6,90,000
20,000,6% Preference Shares of Rs. 10 each	2,00,000	Current Assets (including Bank balance)	3,22,000
	9,00,000		
Issued:			
39,000 Equity Shares of Rs. 10 each fully paid	3,90,000		
16,000,6% Redeemable Preference Shares of Rs. 10 each	1,60,000		
Profit and Loss Account	3,70,000		
Sundry Creditors	92,000		
	10,12,000		10,12,000

The preference shares were redeemed on 1 April 2012 at a premium of ₹ 2 per share, the whereabouts of the holders of 1,200 such shares being not known. The company issued 10,000 equity shares of Rs. 10 each at a premium of Rs. 2 per for redemption.

You are required to prepare: (i) the necessary journal entries to record the above transactions and (ii) the balance sheet as on completion.

Solution:

Basanti Ltd.
Journal Entries

Date	Particulars	Debit Amount	Credit Amount
	Bank A/c Dr. To Share Application and Allotment Account	1,20,000	1,20,000
	Share Application and Allotment Account Dr. To Equity Share Capital Account To Securities Premium Account 6% Redeemable Preference Share Capital Account Dr. Premium on Redemption Account Dr. To Preference Shareholder Account	1,20,000 1,60,000 32,000	1,00,000 20,000 1,92,000
	Preference Shareholder Account Dr. To Bank Account	1,77,600	1,77,600
	Surplus Account Dr. To Capital Redemption Reserve Account	60,000	60,000
	Securities Premium Account Dr. Profit and Loss Account Dr. To Premium on redemption Account	20,000 12,000	32,000

Balance Sheet of Basanti Ltd. As At.....

Particulars	Note	₹	₹
I Equity AND LIABILITIES			
1. Shareholders' Fund			
(a) Share Capital	1	4,90,000	
(b) Reserves and Surplus	2	3,58,000	
		8,48,000	
2. Current Liabilities			
(a) Trade Payables	3	92,000	

(b) Other Current Liabilities	4	14,000	1,06,400
Total Equity and Liabilities			9,54,400
II ASSETS			
1. Non-Current Assets			
(a) Fixed Assets			
Tangible Assets			6,90,000
2. Current Assets			
Cash and Cash Equivalents	5		2,64,000
Total Assets			9,54,000

Notes to Accounts

Particulars	₹	₹
1. Share capital		
Authorized		
20,000 6% Preference Share of Rs. 10 each		2,00,000
70,000 Equity Shares of Rs. 10 each		7,00,000
		<u>9,00,000</u>
Issued , subscribed and fully paid up		
49,500 Equity shares of Rs. 10 each fully paid		4,90,000
Reconciliation		
Equity share capital (Issued , subscribed fully paid up)		
Balance As per last Balance sheet:	3,90,000	
Fresh issue of Equity Shares Issued for the purpose of redemption of 6% Preference Shares	1,00,000	
	<u>4,90,000</u>	
6% Preference Share capital		
Balance as per Last Balance Sheet	1,60,000	
Less: Redeemed	<u>1,60,000</u>	

2. Reserves and Surplus		
(a) Capital Redemption Reserves (Transfer from surplus after Redemption of preference shares)		60,000
(b) Securities Premium		
From issue of fresh Equity share	20,000	
Less: Premium on redemption of preference shares	<u>20,000</u>	

(c) Surplus		
Balance As per Last Balance Sheet	3,70,000	
Less: Premium of redemption of preference shares	(12,000)	
Transfer to Capital Redemption Reserve	(60,000)	2,98,000
3. Trade Payables		
Creditors for Goods		
4. Other Current Liabilities		
Owing to non-traceable Preference Shareholder		3,58,000
3. Cash and cash equivalents		
Balance as per Last balance sheet		92,000
From Issue of Fresh shares		14,400
Less: Payment to Preference shareholders [65,000+ 4,875 (Premium on Redemption)]		3,22,000
		1,20,000
		4,42,000
		(1,77,600)
		2,64,400

Working Notes

(j) Capital Redemption Reserve Account	₹
Nominal Value of Preference Shares	1,60,000
Less: Loss on sale of Investment	1,00,000
	<u>60,000</u>
(ii) Payment to preference Shareholders	
Total Amount Due (1,60,000 + 32,000)	1,92,000
Less: Amount unpaid to nontraceable shareholder	14,400
	<u>1,77,600</u>

Illustration 10: Pass necessary entries in the following cases:

- For redemption of 1,000 8% Redemption Preference Shares of Rs. 100 each at a premium of 5%, the company issued 8,000 equity shares of Rs. 10 each at a premium of 10%.
- For redemption of 2,000 Redeemable Preference shares of Rs. 100 each at a premium of 10%, the Company issued 22,000 12% new preference shares of Rs.10 each at par.

Solution:**Journal**

		₹	₹
(1) Bank A/c	Dr.	88,000	
To Equity Share Application & Allotment A/c			88,000
(Receipt of application money on 8,000 equity shares @ Rs. 11 each)			
Equity Share Application & Allotment A/c	Dr.	88,000	
To Equity Share Capital A/c			80,000
To Securities Premium A/c			8,000
(Transfer of application money on issue of 8,000 shares of ₹ 10 each at 10% premium)			
Securities Premium A/c	Dr.	5,000	
To Premium on Redemption A/c			5,000
(Premium on redemption provided out of premium on issue of shares)			
P & L Appropriation A/c	Dr.	20,000	
To Capital Redemption Reserve A/c			20,000
(Amount uncovered by the fresh issue of shares transferred)			
8% Redemption Pref. Share Capital A/c	Dr.	1,00,000	
Premium on Redemption A/c	Dr.	5,000	
To Redeemable Pref. Shareholder's A/c			1,05,000
(Amount due)			
Redeemable Pref. shareholder's A/c	Dr.	1,05,000	
To Bank			1,05,000
(Amount paid)			

Note: If the amount of securities premium received on issue of shares exceeds the premium payable on redemption, the excess amount will be left unutilized.

		₹	₹
(2) Bank A/c	Dr.	2,20,000	
To 12% Preference Share Application & Allotment A/c			2,20,000
(Application money received on 22,000 preference shares of ₹ 10 each)			
12% Preference Share Application & Allotment A/c	Dr.	2,20,000	
To 12% Preference Share Capital A/c			2,20,000
(Transfer of application money on issue of 22,000 preference Shares of ₹ 10 each)			
P & L A/c	Dr.	20,000	
To Premium on Redemption A/c			20,000
(Premium on redemption provided out of P&L A/c)			

12% Redeemable Pref. Share Capital A/c	Dr.	2,00,000	
Premium on Redemption A/c	Dr.	20,000	
To Redemption Pref. Shareholder's A/c			2,20,000
(Amount due)			
Redeemable Pref. Shareholder's A/c	Dr.	2,20,000	
To Bank A/c			2,20,000
(Amount due)			

Illustration 11: The following items appear in the Balance Sheet of Murti Limited as on 31st March, 2012:

- (i) Share Capital
- Equity -
- Authorized -- 5,00,000 shares of ₹ 10 each
- Issued, subscribed, called and paid up -- 4,00,000 shares of ₹ 10 each
- Preference -
- Authorized, issued and subscribed -- 60,000, 12% preference shares of ₹ 20 each fully paid.
- (ii) Investments - ₹3,50,000
- (iii) Profit & Loss Account (Credit Balance)-Rs. 7,00,000

It was decided to redeem the preference shares at a premium of 5% as on 31st March, 2000. It was further decided to:

- (a) Sell investment for ₹ 3,00,000;
- (b) Finance part of the redemption from company funds, subject to leaving a balance of Rs. 2,00,000 in the profit and loss account; and
- (c) Issue sufficient number of equity shares at a premium of ₹ 2 to raise the balance of the funds required.

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

Solution:

Journal of Murti Ltd.

		₹	₹
(1) Bank A/c	Dr.	3,00,000	
Profit & Loss A/c	Dr.	50,000	
To Investment A/c			3,50,000
(Sale of investments at loss)			
Profit & Loss Appropriation A/c	Dr.	4,50,000	
To Capital Redemption Reserve A/c			4,50,000

(Transfer of available balance in Profit & Loss A/c to Capital

Redemption reserve A/c)

Bank A/c	Dr.	9,00,000	
To Equity Share Application & Allotment A/c			9,00,000
(Application money received on 75,000 equity shares @ ₹12 each)			
Equity Share Application & Allotment A/c	Dr.	9,00,000	
To Equity Share Capital A/c			7,50,000
To Securities Premium A/c			1,50,000
(Transfer of application money on issue of 75,000 equity shares of Rs.10 each at a premium of Rs. 2 each)			
Securities Premium A/c	Dr.	60,000	
To Premium on Redemption A/c			60,000
(Premium on redemption provided out of securities premium)			
12% Redeemable Preference Share Capital A/c	Dr.	12,00,000	
Premium on Redemption A/c	Dr.	60,000	
To Preference Shareholder's A/c			12,60,000
(60,000 Preference Shares of Rs. 20 each de for redemption at a premium of 5%)			
Preference Shareholder's A/c	Dr.	12,60,000	
To Bank A/c			12,60,000
(Preference shares redeemed)			

Working note (1) Calculation of amount transferred to Capital Redemption Reserve:

	₹
Balance in Profit & Loss Account	7,00,000
Less : Loss on sale investments	50,000
	6,50,000
Less : Retention of Rs. 2,00,000 in Profit & Loss Account	2,00,000
	4,50,000
Profit Available for financing the redemption 4,50,00	

Redemption when Calls are in Arrears

Preference Shares on which calls are in arrears cannot be redeemed until the call money is collected from them in full

Redemption of partly-paid Preference Shares

It has been made compulsory under Section 80(a) that partly paid preference shares must be always made fully paid-up before redemption takes place. The amount of call should be collected in cash from partly-paid preference shareholders.

The purpose of imposing the restriction that the preference shares must be fully paid before they can be redeemed is to protect the interests of creditors who calculate the security of their loans on the basis of the face value and not the paid up value of the issued capital. As such, it is not the paid up value but the face value of the shares which requires replacement. Thus, the fresh issue of shares or the Capital Redemption Reserve will have to be created equal to the face value of redeemable preference shares and hence the security available to creditors remains intact when preference shares are redeemed.

Illustration 12: Balance Sheet of A Ltd. as on 31st December, 2012 was as follows:

		₹			₹
Share Capital					
20,000 Equity Shares of Rs.10 each	2,00,000	Sundry Assets	2,80,000		
10,000 12% Redeemable Preference Shares of Rs.10 each, Rs.8 paid	80,000	Investment	30,000		
Sundry Creditors	42,000	Cash at Bank	70,000		
Profit & Loss A/c	58,000				
	3,80,000		3,80,000		

On the above date Directors gave notice to redeem the Preference Shares at a premium of 5%. In order to provide cash towards the redemption of the preference shares all the investment were sold for Rs. 25,000. Directors desire that minimum number of fresh equity shares be issued at par. Show journal entries.

Solution:

1. Since partly paid shares cannot be redeemed, a final call of Rs.2 per share will be made and received in cash.

	Rs.
Balance in Profit & Loss A/c	58,000
Less: Loss on sale on Investments	5,000
	53,000
Less: Premium payable on redemption (5% on Rs. 1,00,000)	5,000
	48,000

As such, only ₹ 48,000 can be transferred from Profit & Loss A/c to Capital Redemption Reserve A/c. Hence new issue required is ₹ 1,00,000-Rs. 48,000 = ₹ 52,000

Journal Entries

		₹	₹
2012			
Dec. 31	Redeemable Preference Share Final Call A/cDr.	20,000	
	To Redeemable Preference Share Capital A/c		20,000
(Final call of Rs. 2 per share due)			
Dec.31	Bank A/c	Dr.	20,000

	To Redeemable Preference share Final Call A/c		20,000
	(Receipt of final call on redeemable preference shares)		
Dec.31	Bank A/c	Dr.	25,000
	Profit & Loss A/c	Dr.	5,000
	To Investments A/c		30,000
	(Investments sold at a loss of Rs.5,000)		
Dec.31	Profit & Loss A/c	Dr.	5,000
	To Premium on Redemption A/c		5,000
	(Premium on redemption provided out of Profit & Loss A/c)		
Dec.31	Profit & Loss A/c	Dr.	48,000
	To Capital Redemption Reserve A/c		48,000
	(Profit transferred to Capital Redemption Reserve)		
Dec.31	Bank A/c	Dr.	52,000
	To Equity Share Application & Allotment A/c		52,000
	(Receipt of application money)		
Dec.31	Equity Share Application & Allotment A/c	Dr.	52,000
	To Equity Share Capital A/c		52,000
	(Transfer of application money on issue of 5,200 new equity Shares of Rs. 10 each)		
Dec.31	12% Redeemable Preference Share Capital A/c	Dr.	1,00,000
	Premium on Redemption A/c	Dr.	5,000
	To Redeemable Preference Shareholders A/c		1,05,000
	(Amount due)		
Dec.31	Redeemable Preference Shareholder's A/c	Dr.	1,05,000
	To Bank A/c		1,05,000
	(Payment made)		

Buy-back of Shares

Companies (Amendment) Act, 1999 vide sections 77A, 77AA and 77B has allowed Companies to purchase their own shares subject to fulfillment of certain conditions.

Conditions for Buy-back:

- (i) The buy-back should be authorized by the Articles of Association of the company.
- (ii) A special resolution is to be passed in the General Meeting of the company authorizing the buy-back. The Companies (Amendment) Act 2001 has authorized the buy-back by passing a resolution at a meeting of the Board of Directors provided the buy-back does not exceed 10% of the total paid up equity capital and free reserves of the Company. However, there cannot be more than one such buy-back in any period of 365 days.

- (iii) The buy-back of the shares cannot exceed 25% of the total paid-up capital and free reserves of the company. However, the buy-back of equity shares in any financial year cannot exceed 25% of its total paid-up equity capital in that financial year.
- (iv) The ratio of the debt owed by the Company should not be more than twice the capital and its free reserve after such buy-back. In other words, the debt-equity ratio should not be more than 2:1 after the buy-back.
- (v) All the shares for buy-back should be fully paid-up.
- (vi) The buy-back should be completed within 12 months from the date of passing the special resolution.
- (vii) The Company must file a 'declaration of solvency' with the Registrar of Companies and the Securities and Exchange Board of India (SEBI), in the form of an affidavit signed by at least two directors of the Company, one of them being managing director, if any. The affidavit must state that the Board of Directors has made a full inquiry into the affairs of the Company as a result of which they have formed an opinion that the Company is capable of meeting its liabilities and will not be rendered insolvent within a period of one year from the date of declaration adopted by the Board.
- (viii) The buy-back of the shares listed on any stock exchange should be in accordance with the regulations made by the Securities and Exchange Board of India (SEBI) in this behalf.
- (ix) A Company that buys-back its own shares is required to extinguish and physically destroy such shares within 7 days of the last date of completion of buy-back in the presence of merchant bankers or Registrar or Statutory Auditor.

Where a Company buys-back its shares, it shall not make further issue of shares within a period of 24 months except by way of bonus issue or in the discharge of some obligations such as conversion of preference shares or debentures into equity shares.

Sources for Buy-back

A Company may buy-back its own shares from out of:

- (i) Its free reserves; or
- (ii) The securities premium account; or
- (iii) The proceeds of any shares or other specified securities.

SEBI Guidelines

Guidelines announced by SEBI stipulate as follows:

1. Buy-back shall be permissible:
 - (a) From the existing shareholders on a proportionate basis; or
 - (b) From the open market; or
 - (c) From old lot holders, that is to say, where the lot of shares is smaller than tradable lot;

Or

 - (d) By purchasing the shares issued to employees of the Company pursuant to a scheme of stock option or sweat equity.

To Bank A/c value of shares repurchased)

(3) If the shares are bought-back at a discount, the entry will be:

Share Capital A/c Dr. (with the nominal value)

To Bank A/c (with the amount paid)

To Capital Reserve A/c (with the amount of discount)

(4) If the shares are bought back at a premium, the entry will be:

Share Capital A/c Dr. (with the nominal value)

General Reserve/Securities

Premium A/c Dr. (with the additional amount)

To Bank A/c (with the total)

(5) If the buy-back is made out of free reserves, the nominal value of the shares purchased shall be transferred to Capital Redemption Reserve Account. Free Reserves are those reserves which as per the latest audited balance sheet of the company, are free for distribution as dividend and will include Securities Premium Account. The entry will be:

Free Reserves A/c Dr.

To Capital Redemption Reserve A/c

Illustration 13: Shahrugh Ltd. purchases its 15,000 equity shares of Rs. 10 each @ Rs. 12 per share. No fresh issue is made for this purpose. Made necessary entries.

Solution:

Journal Entries

		₹	₹
(i)	General Reserve A/c	Dr.	1,50,000
	To Capital Redemption Reserve A/c		1,50,000
	(Transfer of Rs. 1,50,000 from General Reserve to Capital Redemption Reserve Account, the nominal amount of equity Shares bought back out of free reserves)		
(ii)	Equity Share Capital A/c	Dr.	1,50,000
	General Reserve A/c	Dr.	30,000
	To Equity Shareholder's A/c		1,80,000
	(Amount payable to the Equity Shareholder's on buy-back of 15,000 Equity share of Rs. 10 each at Rs. 12 per share)		
(iii)	Equity Shareholder's A/c	Dr.	1,80,000
	To Bank A/c		1,80,000
	(Payment made to equity shareholders for buy-back of shares)		

Illustration 14: Sumita Ltd. had Authorized Capital of Rs.20 Crores of Rs. 100 each, equity shares and an Issued and subscribed Capital of Rs.10 Crores. The Company decided to buy-back 25% of its

share capital direct from its shareholders at ₹ 75 per share. The company had issued Rs. 2 Crores, 10% preference share two months back for the purpose of buy-back. The balance in the following Account were:

Securities Premium Account	₹ 10,00,000
General Reserve Account	₹ 80,00,000

Record the transactions in the books of the company in accordance with the provisions of Section 77A.

Solution:

Journal Entries

		₹	₹
(i)	Securities Premium A/c	Dr.	10,00,000
	General Reserve A/c	Dr.	40,00,000
	To Capital Redemption Reserve A/c		50,00,000
	(Transfer of ₹ 10,00,000 from Securities Premium Account and ₹ 40,00,000 from General Reserve to Capital Redemption Reserve Account)		
(ii)	Equity Share Capital A/c	Dr.	2,50,000
	To Capital Reserve A/c		62,50,000
	To Equity Shareholder's A/c		1,87,50,000
	(Amount payable to the Equity Shareholder's on buy-back Of 2,50,000 equity shares of Rs.100 each at ₹ 75 per share)		
(iii)	Equity Shareholder's A/c	Dr.	1,87,50,000
	To Bank A/c		1,87,50,000
	(Payment made to equity shareholder's for buy-back of shares)		

Illustration 15: Carry and Carry Ltd. passed a resolution to buy back 40,000 of its fully paid equity shares of Rs. 10 each at Rs.13 per share. For this purpose, it issued 15,000 , 12% preference shares of Rs.10 each at par, the entire sum being payable with application. The company uses Rs. 50,000 of its balance in Securities Premium Account apart from its adequate balance in General Reserve Account.

Pass journal entries for all the transactions involved in the buy-back.

Solution:

Journal

		₹	₹
(i)	Bank A/c	Dr.	1,50,000
	To 12% Preference Share Application & Allotment A/c		1,50,000
	(Receipt of application money on 15,000 preference shares @ ₹ 10 per share)		

(ii)	12% Preference Share Application & Allotment A/c	Dr.	1,50,000	
	To 12% preference Share Capital A/c			1,50,000
	(Money received on 12% Preference Share Capital being capitalized)			
(iii)	Securities Premium A/c	Dr.	50,000	
	General Reserve A/c	Dr.	2,00,000	
	To Capital Redemption Reserve A/c			2,50,000
	(Transfer of amount to Capital Redemption Reserve Account for Buy-back of equity shares to the extent not covered by fresh issue Of preference shares)			
(iv)	Equity Share Capital A/c	Dr.	4,00,000	
	General Reserve A/c	Dr.	1,20,000	
	To Equity Shareholders A/c			5,20,000
	(Amount payable to equity shareholders on buy-back of 40,000 Equity shares at Rs. 13 per share)			
(v)	Equity Shareholders A/c	Dr.	5,20,000	
	To Bank A/c			5,20,000
	(Payment made to equity shareholders for buy-back of shares)			

Illustration 16: The following is the Balance Sheet of Axe Ltd. as on 31st March, 2012

Liabilities	Amount	Assets	Amount
		₹	₹
Share Capital:		fixed Assets	71,00,000
8,00,000 Equity Shares of		Investment	12,00,000
₹ 10 each fully paid	80,00,000	Stock	30,00,000
Securities Premium	15,00,000	Sundry Debtors	25,00,000
General Reserve	13,50,000	Cash and Bank Balance	20,00,000
Profit & Loss Account	8,10,000		
8% Debentures	20,00,000		
Term Loan	8,70,000		
Sundry Creditors	10,20,000		
Provision for Taxation	2,50,000		
	<u>1,58,00,000</u>		<u>1,58,00,000</u>

The shareholders approved the scheme of buy-back of equity shares as under:

- Buy-back 20% of the equity shares @ ₹ 16 each
- Issue 9% debentures of Rs.6,00,000 at a premium of 5% to finance the buy-back of shares.

- (iii) Sell investments worth Rs. 5,00,000 for Rs. 6,00,000
- (iv) Maintain a balance of Rs. 4,00,000 in general reserve.
- (v) Securities premium be utilized only for premium paid on buy-back of shares.

Pass journal entries to record the above transaction.

Solution:

Journal of Axe Ltd.

		₹	₹
Bank A/c	Dr.	6,30,000	
To 9% Debentures A/c			6,00,00
To Securities Premium A/c			30,000
(Issue of debentures at premium)			
Bank A/c	Dr.	6,00,000	
To Investment A/c			5,00,000
To Profit & Loss			1,00,000
(Sale of investment at profit)			
General Reserve A/c	Dr.	9,50,000	
Profit & Loss Appropriation A/c	Dr.	6,50,000	
To Capital Redemption Reserve A/c			16,00,000
(Required amount i.e. nominal value of 20% of equity capital Of Rs. 80,00,000 transferred to capital redemption reserve account)			
Equity Share Capital A/c	Dr.	16,00,000	
Securities Premium A/c	Dr.	9,60,000	
To Equity Shareholders A/c			25,60,000
(Amount payable to equity shareholders on buy-back of 1,60,000 Shares @ Rs.16 per share)			
Equity shareholders A/c	Dr.	25,60,000	
To Bank A/c			25,60,000
(Payment made to equity shareholders for buy-back of shares)			

Illustration 17 The balance sheet of Honey Ltd. as on 31st march 2012 is as follow:

Liabilities	Amount	Assets	Amount
Equity shares of Rs.10	3,00,000	Fixed Assets :	
Preference shares of Rs.100	1,00,000	Net Block	800000
Securities Premium Account	1,50,000	Investments	100000
General Reserve	1,00,000		
Profit and Loss account	1,00,000		

Debtures	8,00,000		
Current Liabilities	1,00,000		
	1,65,0000		1,65,0000

Honey Ltd. buys 6,250 equity shares @ Rs.30 each, being the current market price.

Assume that the buy-back has been carried out as per provisions of the Companies Act. Journalize the transactions in the books of Honey Ltd. and prepare balance sheet afterwards.

Solution:

Honey Ltd.
Journal Entries

Date	Particulars	Debit	Credit
		Amount	Amount
(i)	Equity share capital account Dr. Premium on Buy Back of Shares Account Dr. To Equity Shareholders Account (Being the amount due on buy back of 6,250 equity shares)	62,500 1,25,000	1,87,500
(ii)	General Reserve Account Dr. To Capital Redemption Reserve Account (being the creation of capital redemption reserve equivalent to the nominal value of equity share bought back)	62,500	62,500
(iii)	Equity share holders account Dr. To bank account (being the payment to equity shareholders)	1,87,500	1,87,500
(iv)	Securities Premium Account Dr. To Premium on buy back of shares (being premium on buy back of shares written off to securities premium account)	1,25,000	1,25,000

Balance Sheet of Honey Ltd. As At.....

Particulars	Note	₹	₹
1. Equity AND LIABILITIES			
1. Shareholders' Fund			
(a) Share Capital	1	3,37,500	
(b) Reserves and Surplus	2	2,25,000	5,62,500
2. Non- Current Liabilities			
Long Term Borrowings	3	8,00,000	8,00,000
3. Current Liabilities			
		1,00,000	1,00,000

II. Total Equity and Liabilities			14,62,500
ASSETS			
1. Non-Current Assets			
	(a) Fixed Assets (Net block)	8,00,000	
	(b) Non-Current Investment	1,00,000	9,00,000
2. Current Assets			
	Cash and Cash Equivalents		5,62,500
Total Assets			14,62,500

Notes to Accounts

Particulars	₹	₹
1. Share capital		
Authorized		
Issued , subscribed and fully paid up		1,00,000
1,000 Preference Share of Rs. 100 each		2,37,500
23,750 Equity Shares of Rs. 10 each		<u>3,37,500</u>
Reconciliation		
Equity share capital		
Balance As per last Balance sheet (30,000 share)	3,00,000	
Buy-Back (6,250 share)	62,500	
Balance 23,750 shares @ ₹ 0 each		
	<u>2,37,500</u>	
2. Reserves and Surplus		
(a) Capital Redemption Reserves		
Transfer from General Reserve (On Buy Back)		
(b) Securities Premium		
Balance b/d		
Less: Utilized for Premium on Buy-back		62,500
(c) General Reserve	1,50,000	
Balance As per Last Balance Sheet	1,25,000	
Less: Utilized for Buy Back		25,000
(d) Surplus		
	1,00,000	
	<u>62,500</u>	
		<u>37,500</u>

3. Long term Borrowing		1,00,000
Secured Debentures		2,25,000
3. Cash and cash equivalents		8,00,00
Balance as per Last balance sheet		
Less: Payment to Equity shareholders		7,50,000
		(1,87,500)
		5,62,500

Illustration 18 Priya Ltd. furnishes you with the following Balance sheet as at 31st March, 2012:

Particulars		
Source of Funds:		
Share Capital:		
Authorised		
Issued:		100
12% redeemable Preference shares of Rs.100 each fully paid	75	
Equity shares of Rs.10 each fully paid	25	
Reserve and Surplus:		
Capital reserve	15	
Securities premium	25	
Revenue reserves	260	300
		400
Funds employed in :		
Fixed assets : cost	100	
Less: Provision for depreciation	100	Nil
Investments at cost (market value Rs.400 Cr.)		100
Current Asssets	340	
Less: Current Liabilities	40	300
		400

Solution

Priya Ltd
Journal Entries

Date	Particulars		Debit	Credit
			Amount (Crore)	Amount (crore)
(i)	Revenue reserve account	Dr.	75	
	To capital redemption reserve account			75
	(being redemption of preference shares out of reserve or divisible profit)			
(ii)	12% preference share capital account	Dr.	75	
	To preference shareholders account			75
	(Being amount payable on redetion of preference shares)			
(iii)	Preference shareholders account	Dr.	75	
	To bank account			75
(iv)	Equity share capital	Dr.	5	
	Premium on buy back of equity shares account	Dr.	20	
	To equity shareholders account			25
(v)	Revenue reserve account	Dr.	5	
	To capital redemption reserve account			5
	(being creation of capital redemption reserve account equivalent to nominal value of equity shares bought back)			
(vi)	Equity shareholders account	Dr.	25	
	To bank account			25

Balance Sheet of Priya Ltd.

As at 31st March 2012

	Particulars	Note	Rs.(crore)	Rs.(crore)
1	Equity AND LIABLITIES			
	1. Shareholders' Fund			
	(a) Share Capital	1	20	
	(b) Reserves and Surplus	2	280	300
	2. Current Liabilities			40
	Total Equity and Liabilities			340

II	ASSETS		
	1. Non-Current Assets		
	(a) Fixed Assets		
	Tangible assets	3	
	(b) Non-Current Investment	4	
	2. Current Assets		
	Cash and Cash Equivalents	5	240
	Total Assets		340

Note to Accounts

	Particulars	Rs. (crore)	Rs. (crore)
I	SHARE CAPITAL		
	(i) Authorized		
	(ii) issued, subscribed and fully paid up		
	200 lakhs equity shares of Rs.10 each		
	Reconciliation		
	Equity share capital		
	Balance as per last balance sheet (250)	25	
	Less: Bought back 50 lakhs of Rs.10 each	5	
		20	
II	Preference share capital		
	Balance sheet As per Last Balance sheet	75	
	Less: redeemed	75	
2.	RESERVES AND SURPLUS		
	(i) capital reserve		15
	(ii) capital redemption reserve		
	Transfer from Revenue Reserve (on redemption of preference shares)	75	
	Transfer from revenue reserve on buy back	5	
	(iii) Securities Premium		25
	(iv) revenue reserve		
	As per last balance sheet transfer to capital	260	

	Redemption reserve:		
	For redemption of preference shares	(75)	
	For buy back of equity shares	(5)	
	Premium on redemption of buy back	(20)	160
			280
3.	Tangible Assets		100
	Gross Block		(100)
	Provision for Depreciation		—
4.	Non Current Investments (cost)		100
	Unspecified (Market value 400 crores)		
5.	Current Assets including Bank balance		
	Balance b/d		340
	Less: paid to Preference Shareholders		(75)
			265
	Less: paid to equity shareholders		(75)
			240

LESSON 3

DEBENTURES

Dr. Rakesh Gupta
PGDAV (Evening) College
University of Delhi

Debentures are the medium through which a company can raise loans from public. Debentures are the acknowledgement of debt issued under the common seal of the company. It contains a contract for the repayment of the principal sum at a specified date and for the payment of interest (usually half-yearly) at a fixed rate percent until the principal sum is repaid.

Section 2(12) of the companies ACT, 1956 states that, "Debenture includes debenture stock, bonds and any other security of the company whether constituting a charge on the company's assets or not".

According to Mr. Topham, "A debenture is a document given by a company as evidence of a debt to the holder usually arising out of a loan and most commonly secured by a charge".

Issue of Debenture

At the time of issue of debenture, the procedures and accounting entries are very similar to that of issue of shares. The only difference is that in case of debenture, the debenture account is to be credited instead of Share capital account while transferring the amount of allotment and call. A prospectus has to be prepared and issued. The intending lenders apply for debentures in the company on a prescribed form which is deposited with the company's bankers along with the application & money. The applicant may deposit the whole amount along with the application or by installment. After issue of debentures, the same procedure will be followed as per the issue of shares.

Methods of Issue of debenture

There are three methods of issue of debentures:

1. Issue of Debenture for Cash
2. Issue of Debenture for consideration other than cash
3. Issue of Debenture as collateral security

Issue of Debenture for Cash

At the time of issue of debentures for cash, debenture may be issued at par, at premium or at discount, just like shares. There are no legal restrictions, on the issue of debentures at premium, and on the utilization of the amount of premium on issue of debentures, because premium is capital profit, not to be utilized for payment of dividend, generally debentures are issued at par and the amount of debentures is collected in two installments, i.e., on application and on allotment.

When debenture issued at par

The accounting entries will be made:

(a) on receipt of applications:

Bank a/c	Dr.	(With the application money received)
To Debenture Application a/c		

(b) on acceptance of applications and transferring the application money to debenture account:-

{i} Debentures Application a/c	Dr.	(With the amount of application money on the allotment debenture)
To Debenture a/c		

c. On making allotment money due

Debenture Allotment a/c

Dr. (With the amount due on allotment

To Debentures a/c

of the debentures)

(d) On the receipt of allotment money

Bank a/c

Dr. (With the amount actually received

To Debentures Allotment a/c

on allotment)

When debenture issued at discount

Debentures are issued at discount when the amount received on it is less than its face value. For example: if a debenture of Rs.1000 issued for ₹ 950, then this is an issue of debentures at discount. ₹50 is the discount shown on the asset side of the balance sheet under miscellaneous Expenditure.

Generally discount is allowed on debenture at the time of allotment, other entries remain same except allotment. The entries for allotment as under:

1. When Allotment money due

Debenture Allotment A/c

Dr.

Discount on issue of debenture A/c

Dr.

To X% debenture A/c

2. When allotment money received

Bank A/c

Dr.

To Debenture Application A/c

Debenture issued at Premium: Debenture are issued at premium means when debenture is issued more than its face value.

(e.g.,) A debenture of ₹ 10 issued for ₹ 12, ₹ 2 is a premium. Premium on Issue of debentures represents a capital profit and should be transferred to capital reserve.

Generally discount is allowed on debenture at the time of allotment, other entries remain same except allotment. The entries for allotment as under:

1. When Allotment money due

Debenture Allotment A/c

Dr.

To X% debenture A/c

To Securities premium A/c

2. When allotment money received

Bank A/c

Dr.

To Debenture Application A/c

Over-subscription of Debentures

When more applications are received than offered for subscription of debenture, it is known as over-subscription of debentures. In such a case the company may make allotment as same as in the case of shares that is:

Rejection of Applications: The Company has full authority to reject the excess applications. Application money received from such applicants is returned to them in full.

Partial or pro rata Allotment : When there is over-subscription of debentures and applicants are allotted debentures in final proposition. Such an allotment is called pro-rata allotment. Like, Applicants of ₹10,000 debentures are allotted 8,000 debentures. In such a situation, excess application money is adjusted towards allotment money.

Full allotment : When company allotted full to some applicants, partial allotment to others, while no allotment to the rest. In such a case, application money is returned to whom no debentures are allotted. Where partial adjustment is made excess application money received is adjusted towards allotment.

Illustration 1 : (Over-subscription of debentures) Sneha Ltd issued ₹10,000 10% debentures of ₹ 100 each payable: ₹ 20 on application; ₹ 40 on allotment; and ₹ 40 three months after allotment.

The public applied for 12,000 debentures. Applications for 9,500 debentures were accepted in full; applicants for 1000 debentures were allotted 500 debentures and the remaining applications were rejected.

Solution:

S.N	Particulars	L F	Dr. Amount	Cr. Amount
1.	Bank A/c Dr. To debenture application A/c (Being debenture application money received on 12000 debentures at 20 Per debenture)		2,40,00	2,40,00
2.	Debenture application A/c Dr. To 10% debenture A/c To debenture allotment A/c To Bank A/c (Being debenture application money transferred to debenture account & excess money adjusted on allotment & remaining money refunded)		2,40,000	2,00,000 10,000 30,000
	Debenture Allotment A/c Dr. To 10% Debenture A/c (Being Allotment money due)		4,00,000	4,00,000
	Bank A/c Dr. To Debenture Allotment A/c (Being Allotment money received)		3,90,000	3,90,000
	Debenture 1st & final Call A/c Dr. To 10% debenture Account (Being share final call money due)		2,00,000	2,00,000
	Bank A/c Dr. To Debenture 1st & final call A/c (Being share final call money received)		2,00,000	2,00,000

Working Note:

Total application Received	Debenture allotted
9,500	9,500
1,000	500
1,500	Nil
12,000	10,000

Money received from applicant of 1,000 debentures on application = $1,000 \times 20 = 20,000$

Money adjusted on 500 shares allotted to them = $500 \times 20 = 10,000$

Excess money transferred to allotment account = 10,000

Money received from 1,500 debenture will returned to them as no debentures were allotted to them.

Terms of issue and Redemption of Debenture

Debentures may be issued at par, at a premium or discount, and redemption at par, redemption at premium, redemption at discount.

S.no.	Condition Of Issue	Condition Of Redemption
(i)	Issued at par	Redeemable at par
(ii)	Issued at discount	Redeemable at par
(iii)	Issued at premium	Redeemable at par
(iv)	Issued at par	Redeemable at premium
(v)	Issued at discount	Redeemable at premium
(vi)	Issued at premium	Redeemable at Premium

The journal entries for the above cases:

(i) When debentures are issued at par and are redeemable at par.

Bank A/C	Dr.	(With the nominal value of the debentures)
To debentures A/C		

(ii) When debentures are issued at a discount, but are redeemable at par:

Bank A/C	Dr.	(With an amount actually received)
Discount on issue of debentures a/c	Dr.	(With the discount allowed)
To Debentures		(with the nominal value of the debentures)

(iii) When debentures are issued at a premium but are redeemable at par:

Bank a/c	Dr.	(with the amount actually received)
To Debentures a/c		(with the nominal value of the debentures)
To premium on debentures a/c		(with the amount of premium)

(iv) When debentures are issued at par but are redeemable at a premium, i.e., in excess of the nominal value)

Bank a/c	Dr.	(with the actual amount received)
----------	-----	-----------------------------------

Loss on issue of debentures a/c Dr. (With the amount of premium on redemption)
 To Debentures a/c (with the nominal value of the debentures)
 To premium on redemption of Debentures a/c (with the premium on redemption)

(v) When debentures are issued at discount but are redeemable at a premium

Bank a/c Dr. (with the actual amount received)
 Loss on issue of debentures a/c Dr. (with the amount of discount on issue Plus premium on redemption)
 To Debentures a/c (with the nominal value of debentures)
 To premium on redemption of debentures a/c (with the premium payable at the Time at redemption)

Notes:

- (i) Debentures are always credited with the nominal value of the debentures.
- (ii) Premium on redemption of debentures is a personal account, which represents A liability of the company in represent of premium payable on redemption.

(vi) Issued at premium, redeemed at premium

Bank a/c Dr. (With the amount actually received)
 Loss on Issue of Debentures a/c Dr. (With the amount of prem. Payable at premium)
 To Debenture a/c (Face value of debenture)
 To Premium on Redemption of Debentures a/c (with the premium payable at the Time at redemption)
 To Premium on issue of Debenture a/c (with the premium payable at the Time at issue)

Illustration 2 : (Debentures are issued at par and redeemable at par)

Leena Ltd, issued 800, 15% non-convertible debentures of ₹ 1,000 each at par and redeemable at par. Give Journal Entry.

Solution:

Journal Entry

Date	Particular	Dr.	Cr.
	Bank a/c Dr	8,00,000	
	To 15% debentures a/c		8,00,000
	(Being debentures issued at par and Redeemable at par)		

Illustration 3 : (Debentures are issued at discount and redeemable at par)

Journalize the following transactions:-

Z ltd issued ₹ 40,000, 12% debentures at a discount of 5%, redeemable at par?

Solution:

Date	Particulars	Dr.	Cr.
	Bank a/c	Dr. 3,80,000	
	Discount on issue of Debentures a/c	Dr. 20,000	
	To 12% Debentures a/c		4,00,000
	(Being the issue of 12% Debentures at a discount Of 5% and redeemable at par)		

Illustration 4 : (Debentures are issued at a premium and are redeemable at par)

White Ltd issued ₹ 40,000 12% debentures at a premium of 5% redeemable at par. Give journal entry.

Solution:

Journal entry

Date	Particulars	Dr.	Cr.
	Bank a/c	42,000	
	To 12% Debentures a/c		40,000
	To Premium on issue of Debentures a/c		2,000
	(Being debentures issued at premium and redeemable at Par)		

Illustration 5: (Debentures are issued at par and are redeemable at premium)

White Ltd, issued Rs. 40,000 12% debentures at par and redeemable at 10% premium. Pass journal entry.

Solution

Date	Particulars	Dr.	Cr.
	Bank a/c	Dr. 40,000	
	Loss on Issue of debentures a/c	Dr. 2,000	
	To 12% Debentures a/c		40,000
	To premium on redemption of Debentures a/c		2,000
	(Being debentures issued at par and redeemable at Premium)		

Illustration 6 :- (Debenture are issued at discount but are redeemable at premium).

Blue Ltd, issued Rs.10,000 debentures at a discount of 5%, redeemable at a premium of 7%.

Solution :-

Journal of Blue Ltd

Date	Particular	Dr.	Cr.
	Bank a/c Dr.	9,50,000	
	Loss on Issue of debentures a/c Dr.	1,20,000	
	To debentures a/c		10,00,000
	To premium on redemption of Debenture a/c		70,000
	(Being the issue of debenture at Discount of 5% and redeemable at a Premium at 7%)		

Illustration 7 :- (Terms of Issue and redemption) journalize the following Transaction:-

- A debentures issued at Rs.95, repayable at ₹ 100
- A debentures issued at Rs.95, repayable at ₹ 105
- A debentures issued at Rs100, repayable at ₹ 105
- A debentures issued at Rs.105, repayable at ₹ 100.

Note :- The face value of each debentures is ₹ 100

Solution :-

Journal Entries

Date	Particular	Dr.	Cr.
(a)	Bank a/c Dr.	95	
	Discount on issue of Debentures a/c Dr.	5	
	To Debenture a/c		100
	(Being issue of Debenture of ₹ 100 at a Discount of 5%)		
(b)	Bank a/c Dr.	95	
	Loss on issue of Debenture a/c Dr.	10	
	To Debenture a/c		100
	To premium on Redemption of Debentures a/c		5
	(Being issue of debenture of ₹ 100 at Discount of 5% repayable at a premium of 5%)		

(c)	Bank a/c	Dr.	100	
	Loss on Issue of debentures a/c	Dr.	5	
	To Debentures a/c			100
	To premium on Redemption of Debenture a/c			5
	(Being issue of debentures of ₹ 100 at par repayable at a premium of 5%)			
(d)	Bank a/c	Dr.	105	
	To Debentures a/c			100
	To premium on issue of debentures a/c			5
	(Being issue of Debentures of ₹100 at a premium of 5% and repayable at par)			

Illustration 8 : (Various terms of issue and redemption). Pass the Journal Entries:

- A company issued ₹ 80,000 , 12% Debentures at a discount of 10% Redeemable at par;
- A company issued ₹ 80,000 , 12% Debentures at a premium of 5% Redeemable at par;
- A company issued ₹ 80,000, 12% Debentures at a par redeemable at 10% Premium; and
- A company issued ₹ 80,000, 12% Debentures at a discount at 5% and redeemable at 5% premium.

Note : The face value of 12% debentures is Rs.100

Solution :

Journal Entries

Date	Particular	Dr.	Cr.	
(a)	At the time of issue:			
	Bank a/c	Dr.	72,000	
	Discount on issue of Debentures a/c	Dr.	8,000	
	To 12% debentures a/c		80,000	
	(For the issue of 800, 12%, debenture of ₹ 100 each at a discount of 10% redeemable at par)			
(b)	Bank a/c	Dr.	84,000	
	To 12% Debentures a/c		80,000	
	To premium on issue of Debentures a/c		4,000	

	(For issue of 800, 12% debenture of ₹ 100 each at a premium of 5% redeemable at par)		
c.	Bank a/c	Dr.	80,000
	Loss on Issue of Debentures a/c	Dr.	8,000
	To 12% Debentures a/c		80,000
	To premium on redemption at debentures a/c		8,000
	For issue of 800, 12% debentures at ₹ 100 each at par redeemable at 10% premium)		
d.	Bank a/c	Dr.	76,000
	Loss on issue of Debentures a/c	Dr.	8,000
	To 12% Debentures a/c		80,000
	To premium on Redemption Of debentures a/c		4,000
	(For issue of 800, 12% debentures of ₹ 100 each at a discount of 5% Redeemable at 5% premium)		

Writing off of Discount and loss on Issue of Debentures:

If debenture are issued at discount or it is redeemable at premium, the amount of discount or amount of premium is treated as loss for the company. But this loss is not debited to the P&L a/c in the same year but it is to be written off in the several year keeping in the mind the maturity date of debenture. The written off part is debited to the P&L a/c and the balance amount will be shown on the asset side of balance sheet under the heading 'Miscellaneous Expenditure' as it is treated a fictitious asset.

Profit & loss or capital Reserve a/c Dr.

 To Discount (or loss) on issue of Debentures a/c

There are two methods of writing of discount:

(1) Fixed installment method or where debenture are to be redeemed after a specified period: (when whole debentures are to be redeemed after a fixed period)

Under this method, total amount of discount is spread over the life of debentures equally. Therefore this is also called equal installment method. The amount of discount calculated annually by dividing the total amount of discount by the numbers of years after which the debentures will be redeemed.

$$\text{Amount of discount written off annually} = \frac{\text{Total amount of discount on debenture}}{\text{No. of year after which debenture are to be redeemed}}$$

(2) Proportionate benefit method or Fluctuate installment method : according to this method when debentures are to be redeemed in installments then the total amount of discount/loss on issue is

written off in the proportion of debentures amount outstanding at the beginning of the year. Basis of this method is benefits received from debentures fund every year.

Illustration 9 : (Equal Installment method): S Limited company issues ₹ 40,000 debentures on 1st Jan. 2004 at a discount of 5%, repayable at the end of 5 years. The books are closed on 31st Dec. every year.

Show the discount account in the ledger for the period.

Solution : **Discount on Issue of Debentures**

Dr. Cr.

Date	Particulars	Amount	Date	Particulars	Amount
1.1.04	To Debenture A/c	1,000	31.12.04	By P&L A/c	200
			31.12.04	By bal c/d	800
		1,000			1,000
1.1.05	To bal b/d	800	31.12.05	By P&L A/c	200
			31.12.05	By bal c/d	600
		800			800
1.1.06	To bal b/d	600	31.12.06	By P&L A/c	200
			31.12.06	By bal c/d	400
		600			600
1.1.07	To bal b/d	400	31.12.07	By P&L A/c	200
			31.12.07	By bal c/d	200
		400			400
1.1.08	To bal b/d	200	31.12.08	By P&L A/c	200
		200			200

(2) Second Method : (When debentures are to be redeemed in the installment)

When debentures are to be redeemed in installment. In that case the loss on issue of debentures should be written off each year in the ratio in which the amount of debentures has been available. This method also called 'proportionate method' or 'variable installment method', because the total discount is written off during the life time of debentures in proportion to the debentures outstanding at the beginning of each year.

For example : Company issues 2,000 debentures of ₹ 100 each at a discount of 6% and the debentures are to be repaid by equal installment of ₹ 40,000 at the end of year.

Beginning	Outstanding Debentures(₹)	Ratio	Amount of Discount to be written off.
I year	2,00,000	20 or 10	12,000* 10/20 = ₹ 6,000
II year	1,60,000	8 or 4	12,000* 4/20 = ₹ 2,400
III year	1,20,000	6 or 3	12,000* 3/20 = ₹ 1,800
IV year	80,000	4 or 2	12,000* 2/20 = ₹ 1,200
V year	40,000	2 or 1	12,000* 1/20 = ₹ 600
		20	12,000

In this example, the amount of discount Rs.(2,00,000*6/100)

= 12,000

To 11% Debentures a/c		81,800
To premium on issue of debenture a/c		8,200
(Being 820 [₹ 90, 000 /110] debentures of ₹ 100 each issued at premium of 10% to the vendor)		

When the business of another company purchased by the company the following journal entries will be passed in the books of purchasing company:

Sundry assets	Dr.	(With the agreed value of asset taken over)
Goodwill	Dr.	(With excess at purchase consideration over the value of net assets)
To sundry Liabilities		(with the agreed value of liability taken over)
To vendor's a/c		(with purchased consideration)
To capital Reserve a/c		(with excess of value of net assets over the Purchase consideration)

If the value of net assets is not equal to the purchase price, there are two possibilities as under:

- If the company is agreed to pay more than the value of net assets, the payment in excess of the value of net assets is considered to be on account of the good reputation of the vendor and is debited to good will account.
- If the company is required to pay less than the value of net assets taken over. This gain is not due to business operations in the ordinary course so it is treated as capital profit and transferred to capital Reserve.

Illustration 11 : (Issue of debentures to vendors at premium)

The Ratan Ltd. took over assets of ₹ 10,00,000 and liabilities of ₹ 80,000 of Mohan Ltd. For the purchase consideration of ₹ 9,90,000. The Ratan Ltd. paid the purchase consideration by issuing debentures of ₹ 100 each at 10% premium. Give Journal Entries in the book of Ratan Ltd.

Solution :

Date	Particular	Dr.	Cr.
	Sundry assets a/c	Dr.	10,00,000
	Goodwill a/c	Dr.	70,000
	To liabilities a/c		80,000
	To Mohan Ltd.		9,90,000
	(Being the purchase of assets & liabilities of Mohan Ltd.)		
	Mohan Ltd a/c	Dr.	9,90,000
	To Debentures a/c		9,00,000
	To premium on issue of debenture a/c		90,000
	(Being issue of Debenture at 10% premium)		

Working notes :

(i) **Calculation of amount of debentures :** For making payment of ₹ 9,60,000 company has to issue $9,90,000 \div 110 = 9,000$ debentures of ₹ 100 each i.e. 9,00,000

Illustration 12 :- (Issue of debentures to vendors at discount). The Ratan Ltd. Purchased assets of ₹ 7,40,000 and took over Liabilities of ₹ 80,000 at an agreed value of ₹ 5,40,000. the Ratan Ltd, issued debentures at 10% discount in full satisfaction of the purchase price. Give Journal entries in the book of Ratan Ltd.

Solution:

Date	Particular		Dr.	Cr.
	Sundry assets a/c	Dr.	7,40,000	
	To sundry liabilities a/c			80,000
	To capital Reserve a/c			1,20,000
	To vendor company a/c			5,40,000
	Being purchased of assets and liabilities of Vendor Company)			
	Vendor company a/c	Dr.	5,40,000	
	Discount on issue of debenture a/c	Dr.	60,000	
	To Debenture a/c			6,00,000
	(Being issue of debentures at 10% discount)			

Calculation of amount of debentures:

$5,40,000 \div 190 = 6000$ debentures of ₹ 100 each of 10% discount

Debentures are of ₹ 6,00,000 and discount is 10% of ₹ 6,00,000 i.e., 80,000

Illustration 13 (Issue of debentures to vendors with part payment in cash)

A ltd, purchase plant and machinery for Rs. 4,00,000 payable as to Rs.1,30,000 in cash and the balance by an issue of 6% debentures of Rs. 1,000 each at a discount 10%?

Solution:

Date	Particulars		Dr.	Cr.
	Plant and machinery a/c	Dr.	4,00,000	
	To vendor's a/c			4,00,000
	(being assets purchase from vendor for Rs. 4,00,000)			
	Vendor's a/c	Dr.	4,00,000	

Discount on issue of Debentures A/C Dr	30,000	
To cash a/c		1,30,000
To 6% Debentures a/c		3,00,000
(being cash paid to vendors ₹ 1,30,000 for balance issue of debentures at 10% discount)		

Illustration 14: (Issue of debentures to vendors with part payment in cash)

A company purchased and established business for ₹ 8,00,000 payable ₹ 2,60,000 in cash and the balance by 12% Debentures of ₹ 100 at a discount of 10%. Give journal entries.

Solution:

Date	Particulars	Dr.	Cr.
	Business purchase a/c Dr.	8,00,000	
	To vendor's a/c		8,00,000
	(Being business purchased from vendor for ₹ 8,00,000)		
	Vendor's a/c Dr.	2,60,000	
	To cash a/c		2,60,000
	(Being part payment in cash to the vendor)		
	Vendor's a/c Dr.	5,40,000	
	Discount on Issue of Debentures a/c Dr.	60,000	
	To 12% Debentures a/c		6,00,000
	(Being 6,000[₹ 5,40,000 / ₹ 90] debentures of ₹ 100 each issued at discount of 10% to Vendors)		

Illustration 15: (Issue of debenture to vendors with part payment)

R Ltd., purchased building for ₹ 4,40,000. Half the payment was made in cash and the remaining half by issue of 12% debentures at a premium of 10%. Pass Journal Entries.

Solution:

RLtd.

Journal Entries

Date	Particulars	Dr.	Cr.
	Building a/c Dr.	4,40,000	4,40,000
	To vendor a/c		
	(Being building purchased)		
	Vendor a/c Dr.	2,20,000	
	To cash a/c		2,20,000
	(Being half the payment made in cash)		
	Vendor a/c Dr.	2,20,000	

To 12% Debentures a/c	2,00,000
To premium on Issue of debenture a/c (Being half the payment made by issue of Debenture at a premium of 10%)	2,000

$$\text{No. of Debenture Issued} = \frac{\text{Purchase price}}{\text{Issue price of Debentures}}$$

$$= \frac{\text{₹ 4,40,000} - \text{₹ 2,20,000}}{\text{₹ 110}}$$

$$= 2,000$$

Issue of debentures as collateral security

When debentures are issued on a subsidiary or secondary security, this is known as Issue of Debentures as collateral security. In other words, collateral security means secondary security. It is in addition to the principal security given for a loan. Collateral security is to be realized only when the principal security fails to pay the amount of loan. The issue of debentures as collateral security can be dealt with in two ways:-

(1) No journal entry is made in the account books at the time of issue of such debentures. The loan against which debentures have been issued as a collateral security will be recorded as a liability in the usual way, this is ,

Bank A/c Dr.

To Loan A/c

Illustration 16: Bimla Ltd. obtained a loan for 5 years from Bank of India for Rs. 2,00,000 against the security of Plant and Machinery. In addition, it deposited 12% debenture of Rs. 1,50,000 as collateral security. Pass the necessary entry and prepare balance sheet with relevant portion only.

Solution :

Journal Entry

Bank A/c	Dr.	2,00,000
To Loan from Bank of India		2,00,000
(Being loan from Bank of India against Plant and machinery and depositing of Rs. 1,50,000 12% debenture as collateral security)		

Balance Sheet

Particulars	Note	Figures as at the End of Current Accounting Reporting Period
EQUITY AND LIABILITIES		
Non Current Liabilities		
Long term borrowing	1	2,00,000
		2,00,000

II	ASSETS		
	Current Assets		2,00,000
	Cash and cash Equivalents	2	

Notes to Accounts

Particulars	Figures as at the End of Current Accounting Reporting Period
1 Long Term Borrowing	
Loan	
(secured against plant and machinery and the issue of ₹ 1,50,000 debentures as collateral security)	2,00,000
	2,00,000
2. Cash and cash equivalents	
Cash at Bank	2,00,000
	2,00,000

(2) when the debenture issued as collateral security is to be record in the books, the following Journal Entries will be made:

(a) On taking of loan

Bank A/c Dr.

To Bank Loan A/c

(b) On issue of debenture as collateral security

Debenture suspense A/c Dr.

To Debentures a/c

Illustration 17: Madhuri Ltd. took a loan of 10 lakhs for 5 years from Syndicate Bank against the security of its tangible assets. As assets were old so company further deposited 11% debentures of Rs. 6 lakhs as collateral security.

Pass Journal entry and prepare a balance sheet.

Solution :

Journal Entry

Bank A/c	Dr.	10,00,000	
To Loan from Bank of India			10,00,000
(Being loan from Bank of India against tangible assets and depositing of Rs. 6,00,000 11% debenture as collateral security)			
Debenture Suspense A/c	Dr.	6,00,000	
To 11% Debenture A/c			6,00,000

	Particulars	Note	Figures as at the End of Current Accounting Reporting Period
	EQUITY AND LIABILITIES		
	Non Current Liabilities		
	Long term borrowing	1	16,00,000
			16,00,000
II	Assets		
	Non Current Assets		
	Other non-current assets	2	6,00,000
	Current Assets		
	Cash and cash Equivalents	3	10,00,000

Notes to Accounts

Particulars	Figures as at the End of Current Accounting Reporting Period
1 Long Term Borrowing	
(a) Bank Loan (secured against tangible assets and the issue of Rs. 6,00,000 , 11% debentures as collateral security)	10,00,000
(b) 11% Debenture (Issued as collateral security)	6,00,000
	16,00,000
2. Other Non Current assets	
Debenture Suspense account	6,00,000
3. Cash and cash equivalents	
Cash at Bank	10,00,000

Redemption of Debenture

Meaning of Redemption of Debenture

Debenture holder is the creditor for the company. They provide funds to the company as a loan which has to be return by company to the debenture holder after an agreed period. Redemption of debenture means paying back the amount of debenture to debenture holders or refunding their loans. Debentures are generally redeemed on the due date but if article of the company permits and terms of issue as stated in the prospectus allowed then the debentures may be refunded before the due date either by installment or by purchasing them in the open market.

Sources of Redemption of Debentures

The company has available the following sources to redeem the debentures:

- 1. Issue of new share and debenture:** when a company needs funds for redemption of debenture, it can utilize the proceeds from fresh issue of shares or debentures.
- 2. Out of profit:** Every rational company retains a part of its profit and can utilize this profit for the redemption of debenture.
- 3. Out of capital:** A company can also redeem its debentures by proceeds from sale of asset but this is not generally a wise decision and it must be avoided.

Methods of Redemption of Debenture

A company may redeem its debenture by way of following methods:

- (1) Lump Sum Method
- (2) Installment by draw of lot
- (3) Purchase in open market
- (4) Conversion
- (5) Sinking fund
- (6) Insurance policy

- (1) **Lump Sum Method:** under this method, the debentures are redeemed at the end of the specified period. There may be following conditions of redemption of debenture:

(a) when debenture redeemed at par:

- (i) When debentures are due for payment:

Debenture A/c Dr.
 To Debenture holder's A/c

- (ii) When payment is made to debenture holder:

Debenture A/c Dr.
 To Bank A/c

(b) When debentures are redeemed at premium:

- (i) When debentures are due for payment:

Debenture A/c Dr.
 Premium on Redemption A/c Dr.
 To Debenture holder's A/c

- (ii) When payment is made to debenture holder:

Debenture A/c Dr.
 To Bank A/c

A company may opt any of the following two options for redeeming its debenture under Lump sum method:

- (a) Out of capital
- (b) Out of profit

Redemption of debenture out of capital:

Generally, every company transfers a sufficient amount of its profit to the Debenture Redemption Reserve Account (DRR) for the redemption of debenture. But if adequate amount of profit not transferred to DRR A/c before the redemption of debenture, such redemption is said to be redemption out of capital.

Illustration 18: (Out of capital) Rani Ltd. Redeemed 10,000, 10% debenture of Rs.10 each on 31st Dec. 2008, which were issued at par. Pass necessary entries assuming that these debentures are redeemed: (i) at par. (ii). at a premium of 10%.

Solution:

Date	Particulars	L.F.	Amount	Amount
31.12.08	(i) At Par 10% Debenture A/c Dr. To Debenture holder A/c (being amount due for 10,000, 10% debentures of Rs.10 each)		1,00,000	1,00,000
	Debenture holder A/c Dr. To Bank A/c (being the amount paid to debenture holder)		1,00,000	1,00,000
31.12.08	(ii) At a premium of 10%: 10% Debenture A/c Dr. Premium on redemption A/c Dr. To Debenture holder A/c (Being the amount due for redemption on premium)		1,00,000 10,000	1,10,000
	Debenture holder A/c Dr. To Bank A/c (Being amount paid to debenture holder)		1,10,000	1,10,000

Redemption of debenture Out of profit

It means that adequate profits are transferred from P&L Appropriation A/c to Debenture Redemption Reserve (DRR) A/c for the redemption of debenture before the redemption of debenture. It is mandatory for every company to transfer a sufficient amount to DRR A/c. DRR A/c shown on the liability side on the balance sheet under the heading 'reserve and surplus'

The following additional entry need to be passed when debentures are redeemed out of profit:

When DRR is created:

Surplus A/c Dr.
 To Debenture Redemption Reserve A/c

Note: As per the SEBI guidelines, it is required for every company to create DRR an amount equivalent to 50% of the amount of total debenture issued before the commencement of redemption of debenture. But, for Infrastructure Companies and company who issues debentures for less than a period of 18 months, is not mandatory to create DRR.

(2) Redemption of Debenture by draw of lot

This method is known as lottery method. Under this method, the name of all debenture holders are written on the slips which are put in a box and out of these slips some slips are drawn randomly out of the box. The Debentures are redeemed of those debenture holders, whose names are written on the slip drawn. All the entries under this method remain same as discussed earlier.

(3) Redemption of Own Debenture by purchase in the Open Market:

Debentures can be purchased by the company from the Open Market if the article of the company permits to do so. Generally, a company purchases their debenture from Open Market when interest rate in the market is low as compare to interest rate on its own debentures. By doing so, the company can discharge their liability before maturity. Debentures are purchased by the company for immediate cancellation or for investment purpose.

Case I When debentures are purchased for immediate cancellation:

(1) When Debentures are purchased at its face value:

(a) When debentures are purchased:

Own debenture A/c	Dr.
To Bank A/c	

(With the purchase price of debenture)

(b) For Cancellation of debenture:

Debenture A/c	Dr.
To Own Debenture A/c	

(2) When debentures are purchased at less than its face value:

(a) When debentures are purchased:

Own debenture A/c	Dr.	
To Bank A/c		

(With the purchase price of debenture)

(b) For cancellation of debenture:

Debenture A/c	Dr.	(Face value)
To Own Debenture A/c		(purchase price)
To Profit on cancellation of debenture A/c		
(Excess of face value over purchase price)		

(c) On transfer of profit on cancellation:

Profit on cancellation of debenture A/c	Dr.
To capital reserve A/c	

Case II: When debentures are purchased from Open market for investment purpose.

(1) on the purchase of debenture:

Investment in own debenture A/c Dr.
 To bank A/c

(2) When debenture are resold in the market:

(a) when own debenture are sold at a price less than the purchase price.

(i) Bank A/c Dr.

Loss on sale of investment A/c Dr.
 To investment in own debenture A/c

(ii) when loss transferred to P&L A/c

P&L A/c Dr.

To loss on sale of investment A/c

(b) when own debenture are sold at a price more than the purchase price.

(i) Bank A/c Dr.

To investment in own debenture A/c

To profit on sale of investment A/c

(ii) Profit on sale of investment A/c Dr.

To P&L A/c

Illustration 19: Bansal constructions Ltd. Issued 10,000 8% Debentures of ₹ 500 each. The board of directors decided to purchase 1,000 debentures at a price of ₹ 485 each for:

(i) immediate cancellation

(ii) for investment purpose, assuming that investment is sold at ₹ 510 each.

Pass the necessary entries assuming that there is sufficient balance in DRR.

Solution: (i) immediate cancellation

Date	Particulars	L.F.	Amount	Amount
	Own debenture A/c Dr. To Bank A/c (being purchase of own debenture)		4,85,000	4,85,000
	8% debenture A/c Dr. To own debenture A/c To profit on cancellation A/c (being the cancellation of own debenture)		5,00,000	4,85,000 15,000
	Profit on cancellation A/c Dr. To capital reserve A/c (being transfer of profit on redemption to capital reserve A/c)		15,000	15,000

Discount on issue of share/debenture A/c Dr.

To share capital/new debenture A/c

Illustration 20: Kajal Ltd. redeemed 3,000, 10% debentures of Rs. 100 each which were issued at a premium of 5% as follows:

- (i) 1,200, 10% debentures are converted into equity share of Rs. 100 each at a premium of 25%.
- (ii) 1,800, 10% debentures are converted into 8% pref. share of Rs. 100 each at a discount of 10%.

Pass necessary entries.

Sol.

Journal

Date	Particulars	L.F	Dr.	Cr.
			Amount	Amount
	10% debenture A/c Dr.		3,00,000	
	To debenture holder A/c			
	(Being debentures are due for redemption)			3,00,000
	Debenture holder A/c Dr.		1,20,000	
	To Eq. Share capital A/c			96,000
	To Securities Premium A/c			24,000
	(Being conversion of debenture into 960 equity share of ₹ 100 at 25% premium)			
	Debenture holder A/c Dr.		1,80,000	
	Discount on issue A/c Dr.		20,000	2,0,000
	To 8% Pref. share capital A/c			
	(Being conversion of debenture into 2,000 pref. share of ₹ 100 each at a discount of 10%)			

Working note:

$$\text{No. of equity share issued} = \frac{\text{Amount due to denture holder}}{\text{Issue price of share}} = \frac{1,20,000}{125}$$

$$\text{No. of Pref. Share issued} = \frac{1,80,000}{90} = 2,000$$

(III) Redemption of debenture by conversion into shares when debenture originally issued on discount:

If debentures which were originally issued at discount are converted into shares so the provision of section 79 should be followed, for this the amount for conversion of debenture into share should be the amount must equal to net proceeds from debenture. In such a case two situations may arise:

1. When debenture are converted before due date - in such a case the entries will be as follows:

- (i) when debentures are due for redemption

Debenture A/c Dr.	(Face value)
To Debenture holder A/c	(Net proceeds)
To Discount on issue of share A/c	(Discount amount)

- (ii) When debenture converted into shares

Debenture holder A/c Dr.
To Share capital A/c

2. When debenture are converted on due date- in such a case entries will be:

- (i) when debentures are due for redemption

Debenture A/c Dr.	(Face value)
To Debenture holder A/c	(Net proceeds)

- (ii) When debenture converted into shares

Debenture holder A/c Dr.
To Share capital A/c

Illustration 21: Ratan Ltd. redeemed 2,000 11% debenture of Rs. 100 each which were issued at a discount of 5% by converting them into equity shares of Rs. 10 each issued at a premium of 25%. Pass necessary journal entries assuming that:

- (i) Conversion is done before due date of Debenture
(ii) Conversion is done on due date

Solution: (i) Before maturity date

Journal

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
	10% debenture A/c Dr.		2,00,000	
	To debenture holder A/c			1,90,000
	To discount on issue of debenture A/c			10,000
	(Being debentures are due for redemption)			
	Debenture holder A/c Dr.		1,90,000	
	To Eq. Share capital A/c			1,52,000
	To Securities Premium A/c			38,000
	(Being conversion of debenture into 15,200 equity share of ₹ 10 at 25% premium)			

Working note:

$$\text{No. of equity share issued} = \frac{\text{Amount due to denture holder}}{\text{Issue price of share}} = \frac{1,90,000}{25} = 15,200 \text{ shares}$$

(ii) On maturity date

Journal

Date	Particulars	L.F	Dr. Amount	Cr. Amount
	10% debenture A/c Dr.		2,00,000	
	To debenture holder A/c			2,00,000
	(Being debentures are due for redemption)			
	Debenture holder A/c Dr.		2,00,000	
	To Eq. Share capital A/c			1,60,000
	To Securities Premium A/c			40,000
	(Being conversion of debenture into 16,000 equity share of Rs. 10 at 25% premium)			

Working note:

$$\text{No. of equity share issued} = \frac{\text{Amount due to denture holder}}{\text{Issue price of share}} = \frac{2,00,000}{12.5} = 16,000 \text{ shares.}$$

(5) Sinking fund Method

Debentures are to be redeemed after a specified period of time in future. Sometime companies set aside some amount every year out of profits for the redemption of debenture. As discuss earlier, debentures are redeemed after a specific period, and if we retain that amount of profit set aside for the purpose of redemption, that amount will not generate any income for the company. So this amount is invested by the company in some securities which yield interest/income for the company.

The Journal Entries for the Redemption of Debentures:

On Issue of Debentures:

Bank a/c Dr.
 To Debentures a/c

Through sinking fund method, the annual amount to be set aside is calculated taking into consideration the period and the rate of interest expected on investment. The Journal Entries will be at the end of the year:

First year

1. Surplus A/c Dr.

To sinking fund a/c

(With the amount set aside, as calculated with the help of sinking fund tables)

2. Sinking fund Investment a/c Dr.

To Bank a/c

(For Investing the amount set aside)

3. Second and Subsequent year

(i) Bank a/c Dr.

To Interest on sinking fund Investment a/c

(Interest received on sinking fund Investment)

(ii) Interest on sinking fund Investment a/c Dr.

To Sinking fund a/c

(Interest transferred to sinking fund)

(iii) Surplus a/c Dr.

To Sinking fund a/c

(Annual amount set aside)

(iv) Sinking fund Investment a/c Dr.

To Bank a/c

(Investment purchased)

Last year

1. Bank a/c Dr.

To Interest on sinking fund Investment a/c

(Interest received on Investment)

2. Surplus a/c Dr.

To Sinking fund a/c

(Annual amount set aside)

3. Bank a/c Dr.

To Sinking fund investment a/c

(Sinking fund Investment sold)

4. Interest on Sinking fund Investment a/c Dr.

To Sinking fund a/c

(Interest transferred to sinking fund)

5. Sinking fund Investment a/c Dr.

To Sinking fund a/c

(Profit on sale of investment transferred to sinking fund)

Note : In the case of lose on sale of Sinking fund investment, the above entry will be reversed

6. Debentures a/c Dr.

To Bank a/c

(Payment of Debentures)

7. Sinking fund a/c Dr.

To General Reserve a/c

(Balance of Sinking fund transferred to General Reserve)

ILLUSTRATION 22:- On 1st April 2006 Kishan Ltd. issued 4,420, 12% Debentures of ₹ 100 each at a discount of 10% redeemable at a premium of 5% after 4 years. It was decided to institute a Sinking fund for the purpose of accumulating sufficient funds to redeem the Debenture and to invest in some readily convertible securities yielding 10% interest p.a. Reference to the table shows that ₹ 1.00 p.a. at 10% compound interest amounts to ₹ 4.641 in 4 years. Investment are to be made in the Bonds of ₹ 100 each available at par.

On 31st March 2009, the investment realized ₹ 3,40,000-and debentures were redeemed. The bank balance as on that date was ₹ 45,000.

Required: Give the necessary journal entries and prepare Debenture Redemption Fund Account and Debentures Redemption Fund Investments Account for 4 years. (Ignore interest on Debentures and Writing off a Discount on Issue of Debenture)

Solution:

Journal of Kishan Ltd.

Date	Particular	L.F.	Dr. (₹)	Cr. (₹)
1.	Bank A/c Dr. To Debentures Application A/c (Being the receipt of application money)		3,97,800	3,97,800
	Debenture Application A/c Dr. Loss on Issue of Debenture A/c Dr. To 12% Debentures A/c To Debentures Redemption Premium A/c (Being the issue of 4,420, 12% Debenture of ₹ 100 each at 10% Discount & redeemable at 5% premium)		3,97,800 66,300	4,42,000 22,100
2.	Surplus A/c Dr. To Debenture Redemption Reserve A/c (Being the transfer of profit to DRR A/c to provide for redemption of debentures)		1,00,000	1,00,000
	Debenture Redemption Fund Investment A/c Dr. To Bank A/c		1,00,000	1,00,000

	(Being the Investment made in the multiples of Rs.100)			
3.	Bank a/c To Interest on DRFI A/c (Being the receipts of interest on investments)	Dr.	10,000	10,000
3.	Interest on DRFI A/c To Debenture Redemption Reserve A/c (Being the transfer of Interest on DRFI to DRR A/c)	Dr.	10,000	10,000
	Surplus To Debenture Redemption Reserve A/c (Being the transfer to profit to DRR A/c to provide for redemption of debenture)	Dr.	1,00,000	1,00,000
	Debentures Redemption Fund Investment A/c Dr To Bank A/c (Being the investment made in the multiple of Rs.100)		1,10,000	1,10,000
4.	Bank A/c To Interest on DRFI A/c (Being the receipt of Interest on DRFI to DRR A/c)	Dr.	21,000	21,000
	Interest on DRFI A/c To Debenture Redemption Reserve A/c (Being the transfer of Interest on DRFI to DRR A/c)	Dr.	21,000	21,000
	Surplus A/c To Debenture Redemption Reserve A/c Being the transfer of profit to DRR A/c to provide for the redemption of debentures)	Dr.	1,00,000	1,00,000
	Debenture Redemption Fund Investment A/c Dr To Bank A/c (Being the investment made in the multiple of Rs100)		121,000	1,21,000
5.	Bank A/c To Interest on DRFI A/c (Being the receipt of interest on DRFI)	Dr.	33,100	33,100
	Interest on DRFI A/c To Debenture Redemption Fund A/c	Dr.	33,100	33,100

(Being the transfer of interest on DRFI to DRR to DRR A/c)			
Surplus A/c	Dr.	1,00,000	
To Debenture Redemption Reserve A/c			1,00,000
(Being the transfer of profit to DRR A/c)			
Bank A/c	Dr.	3,40,000	
To Debenture Redemption Fund investment A/c			3,40,000
(Being the realization of Investments)			
Debenture Redemption Fund Investment A/c	Dr.	9,000	
To Debenture Redemption Reserve A/c)			9,000
(Being the transfer of profit on sale of Investment)			
15% Debenture A/c	Dr.	4,42,000	
Debentures Redemption Premium A/c	Dr.		
To Debenture-holder's A/c		22,100	
(Being the amount due on redemption)			
Debenture-holder's A/c	Dr.	4,64,100	
To Bank A/c			4,64,100
(Being the payment made due to Debenture-holders)			
Debenture Redemption Reserve A/c	Dr.	22,100	
To Loss on Issue of Debenture A/c			22,100
(Being the transfer of loss on issue of debentures equal to the amount of premium payable on redemption)			
Debentures Redemption Reserve A/c	Dr.	4,51,000	
To General Reserve A/c			
(Being the transfer of the balance in DRR A/c to General Reserve)			
			4,51,000

Dr. Debentures Redemption Fund Account Cr.

Date	Particular	₹	Date	Particular	₹
1.	To Balance c/d	1,00,000	1.	By Surplus A/c	1,00,000
	To Balance c/d	2,10,000		By Balance b/c	1,00,000
				By Interest to DRFI A/c	10,000

			By; Surplus A/c	1,00,000
		<u>2,10,000</u>		<u>2,10,000</u>
2.	To Balance c/d	3,31,000	By Balance b/d	2,10,000
			By; Interest on DRFI A/c	21,000
			By Surplus A/c	1,00,000
		<u>3,31,000</u>		<u>3,31,000</u>
3.	To Loss on Issue of Debenture A/c (premium)	22,100	By Balance b/d	3,31,000
	To General Reserve A/c	4,51,000	By Interest on DRFI A/c	33,100
		<u>4,73,100</u>	By Surplus A/c	1,00,000
			By Debenture Red. Fund Investment A/c (Profit)	9,000
				<u>4,73,100</u>

Dr. Debentures Redemption Fund Investment Account Cr.

Date	Particular	₹	Date	Particular	₹
1.	To bank a/c	1,00,000	1.	By Balance	1,00,000
	To Balance b/d	1,00,000		By Balance	2,10,000
	To Bank A/c	1,10,000			<u>2,10,000</u>
		<u>2,10,000</u>			
	To Balance b/d	2,10,000		By Balance	3,31,000
	To Bank A/c	1,21,000			<u>3,31,000</u>
		<u>3,31,000</u>			
	To Balance b/d	3,31,000		By Bank A/c (Sales)	3,40,000
	To Debenture Redemption Reserve A/c (profit)	9,000			<u>3,40,000</u>
		<u>3,40,000</u>			

Working Notes:

(i) Calculation of the amount of profit set aside	₹	Date
A face value of Debentures	4,42,000	
B Premium Payable on Redemption	22,100	
C Total Amount to be Redeemed(A+B)	4,64,100	
D Value of annuity per Re 1	4,641	
E Annual amount of profits to be set aside(C/D)	1,00,000	

Year (A)	Opening Balance(B)	Interest C=B*10/100	Savings D	Investments E=C+D	Closing Balance F=B+E
1	-----	-----	1,00,000	1,00,000	1,00,000
2	1,00,000	10,000	1,00,000	1,10,000	2,10,000
3	2,10,000	21,000	1,00,000	1,21,000	2,10,000
4	3,31,000	33,100	1,00,000	-----	-----

ILLUSTRATION 23 :- The following balances appeared in the books of a company on 1ST Jan 2012

12% Debentures ₹ 4,00,000

12% Debentures redemption reserve ₹ 3,00,000

12% Debentures Sinking Fund Investment ₹ 3,00,000

[Represented by 10% Rs.3,60,000 secured bonds of Govt. of India]

Annual contribution to the Debenture Redemption Reserve was ₹ 64,000 made on 31st Dec. each year. On 31st Dec., 2012, balance at bank was ₹ 2,00,000 after receipt of interest. The company sold the investment at 80% & debentures were paid off.

Required: Prepare the following accounts for the year ,2012:

(i) Debentures Account (ii) Debentures Redemption Reserve Account (iii) Debentures Sinking fund investment account, and (iv) Bank account.

SOLUTION:

Dr. Debentures Redemption Reserve A/c Cr.

Date	Particular	₹	Date	Particular	₹
31.12.12	To debenture redemption fund investment A/c	12,000	01.01.12	By balance b/d	3,00,000
	To general reserve (t/f)	3,88,000	31.12.12	By bank A/c (int. @ 10% on ₹ 3,60,000)	36,000
		40,00,00	31.12.12	By surplus	64,000
					4,00,000

Dr. Debentures Sinking Fund Investment A/c Cr.

Date	Particular	₹	Date	Particular	₹
01.01.12	To Balance b/d (face value 3,60,000)	3,60,000	31.12.12	By bank A/c (80% on ₹ 3,60,000)	2,88,000
				By debenture redemption A/c	12,000
		3,60,000			3,60,000

Dr. 12% Debenture Account Cr.

Date	Particulars	Amount	Date	Particulars	Amount
31.12.12	To debenture Holder's A/c	4,00,000	01.01.12	By balance b/d	4,00,000
		4,00,000			4,00,000

Dr. Debenture-holder's A/c Cr.

Date	Particulars	Amount	Date	Particulars	Amount
31.12.12	To bank A/c	4,00,000	31.12.12	By 12% debentures A/c	4,00,000
		4,00,000			4,00,000

Dr. Bank A/c Cr.

Date	Particulars	Amount	Date	Particulars	Amount
31.12.12	To balance b/d	2,00,000	31.12.12	By debentures holder's A/c	4,00,000
	To debenture redemption A/c	2,88,000		By balance c/d	88,000
		3,60,000			3,60,000

(6) Insurance Policy Method

This method is almost similar to Sinking fund method, in this method funds are also provided for redemption of debentures. Insurance policy method provides security and there is no risk of any loss on sale of sinking fund investment as is possible under sinking fund method.

In Insurance policy method, the Insurance Company is contacted and policy for the specified period is taken. Annual premium is paid, no interest is received every year and therefore no investment of such interest is required. At the time of maturity of the policy the insurance company pays the amount and debentures are redeemed.

All the entries under this method remain same as under sinking fund method except the entries for interest, as no such interest is earned under this method. Under this method 'Debenture Redemption Policy Account' is opened instead of 'Debenture Redemption Fund Investment Account'.

Following Journal entries are passed in the method:

First Year

- (i) For amount of premium appropriated from Profit and loss account:

Surplus Account Dr.

To Debenture Redemption Fund Account

- (ii) For amount of premium paid to insurance company

Debenture Redemption Fund Policy account Dr.

To Bank Account

Same entries are to be passed every subsequent year including the last year but the following additional entries will also be passed at the end of last year:

- (i) For the amount received from insurance company

Bank A/c Dr.

To Debenture Redemption Fund Policy A/c

- (ii) For profit on insurance policy

Debenture Redemption Fund Policy A/c Dr.

To Debenture Redemption Fund A/c

- (iii) For amount paid to debenture holders

Debentures A/c Dr.

To Bank A/c

- (iv) For balance of Debenture Redemption Fund A/c transferred to General Reserve account

Debenture Redemption Fund Account Dr.

To General Reserve Account

Illustration 24 : Annie Ltd issued Debenture of ₹ 5,00,000 on 1st April 2010, redeemable at the end of third year from the date of their issue. It was decided to make provision for their redemption by means of a three years insurance policy purchased on 1st April 2010 for an annual premium of ₹ 1,60,000.

Prepare the necessary ledger accounts assuming that the amount of policy was duly realized and debentures were paid.

Solution:

Dr.

Debentures Account

Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2011 March,31	To Balance C/d	5,00,000	2010 April,1	By Bank Account	5,00,000
2012 March,31	To Balance C/d	5,00,000	2011 April,1	By Balance b/d	5,00,000
2013 March,31	To Debentureholders A/c	5,00,000	2012 April,1	By Balance b/d	5,00,000

Dr.

Debenture Redemption Fund Account

Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2011 March,31	To Balance C/d	1,60,000	2010 April,1	By Surplus Account	1,60,000
2012 March,31	To Balance C/d	3,20,000	2011 April,1	By Balance b/d	1,60,000
			2012	By Surplus Account	1,60,000

March, 31

		3,20,000			3,20,000
2013	To General Reserve A/c	5,00,000	2012	By Balance b/d	3,20,000
March,31			April,1		
			2013		
			March 31	By Surplus Account	1,60,000
			March 31	By Deenture Red.	20,000
				Fund Policy a/c	
		5,00,000			5,00,000

Dr.			Cr.		
Debenture Redemption Fund Policy Account					
Date	Particulars	Amount	Date	Particulars	Amount
2010	To Bank A/c	1,60,000	2011	By Balance c/d	1,60,000
April,1			March,31		
2011			2012		
April,1	To balance b/d	1,60,000	March,31	By balance c/d	3,20,000
April,1	To Bank Account	1,60,000			
		3,20,000			3,20,000
2012			2013		
April,1	To Balance b/d	3,20,000	March 31	By Bank A/c	5,00,000
April,1	To Bank Account	1,60,000	March 31		
2013					
March,31	To debenture Red. Fund A/c	20,000			
		5,00,000			5,00,000

Note: The difference of Debenture Redemption Fund Policy Account amounting to ₹ 20,000 will be treated as interest on the policy. It will be transferred to the credit of Debenture Redemption Fund Account by passing the following entry:

Debenture Redemption Fund Policy Account	Dr.	20,000	
To Debenture Redemption Fund Account			20,000

ANALYSIS OF FINANCIAL STATEMENTS

The term 'financial statements' refer to those statements which incorporate the accounting data in a purposive and useful manner. In India, such statements, commonly prepared for supplying to the outsiders, include the Income statement and the Position Statement which are widely known by the names profit and loss account and balance sheet respectively. In addition to these two the management, for purposes of making evaluations and financial decisions, also prepares many other statements like funds-flow statement, of retained earnings, statement containing important ratios, statement highlighting various achievements, etc. According to the International Accounting Standards Committee (ISAC), financial statements include; a balance sheet, income statement, notes and other statements and explanatory material which are identified as part of the financial statement.

Maintenance of Accounts:

Tracing back the history of accounting we find that it is as old as money-the only yardstick of accounting data. Chanakya highlighted the need for maintenance of accounting and their audit long back in his well known and historical published work "Arthashastra". The single entry system, also called as the Indian system of accounting, is as scientific and systematic as the one developed by the Westerners. The present-day system of accounting, widely known as the double-entry system, was developed by Luccas Pacioli of Italy far back in the 15th century. But modern uses of accounting data could be developed only during the last few decades when after the industrial revolution, complex industrial units with heavy capital investment came into being and the various management experts like Taylor, Fayol and others emphasized the need for improving the management of financial resources, efficiency, increasing productivity, and thus maximise output and minimise input. In this task, the "American Institute of Certified Public Accounts" (AICPA) has played a notable part. Further, modern accounting machines and electronic computers have tremendously added the 'use-value' of the accounting data and hence the need for their proper recording and maintenance.

According to AICPA, accounting is "the art of recording, classifying and summarising in a significant manner and in terms of money transactions and events which are, in part at least, of a financial character, and interpreting the results thereof." Thus, important attributes of accounting are:

- (i) events and transactions of a financial nature, even though only partly of this type, are recorded-events of a non-financial nature, say the passing of control from one person to another can not be recorded;
- (ii) the record must be in such a way as to be able to portray the significance of all transactions and events individually and collectively, class by class and as a whole-this involves both analysis and summarization;
- (iii) the parties concerned must be able to gather the true message of the results as embodied in the statements finally prepared. Accounting knowledge should also help a person understand the meaning of the financial statements of any firm or institution placed before him.

Thus, maintenance of accounts in one form or the other dates back to the origin of human civilization and man's taking-up of trade activities. It developed with the growth of the single entry system and was further improved upon by the invent of the double entry system of accounting. But the double entry system of accounting itself does not make it obligatory on any organization, business or non-business, to keep proper accounts or even the books of accounts. Accounting, originally, was adopted as an aid to memory, a piece of evidence in case of disputes and as a matter of convenience. But with the growth of civilization, innovations and transformations in trade, its activities and the manner of organizing it, was felt more and more necessary to maintain proper accounting records. In the course of time

different forms of organizations, namely company, partnership, cooperative societies, clubs and other associations got legal recognition. It was as early as in the 18th century when the New York stock exchange and the Securities Exchange Commission in USA first recognized the importance of protecting the interests of ever increasing shareholders, other investors and their funds invested in any form in corporate firms (called companies in India). The exchange made it obligatory on the part of the member firms to circulate published accounts to its shareholders so that they could know the state of affairs and true financial position of the firm(s) in which they invest their funds.

Thus, through the efforts of organizations like stock exchanges, investors, or shareholders' organizations and growing awareness of the governments, today, we find that in almost every civilized country there are laws which make it obligatory on organizations, both business and non-business, to maintain proper accounts and distribute them in a given form to those who have invested their funds in them or otherwise have an interest in their management. We in India find that Indian Companies Act, Cooperative Societies Act, income tax act etc. several statutes, require corporate firms, associations and other bodies corporate to maintain proper books of account. Some of these statutes even require them to circulate copies of its accounts among its members periodically. Generally for this purpose most of the organizations have an independent accounting department. Besides maintaining proper accounting records one of the fundamental responsibilities of a modern accounting department is the preparation of various financial statements and reports to be used by management and interested outside parties. Besides the management of an organization the following other external parties are generally interested in the financial statements.

- (a) *Shareholders*: In the case of corporate bodies, shareholders can learn about the results of operations and financial position of the company only through the annual statements showing the profit earned (or loss suffered) and the assets and liabilities.
- (b) *Investors*: Those who want to invest their funds in the shares or other securities of a corporate body are also naturally interested in the financial statements to know how safe the investment already made is and how safe the proposed investment will be.
- (c) *Creditors*: Generally suppliers of goods to various organizations do so on credit, they also would like to be satisfied that they will be paid on time. The financial statements greatly help them in properly assessing the capability of the organization to do so.
- (d) *Labour*: Workers being entitled to payment of bonus, which depends on the size of the profit earned, also feel interested in the accounts. Naturally, they would like to be satisfied that the bonus being paid to them is correct, they are much interested in knowing the profit earned or loss suffered by the firm. This knowledge also helps them in conducting negotiations for future wages.
- (e) *Government*: Financial statements also help the state governments in compiling their national accounts. Such statements are of obvious importance for them in ascertaining the income-tax relizable.
- (f) *Researchers*: As a mirror to business condition, the financial statements are of immense value for conducting research studies into business affairs. These statements are, therefore, of great interest to scholars undertaking research in matters pertaining to aspects such as financing, profitability, liquidity etc.

Purpose or Uses of Financial Statements

Financial statements may take the form of an annual report, company prospectus, project report, etc. As discussed above, these statements are frequently used for studying different financial aspects, relating to an organization, by shareholders, creditors, financial analysts, government agencies, trade unions, banks and even management. In every case they must furnish the recipient with proper and sufficient information to enable him to make an intelligent decision or judgement concerning some aspect

of the entity, about the purpose of financial statements, a judgement concerning some aspect of the entity. About the purpose of financial statements, a group of progressive American accountants, some forty years ago, rightly stated that financial statements are prepared for the purpose of presenting a periodical review or report on progress made by the management and deal with the status of the investment in the business and the results achieved during the period under review. They reflect a combination of recorded facts, accounting conventions, and personal judgements, and the judgements and conventions applied affect them materially. The soundness of the judgement necessarily depends on the competence and integrity of those who make them on their adherence to generally accepted accounting principles and conventions."

Again, modern accountants maintain that accounting is useful for the proposes of:

- (a) formulating, implementing and approving the policies;
- (b) bringing out coordination among different activities;
- (c) planning and control of day to day operations;
- (d) accounting for responsibilities within the business;
- (e) studying specific projects or phases of a business;
- (f) measuring the financial position and income of the business; and
- (g) reporting on the stewardship of the business to the owners and outsiders such as creditors, government agencies, etc.

In brief financial statements are prepared with the project of transmitting reliable and useful accounting information to those who need it, both within and outside the organization, and that proper use of the information so transmitted will help the recipient in making a sound decision.

But, here, we must be aware of the fact that there are no standardized forms which may be adopted by all industrial, commercial and other organizations, for presenting their accounting information and preparing financial statements. As a consequence, the classification of some of the financial statement items varies widely. Such a variation is further widened by the factors like

- managements' wishes
- intended use of the statements;
- accountant's knowledge, training, experience and his attitude towards such statements;
- deviation from the generally accepted accounting principles, concepts and changes in terminology.

So, frequently, a researcher or an analyst may desire to recast and rearrange the accounting data in accordance with his requirements, views and the purpose of analysis.

Accounting is widely accepted as an art. It is also claimed to be a science, but an inexact science. The more we practice it the better we are in accounting and hence financial statement preparation. Financial statements reflect the opinion, experience and judgement of the accountant and the management. Thus, the estimated life and the method of depreciation to be used in the valuation of plant and equipment, the method of inventory valuation, the valuation of intangibles (patents, goodwill etc.) are some of the areas which are largely influenced by personal opinions and value judgements. As a result equally competent accountants, when given the same set of facts, may arrive at different results.

Limitations of financial statements

All financial statements are prepared with the help of the recorded facts of business transactions. Here accounting concepts and conventions as also the personal judgements of the accountants play an important role. As a consequence, we experience the following limitations of the financial statements.

1. The allocation of revenue and costs to an accounting period involves personal judgement. The problem involves the achievement of a satisfactory (but never a perfect) matching of

costs with revenues. Other factors that tend to make statement data uncertain include the existence of contingent assets and liabilities.

2. The statements show exact rupee amounts, which give an impression of finality and precision. Rarely does the stated value of an asset represent the amount of cash that would be realized on winding up of the business. Even the cash balance would be reduced by the expenses incidental to the liquidation process. For example, a patent, trade mark, or organization costs may be stated, due to a management's policy, at the conservative of rupee one; in a liquidation a large sum might be realized on such assets.
3. Both the basic financial statements namely balance sheet and profit and loss account, reflect transactions that involve rupee values of many dates. Due to continuous inflationary pressure on the economy prices have been showing an increasing trend. As a result many industrial plants established some forty years ago cannot be replaced today even at four times the original historical cost shown on the balance that. The depreciation charged against current revenues by companies using pre war plants is less than the depreciation appropriate on a replacement-cost basis. The balance sheet itself does not indicate the current economic realities.
4. Non-monetary factors, which too have a bearing on the working of an organization, cannot be communicated or shown on the financial statements. Such factors include sources and commitments for materials, merchandise, and supplies, the reputation and prestige of the company with the public; the credit rating of the company; and the efficiency, loyalty and integrity of management and employees. Contingent assets and liabilities customarily are not, and usually can not be, stated definitely in rupees.

The foregoing discussion of the limitations of financial statements shows their tentative character under normal or peacetime conditions. It should be evident that financial statements are still more tentative when abnormal or wartime conditions prevail.

The variations complained in accounting classifications, practices, opinions and judgements can, to a large extent, be checked by adopting the following four principles of presenting accounting information:

- (a) *Classification*: The facts, figures and items recorded must be grouped in suitable groups or classifications.
- (b) *Arrangement*: The data should be arranged in a manner such that individual items, classes, totals highlight important facts, events and relations, if any.
- (c) *Order*: The data should be so presented as to bring into focus the important figures, such as net profit on cost of materials consumed, product sales, etc. in a profit and loss account.
- (d) *Description*: Instead of taking titles verbatim from the ledger they should be given proper headings or group names. Also, it must be ensured that description of amounts are both accurate and understandable.

Analysing Financial Statements

The dictionary meaning of "analysis" is resolving or separating a thing into its elements or component parts for tracing their relation to the things as a whole and to each other. Financial analysis may be defined as the examination and comparison of financial data of a business with a view to assessing its overall health. It is the process of inductive reasoning for the purpose of formulating probability belief about a particular firm, an information processing system designed to supply firm related data for decision makers. It aims at measuring the historical and current facts with a view to projecting the viability and prospectus of a concern.

The object of analyzing any statement is to simplify the data in order to make it easily understandable to the user. Analysing financial or accounting statements consists of a study of relationships and trends to determine whether or not the financial position and results of operations and the financial

progress of the company are satisfactory or unsatisfactory. Further, an analytical study of the financial statements can be useful to an external user who wants to measure the profitability of operations and the financial soundness of the business in order to determine the desirability of investing in or extending credit to the business. The management or an internal analyst can use it to determine the efficiency and effectiveness of its policies and working and to explain changes in the financial position. Also, it is an aid to data interpretation for measuring performance against planned operations and exercising effective control. For a proper understanding of the data the analyst first computes and organizes his data and then analyses and interprets them to make them more meaningful.

Thus, the central theme of any analysis is the evaluation of financial data through comparisons and measurement. By some consistent standard to determine performance. Four types of standards have been proposed.

- (a) a firm's past performance;
- (b) a firm's planned targets;
- (c) performance of other firms in the same industry;
- (d) performance of other industries.

In using each of the above standards, the analyst should be aware of certain basic limitations. For example, if a firm with a capital Rs. 5 lacs makes a profit only of Rs. 5000 in the previous year and improves to Rs. 9,000 in the current year, then, though, its profits have increased 80%, yet it can't be treated to be a flourishing firm. Likewise, the performance of other companies and the industry standards have similar pitfall. Despite these limitations, the above suggested standards can be of significant use for highlighting improvements, relations and regressions of various figures and understanding them.

The above suggested standards of comparison are frequently used while applying the tools of analyzing financial statements. Experts have classified these tools as:

- (a) Comparative financial statements;
- (b) percentage-analysis or common size statements;
- (c) ratio analysis; and
- (d) combinations of these.

ACCOUNTING RATIOS

In comparative financial statements, the various figures are put for the last two, three, five, or ten years according to the nature and purpose of the statement and the object to be achieved from such a comparison. Such statements, while reviewing the progress reflect the business history of the organization. The consistent application of generally accepted accounting principles in the comparative statements is a prerequisite for an effective analysis and interpretation of the data contained in the statements. Addition of figures indicating increase or decrease in absolute figures, both in monetary units and percentages, will add to the use value of comparative statements. Trend percentages, or the reduction of the absolute figures for different years to a common denominator highlight significant changes and are thus especially valuable to management in decision-making process.

Common size statements refer to showing balance sheet and income statement data in analytical percentages-viz., parentages of individual assets to total assets, individual liabilities to total liabilities and owner's equity, and different items of expenditure to total sales-a common basis for comparison is provided. Under this technique the total of one side of the statement or any other significant item on it is expressed as 100 and each individual item is stated as a percentage of the total of 100. So common size statements are also known as "component percentages" or ".00 percent" statements. Each percentage shows the relation of individual items to its respective total. Therefore, the common size percentage (analytical method) represents a type of ratio analysis because each individual item on a statement is expressed as a percentage of the total. The common size statements are useful to the analyst studying the

current financial position and operating results of a business and especially in making comparisons between firms in the same industry and with industry standards. To some extent, this method of analysis may be used in making an historical study of a particular business because changes in the distribution of the individual items are revealed.

Ratio Analysis

The relationship of one item to another expressed in simple mathematical form is known as a ratio. The term accounting ratios or ratio analysis is used to describe significant relationships which exist between figures shown on a balance sheet, in a profit and loss account in a budgetary control system or in any other part of the accounting organization. These ratios may serve many a purposes; they can assist management in its basic functions forecasting, planning, coordination, control and communication. If properly used they can improve efficiency and therefore, profits. In the wrong hands they may mislead and result in the wrong conclusions being arrive at. Generally, more than one ratios are used for analytical studies. They are relatively more reliable tools of financial analysis. But financial ratios and other analytical devices must be considered in relation to the nature of the company, the economic environment, the accounting methods employed, similar ratios and devices previously employed and ratios employed in similar firms that are relevant to the current situation. Otherwise the interpretation of the statements will yield in useless, if not misleading conclusions.

To be most meaningful and informative i.e. reliable and representative, standard ratios should be developed for companies of an industry that:

- (a) represent a homogeneous group generally following similar policies;
- (b) use similar accounting procedures, uniform accounting system and classification of accounts;
- (c) follow a common accounting period, preferably on a natural business year basis;
- (d) adopt similar assets valuation and their amortization policies.

The different ratios in practice can be grouped in a number of ways. Some classify them on the basis of their nature i.e. as primary and secondary ratios; while others classify them on the basis of their statement of origin, on the basis of their use in inter-firm comparisons, or on the basis of their use in indicating important relation. Thus, we find that ratios can be those relating to the financial liquidity position of the company, its profitability, capital structure, sales etc.

Objectives of Ratio Analysis

The objective of ratio analysis are as follows:-

- a) To simply the understanding of financial statements and to condense the large number of figures.
- b) To highlight the changes in the financial position of the business.
- c) To facilitate intra-firm comparison of the performance of the different divisions of the company.
- d) To facilitate inter-firm comparison.
- e) To facilitate planning and control and, help in decision-making, process.

Merits of Ratio Analysis

Ratio analysis is a very useful tool in the hands of management and other users of financial statements. Ratio analysis simplifies, summarises and systematizes a long array of figures contained in financial statements. It is an instrument for diagnosis of the health of an enterprise. Ratio analysis offers following advantages:

A. Easy Understanding of Financial Statements — Ratio analysis facilitates the comprehension of financial statements by simplifying and summarizing a large number of accounting figures. It facilitates

evaluation of several aspects such as financial health, profitability and operational efficiency of the undertaking.

B. Inter-Firm Comparison — Ratio analysis provides data for inter-firm comparison to measure efficiency and helps the management to take remedial measures. Ratios highlight the strong points and weak points of the company in comparison to other companies in the industry.

C. Intra-Firm Comparison — Ratio analysis make possible comparison of the performance of different units of the same company. Ratio analysis helps in deciding about the efficiency or deficiency of different units and helps the management to take corrective actions.

D. Planning and Forecasting — Ratio analysis helps in planning and forecasting. Ratio related to past sales, profits and financial position may be used for forecasting future trends. In recent years, ratios have been used as a measure of prediction of events. Ratios are being used as a warning system to indicate the failure of companies.

E. Decision Making — Ratio analysis helps in investment decision in the case investors and lending decisions in the case of bankers and financial institutions. The credit suppliers, lending institutions and investors all use ratio analysis as their initial tool for evaluating the company's affairs.

Use of Ratio Analysis for different stakeholders

The main objective of ratio analysis is to provide various decision-makers information about a business enterprise for use in decision-making. Users of financial statement information are the decision-makers concerned with evaluating the financial health of the undertaking and predicting its future course. Different groups look at the enterprise from their respective view points. The significance of ratio analysis for the various groups may be discussed as under:

- (i) Short-term Creditors.
- (ii) Long-term Creditors.
- (iii) Management.
- (iv) Owners and Investors.

(i) **Short-Term Creditors** — Short-term creditors are the creditors who supply credit for a period of less than one year. Trade creditors i.e., suppliers of goods are short-term creditors. Short-term creditors are primarily interested in the liquidity of the enterprise i.e., whether the business enterprise is in a position to meet its obligations when they are due for payment. Short-term creditors use liquidity ratios such as current ratio and acid-test ratio to assess the liquidity position of the company. Liquidity ratios give them an idea of company's ability to repay their claims at the time of maturity of the claims.

(ii) **Long-Term Creditors** — Long-term creditors are the creditors who provide funds to the company for a period over one year. Debentureholders, bankers and financial institutions are long-term creditors. Long-term creditors are interested in the solvency of the company i.e., the financial soundness of the company to repay the principal amount at the time of maturity and to pay its interest obligations. Solvency ratios such as debt-equity ratio, proprietary ratio and interest coverage ratio are calculated by long-term creditors.

(iii) **Management** — Management includes the persons who manage the affairs of the business enterprise. Management makes the use of ratio analysis as a means self-evaluation. Management assesses its managerial skill and performance on the basis of profitability ratios and turnover ratios. Management uses different ratios for forecasting of events. Management can assess its performance by making inter-firm comparison and intra-firm comparison. Management uses ratio analysis to know company's viability as an ongoing concern, adequacy of capital structure and effectiveness of policies.

(iv) **Owners and Investors** — Owners are the person who provide funds to the business and share the risks. Investors and owners are primarily interested in the profitability and safety of their

investments. Hence, they calculate profitability ratios such as earnings per share, dividend per share, return on investment, return on equity, dividend yield etc. On the basis of these ratios, investors decide whether to buy or retain the shares of the company.

Although ratio analysis is of immense use and aid to various groups of persons interested in the affairs of the company, it is primarily used by the management in the discharge of its basic function of forecasting, planning, coordination, communication and control. Ratio analysis paves the way for effective control of business operations. Ratio analysis is very useful for measuring the performance. It is very useful in cost control also. According to **Batty** "ratios can assist management in its basic function of forecasting, planning, coordination, control and communication."

Limitations of Ratio Analysis

Ratio analysis is subject to some limitations which are given below:

- (1) **Limitations of Financial Statements** — Ratios are based on the information contained in financial statements. Financial statements suffer from a number of limitations. The ratios derived therefrom, therefore, are also subject to these limitations. For example, financial statements ignore qualitative or non-monetary factors. As a consequence, the ratios obtained from the financial statements ignore qualitative factors which may be important.
- (2) **Overlooking of Background** — In case of inter-firm comparison, no two firms are similar in size, age and nature of products. Therefore, ratio analysis cannot give satisfactory results unless these factors are taken into account. Ratio analysis will give accurate results only when absolute data are also taken into account.
- (3) **Problem of Price-Level Changes** — Ratio analysis becomes less effective due to price-level changes. A change in price level affects the validity of ratios calculated for different time periods. For example, fixed assets turnover ratio in 2005 would be much higher than in 1995 because sales are recorded at the current market values while fixed assets are not recorded at current market values. Similarly, Return on Investment (ROI) of an old company and a newly established company will differ due to price-level changes.
- (4) **Differences in Definitions and Accounting Policies** — There are different opinions regarding the meaning of gross profit, net profit, current assets, current liabilities etc. Comparisons would be misleading if these terms are not properly defined. Further, accounting ratios are not comparable if different companies follow different accounting policies with reference to depreciation, inventory valuation etc. For example, a company may adopt straight line method while another company may adopt written down value method of depreciation.
- (5) **Improper Use of Ratios** — Since ratios are easy to calculate, there has been a tendency to overemploy them. Ratios are the tools in the hands of an analyst who has to exercise his personal judgement. Ratios can be affected with the personal ability and prejudice of the analyst. Again, the analyst has to rely on several ratios before reaching a conclusion.
- (6) **Need for Further Investigation** — Ratio analysis cannot give satisfactory results unless other relevant factors are taken into account. A ratio points out the probability of a matter needing further investigation. Ratios offer misleading conclusions in absence of absolute data.
- (7) **Window-Dressing** — Window-dressing means manipulation of accounts in a way as to conceal vital facts and present the picture in a way to show a better position than what it actually is. Ratios are based on the information contained in the balance sheet on the given date. This may lead to window-dressing in some cases. An analyst should rely on the average figures for calculating ratios. In this way, ratio analysis may not be reliable.
- (8) **Personal Bias of the Analyst** — Ratio analysis is only a tool in the hands of an analyst and not an end in itself. It is helpful to spot out the symptoms. An analyst has to exercise his judgement

in arriving at a correct diagnosis. Ratios can be effected with the personal ability and bias of the analyst.

It may, therefore, be concluded that ratio analysis is a double-edged sword. Ratio analysis requires a great deal of understanding of background of the company, accounting principles and management process. Ratio analysis need to be supplemented by further investigation on the part of analyst. The ratios, if discriminately calculated and wisely interpreted can be a useful tool of financial analysis. The utility of ratio analysis depends on the personal ability and skill of the analyst.

The various ratios can be troubled as shown below:-

Balance Sheet Ratios

<i>Ratios</i>	<i>Components</i>
1. Current (or capital) ratio	Current assets to current liabilities
2. Liquid (quick assets or acid test) ratio	Liquid (or quick) assets to quick liabilities.
3. Debt-equity ratio	External equity to internal equity.
4. Share-equity ratio	Shareholder's equity to "long-term debts" and shareholder's equity.
5. Capital gearing ratio	Equity shareholder's fund to preference share capital and long-term borrowings.
6. Proprietary ratio	Proprietor's equity to total assets.
7. Asset-proprietorship ratio	Current (or fixed) assets to proprietor's equity.

Profit and Loss A/c ratios

<i>Ratios</i>	<i>Components</i>
1. Gross profit ratio	Gross profit to net sales
2. Operating ratio	Operation cost (viz, cost of sales plus administrative and selling expenses) to net sales.
3. Expense ratios	(a) Cost of sales to net sale (b) administrative expenses to net sales (c) Selling expenses to net sales. (d) Individual expense, to net sales.
4. Operating profit ratio	Operating net profit to net sale.
5. Net profit ratio	Net profit to net sales.
6. Fixed dividend cover ratio	Net profit to preference dividend.
7. Fixed charges cover ratio	Net profit (before interest and tax) to interest.

Inter-statement ratios

<i>Ratios</i>	<i>Components</i>
1. Return on equity capital	Net profit (after preference dividend) to equity share capital.
2. Return on equity shareholder's fund.	Net profit (after preference dividend) to equity shareholder's fund.
3. Return to proprietor's equity.	Net profit to proprietor's (both equity and preference shareholder's fund)

4. Return on capital employed	Net profit (before interest and income tax) to long-term borrowings and shareholders' fund).
5. Total capital turnover ratio	Cost of sales to capital employed.
6. Working capital turnover	Cost of net sales to average working capital.
7. Debtor's (receivables) turnover	Net (credit) sales to average trade debtors and bills receivable.

It need be emphasized here that ratios derived from the accounting data given in an income statement (or profit and loss account) point out to the earning capacity of a firm; ratios from balance sheet to solvency, liquidity and leverage, while the ratios derived from the date of the two statements highlight its turnover or activity. Since the ratios on earning capacity and financial position are basic to the needs of both the investors and management so these ratios are of primary importance to them. Some of the important ratios are discussed and illustrated below:

Ratios of Financial leverage: Under this category important ratios are:

(a) Net worth to capital employed; Such a ratio explains as to how much of the total capital employed relates to shareholders or are owned by them. Net worth means equity share capital plus any balance on the profit and loss account and any reserve indicating undistributed profits of the past years. The share of capital employed other than that of net worth indicates the extent of borrowed capital invested in the firm and this explains the extent of leverage factor. Here it need be clarified that, for purposes of our study-by capital employed we mean total of assets less current liabilities. It may be added that neither a too low nor a too high ratio is desirable from the financial management point of view. A too low ratio involves a risk element and a heavy burden of fixed expense in the form of interest, on the other hand-a too high ratio will indicate that the company has not been able to appreciate and utilise the presence of loan capital, with a fixed charge of interest deductible as an expense and thereby increase the distributable profits of the company.

(b) *External equity capital employed:* The term "external equity" refers to those long-term funds which co. not belong to the equity shareholders and hence are borrowed from one source or the other. Some writers include preference share capital into external equity while others consider it as part of the equity share capital. But strictly speaking redeemable preference shares should be treated part of the external equity. The reasons for such a treatment are that the preference shareholders are different from the equity shareholders in as much as the latter are treated as owners of the company who alone have voting rights in the company. Secondly, preference shareholders get dividend, usually at a fixed rate like interest on loan or debentures. This ratio is a complementary and supplementary to the "net worth to capital employed" ratio and the general observations made above about that ratio are applicable in case of this ratio too.

(c) *External equity to Net worth:* This ratio is also called the "debt to equity" ratio. We have noticed earlier that external equity and net worth are the two components of the total capital employed. This ratio tells us as to how much are the debts or external funds when compared with the shareholders' funds. It is suggested that generally this ratio should be 1:1 or 100% but it varies from industry to industry and from the firm to firm. The 100% ratio is advisable for the medium sized capital intensive firms while for heavy capital intensive units even a lower percentage may be advisable. A large ratio is advisable for the consumer products units with short gestation and turnover periods.

Illustration 1:

Balance sheet of M/s A.B. Brothers Ltd.

Liabilities	Rs.	Assets	Rs.
Share Capital:			
Equity	1,50,000	Fixed Assets (Net)	2,50,000
9% Preference (Returnable)	50,000	Current Assets	1,50,000
Debentures	60,000	Investments	75,000
Loans from financial Institutions	40,000	P&L A/c (Loss)	25,000
Current liabilities	75,000		
P & L A/c	50,000	General Reserve	75,000
	5,00,000		5,00,000

Capital Employed = Total of assets-(P&L A/c Loss+current liabilities)

$$= \text{Rs. } 5,00,000 - (\text{Rs. } 25,000 + 75,000)$$

$$= \text{Rs. } 4,00,000.$$

Net worth = Equity capital + General Reserve & P & L A/c (Balance) - P & L a/c (loss)

$$= \text{Rs. } 1,50,000 + \text{Rs. } 75,000 + \text{Rs. } 5,000 - \text{Rs. } 25,000$$

$$= \text{Rs. } 2,50,000.$$

External funds or equity: Preference capital + Debentures + Loans from Financial Institutions

$$= \text{Rs. } 50,000 + 60,000 + 40,000$$

$$= \text{Rs. } 1,50,000.$$

Thus:

$$(a) \text{ Net worth to capital Employed} = \frac{\text{Rs. } 2,50,000}{\text{Rs. } 4,00,000} = 5/8 \text{ or } 62.5\%$$

$$= 5:3$$

$$(b) \text{ External Equity to capital Employed} = \frac{\text{Rs. } 1,50,000}{\text{Rs. } 4,00,000}$$

$$= 3/8 \text{ or } 37.5\%$$

$$(c) \text{ External equity to Net worth} = \frac{\text{Rs. } 1,50,000}{\text{Rs. } 2,50,000} = 3/5 \times 100 = 60\%$$

Ratios of Liquidity

(i) *Current Ratio*: This ratio is also known as “working capital” ratio. By the term working capital we mean current assets as reduced by the current liabilities. Generally current assets are advised to be maintained at least twice the current liabilities. Hence this ratio is also known as “2 to 1 ratio”. Mathematically it is given as

$$\frac{\text{current assets}}{\text{current liabilities}}$$

Such a ratio shows the relationship between total current assets and total current liabilities, i.e. cash, or those expected to be converted into cash within a year (current assets) and those to be paid off within the same period (current liabilities).

(ii) Quick or Liquid ratio: It shows the ability of a business to meet its current commitments. This ratio is also known as the "acid-test ratio." The liquid assets are also referred to as "quick assets" or "near money." Mathematically this ratio is:

$$\frac{\text{Liquid assets}}{\text{Current Liabilities}}$$

The liquid assets would include cash, debtors (excluding bad debts), and securities which can be realized without any difficulty. Current liabilities would include creditors and any amounts due but not yet paid. Generally such a ratio should be at least 1 to 1. If not, and liquid assets do not cover current liabilities, then steps should be taken to obtain additional cash.

(iii) *Cash and bank balances to working capital*: This ratio tells us about the relationship between the cash and bank balances of a firm with its working capital. Neither a high nor a very low ratio is advisable as they may effect the efficiency of financial management adversely.

Illustrations 2: Stretching further the current assets and liabilities position given in illustrational 1, we get the following information:

Current Assets:		Current Liabilities	
	Rs.		Rs.
Cash in hand	= 10,000	S. Crs.	= 40,000
Cash at bank	= 20,000	B/P	= 15,000
Stock	= 40,000	Bank overdraft	= 20,000
S. Drs. (Net)	= 60,000		
B/R	= 20,000		
	<u>1,50,000</u>		<u>75,000</u>

Working capital = Current assets-current liabilities = Rs. 75,000

Quick assets = cash in hand + cash at Bank + B/R = Rs. 50,000

(i) Current ratio = $\frac{\text{Rs. } 75,000}{\text{Rs. } 1,50,000} \times 100 = 50\%$

(ii) Quick ratio = $\frac{\text{Rs. } 50,000}{\text{Rs. } 75,000} \times 100 = 66.7\%$

(iii) Cash and bank balances to working capital = $\frac{\text{Rs. } 30,000}{\text{Rs. } 75,000} \times 100 = 40\%$

Ratios of Profitability : These ratios are calculated from the data taken from the profit & Loss Account. Some of the important profitability ratios are discussed below:

(i) *Gross Profit ratio*. It establishes a relation between the gross profit or profit earned from the trading operations. The ratio is expressed as

$$\frac{\text{Gross profit}}{\text{Sales}} \times 100$$

Any major change in this ratio over a period of years should be investigated-the change may be due to a change in the economic situation (change in costs without a change in selling prior or vice versa) or due to errors or due to a change in the basis of accounting-say, valuing stock on LIFO basis rather than the FIFO basis. For comparison over a number of years, the method of calculating gross profit should not change and, if the figures for a number of firms are to be compared, the firms should follow the same accounting system and practice. Of course, higher the gross profit ratio, the better it is.

(ii) *Net Profit ratio (or Margin)*: Such a ratio along with the above discussed ratio can tell us to how much have been administrative and other expenses (also called non trading expenses) and what has been their impact on gross profit. The profit is usually only the operating profit, that is, income from non-trading assets and expenses which do not relate to trading or manufacturing are not included. The ratio is calculated as:

$$\frac{\text{Net operating profit}}{\text{Sales}} \times 100$$

(iii) *Operating ratio*: it measures the extent of costs incurred for making the sale. It is ascertained as:

$$\frac{\text{cost of goods sold plus all other operating expenses, i.e. manufacturing, administrative and selling expenses (but excluding financial expenses like interest)}}{\text{Sales}} \times 100$$

Operation ratio and the net profit ratio complementary to each other and the totals of the two is 100. Decline in efficiency is indicated by an increase in the operating ratio and hence lower the ratio, the better it is.

Various components of operating ratio are:

(a) Materials consumed ratio = $\frac{\text{Materials consumed}}{\text{Sales}} \times 100$

(b) Conversion cost (or manufacturing expenses/ratio)

$$\frac{\text{manufacturing expenses (excluding materials)}}{\text{Sales}} \times 100$$

(c) Administrative expenses ratio = $\frac{\text{Administrative expenses}}{\text{Sales}} \times 100$

(d) Selling expenses ratio = $\frac{\text{Selling and distribution expenses}}{\text{Sales}} \times 100$

Illustration 3:

In addition to the balance sheet and other information given in illustrations I and above M/s. A.B. Brothers Ltd., we are provided with the following information:

Net operating Profit	:	Rs. 50,000
Gross Profit	:	Rs. 2,00,000
Sales	:	Rs. 5,00,000

Cost of goods sold (including all expenses except financial expenses) = Rs. 4,00,000

Thus:

$$(i) \text{ Gross profit ratio} = \frac{\text{Gross profit}}{\text{Sales}} \times 100 = \frac{\text{Rs. } 2,00,000}{\text{Rs. } 5,00,000} \times 100 = 40\%$$

$$(ii) \text{ Net Profit ratio} = \frac{\text{Net operating profit}}{\text{Sales}} \times 100 = \frac{\text{Rs. } 50,000}{\text{Rs. } 5,00,000} \times 100 = 10\%$$

$$(iii) \text{ Operating ratio} = \frac{\text{Cost of goods sold}}{\text{Sales}} \times 100 = \frac{\text{Rs. } 4,00,000}{\text{Rs. } 5,00,000} \times 100 = 80\%$$

Activity Ratios: These ratios are also called as "Turnover or Performance ratios." This is so because they judge how well the facilities at the disposal of the concern are being used. Also they indicate the rapidity with which a unit of capital invested in fixed assets, stock, etc. produces sales. Such ratios are calculated in relation to the cost of sales. Some of the important activity ratios are:

(a) *Total capital turnover ratio:* This ratio takes into account both long-term and short-term capital and is calculated as:

$$\frac{\text{Cost of Sales}}{\text{Capital employed}} \times 100$$

(b) *Working capital turnover ratio:* It gives us the number of times a unit invested in working capital produces sale. Mathematically the ratio is expressed as:

$$\frac{\text{Cost of Sales}}{\text{Net working capital (i.e. current assets - current liabilities)}} \times 100$$

(c) *Debtors ratio or Debt collection period:* This ratio shows the number of day's sale that remains uncollected on an average. On comparison with the official credit period, it would show whether debts are being collected on time or not. This ratio is expressed as

$$\frac{\text{Accounts receivable (sundry debtors and bills receivable)}}{\text{Average daily credit sale}}$$

Illustration 4: Continuing with the data given in illustrations 1 to 3, we find that:—

- (i) Capital employed : Rs. 4,00,000
- (ii) Cost of Sales : Rs. 4,00,000
- (iii) Net working capital : Rs. 75,000
- (iv) Accounts receivables : Rs. 60,000 + Rs. 20,000
(Sundry Debtors and bills receivables) = Rs. 80,000
- (v) Average daily sales = Rs. 5,00,000/250 = Rs. 2,000 (Sales presumed only for 250 days due to a strike during the year)

Thus:

$$(a) \text{ Total capital Turnover ratio} = \frac{\text{Rs. } 4,00,000}{\text{Rs. } 4,00,000} \times 100 = 100\%$$

$$(b) \text{ Working capital turnover} = \frac{\text{Rs. } 4,00,000}{\text{Rs. } 75,000} \times 100 = 533.3\%$$

(c) Debtors ratio = $\frac{\text{Rs. } 80,000}{\text{Rs. } 2,000} = 40$ days which may be checked with the policy of the management on credit sales.

Some practical guidelines to the analyst

It need be emphasized here that anadequate understanding and analysis of financial statement data can be achieved if the analyst:

- (i) is familiar with accounting conventions, concepts and terminology;
- (ii) understands the nature and limitations of accounting;
- (iii) has some knowledge about the business of the firm of which analytical study is being conducted; and
- (iv) is acquainted with the nature and tools of financial analysis.

Further while making a comparative analysis of financial statements the analyst must keep in view the following guiding principles.

1. The statement being compared must be based on the consistent application of generally accepted accounting principles. This, if there is an absence of comparability in any particular figure or year's figure(s) then it should be made known in the Directors' report.
2. Factors like differences in size and age of the firm and nature of the products dealt in be given due consideration.
3. Effect of price-level changes should be segregated or properly disclosed in order to assess the realistic figures revealing efficiency and financial soundness of the firm.
4. The terms like gross profit, cost of goods sold, net profit etc. be clearly defined and understood with special reference to the firms covered by the study.
5. Short-term fluctuations and transactions entered around the closing of the accounts generally with a motive of creating window dressing, should be carefully looked into.

Also, a brief mention be made here of the intangible factors like efficiency of management, high morale and good human relations prevalent in one or more of the organizations about which the analytical study is being conducted. Such intangibles cannot be highlighted by the financial statements yet presence or absence of those can widely influence the judgement or conclusions of the study. The analyst must carefully evaluate the impact of changing price levels on the statements, if they are not indicated or disclosed in them. It is also pointed out that differences in financial statements may be due to the wide variations that erupt within the framework of generally accepted accounting principles and procedures in the valuation of inventories, the selection of basis of depreciation, the treatment of intangibles and the method of disclosing extra-ordinary and non-recurring items, for example.

Illustration 5:

- (i) Calculate the amount of current assets and current liabilities from the following: Current ratio 2.5:1; Working Capital Rs. 60,000
- (ii) Calculate Gross Profit ratio—
Gross Profit Rs. 1,00,000; Total Sales Rs. 5,25,000; Sales Returns Rs. 25,000.

Solution:

(i) $\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$

Working capital = Current Assets—Current Liabilities

If Working Capital is 1.5, Current assets = 2.5

If Working Capital is 1, Current assets = $\frac{2.5}{1.5}$

If Working Capital is 60,000 Current assets = $\frac{2.5}{1.5} \times 60,000 = 1,00,000$

$$WC = CA - CL$$

$$CL = CA - WC$$

$$= 1,00,000 - 60,000 = \text{Rs. } 40,000$$

(ii) $G. \text{ Ratio} = \frac{G.P.}{* \text{ Net Sales}} \times 100$

$$= \frac{1,00,000}{5,00,000} \times 100 = 20\%$$

* Net Sales = Total sales - Returns

Illustration 6: Calculate (i) Current Ratio (ii) Net Profit Ratio & (ii) G.P. Ratio

Net sales = Rs. 1,40,000; Gross Profit = Rs. 10,000; Net Profit = Rs. 6,000

B/R=RS. 2,000; debtors Rs. 8,800; Stock Rs. 10,000; Cash Rs. 6,000; Creditors Rs. 12,000; B/P=Rs. 8,800

(i) Current Ratio = $\frac{2,000 + 8,800 + 10,000 + 6,000}{12,000 + 8,800} = \frac{26,800}{20,800} = 1.29$

(ii) N.P. Ratio = $\frac{6,000}{1,40,000} \times 100 = 4.3$

(iii) G.P. Ratio = $\frac{1,00,000}{1,40,000} \times 100 = 7.14$

Illustration 7: From the following, prepare (i) Current Ratio; (ii) Quick Ratio; (iii) Debtor's Turnover; (iv) Average Collection period; (v) Stock Turnover Ratio; (vi) Number of times Interest Earned; (vii) Rate of Return on Equity Shareholder's Equity; (viii) Rate of Return on Total Assets; (ix) Total Debts to Shareholders' Equity.

Balance Sheet As on 31.12.2000

	Amount Rs.		Amount Rs.
Eq. Share Capital	1,00,000	Buildings	1,00,000
12% Pref. Share Capital	40,000	Less Dep.	20,000
P&L	50,000	Plant & Equipment	1,00,000
Mortgage Loan	1,00,000	Stock	1,00,000
B/P	60,000	Drs. (last year Rs. 80,000)	60,000
I. Tax Payable	50,000	Short-term Investments	20,000
		Cash	40,000
	4,00,000		4,00,000

Trading & P&L A/c for the year ending 31.12.2000

	Amount Rs.		Amount Rs.
To Opening Stock	1,00,000	By Credit Sales	5,50,000
To Purchases	2,00,000	By Stock	1,50,000
To Gross Profit	4,00,000		
	7,00,000		7,00,000
To Operative Exp.	1,50,000	By Gross Profit	4,00,000
To Operating income	2,50,000		
	4,00,000		4,00,000
To Interest on Mortgage	65,000	By Operating income	2,50,000
To Income-tax	1,85,000		
	2,50,000		2,50,000
To Income before-tax	95,000	By Net income	1,85,000
To Net income after tax	90,000		
	1,85,000		1,85,000

Solution:

$$(1) \text{ Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$= \frac{\text{Cash} + \text{Stock} + \text{Investments} + \text{Debtors}}{\text{Bills Payable} + \text{Tax Payable}} = \frac{2,20,000}{1,10,000} = 2$$

$$(2) \text{ Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

$$= \frac{\text{Debtors} + \text{Investments} + \text{Cash}}{\text{Bills Payable} + \text{Tax Payable}} = \frac{1,20,000}{1,10,000} = 1.09$$

$$(3) \text{ Debtor's Turnover} = \frac{\text{Net Sales (Credit)}}{\text{Average Debtors}}$$

$$= \frac{5,50,000}{70,000} = 7.86 \text{ times}$$

$$(4) \text{ Average Collection Period} = \frac{365 \text{ Days}}{\text{Debtor's Turnover}}$$

$$= \frac{365}{7.86} = 46.5 \text{ days}$$

$$(5) \text{ Stock Turnover Ratio} = \frac{\text{Cost Goods Sold}}{\text{Average Inventory}}$$

$$\begin{aligned} \text{Cost of goods sold} &= \text{Opening stock} + \text{Purchases} - \text{Closing Stock} \\ &= 1,00,000 + 2,00,000 - 1,50,000 = 1,50,000 \end{aligned}$$

$$\begin{aligned} \text{Average Inventory} &= \frac{\text{Opening Stock} + \text{Closing Stock}}{2} = \frac{1,00,000 + 1,50,000}{2} \\ &= \frac{1,50,000}{1,25,000} = 1.2: \end{aligned}$$

(6) Number of Times Interest Earned

$$= \frac{\text{Opening Income}}{\text{Interest on Mortgage Loan}} = \frac{2,50,000}{65,000} = 3.85:1$$

(7) Rate of Return on Equity Shareholders Equity

$$\begin{aligned} &= \frac{\text{Net income (after tax - Preference dividend)}}{\text{Equity share capital} + \text{Accumulated Profit}} \times 100 \\ &= \frac{90,000 - 4,000 \text{ (10\% on 40,000)}}{1,00,000 + 50,000} \times 100 = \frac{86,000}{1,50,000} \times 100 = 57.33\% \end{aligned}$$

(8) Rate of Return on Total Assets

$$\begin{aligned} &= \frac{\text{Net income (after tax)}}{\text{Total Assets}} \times 1000 \\ &= \frac{90,000}{4,00,000} \times 100 = 22.5\% \end{aligned}$$

(9) Total Debt. to Shareholders Equity

$$\begin{aligned} &= \frac{\text{Mortgage Loans} + \text{Bills payable} + \text{Tax Payable}}{\text{Equity Share Capital} + \text{Preference Share Capital} + \text{Accumulated Profits}} \\ &= \frac{1,00,000 + 60,000 + 50,000}{1,00,000 + 40,000 + 50,000} = \frac{2,10,000}{1,90,000} = 1.1: \end{aligned}$$

Illustration 8: Current liabilities of a company were Rs. 1,20,000 and its current ratio was 2.5:1. Afterwards it purchased goods for Rs. 60,000 on credit. Calculate the revised current ratio.

Solution

$$\begin{aligned} \text{Current Ratio} &= 2.5 : 1 \\ \text{Current Liabilities} &= \text{Rs. } 1,20,000 \\ \text{Therefore Current Assets} &= 1,20,000 \times 2.5 = \text{Rs. } 3,00,000 \\ \text{Revised Current Assets} &= 3,00,000 + 60,000 = \text{Rs. } 3,60,000 \\ \text{Revised Current Liabilities} &= 1,20,000 + 60,000 = 1,80,000 \\ \text{Revised Current Ratio} &= \frac{\text{Revised Current Assets}}{\text{Revised Current Liabilities}} = \frac{3,60,000}{1,80,000} \\ &= 2 : 1. \end{aligned}$$

Illustration 9: Current ratio of a company is 4:3, working capital is Rs. 60,000. Calculate the amount of Current Assets and Current Liabilities.

Solution

$$\begin{aligned}
 \text{Let Current Liabilities} &= x \\
 \text{Current Ratio} &= \text{Current Assets} : \text{Current Liabilities} = 4:3 \\
 \text{Current Assets} &= \frac{4}{3} x \\
 \text{Working Capital} &= \text{Current Assets} - \text{Current Liabilities} \\
 &= \frac{4}{3} x - x = \frac{1}{3} x \\
 \text{Working Capital} &= \frac{1}{3} x = 60,000 \\
 x &= 60,000 \times 3 = \text{Rs. } 1,80,000 \\
 \text{Current Liabilities} &= \text{Rs. } 1,80,000 \\
 \text{Current Assets} &= \frac{1,80,000 \times 4}{3} \\
 &= \text{Rs. } 2,40,000
 \end{aligned}$$

Illustration 10: X Ltd. has a liquid ratio 7:3. If its stock is Rs. 25,000 and its current liabilities are Rs. 75,000, find out the current ratio.

Solution

$$\begin{aligned}
 \text{Liquid Ratio} &= \text{Quick Assets} : \text{Current Liabilities} \\
 &= 7:3 \\
 \text{Quick Assets} &= \frac{\text{Current Liabilities} \times 7}{3} \\
 &= \frac{75,000 \times 7}{3} = \text{Rs. } 1,75,000 \\
 \text{Current Assets} &= \text{Quick Assets} + \text{Stock} \\
 &= 1,75,000 + 25,000 \\
 &= \text{Rs. } 2,00,000 \\
 \text{Current Ratio} &= \text{Current Assets} : \text{Current Liabilities} \\
 &= 2,00,000 : 75,000 \\
 &= 8:3 = 2.67:1
 \end{aligned}$$

Illustration 11: A company earns a gross profit of 20% on cost. Its credit sales are twice its cash sales. If the credit sales are Rs. 4,00,000, calculate the gross profit ratio.

Solution:

$$\text{Credit Sales} = \text{Rs. } 4,00,000$$

$$\text{Cash Sales} = \frac{1}{2} \text{ of Credit Sales}$$

$$= \frac{1}{2} \times 4,00,000 = \text{Rs. } 2,00,000$$

$$\text{Total Sales} = 4,00,000 + 2,00,000 = \text{Rs. } 6,00,000$$

$$\text{Let Cost} = 100$$

$$\text{Profit} = 20$$

$$\text{Sales} = 100 + 20 = 120$$

$$\text{Rate of Gross Profit to Sales} = \frac{20}{120} = \frac{1}{6}$$

$$\text{Gross Profit} = \frac{1}{6} \times \text{Sales}$$

$$= \frac{1}{6} \times 6,00,000 = \text{Rs. } 1,00,000$$

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

$$= \frac{1,00,000}{6,00,000} \times 100 = 16.67\%$$

Illustration 12: Compute the Debtor's turnover ratio from the following:

Particulars	Year 2006 (Rs.)	Year 2007 (Rs.)
Gross Sales	9,00,000	7,50,000
Debtors in the beginning of year	83,000	1,17,000
Debtors at the end of year	1,17,000	83,000
Sales Returns	1,00,000	50,000

Solution:

$$\text{Debtors Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Debtors}}$$

$$\text{where, Net Sales} = \text{Gross Sales} - \text{Sales Returns}$$

$$\text{Average Debtors} = \frac{\text{Opening Debtors} + \text{Closing Debtors}}{2}$$

Particulars	Year I (Rs.)	Year II (Rs.)
Gross Sales	9,00,000	7,50,000
Sales Returns	1,00,000	50,000
Net Sales	8,00,000	7,00,000
Opening Debtors	83,000	1,17,000
Closing Debtors	1,17,000	83,000
Average Debtors	$\frac{83,000 + 1,17,000}{2}$	$\frac{83,000 + 1,17,000}{2}$
	= 1,00,000	= 1,00,000
Debtors Turnover Ratio	$\frac{8,00,000}{1,00,000}$	$\frac{7,00,000}{1,00,000}$
	= 8 times	= 7 times

Illustration 13: Calculate Debtors Turnover Ratio from the following:

Credit sales for the year	Rs. 60,000
Debtors	Rs. 5,000
Bills Receivable	Rs. 5,000

Solution

$$\text{Debtors Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Average Debtors}}$$

$$\text{Average Debtors} = \frac{\text{Opening Debtors} + \text{Closing Debtors}}{2}$$

Since there is no information regarding opening debtors, we take closing debtors as average debtors.

$$\text{Therefore, Average Debtors} = \text{Debtors} + \text{Bills Receivable}$$

$$= 5,000 + 5,000$$

$$= \text{Rs. } 10,000$$

$$\text{Debtors Turnover Ratio} = \frac{60,000}{10,000}$$

$$= 6 \text{ times}$$

Illustration 14: Net Credit sales of M.K. Limited during the year were Rs. 3,69,000. If debtors turnover is 4 times, calculate debtors in the beginning and at the end of the year. You are informed that closing debtors are 2 times in comparison to opening debtors.

Solution:

$$\begin{aligned} \text{Debtors Turnover Ratio} &= \frac{\text{Credit Sales}}{\text{Average Debtors}} \\ \text{Therefore, } \frac{\text{Credit Sales}}{\text{Average Debtors}} &= 4 \\ \frac{3,60,000}{\text{Average Debtors}} &= 4 \\ \text{Average Debtors} &= \frac{3,60,000}{4} = \text{Rs. } 90,000 \\ \text{Let } \text{Opening Debtors} &= x \\ \text{Closing Debtors} &= 2x \\ \text{Average Debtors} &= \frac{x + 2x}{2} = \frac{3x}{2} \\ \frac{3x}{2} &= 90,000 \\ x &= \frac{90,000 \times 2}{3} \\ \text{Opening Debtors} &= \text{Rs. } 60,000 \\ \text{Closing Debtors} &= 60,000 \times 2 = \text{Rs. } 1,20,000 \end{aligned}$$

Illustration 15: Average stock carried by a trader is Rs. 60,000. Stock turnover ratio is 10 times. Goods are sold at a profit of 10% on cost. Find out the profit.

Solution

$$\begin{aligned} \text{Stock Turnover Ratio} &= \frac{\text{Cost of Goods Sold}}{\text{Average Stock}} \\ \text{Cost of Goods Sold} &= \text{Average Stock} \times \text{Stock Turnover Ratio} \\ \text{Hence, Cost of Goods Sold} &= 60,000 \times 10 = \text{Rs. } 6,00,000 \\ \text{Rate of Profit} &= 10\% \text{ on Cost of goods sold} \\ \text{Profit} &= 10\% \text{ on } 6,00,000 = \text{Rs. } 60,000 \end{aligned}$$

Illustration 16: From the following details, determine the amount of:

- (i) Opening Stock and
- (ii) Closing Stock

Details:

Stock Turnover 6 times.

Gross Profit 25% on sales, which was Rs. 1,80,000.

Closing Stock was Rs. 15,000 in excess of Opening Stock.

Solution:

$$\text{Sales} = \text{Rs. } 1,80,000$$

$$\text{Gross Profit} = 25\% \text{ on Sales}$$

$$\text{Cost of Goods Sold} = \text{Sales} - \text{Gross Profit}$$

$$= 1,80,000 - 25\% \text{ of } 1,80,000$$

$$= 1,80,000 - 45,000 = \text{Rs. } 1,35,000$$

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold}}{\text{Average Stock}}$$

$$6 = \frac{1,35,000}{\text{Average Stock}}$$

$$6 \times \text{Average Stock} = 1,35,000$$

$$\text{Average Stock} = \frac{1,35,000}{6} = \text{Rs. } 22,500$$

$$\text{Opening Stock} = 22,500 - \frac{15,000}{2}$$

$$= 22,500 - 7,500 = \text{Rs. } 15,000$$

$$\text{Closing Stock} = 22,500 + \frac{15,000}{2}$$

$$= 22,500 + 7,500 = \text{Rs. } 30,000$$

Illustration 17: Compute the amount of gross profit and sales if opening stock is Rs. 60,000, closing stock is Rs. 1,00,000, Stock turnover rate – 8 times. Goods are sold at a profit of 20% on sales.

Solution:

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods sold}}{\text{Average stock}} = 8$$

$$\text{Cost of Goods Sold} = 8 \times \text{Average Stock}$$

$$= 8 \times \frac{60,000 + 1,00,000}{2}$$

$$= 8 \times 80,000 = 6,40,000$$

$$\text{Gross Profit} = 20\% \text{ on Sales}$$

$$\text{Cost of Goods Sold} = \text{Sales} - 20\% = 80\% \text{ of Sales}$$

80% of Sales = 6,40,000

Sales = $6,40,000 \times \frac{100}{80} = \text{Rs. } 8,00,000$

Gross Profit = $\frac{20}{100} \times 8,00,000 = \text{Rs. } 1,60,000$

CASH FLOW STATEMENT

This Lesson discusses the following

1. Introduction
2. Advantages and limitations
3. Some Definitions
4. Classification of Cash flows
5. Special items
6. Preparation of Cash Flows

(a) *Direct Method*

(b) *Indirect Method*

I. Introduction

The Institute of Chartered Accounts of India (ICAI) issued in 1981 Accounting Standard (AS-3) Change in Financial position. This Standard dealt with Funds Flow Statement. The Fund Flow Statement shows flow of working capital, which included items like stock and prepaid expenses, which do not contribute to the short-term ability of the enterprise to pay its debts. In view of this limitation, the need for cash flow statement was realized. In 1997, ICAI issued AS-3 (Revised). This AS-3 Revised replaced AS-3 'Changes in Financial position.'

II. Advantages

1. Cash flow statement, along with other financial statements, gives an idea about the ability of the enterprise to meet its short-term debts.
2. It provides information regarding all the investing and financing activities of the enterprise.
3. It helps in forecasting the amount, timing and certainty of future cash flows. This information helps in-preparing cash budgets.
4. It enhances the comparability of the reporting of operating performance by different enterprises. This is so because it eliminates the effects of using different accounting treatment of the same transaction. Thus figure of cash inflow from operation gives much more reliable picture of the result of the operations than the usual profit and loss account. In the usual profit and loss account, the amount of profit can be manipulated by changing the quantum of depreciation etc.
5. It helps in avoiding a situation where an enterprise has earned huge profit but is short of cash.

Limitations

1. It ignores the accrual accounting concept.
2. Judging profitability of an enterprise by ignoring non-cash expenses does not give correct picture of the profitability.

III. Definitions

1. **Cash:** Cash comprises cash in hand and demand deposits with banks.
2. **Cash equivalents:** Cash equivalents are short term, highly liquid investments that are readily convertible into known amount of cash and which are subject to an insignificant risk of change in value.

From this purpose an investment to qualify as a cash equivalent, the following points must be noted:

(a) It is readily convertible to a known amount of cash.

(b) There is no significant risk of changes in value.

Thus readily convertibility of investment means: The investment is of short maturity, say a few months. Investment in preference shares/debentures are excluded from cash equivalents unless they have been acquired shortly before redemption and further the repayment is also assured. Examples of cash equivalents are treasury bills, commercial papers etc.

3. Cash flows: Cash flows are inflows and outflows of cash and cash equivalents. Cash inflow increases total cash and cash equivalents of the enterprise whereas cash outflows reduce them. The difference of cash inflows and outflows are net cash flow. This net cash flow may be net cash inflow or net cash outflow.

IV. Classification of cash flows

The cash flow statement is prepared to highlight three major categories of cash flows:

(a) Operating activities,

(b) Investing activities, and

(c) Financial activities

(a) Operating activities

Operating activities mean business transactions connected with regular business activities like purchase and sale of goods and services. Cash flows from these activities result from transactions and other events that enter into the determination of net profit/net loss. Cash flows from operating activities include the following:

(a) Cash receipt from sale of goods and rendering of the services;

(b) Cash receipts from royalties, fees, commission and other revenue;

(c) Cash payment to supplies of goods and services like rent, electricity bill, fire insurance premium etc.

(d) Cash payments to and on behalf of employees like wages, salaries, life insurance premium etc.

(e) Cash receipt and payments of an insurance enterprise for premiums, claims annuities and other policy benefits;

(f) Cash payment of refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) Cash receipts and payment relating to future contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

(b) Cash flows from Investing activities

Investing activities are the acquisition and disposal of long term assets and other investments, not included in cash equivalents. In other words, investing activities include transactions and events that involve the purchase and sale of long-term productive assets (e.g. land building, plant and machinery etc. not held for resale) and other investments. The following are example of cash flows arising from investing activities:

(a) Cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalized research and development costs and self-constructed fixed assets.

- (b) Cash receipts from disposal of fixed assets (including intangibles)
- (c) Cash payments to acquire shares, or debt instruments of other enterprises and interests in joint ventures (other than payment for those instruments considered to be cash equivalents and those for dealing or trading purpose).
- (d) Cash receipt from disposal of shares, warrants, or debt instruments of other enterprise and interest in joint ventures (other than receipt from those instruments considered to be cash equivalents and those held for dealing or trading purposes).
- (e) Cash advances and loans made to third parties other than advances and loans made by a financial enterprise.
- (f) Cash receipt from the repayments of advances and loans made by third parties (other than advances and loans by a financial enterprise).
- (g) Cash receipts and payments relating to future contracts; option contracts and swap contracts except when the contracts are held for dealing purpose, or the receipts are classified as financing activities.

(c) Cash flows from Financing activities

Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise. Following are the example of cash flows arising from financing activities:

- (a) Cash proceeds from issue of shares or other similar instruments;
- (b) Cash proceeds from issue of debentures, loans notes, bonds and other short term borrowings;
- (c) Cash repayments of amounts borrowed;
- (d) Payment to redeem preference shares.

V. Special Items

Besides the items discussed in the above these categories. AS-3 (revised) discusses treatment of cash flows of some special items. There are:

- (i) **Foreign Currency:** Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount, the exchange rate between the reporting currency and foreign currency at the date of cash flow. However, a rate, approximating actual rate, may be used if there are not significant differences in result as would be in case of rates prevailing on the date of preparation of cash flow statement were used. It must be kept in mind that the unrealized gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalent held or due in foreign currency is reported in cash flow statement in order to reconcile cash and cash equivalents in the beginning and end of the period.
- (ii) **Extra-ordinary Items:** The examples of extra-ordinary items are bad-debts recovered, claims from insurance companies, winning of a lottery or law-suit etc. The cash-flows associated with such items are disclosed separately as arising from operating, investing and financing activities as appropriate and separately disclose. (See Illustration IV).
- (iii) **Interest and dividends:** The treatment of interest and dividend received or paid in the cash flow statement depends upon the nature of the enterprise. For this purpose, enterprise may be classified as
 - (a) Financial enterprise, and
 - (b) Other enterprise.

- (a) **Financial enterprises:** Cash flows for such enterprises from interests and dividends received and paid should be classified as arising from operating activities.
- (b) **Other enterprises:** In the cash of other enterprises, cash flows from interest and dividends paid or received should be treated as cash flow financing activities. It may be noted the Securities Exchange Board of India (SEBI) allows dividends to be classified as part of operating activities, but companies generally treat them as part of financial activities.
- (iv) **Taxes on Income:** Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows operating activities. Where it is practicable to identify the tax cash flow with investing or financing activities, it should be classified accordingly. Thus capital gain tax on sale of building is identifiable with investing activities and should be shown as outflow from investing activities.
- (v) **Acquisition and disposals of subsidiaries etc.:** The aggregate cash flows from acquisitions and from disposals of subsidiaries or other business units should form part of investing activities.
- (vi) **Non Cash Transactions:** Non-cash transactions do not involve flow of cash or cash-equivalents and are not included in the cash flow statement. However, significant non-cash transactions should be reported in a separate schedule to the cash flow statement. Examples of non-cash transactions are: Acquisition of a business by issue of share/debentures; Acquisition of fixed asset on credit; conversion of debentures into shares etc. However issue/receipt of bonus shares; stock splits, appropriation of retained earnings are not treated as significant and are not disclosed in cash flow statement or in a separate schedule.

VI. Preparation of cash Flow statement

Cash flow statement is prepared on the basis of information provided by the following sources. These are:

- Corporate balance-sheet:** To ascertain the changes in different items of the balance sheet during the year, balance-sheets in the beginning and end of the accounting period is necessary.
- Income statement (IS):** To find out the cash generated/used, income statement of the current period is required.
- Additional Information:** To extract hidden transactions not disclosed by balance-sheets or income-statement.

After information obtained from the above-stated sources, the following steps are taken to prepare cash flow statement:

- Calculating net change in cash and cash equivalent:** The difference between the total of opening and closing balances will show increase/decrease in cash and cash equivalents. This can be explained as flow:

	Opening balance Rs.	Closing balance Rs.
Cash in hand	—	—
Cash in Bank	—	—
Short-term investment	—	—
Total	—	—

- Net cash flow from operating activities:** On the basis of comparative balance-sheets, income statement and other information, net cash flow generated/used by operating activities are ascertained.

Income-statement indicates net profit on accrual basis which is not the same thing as cash generated/used from operating activities. To arrive at cash generated/used, non-cash items are eliminated. AS-3 (revised) has given two alternative procedures. These are (a) Direct Method and (b) Indirect Method (These will be discussed later on in this lesson).

- (3) Calculation of net cash generated/used by investing and financing activities.
- (4) Cash flow statement is prepared by classifying all such flows (inflows/outflows) in terms of operating, investing and financing activities.
- (5) Significant investing and financing transactions which do not involve cash/cash equivalents (i.e. exchange transactions) should be shown separately in a schedule attached to the cash flow statement.

Net cash flow from operating activities are calculated on the basis of

- a) Direct Method, or
- b) Indirect method

a) Direct Method

Income is prepared on the accrual basis. Under this method, attempt is made to covert it into cash basis. Of all sales, purchases, expenses etc. are analyzed to find out the cash effects of all these transactions. Hence cash realized may obtained as follows:

	Rs.
Cash sales	— —
Credit Sales as per IS	— —
Less closing balance of debtors and bills	— —
Add opening balance of debtors and bills	— —
Total Cash generated	— —

	Rs.
Cost of goods sold (as per IS)	— —
Less Opening Stock	(— —)
Add Closing stock	— —
Add opening balance of creditors	— —
Less closing balance of creditors	(— —)
Cash paid for purchases	— —

Alternatively

Purchased for the year	— —
+ Opening Balance of Creditors	— —
- Closing balance of Creditors	— —
Cash paid for purchases	— —

(iii) Cash paid for expenses

Expenses as per IS	Rs.

Add Expenses outstanding in the beginning and prepaid at end	---
Less Expenses outstanding at the end and prepaid in the beginning	---
Cash paid for expenses	_____

It should be noted that under this method, non-cash expenses such as depreciation, fictitious assets written off, amortization of intangible assets, profit/loss on sale of fixed assets/investment etc. are ignored to ascertain cash flows from operating activities.

Format of A Cash Flow Statement

A cash flow statement can be prepared in the following form:

Cash Flow Statement
for the year ending on.....

Balance as on 1 January	
Cash Balance	.....
Bank Balance	.....
Add: Sources of Cash:	
Issue of Shares	.....
Raising of Long-term loans	.....
Sale of Fixed Assets	.....
Short-term Borrowings	.....
Cash from Operations:	
Profit as per Profit and Loss A/c	.....
Add/Less: Adjustment for Non-cash Items	.....
Add: Increase in Current Liabilities	.....
Decrease in Current Assets	.....
Less: Increase in current assets	.....
Decrease in current liabilities	.....
Total Cash available (1)	.....
Less: Applications of Cash:	
Redemption of Redeemable Preference Shares	.....
Redemption of Long-term Loans	.....
Purchase of Fixed Assets	.....
Decrease in Deferred Payment Liabilities	.....
Cash Outflow on Account of Operations	.....
Tax paid	.....
Dividend paid	.....
Decrease in unsecured Loans, Deposits, etc.	.....
Total Applications (2)	.....
Closing Balance*	.....
Cash balance	.....
Bank balance	.....

* It should tally with the balance as shown by (1)-(2).

Distinction Between Cash Flow Statement and Funds Flow Statement

Following are the points of difference between a Cash Flow Statement and a Funds Flow Statement.

1. A Cash Flow Analysis is concerned only with the change in cash position while a Fund Flow Analysis is concerned with change in working capital position, between two balance sheet dates. Cash is only one of the constituents of working capital besides several other constituents such as inventories, accounts receivable, prepaid expenses.
2. A Cash Flow Statement is merely a record of cash receipts and disbursements. Of course, it is valuable in its own way but it fails to bring to light many important changes involving the disposition of resources. While studying the short-term solvency of a business one is interested not only in cash balance but also in the assets which can be easily converted into cash.
3. Cash flow analysis is more useful to the management as a tool of financial analysis in short-periods as compared to funds flow analysis. It has rightly been said that shorter the period covered by the analysis, greater is the importance of cash flow analysis. For example, if it is to be found out whether the business can meet its obligations maturing after 10 years from now, a good estimate can be made about the Iran's capacity to meet its long-term obligations if changes in working capital position on account of operations are observed. However, if the firm's capacity to meet a liability maturing after one month is to be seen, the realistic approach would be to consider the projected change in the cash position rather than an expected change in the working capital position.
4. Cash is part of working capital and, therefore, an improvement in cash position results in improvement in the funds position but the reverse is not true. In other words "inflow of cash" results in "inflow of funds" but inflow of funds may not necessarily result in "inflow of cash". Thus, sound funds position does not necessarily means sound cash position but a sound cash position generally means sound funds position.
5. Another distinction between a cash flow analysis and a funds analysis can be made on the basis of the techniques of their preparation. An increase in a current liability or decrease in a current asset results in decrease in working capital and *vice versa*. While an increase in a current liability or decrease in a current asset (other than cash) will result in increase in cash and *vice versa*.

Some people, as stated before, use term 'funds' in a very narrow sense of 'cash' only. In such an event the two terms 'Funds' and 'Cash' will have synonymous meanings.

Uses of Cash Flow Statement

A Cash Flow Statement is useful for short-term planning. A business enterprise needs sufficient cash to meet its various obligations in the near future such as payment for purchase of fixed assets, payment of debt maturing in the near future, expenses of the business, etc. A historical analysis of the different sources and applications of cash will enable the management to make reliable cash flow projections for the immediate future. It may then plan out for investment of surplus or meeting the deficit, if any. Thus, a cash flow analysis is an important financial tool for the management. Its chief advantages are as follows:

1. Helps in efficient cash management — Cash flow analysis helps in evaluating financial policies and cash position. Cash is the basis for all operations and hence a projected cash flow statement will enable the management to plan and coordinate the financial operations properly. The management can know how much cash is needed, from which source it will be derived, how much can be generated internally and how much could be obtained from outside.

2. Helps in internal financial management — Cash flow analysis provides information about funds which will be available from operations. This will help the management in determining policies regarding internal financial management, e.g., possibility of repayment of long-term debts, dividend policies, planning replacement of plant and machinery, etc.

3. Discloses the movements of cash — Cash flow statement discloses the complete story of cash movement. The increase in or decrease of cash and the reasons therefore can be known. It discloses the reasons for low cash balance in spite of heavy operating profits or for heavy cash balance in spite of low profits. However, comparison of original forecast with the actual results highlights the trends of movements of cash which may otherwise go undetected.

4. Discloses success or failure of cash planning — The extent of success or failure of cash planning can be known by comparing the projected cash flow statement with the actual cash flow statement and necessary remedial measures can be taken.

Limitations of Cash Flow Analysis

Cash flow analysis is a useful tool of financial analysis. However, it has its own limitations. These limitations are as under:

1. Cash flow statement cannot be equated with the Income Statement. An Income Statement takes into account both cash as well as non-cash items and, therefore, net cash does not necessarily mean net income of the business.
2. The cash balance as disclosed by the cash flow statement may not represent the real liquid position of the business since it can be easily influenced by postponing purchases and other payments.
3. Cash flow statement cannot replace the Income Statement or the Funds Flow Statement. Each of them has a separate function to perform.

In spite of these limitations it can be said that cash flow statement is a useful supplementary instrument. It discloses the volume as well as the speed at which the cash flows in the different segments of the business. This helps the management in knowing the amount of capital tied up in a particular segment of the business. The technique of cash flow analysis, when used in conjunction with ratio analysis, serves as a barometer in measuring the profitability and financial position of the business.

Illustration 1: From the following, prepare cash flow from opening activities, using direct method.

Profit and Loss Account For the year ending March 31, 2002

	Rs.			Rs.
To Opening Stock	1,57,000	By Sales		9,24,000
To Purchases	6,41,000	By Closing Stock		1,74,500
To Gross Profit c/d	3,00,000			
	10,98,500			10,98,500
To Salaries	1,67,000	By Gross profit b/d		3,00,000
To Trade Expenses	21,500			
To Depreciation on furniture	13,500			
To Provision for tax	49,000			
To Net profit c/d	49,000			
	3,00,000			3,00,000
To General Reserve	10,000	By balance b/d		9,000
To Proposed Dividend	37,500	By Net profit b/d		49,000
To Balance carried to Balance Sheet	10,500			
	58,000			58,000

Balance Sheets

Liabilities	As on 31.3.2001 Rs.	As on 31.3.2002 Rs.	Assets	As on 31.3.2001 Rs.	As on 31.3.2002 Rs.
Share Capital	2,50,000	2,50,000	Machinery	1,50,000	1,35,000
General Reserve	50,000	60,000	Less Depreciation	15,000	13,500
Profit & Loss A/c	9,000	10,500		1,35,000	1,21,500
Creditors	33,150	42,100	Stock	1,57,500	1,74,500
Expenses O/s	850	900	Debtors	41,500	40,500
Prev. for Taxation	47,000	49,000	Cash in hand	1,000	2,750
Proposed Dividend	37,500	37,500	Cash at Bank	45,000	60,000
			Prepared Expenses	—	750
			Income Tax Advance	47,500	50,000
	4,27,500	4,50,000		4,27,500	4,50,000

During the year dividend Rs. 37,500 for the year 2000-2001 was paid. A tax refund of Rs. 500 for the year 2000-2001 was received. Advance Tax of Rs. 50,000 was paid during the year.

Solution:

(i) Cash Flows from Operating Activities	Rs.
Cash receipts from customers	9,25,000
Cash paid to suppliers and employees	(8,21,250)
Cash inflows from operations	1,03,750
Income tax paid	(49,500)
Net Cash from operating activities	<u>54,250</u>

Working Notes:

(i) Cash receipts from customers	Rs.
Sales for the year	9,24,000
Add Debtors on 31-3-2001	41,500
	<u>9,65,500</u>
Less Debtors on 31-3-2002	40,500
	<u>9,25,000</u>
(ii) (a) Cash paid to suppliers	Rs.
Purchase for the year	6,41,000
Add Creditors on 31-3-2001	33,150
	<u>6,74,150</u>
Less Creditors on 31-3-2002	42,100
	<u>6,32,050</u>
(b) Cash paid for employees	Rs.
Salaries	1,67,000
Trade Expenses	21,500
	<u>1,88,500</u>
Less Expenses O/s 31-3-2002	900
	<u>1,87,600</u>
Add Expenses O/s on 31-3-2001	850

	1,88,450
Add prepared Expenses on 31-3-2002	750
	<u>1,89,200</u>
Cash paid to suppliers	6,32,050
Add cash paid to employees	1,89,200
Cash paid to suppliers and employees	<u>8,21,250</u>
(c) Tax Paid in Advance	50,000
Less Refund of Tax	500
Tax paid, Net	<u>49,500</u>

b) Indirect Method: In indirect Method, cash flow from operating activities is also known as reconciliation method. Under this method, the following steps are taken to calculate cash from operating activities.

- 1) Take net profit before tax and extra-ordinary items.
- 2) Make adjustments for non-cash and non operating expenses and losses —
 - (a) Add non-cash expenses like.
 - (i) Depreciation
 - (ii) Intangible and fictitious assets (like Goodwill, Preliminary expense written off)
 - (iii) Loss on sale of fixed assets/investments.
 - (b) Deduct non-operating income like
 - (i) Profit on sale of fixed assets/investments.
 - (ii) Interest incomes, dividend income.
 - (iii) Interest accrued.
- 3) Changes in current operating assets (excluding cash and cash equivalents) and current operating liabilities.
 - (a) Add
 - (i) Decrease in current operating assets like trade debtors, bills receivable, stock, prepaid expenses, and
 - (ii) increase in current operating liabilities (except bank overdraft like trade creditors, bills payable, expenses outstanding).
 - (b) Deduct
 - (i) increase in current operating liabilities.
 - (ii) decrease in current operating liabilities.
- 4) Deduct Income Tax paid.
- 5) Make adjustments for extra-ordinary items.

Illustration 2: Calculate cash flows from operating activities by using indirect method on the basis of information provided in Illustration 1.

Solution:

Cash flow from operating activities

	Rs.
Net profit before tax	98,000
Adjustments	
for Depreciation on furniture	13,500
Operating profit before working capital changes	1,11,500
Adjustments for	
Increase in stock	(17,000)
Decrease in debtors	1,000
Increase in prepaid expenses	(750)
Increase in Creditors	8,950
Increase in outstanding expenses	50
Cash generated from operations	1,03,750
Tax Paid	(49,500)
Net cash from operating activities	<u>54,250</u>

Illustration 3: The balance sheets of X Ltd. are given below:

(Rs. in lacs)					
Liabilities	31.12.2001	31.12.2002	Assets	31.12.2001	31.12.2002
	Rs.	Rs.		Rs.	Rs.
Share capital	1,000	1,000	Fixed Assets (Net)	1,700	2,000
Reserve and Surplus	850	1,000	Stock	680	700
Long Term Debt	1,000	1,110	Debtors	720	660
Trade Creditors	200	190	Cash	100	100
Provisions	150	160			
	<u>3,200</u>	<u>3,460</u>		<u>3,200</u>	<u>3,460</u>

The income statement of X Ltd for 2002 is also given below:

(Rs. in lacs)		
	Rs.	Rs.
Net Sales		4,080
Cost of Goods Sold:		
Stocks	2,020	
Wages and Salaries	420	
Other Manufacturing Expenses	280	(2,720)
Gross Profit		1,360
Operating Expenses		
Depreciation	220	
Selling, Administrative expenses	460	(680)
Operating Profit		680
Non Operating Surplus		50

Profit before Interest and Tax	730
Interest	(140)
Profit before tax	590
Tax	(260)
Profit before dividends	330
Dividends	(180)
Retained Earnings	150

Prepare cash flow statement

Solution:

Indirect Method

**Cash Flow Statement
For the year ending - 2002**

		Rs. in lacs	
		Rs.	Rs.
(a) Cash flows from operating activities			
Profit before tax		590	
adjustments for			
+ Depreciation		220	
+ Interest		140	
- Non operating surplus		(50)	
Operating profit before working capital changes		900	
Adjustment for:			
+ Increase in provision		10	
+ Decrease in Debtors		60	
		970	
- Decrease in Creditors		(10)	
- Increase in Stock		(20)	
Cash generated from operations		940	
- Tax paid during the year		(260)	
Net Cash from operating activities			680
(b) Cash flows from investing activities			
Purchase of Fixed assets		(520)	
Non-operating surplus		50	
Net cash from investing activities			(470)
(c) Cash flows from financing activities			
Issue of Long Term Debt		110	
Interest paid		(140)	
Dividend paid		(180)	(210)
Increase in cash and cash equivalents			0
Cash and cash equivalents in the beginning		100	
Cash and cash equivalents at the end		100	

Illustration 4: Prepare Cash Flow statement from the Comparative Balance Sheet and income statement.

Liabilities	1999 Rs.	1998 Rs.	Assets	1999 Rs.	1998 Rs.
Creditors	65,000	74,000	Cash	92,000	57,800
Wages outstanding	9,000	15,000	Debtors	82,000	90,000
Income tax unpaid	14,000	10,000	Stock	96,000	1,02,000
Mortgage note (payable 2006)	2,00,000	—	Prepaid Exp.	8,200	7,400
Equity Share capital	8,00,000	7,00,000	Machinery	6,60,000	6,20,000
Securities Premium	1,10,000	90,000	Buildings	11,60,000	9,50,000
Profit & Loss Account	3,08,200	2,38,200	Land	1,20,000	1,00,000
Accumulated Depreciation					
Machinery	2,62,000	3,70,000			
Buildings	4,50,000	4,30,000			
	22,18,200	19,27,200		22,18,200	19,27,200

Additional information:

- Dividends of Rs. 80,000 was declared during the year.
- Machinery (Original Cost Rs. 1,60,000 and accumulated depreciation of Rs. 14,800) was sold for Rs. 12,000. A New Machinery was also purchased for Rs. 2,00,000.
- Buildings were Acquired during the year for Rs. 2,30,000. Down payment of Rs. 30,000 was paid. Remaining payments was made by the issue of mortgage noted, for Rs. 2,00,000 to the vendor.

Income Statement for the year ending 31-12-1999

	Rs.	Rs.
Sales		16,20,000
Cost of Goods Sold		(9,20,000)
Gross profit on sales		7,00,000
Operating Expenses		
Depreciation on Machinery	40,000	
Depreciation on Building	20,000	
Other operating expenses	3,61,000	4,21,000
Net profit before taxation and extraordinary item		2,79,000
Extraordinary item		
Govt. compensation for loss in roits		10,000
Net profit before tax		2,89,000
Income tax		1,35,000
Net profit		1,54,000

Cash Flow Statement

	Rs.	Rs.
Cash Flows from operating activities		
Net profit before tax and extra-ordinary items	2,79,000	
Adjustments for		
Depreciation	60,000	
Operating profit before working capital changes	3,39,000	
Decrease in Debtors	8,000	
Decrease in Stock	6,000	
Increase in prepaid expenses	(800)	
Decrease in Creditors	(9,000)	
Decrease in Wages Outstanding	(6,000)	
Cash generated from operations	3,37,200	
Income tax paid	(1,35,000)	
Cash flow before extra-ordinary item	2,02,200	
Govt. compensation for loss in riots	10,000	
Net cash flow from operating activities		2,12,200
Cash flow from investing activities:		
Purchase of building (Down payment)	(30,000)	
Sale of machinery	12,000	
Purchase of machinery	(2,00,000)	
Net cash used in investing activities		(2,18,000)
Cash flows from financing activities:		
Issue of share capital	1,20,000	
Dividends paid	(80,000)	40,000
Net increase in cash and cash equivalents		34,200
Cash and cash equivalents at the beginning		57,800
Cash and cash equivalents at the end		92,000

Illustration 5: Prepare Cash Flow statement from the following Balance Sheets and additional information:

Liabilities	31.3.2001	31.3.2002	Assets	31.3.2001	31.3.2002
	Rs.	Rs.		Rs.	Rs.
Equity Share capital	3,00,000	4,00,000	Goodwill	1,15,000	90,000
10% Redeemed Preference			Land & Bldg.	2,00,000	1,70,000
Share Capital	1,50,000	1,00,000	Plant	80,000	2,00,000
General Reserve	40,000	70,000	Debtors	1,60,000	2,00,000
Proposed Dividend	42,000	50,000	Stock	77,000	1,09,000
Profit & Loss A/c	30,000	48,000	Bills		
Creditors	55,000	83,000	Receivable	20,000	30,000
Bills Payable	20,000	16,000	Cash	25,000	18,000
Provision for Taxation	40,000	50,000			
	6,77,000	8,17,000		6,77,000	8,17,000

Additional information:

- (a) Depreciation of Rs. 10,000 and Rs. 20,000 have been charged on Land & Building in 2002.
 (b) An interim dividend of Rs. 20,000 have been paid in 2002.
 (c) Income Tax of Rs. 35,000 have been paid during 2002.

Cash Flow Statement for the year ending 31.3.2002

	Rs.	Rs.
Cash Flows from operating activities		
Net profit before taxation	1,63,000	
Adjustments for Depreciation	30,000	
Goodwill written off	25,000	
Operating profit before working capital changes	2,18,000	
Increase in Trade Creditors	28,000	
Increase in Debtors	(40,000)	
Increase in Plant	(32,000)	
Increase in Bills Receivable	(10,000)	
Decrease in Bills Payable	(4,000)	
Cash generated from operations	1,60,000	
Income tax paid	(35,000)	
Net cash flow from operating activities		1,25,000
Cash flow from investing activities:		
Sale of Land & Building	10,000	
Purchase of Plant	(1,30,000)	
Net cash flow from investing activities		(1,20,000)
Cash flows from financing activities:		
Issue of Equity shares	1,00,000	
Redeemable of Preference Shares	(50,000)	
Payment of Dividend		
Final 42,000		
Interim 20,000	62,000	
Net cash flow from financial activities		(12,000)
Net decrease in cash and cash equivalents		(7,000)
Cash and cash equivalent at the beginning		25,000
Cash and cash equivalent at the end		18,000

Working Notes:

1.

Provision for Taxation A/c.

	Rs.		Rs.
To Bank	35,000	By Balance b/d	40,000
To Balance c/d	50,000	By Profit & Loss	45,000
		(Balancing Figure)	
	85,000		85,000

2. **Plant A/c.**

	Rs.		Rs.
To Balance b/d	80,000	By Depreciation	10,000
To Bank	1,30,000	By Balance c/d	2,00,000
		(Balancing Figure)	
	2,10,000		2,10,000

3. **Land & Building**

	Rs.		Rs.
To Balance b/d	2,00,000	By Depreciation	10,000
		By Bank (Bal. Figure)	20,000
		By Balance c/d	1,70,000
	2,00,000		2,00,000

4. **Profit & Loss Appropriation A/c**

	Rs.		Rs.
To Interim Dividend	20,000	By Balance b/d	30,000
To Proposed Dividend	50,000	By Net Profit (Bal. Fig.)	1,18,000
To General Reserve	30,000		
To Balance c/d	48,000		
	1,48,000		1,48,000

Net Profit	1,18,000
+ Provision for Taxation	45,000
	<u>1,63,000</u>

Illustration 6: Balance Sheet of A and B on 1 January, 1993 and 31 December, 1993 were as follows:

Balance Sheet

Liabilities	1 Jan., 1993	31 Dec., 1993	Assets	1 Jan., 1993	31 Dec., 1993
	Rs.	Rs.		Rs.	Rs.
Creditors	40,000	44,000	Cash	10,000	7,000
Mrs. A's Loan	25,000	—	Debtors	30,000	50,000
Loans from Bank	40,000	50,000	Stock	35,000	25,000
Capital	1,25,000	1,53,000	Machinery	80,000	55,000
			Land	40,000	50,000
			Building	35,000	60,000
	2,30,000	2,47,000		2,30,000	2,47,000

During the year a machine costing Rs. 10,000 (accumulated depreciation Rs. 3,000) was sold for Rs. 5,000. The provisions depreciation against Machinery as on 1 January, 1993 was Rs. 25,000 and on 31 December, 1993 was Rs. 40,000. Net profit for the year 1993 amount of Rs. 45,000. You are required to prepare Cash Flow Statement.

Solution:

(i) Traditional Approach

Cash Flow Statement

		Rs.
	Cash Balance as on January, 1993	10,000
Add:	Sources:	
	Cash from Operations	59,000
	Loan from Bank	10,000
	Sale of Machinery	5,000
		74,000
		84,000
Less:	Applications:	
	Purchase of Land	10,000
	Purchase of Building	25,000
	Mrs. A's Loan repaid	25,000
	Drawings	17,000
		77,000
	Cash balance as on 31 Dec., 1993	7,000

Working Notes

		Rs.
	<i>Cash from Operations</i>	
	Profit made during the year	45,000
Add:	Depreciation on Machinery	18,000
	Loss on sale of Machinery	2,000
	Decrease in Stock	10,000
	Increase in Creditors	4,000
		79,000
Less:	Increase in Debtors	20,000
	Cash from Operations	59,000

Machinery Account (At Cost)

Particulars	Rs.	Particulars	Rs.
To Balance b/d	1,05,000	By Bank	5,000
		By Loss on sale of Machinery	2,000
		By Provision for Depreciation	3,000
		By Balance c/d	95,000
	1,05,000		1,05,000

Provision for Depreciation

Particulars	Rs.	Particulars	Rs.
To Machinery A/c	3,000	By Balance b/d	25,000
To Balance c/d	40,000	By P. and L. A/c (deprn. Charged—balancing figure)	18,000
	43,000		43,000

(ii) Modern Approach

Cash Flow Statement

	Rs.
Net Cash Flows from Operating Activities	59,000
Cash flows from Investing Activities:	
Sale of Machinery	5,000
Purchase of Land	(10,000)
Purchase of Building	(25,000)
Net Cash flows from Investing Activities	(30,000)
Cash flows from Financing Activities:	
Loan from Bank	10,000
Mrs. A's Loan repaid	(25,000)
Drawings	(17,000)
Net Cash Flow from Financial Activities	32,000
Net Increase (Decrease) in cash and cash equivalents	3,000
Cash and Cash Equivalents on Jan. 1, 1993	10,000
Cash and Cash Equivalents on Dec. 31, 1993	7,000

Illustration 7: The following are the summarized Balance Sheet of a company as on December, 1992 and 1993:

Liabilities	1992	1993	Assets	1992	1993
	Rs.	Rs.		Rs.	Rs.
Share Capital	2,00,000	2,50,000	Land and buildings	2,00,000	1,90,000
General Reserve	50,000	60,000	Machinery	1,50,000	1,69,000
Profit and loss	30,500	30,600	Stock	1,00,000	74,000
Bank loan (Long-term)	70,000	—	Sundry Debtors	80,000	64,200
Sundry creditors	1,50,000	1,35,200	Cash	500	600
Provision for taxation	30,000	35,000	Bank	—	8,000
			Goodwill	—	5,000
	<u>5,30,500</u>	<u>5,10,800</u>		<u>5,30,500</u>	<u>5,10,800</u>

Additional Information

During the year ended 31 December, 1993:

1. Dividend of Rs. 23,000 was paid.
2. Assets of another company were purchased for a construction of Rs. 50,000 payable in shares.

The following assets were purchased: Stock Rs. 20,000; Machinery Rs. 25,000.

3. Machinery was further purchased for Rs. 8,000.
4. Depreciation written off machinery Rs. 12,000.
5. Income tax provided during the year Rs. 33,000.
6. Loss on sale of machinery Rs. 200 was written off to General Reserve.

You are required to prepare a cash flow statement.

Solution:

(i) Traditional Approach

Cash Flow Statement

for the year ending 31 December, 1993

Particulars		Rs.
	Cash Balance as on 1 Jan., 1993	500
<i>Add:</i>	Sources of Cash:	
	Sale of Machinery	1,800
	Cash from Operations	
	Funds from Operations	88,300
<i>Add:</i>	Decrease in Stock	46,000
	Decrease in Debtors	15,800
		<u>15,50,100</u>
<i>Less:</i>	Decrease in Creditors	14,800
		<u>1,35,300</u>
<i>Less:</i>	Applications of Cash:	
	Payment of Dividend	23,000
	Purchase of Machinery	8,000
	Tax paid (See Note 4)	28,000
	Mortgage Loan repaid	70,000
		<u>1,29,000</u>
	Closing Cash and Bank Balances	8,600
	(Cash in hand Rs. 600 + Cash at Bank Rs. 8000)	

Working Notes

1. Adjusted Profit Loss Account

Particulars	Rs.	Particulars	Rs.
To Dividend	23,000	By Balance b/d	30,500
To Depreciation on Building	10,000	By Funds from Operations	
To Provision for Tax	33,000	(balancing figure)	88,300
To Transfer to General Reserve	10,200		
To Deprn. on Machinery	12,000		
To Balance c/d	30,600		
	<u>1,18,800</u>		<u>1,18,800</u>

2. Machinery Account

Particulars	Rs.	Particulars	Rs.
To Balance b/d	1,50,000	By Depreciation	12,000
To Share Capital	25,000	By General Reserve	200
To Bank	8,000	By Bank	1,800
		By Balance c/d	1,69,000
	<u>1,83,000</u>		<u>1,83,000</u>

3. **General Reserve**

Particulars	Rs.	Particulars	Rs.
To Machinery A/c	200	By Balance b/d	50,000
To Balance c/d	60,000	By P & L b/d	10,200
	<u>60,200</u>		<u>60,200</u>

4. **Provision for Taxation**

Particulars	Rs.	Particulars	Rs.
To Bank	28,000	By Balance b/d	30,000
To Balance c/d	35,000	By P & L A/c	33,000
	<u>63,000</u>		<u>63,000</u>

5. **Decrease in Stock**

	Rs.
Stock as on December, 1992	1,00,000
Less: Stock as on December, 1993 (after deducting stock purchased by issuing share)	54,000
Increase in Cash	<u>46,000</u>

(ii) **Modern Approach as per AS: 3 (Revised)**

Cash Flow Statement
for the ending 31 December, 1993

Particulars	Rs.
Cash Flows Operating Activities:	
Funds from operations	88,300
Adjustments for:	
Decrease in Stock	46,000
Decrease in Debtors	15,800
Decrease in Creditors	(14,800)
Tax paid	28,000
Net Cash from Operating Activities	<u>1,07,300</u>
Cash Flows Investing Activities:	
Sale of Machinery	1,800
Purchase of Machinery	(8,000)
Net Cash used for Investing Activities	<u>(6,200)</u>
Cash Flows from Financing Activities	
Payment of Dividend	(23,000)
Mortgage Loan repaid	(70,000)
Net Cash used in Financing Activities	<u>(93,000)</u>
Net Increase in Cash and Cash Equivalents	8,100
Cash and Cash Equivalents as on 1st Dec., 1993	500
Cash and Cash Equivalents 31st Dec., 1993	<u>8,600</u>
(Cash Rs. 600 + Bank Rs. 8,000)	

Illustration 8: The Balance Sheet of XYZ Limited are as follows:

Liabilities	1994 Rs.	1995 Rs.	Assets	1994 Rs.	1995 Rs.
Equity	800	900	Fixed assets	600	800
General Reserve	300	400	Additions	200	100
P & L A/c	200	300	Depreciation	800	900
Provision for Taxation	300	400		300	350
Overdraft	300	464	Investments	500	550
Sundry Creditors	1,200	1,000	Stock	200	—
Proposed Dividend	80	90	Debtors	1,400	1,230
	3,180	3,554		1,080	1,774
	<u>3,180</u>	<u>3,554</u>		<u>3,180</u>	<u>3,554</u>

Profit and Loss Account
for the year ending...

Particulars	1994 Rs.	1995 Rs.	Particulars	1994 Rs.	1995 Rs.
To Taxation	250	450	By Trading Profit	430	660
To Proposed Dividend	80	90	By Profit on sale of Investment	—	30
To Transfer to General Reserve	100	100	By Income Tax excess provided in the previous year	—	50
To Balance c/f	200	300	By Balance from last year	200	200
	<u>630</u>	<u>940</u>		<u>630</u>	<u>940</u>

Additional Information

- (1) For the year ending 31 December, 1995, purchases were Rs. 60 lakhs and sales were Rs. 70 lakhs.
- (2) Trading profit for the year ended 31 December, 1995 was arrived at after charging depreciation Rs. 50,000 and directors remuneration Rs. 1,20,000.

Prepare the Cash Flow Statement.

Solution:

(i) Traditional Approach

Cash Flow Statement

for the year ending 31 December, 1995 (Rs. in thousands)

Overdraft as on 1 January, 1995		(300)
Add: Sources:		
Increase in Share Capital	100	
Investments sold (200 + 30)	230	330
Total Sources:		30
Less: Applications:		
Fixed Assets purchased	100	
Dividend paid	80	

Tax paid	300	
Cash Outflow on account of operations (Note ii)	<u>14</u>	(494)
Bank Overdraft as on 31 December, 1994		<u>464</u>

Working Notes:

(i) **Adjusted Profit and Loss Account**

Particulars	Rs.	Particulars	Rs.
To Provision for Tax	450	By Balanced b/d	200
To Proposed Dividend	90	By Provision for Tax (excess)	50
To Preparation	50	By profit on sale of Investments	30
To Transfer to General Reserves	100	By Funds from Operations (bal. fig.)	<u>710</u>
To Balance c/d	<u>300</u>		
	<u>990</u>		<u>990</u>

(ii) **Cash From Operations**

Particulars		Rs.
Funds from Operations		710
Add: Decrease in Stock		<u>170</u>
		880
Less: Increase in Debtors	694	
Decrease in Creditors	<u>200</u>	<u>894</u>
Cash Flow on account of Operations		<u>14</u>

(iii) **Provision for Taxation**

Particulars	Rs.	Particulars	Rs.
To P & L A/c (Excess Provision)	50	By Balanced b/d	300
To Bank	300	By P & L A/c	450
To Balance c/d	<u>400</u>		
	<u>750</u>		<u>750</u>

Cash outflow on account of Operation could have also been found out as follows:

		Rs.
	Trading Profit	660
Add:	Depreciation	50
	Funds from Operations	710
Add:	Decrease in Stock	<u>170</u>
		880
Less:	Increase in Debtors	694
	Decrease in Creditors	<u>200</u>
	Cash Outflow on account of operation	<u>14</u>

(ii) Modern Approach as per AS 3 (Revised)

Cash Flow Statement
for the year ending 31st Dec., 1995 (Rs. in '000)

Cash Flows from Operations:	
Funds from Operations	710
Adjustments for:	
Decrease in Stock	170
Increase in Debtors	(694)
Decrease in Creditors	(200)
Tax paid	(300)
Net Cash used for Operating Activities	(314)
Cash flows from Investing Activities:	
Fixed Assets purchased	(100)
Investment sold	230
Net Cash from Investing Activities	130
Cash Flows from Financing Activities:	
Proceeds from Issuance of Share Capital	100
Dividends	(80)
Net Cash from Financing Activities	20
Net Increase (Decrease) in Cash and Cash Equivalents	(164)
Cash and Cash Equivalents as on 1st Jan., 1995	(300)
Cash and Cash Equivalents as on 31st Dec., 1995	(464)

Let us recapitulate the main points of cash flow statement. These are:

1. Earlier AS-3 was issued in 1981 to deal with 'Changes in Financial Position' (i.e. Funds flow statement). This has been replaced by AS-3 (Revised). It deals with cash flow statement.
2. Cash flow statement is prepared wherein includes cash equivalents. Cash equivalents include short term, highly liquid investments which are subject to an insignificant risk of change in value.
3. **Cash flow statement highlights three major categories of cash flows.**

(a) Operating Activities

(b) Investing activities, and

(c) Financing activities

(a) Cash inflows from **operating activities**, are

(i) Cash sales of goods and services

(ii) Cash collected from customers.

(iii) Cash receipts from royalties, fees commissions and other revenue.

Cash outflows **operating activities** are:

(i) Cash payment for purchase of inventories

(ii) Cash payment for various operational expenses, like rent, power, etc.

(iii) Cash payments for wages and salaries.

(iv) Cash payments of income-tax.

(b) **Investing Activities**; These include **cash inflows** from:

(i) Sales of property like plant, machinery and other Fixed assets (including intangibles)

(ii) Sale of Debentures, bonds, shares, warrants of other entities.

- (iii) Repayment of advances and loans made to other entities.
- (iv) Interest and dividends received.

Cash outflows from investing activities include:

- (i) Purchase of property like, plant machinery and other fixed assets (including intangibles)
- (ii) Purchase of debentures, bonds, shares and warrants of other entities.
- (iii) to make loans and advances of other entities.

(c) Financing Activities:

Cash inflows financing activities includes:

- (i) Issue of shares
- (ii) Issue of debentures, loans, bonds, and other short-term and long-term borrowings.
- (iii) Interest and dividends paid.

Cash outflows from financing activities include:

- (i) Dividends paid to shareholders.
- (ii) Repayment of short-term borrowings.
- (iii) Redemption of preference shares.

3. Cash flow statement is prepared by

- (i) Direct Method
- (ii) Indirect Method

These two alternatives are used only in calculation of cash flows from operating activities. As far as calculation of cash flows from investing and financing activities are concerned, the procedure is the same.

SELF TEST

1. State True/False

- (i) AS-3 and AS-3 (revised) are complimentary.
 - (ii) In AS-3 (Revised) the concepts the cash and equivalents have widened the concept of cash flow statement.
 - (iii) Direct and indirect methods help in calculating cash flows from operating activities by adopting two alternative procedures.
 - (iv) Investing financing activities can be calculated by adopting two alternative procedures.
 - (v) Cash flow statement ignores the accrual accounting concepts.
 - (vi) Cash flow statement ignores non-cash expenses.
- (i, iv, are false, ii, iii, v, and vi, are true)

2. Classify the following into cash flows from operating activities, investing activities and financing activities.

- (i) Cash sale of goods.
- (ii) Cash payment of wages and salaries.
- (iii) Cash paid for purchase of furniture.
- (iv) Cash paid to suppliers of goods.
- (v) Payments of income tax.
- (vi) Payment of dividends.
- (vii) Interest paid on debentures.
- (viii) Interest received on investments.
- (ix) Cash repayment of long-term loans.
- (x) Cash proceeds from issue of shares at a premium.

Ans.

Cash flows from operating activities – i, ii, iv, v

Cash flows from investing activities – iii, viii

Cash flows from financing activities – vi, vii, ix, x

LESSON 6

Financial Statements of Companies

LEARNING OBJECTIVES

After studying this chapter, students will be able to understand:

- Format of Statement of Profit and Loss and Balance Sheet
- Accounts related to current tax, advance tax, tax payable, etc.
- Deferred tax
- Provisions relating to disposal of profits, particularly dividends
- Preparation of Statement of Profit and Loss and Balance Sheet.

The basic financial statements are : (1) Statement of Profit and Loss or Income Statement and (2) Balance Sheet or Position Statement. Nowadays a third statement namely Cash Flow Statement is also prepared. Statement of Profit and Loss or Income Statement is a statement of revenue from operations, other income and expenses for a particular period. It also shows exceptional items, extraordinary items and tax expense. Balance Sheet is a statement of assets (non-current assets and current assets) and equity (shareholders' funds) and liabilities (non-current liabilities and current liabilities). It shows the financial position of the enterprise as at a particular date. Cash Flow Statement shows the inflows and outflows of cash from operating activities, investing activities and financing activities. In this chapter, we shall study the preparation of Statement of Profit and Loss and Balance Sheet. **Statement of Profit and Loss is the new name prescribed by the Revised Schedule VI to the Companies Act, 1956 (hereinafter called Revised Schedule VI) for the Profit and Loss Account.** As per the proposed new Companies Bill, 2012 this has been numbered as Schedule III.

Section 210 of the Companies Act, 1956 provides that at every annual general meeting of a company the Board of Directors of the company shall lay before the company (1) a balance sheet as at the end of the period and (2) a profit and loss account (statement of profit and loss as per Revised Schedule VI) for that period. In the case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at the annual general meeting instead of profit and loss account. Section 210A deals with the constitution of National Advisory Committee on Accounting Standards.

Section 211 of the Companies Act, 1956 provides that every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year. It should be in the form set out in Schedule VI to the Companies Act, 1956 or in such other form as may be approved by the Central Government either generally or in a particular case. *It further provides that every profit and loss account (statement of profit and loss as per Revised Schedule VI) of a company shall give a true and fair view of the profit or loss of the company for the financial year.* Revised Schedule VI prescribes the format of statement of profit and loss also. Old Schedule VI did not prescribe the format of profit and loss account. The provisions of this section are not applicable to any insurance or banking company or any company engaged in the generation or supply of electricity or any other class of company for which a form of balance sheet and profit and loss account has been specified in or under the Act governing such class of company.

The Companies (Amendment) Act, 1999 which came into force on 31st day of October, 1998 has made the compliance of accounting standards mandatory by adding three new subsections (3A), (3B) and (3C) in section 211. Every profit and loss account and balance sheet of the company shall comply with

the accounting standards [S.211(3A). Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose, in its profit and loss account and the balance sheet, the following :

- (a) the deviation from the accounting standards;
- (b) the reasons for such deviation; and
- (c) the financial effect, if any, arising due to such deviation [S. 211(3B)]

For the purposes of S. 211 the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949, in consultation with the National Advisory Committee on Accounting Standards. Standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be Accounting Standards prescribed by the Central Government.

Revised Schedule VI

Schedule VI to the Companies Act 1956 provides the manner in which every company registered under the Act shall prepare its Statement of Profit and Loss, Balance Sheet and Notes to the financial statements. There was a need of enhancing the disclosure requirements under the Old Schedule VI to the Companies Act, 1956 to harmonise them with the notified accounting standards. Therefore, the Ministry of Corporate Affairs issued a revised form of Schedule VI, vide Notification No. S.O. 447(E), dated February 28, 2011. *The Revised Schedule applies to the companies for the Financial Statements to be prepared for the financial year commencing on or after April 1, 2011.* Further for the Financial Statements prepared for the year 2011-12 (1st April, 2011 to 31st March, 2012), the corresponding amounts for the immediately preceding period are to be disclosed in the Financial Statements including the Notes to the Accounts. **As per the proposed new Companies Bill, 2012 this has been numbered mm Schedule III.**

General Instructions

1. The Revised Schedule VI provides that where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head/Sub-head or any changes inter se, in the Financial Statements or statements forming part thereof, the same shall be made and the requirements of the Schedule VI shall stand modified accordingly. **Thus the Revised Schedule gives overriding status to the other requirements of the Companies Act, 1956 and the Accounting Standards as applicable to the companies. In other words, the requirements of the Accounting Standards and other provisions of the Companies Act would prevail over the Revised Schedule.**

2. The second para of the General Instructions states that the *disclosure requirements specified in Part I (Form of Balance Sheet) and Part II (Form of Statement of Profit and Loss Account) of the Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 1956.* Additional disclosures specified in the Accounting Standards shall be made in the Notes to Accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the Notes to Accounts in addition to the requirements set out in the Schedule.

3. The third para states that the Notes to Accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (a) narrative descriptions or

disaggregations of items recognized in those statements and (b) information about items that do not qualify for recognition in those statements. These items normally include contingent liabilities and commitments which are not shown on the face of the Balance Sheet.

It further provides that each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the Notes to Accounts. In preparing the Financial Statements including the Notes to Accounts, a balance shall be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation.

The manner of cross reference has been changed to "Note No." as compared to "Schedule No." in the Old Schedule VI*.

4. The Revised Schedule VI has introduced new norms of rounding off depending upon the turnover of the company. The figures appearing in the Financial Statements may be rounded off as below :

Turnover	Rounding off
(i) less than one hundred crores rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(ii) one hundred crore rupees or more	To the nearest lakhs, millions or crores, or decimals thereof.

However, it is not compulsory to round off the figures.

5. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

6. For the purpose of the Revised Schedule VI, the terms used in the Schedule shall be as per the applicable Accounting Standards.

The Notes to the General Instructions reiterate that the Revised Schedule VI lays down the minimum requirements for disclosure in the Financial Statements including Notes to Accounts. It is reproduced below :

NOTES

This part of Schedule sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as "Financial Statements" for the purpose of this Schedule) and Notes. Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

* Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

Part I—Form of BALANCE SHEET

The following is the form of the Balance Sheet as per Revised Schedule VI:

Name of the Company

Balance Sheet as at

(Rupees in)

<i>Particulars</i>	<i>Note</i>	<i>Figures as at the end of current reporting period</i>	<i>Figures as at the end of the previous reporting period</i>
1	2	3	4
I. EQUITY AND LIABILITIES			
(1) Shareholders' funds			
(a) Share capital			
(b) Reserves and surplus			
(c) Money received against share warrants			
(2) Share application money pending allotment			
(3) Non-current liabilities			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long-term liabilities			
(d) Long-term provisions			
(4) Current liabilities			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
TOTAL			
II. ASSETS			
(1) Non-current assets			
(a) Fixed assets			
(i) Tangible assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (net)			
(d) Long-term loans and advances			
(e) Other non-current assets			

(2) Current assets			
(a) Current investments			
(b) Inventories			
(c) Trade receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			
-TOTAL			

See accompanying notes to the financial statements.

Notes:

General Instructions for Preparation of Balance Sheet

The general instructions for preparation of Balance Sheet as per Revised Schedule VI a produced below :

1. An asset shall be classified as current when it satisfies any of the following criteria :

- (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is expected to be realized within twelve months after the reporting date; or
- (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

3. A liability shall be classified as current when it satisfies any of the following criteria:

- (a) it is expected to be settled in the company's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is due to be settled within twelve months after the reporting date; or
- (d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterpart, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in the Notes to Accounts :

A. Share Capital

for each class of share capital (different classes of preference shares to be treated separately)

- (a) the number and amount of shares authorized;
- (b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
- (c) par value per share;
- (d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;
- (e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
- (f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;
- (g) shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held;
- (h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;
- (i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared—
 - Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.
 - Aggregate number and class of shares allotted as fully paid up by way of bonus shares.
 - Aggregate number and class of shares bought back.
- (j) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date;
- (k) calls unpaid (showing aggregate value of calls unpaid by directors and officers);
- (l) forfeited shares (amount originally paid up).

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as :

- (a) Capital Reserve;
- (b) Capital Redemption Reserve;
- (c) Securities Premium Reserve;
- (d) Debenture Redemption Reserve;
- (e) Revaluation Reserve;
- (f) Share Options Outstanding Account;
- (g) Other Reserves—(specify the nature and purpose of each reserve and the amount in respect thereof);
- (h) Surplus *i.e.* balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.

(Additions and deductions since last Balance Sheet to be shown under each of the specified heads)

- (ii) A reserves specifically represented by earmarked investments shall be termed as a 'fund'.
- (iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-term Borrowings

- (i) Long-term borrowings shall be classified as :
 - (a) Bonds/debentures
 - (b) Terms loans
 - From banks
 - From other parties
 - (c) Deferred payment liabilities
 - (d) Deposits.
 - (e) Loans and advances from related parties
 - (f) Long-term maturities of finance lease obligations
 - (g) Other loans and advances (specify nature)
- (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.
- (v) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.
- (vi) Terms of repayment of term loans and other loans shall be stated.
- (vii) Period and amount of continuing default as on the Balance Sheet date in repayment of loans and interest, shall be specified separately in each case.

D. Other Long-term Liabilities

Other Long-term Liabilities shall be classified as :

- (a) Trade payables
- (b) Others

E. Long-term Provisions

The amounts shall be classified as :

- (a) Provision for employee benefits
- (b) Others (specify nature)

F. Short-term Borrowings

- (i) Short-term borrowings shall be classified as :
 - (a) Loans repayable on demand

- From banks
- From other parties
- (b) Loans and advances from related parties
- (c) Deposits
- (d) Other loans and advances (specify nature)
- (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) Period and amount of default as on the Balance Sheet date in repayment of loans and interest, shall be specified separately in each case.

G. Other Current Liabilities

The amounts shall be classified as :

- (a) Current maturities of long-term debt
- (b) Current maturities of finance lease obligations
- (c) Interest accrued but not due on borrowings
- (d) Interest accrued and due on borrowings
- (e) Income received in advance
- (f) Unpaid dividends
- (g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable *i.e.*, the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities.'
- (h) Unpaid matured deposits and interest accrued thereon
- (i) Unpaid matured debentures and interest accrued thereon
- (j) Other payable (specify nature);

H. Short-term Provisions

The amounts shall be classified as :

- (a) Provision for employee benefits
- (b) Others (specify nature)

I. Tangible Assets

- (i) Classification shall be given as :
 - (a) Land

- (b) Buildings
 - (c) Plant and Equipment
 - (d) Furniture and Fixtures
 - (e) Vehicles
 - (f) Office equipment
 - (g) Others (specify nature)
- (ii) Assets under lease shall be separately specified under each class of asset.
 - (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and at end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.
 - (iv) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every Balance Sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible Assets

- (i) Classification shall be given as :
 - (a) Goodwill
 - (b) Brands/trademarks
 - (c) Computer software
 - (d) Masterheads and publishing titles
 - (e) Mining rights
 - (f) Copyrights, and patents and other intellectual property rights, services sand operating rights
 - (g) Recipes, formulae, models, designs and prototypes
 - (h) Licenses and franchise
 - (i) Others (specify nature).
- (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and at the end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.
- (iii) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every Balance Sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable tougher with the date thereof for the first five years subsequent to the date of such reduction or increase.

K. Non-current Investments

- (i) Non-current investments shall be classified as trade investments and other investments and further classified as :
 - (a) Investment in property
 - (b) Investments in Equity Instruments

- (c) Investments in preference shares
- (d) Investments in Government or trust securities
- (e) Investments in debentures or bonds
- (f) Investments in Mutual Funds
- (g) Investments in partnership firms
- (h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities in whom investments have been made and the nature and extent of the investments so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.
- (iii) The following shall also be disclosed :
 - (a) Aggregate amount of quoted investments and market value thereof;
 - (b) Aggregate amount of unquoted investments;
 - (c) Aggregate provision for diminution in value of investments.

L. Long-term Loans and Advances

- (i) Long-term loans and advances shall be classified as :
 - (a) Capital Advances;
 - (b) Security Deposits;
 - (c) Loans and advances to related parties (giving details thereof);
 - (d) Other loans and advances (specify nature).
- (ii) The above shall also be separately sub-classified as :
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other Non-current Assets

Other non-current assets shall be classified as :

- (i) Long-term Trade Receivables (including trade receivables on deferred credit terms);
- (ii) Others (specify nature).
- (iii) Long-term Trade Receivables, shall be sub-classified as :
 - (i) (a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful.

(ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

(i) Current investments shall be classified as :

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares;

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms;

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are : (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed :

(a) The basis of valuation of individual investments;

(b) Aggregate amount of quoted investments and market value thereof;

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as :

(a) Raw materials;

(b) Work-in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) Stores and spares;

(f) Loose tools;

(g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

P. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from

the date they are due for payment should be separately stated.

- (ii) Trade receivables shall be sub-classified as :
 - (a) Secured, considered good;
 - (b) Unsecured considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
- (iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and Cash Equivalents

- (i) Cash and cash equivalents shall be classified as :
 - (a) Balances with banks;
 - (b) Cheques, draft on hand;
 - (c) Cash on hand;
 - (d) Others (specify nature).
- (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
- (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- (v) Banks deposits with more than 12 months maturity shall be disclosed separately.

R. Short-term Loans and Advances

- (i) Short-term loans and advances shall be classified as :
 - (a) Loans and advances to related parties (giving details thereof);
 - (b) Others (specify nature).
- (ii) The above shall also be sub-classified as :
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
- (iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partners or a director or a member shall be separately stated.

S. Other Current Assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent Liabilities and Commitments

(to the extent not provided for)

- (i) Contingent liabilities shall be classified as :

- (a) Claims against the company not acknowledged as debt;
 - (b) Guarantees;
 - (c) Other money for which the company is contingently liable.
- (ii) Commitments shall be classified as :
- (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
 - (b) Uncalled liability on shares and other investments partly paid;
 - (c) Other commitments (specify nature).
- U. The amount of dividends proposed to be distributed to equity and preference shareholder for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.**
- V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the Balance Sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested.**
- W. If, in the option of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the 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.**

Major Changes related to the Balance Sheet In Revised Schedule VI

The following are the major changes related to the Balance Sheet in Revised Schedule VI as compared to Old Schedule VI :

1. Only vertical format. The Revised Schedule VI prescribes only the vertical format of the Balance Sheet and Statement of Profit and Loss. Further the details of various items is to be shown in the Notes to Accounts. For example, the appropriation items are to be disclosed as part of the Notes of Reserves and Surplus as follows :

Note No.... Surplus in the Statement of Profit and Loss

Opening balance	xxx	xxx
Add : Profit for the year	xxx	xxx
Less : Transfer to General Reserve	xxx	xxx
Less : Transfer to other (specify the nature) reserve	xxx	xxx
Less : Proposed Preference Dividend	xxx	xxx
Less : Proposed Equity Dividend	xxx	xxx
Less : Dividend Distribution Tax	xxx	xxx
Closing balance	xxx	xxx

2. Current and non-current classification. The Revised Schedule VI prescribes bifurcation of all items of assets and liabilities between current and non-current portions. These are to be presented separately on the face of the Balance Sheet. This was not required under Old Schedule VI.

3. Details of shareholder(s) holding more than 5% shares. The Revised Schedule requires the disclosure of each shareholder holding more than 5% shares in the company.

4. Disclosure of certain details only for a period of five years. As per the Revised Schedule

VI the details of *aggregate number and class of shares* allotted for consideration other than cash, bonus shares and shares bought back need to be disclosed only for a period of five years immediately preceding the Balance Sheet date including the current year. Year-wise break up is not necessary.

5. Disclosure of debit balance in the Statement of Profit and Loss. Debit balance of statement of profit and loss will be shown under the head 'Surplus'. The aggregate amount of 'Reserve and Surplus' will be shown after adjusting the negative balance of 'surplus', if any. If the net figure is negative, the negative figure will be shown under the head 'Reserve and Surplus'.

6. 'Specific disclosure for share application money. Share application money *pending allotment* will be disclosed as a separate line item on the face of the Balance Sheet. This will be shown between "Shareholders' Funds" and "Non-current Liabilities". But the application money received for allotment of securities and due for refund and interest accrued thereon will be shown under the head "Other current liabilities".

7. Trade receivables and Trade payables. The term "sundry debtors" has been replaced by the term "trade receivables". Similarly the term 'sundry creditors' has been replaced by the term "trade payables". Further the Revised Schedule requires disclosure of trade receivables outstanding for a period exceeding six months *from the date the bill is due for payment and not for a period exceeding six months from the date of the bill/ invoice raised.* The term 'trade payables' means payables in respect of the amount due on account of goods purchased or services received in the normal course of business. It does not include dues payables in respect purchase of fixed assets, interest accrued on trade payables etc. However, acceptances (bills payables) should be disclosed as part of trade payables as per Revised schedule VI.

8. Capital advances. "Capital advances" for acquisition of fixed assets are usually noncurrent assets. They are to be disclosed separately under "Long-term loans and advances". They are not to be classified under Capital Work in Progress.

9. Tangible assets under lease. As per the Revised Schedule, assets under lease are to be separately specified under each class of asset. Assets given on operating lease are shown in the books of the lessor and assets given of finance lease are shown in the books of the lessee as per accounting standard on lease accounting.

10. Capital and other commitments. As per Revised Schedule VI, not only capital commitments but other commitments are also to be disclosed.

11. Disclosure of all defaults in repayment of loans and interest. As per the Revised Schedule VI, the companies are required to disclose all defaults in repayment of loans and interest thereon.

12. Other disclosures. The Revised Schedule VI has introduced a number of other disclosures, some of which are as follows :

- (a) A reconciliation on the number of shares outstanding at the beginning and at the end of the reporting period is to be shown for each class of share capital.
- (b) The rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and repayment of capital is to be shown for each class of share capital.
- (c) For each classification of investment, details to be given of names of the bodies corporate in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly paid).
- (d) Aggregate provision for diminution in value of investments is to be shown separately for current investments and long-term investments.

- (e) Stock-in-trade held for trading purposes to be shown separately from other finished goods.
- (f) The Revised Schedule does not contain any specific disclosure requirement about the unwritten off portion of expense items such as discount on issue of shares, discount on issue of debentures and share issue expenses which were required to be disclosed under the head "Miscellaneous Expenditure" under the Old Schedule VI. The Guidance Note on the Revised Schedule VI to the Companies Act, 1956 recommends that an entity can disclose the unamortised portion of such expenses as "Unamortised expenses", under the head "Other current assets"/ "Other non-current assets", depending on whether the amount will be amortised in the next 12 months or thereafter.
- (h) Each item on the face of the Balance Sheet and Statement of Profit and Loss is to be cross-referenced to any related information in the Notes to the Accounts by giving "Note No." in place of "Schedule No."

The following is the form of Statement of Profit and Loss as per Revised Schedule VI :

Name of the Company

Profit and loss statement for the year ended

(Rupees in

<i>Particulars</i>	<i>Note No.</i>	<i>Figures for the current reporting period</i>	<i>Figures for the previous reporting period</i>
I. Revenue from operations		xxx	xxx
II. Other income		xxx	xxx
III. Total Revenue (I + II)		xxx	xxx
IV. Expenses:			
Cost of materials consumed		xxx	xxx
Purchases of Stock-in Trade		xxx	xxx
Changes in inventories of finished goods work-in progress and Stock-in-Trade. Employee benefits expense.		xxx	xxx
Finance costs Depreciation and amortization expense			
Other expenses		xxx	xxx
Total expenses		xxx	xxx
V. Profit before exceptional and extraordinary items and tax (III - IV)		xxx	xxx
VI. Exceptional items		xxx	xxx
VII. Profit before extraordinary items and tax (V-VI)		xxx	xxx
VIII. Extraordinary items		xxx	xxx
IX. Profit before tax (VII - VIII)		xxx	xxx
X Tax expenses :		xxx	xxx

(1) Current tax	xxx	xxx
(2) Deferred tax		
XI. Profit (Loss) for the period from continuing operations (VII - VIII)	xxx	xxx
XII. Profit/(loss) from discontinuing operations	xxx	xxx
XIII. Tax expense of discontinuing operations	xxx	xxx
XIV. Profit/(loss) from Discontinuing operations (after tax) (XII -XIII)	xxx	xxx
XV. Profit (Loss) for the period (XI + XIV)	xxx	xxx
XVI. Earnings per equity share :		
(1) Basic	xxx	xxx
(2) Diluted	xxx	xxx

See accompanying notes to the financial statements

Notes:

General Instructions for Preparation of Statement of Profit and Loss

The general instructions for preparation of Statement of Profit and Loss as per Revised Schedule VI are reproduced below :

- The provisions of this Part shall apply to the income and expenditure account referred to in subsection (2) of Section 210 of the Act, in like manner as they apply to a statement of profit and loss.
- (A) In respect of a company other than a finance company **revenue from operations** shall disclose separately in the notes revenue from
 - sale of products;
 - sale of services;
 - other operating revenues;

Less :

- Excise duty.
- (B) In respect of a finance company, revenue from operations shall include revenue
- interest; and
 - other financial services

Revenue under each of the above heads shall be disclosed separately by way of Notes to Accounts to the extent applicable.

3. Finance Costs

Finance costs shall be classified as :

- Interest expense;
- Other borrowing costs;
- Applicable net gain/loss on foreign currency transactions and translation.

4. Other income

Other income shall be classified as :

- Interest Income (in case of a company other than a finance company);
- Dividend income;

- (c) Net gain/loss on sale of investments;
- (d) Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information

A Company shall disclose by way of notes additional information regarding **aggregate expenditure and income** on the following items :

- (i) (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].
- (b) Depreciation and amortization expense;
- (c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000, whichever is higher;
- (d) Interest Income;
- (e) Interest Expense;
- (f) Dividend Income;
- (g) Net gain/loss on sale of investments;
- (h) Adjustments to the carrying amount of investments;
- (i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
- (j) Payments to the auditor *as* (a) auditor; (b) for taxation matters, (c) for company law matters, (d) for management services, (e) for other services, (f) for reimbursement of expenses;
- (k) Details of items of exceptional and extraordinary nature;
- (l) Prior period items;
- (ii) (a) *In the case of manufacturing companies,—*
 - (1) Raw materials under broad heads.
 - (2) Goods purchased under broad heads.
- (b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.
- (c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.
- (d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.
- (e) In the case of other companies, gross income derived under broad heads.
- (iii) *In the case of all concerns having work-in-progress, work-in-progress under broad heads.*
- (iv) (a) *The aggregate, if material, of any amounts set aside or proposed to be set a side, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance sheet is made up.*
- (b) *The aggregate, if material, of any amounts withdrawn from such reserves.*
- (v) (a) *The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.*

- (b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.
- (vi) *Expenditure incurred on each of the following items, separately for each item :*
- (a) Consumption of stores and spare parts.
 - (b) Power and fuel.
 - (c) Rent.
 - (d) Repairs to buildings.
 - (e) Repairs to machinery,
 - (g) Insurance.
 - (h) Rates and taxes, excluding, taxes on income,
 - (i) Miscellaneous expenses.
- (vii) (a) Dividends from subsidiary companies,
 (b) *Provisions for losses of subsidiary companies.*
- (viii) *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 materials;
 - II. Components and spare parts;
 - III. Capital goods;
 - (b) Expenditure of foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;
 - (c) Total value of all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;
 - (d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;
 - (e) Earnings in foreign exchange classified under the following heads, namely :
 - I. Export of goods calculated on F.O.B. basis;
 - II. Royalty, know-how, professional and consultation fees;
 - III. Interest and dividend;
 - IV. Other income, indicating the nature thereof.

Note : Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of Financial Statements.

Major Changes and Explanation of items related to Statement of Profit and Loss Account

The following are the major changes related to Statement of Profit and Loss introduced by Revised Schedule VI :

1. **Change of name.** The name of the income statement has been changed to "Statement of Profit and Loss" in the Revised Schedule VI in place of "Profit and Loss Account."

2. **Format of Statement of Profit and Loss.** The Revised Schedule VI has prescribed a format for presentation of "Statement of Profit and Loss Account. The format of Statement of Profit and Loss does not prescribe any appropriation items on its face. Such below the line adjustments are to be presented under "Reserves and Surplus" in the Balance Sheet. The Old Schedule VI had not prescribed any format for presentation of Profit and Loss Account.

3. **Presentation of Revenue from operations.** The Revised Schedule VI requires that in case of companies **other than finance companies**, revenue from operations is to be disclosed separately in the notes, showing revenue from :

- (a) Sale of products
- (b) Sale of services
- (c) Other operating revenues
- (d) Less : Excise duty.

As per AS-9 "Revenue Recognition" the disclosure in respect of **excise duty** is required to be presented on the face of the Statement of Profit and Loss. Since Accounting Standards override Revised Schedule VI (as per Revised Schedule VI itself), the disclosure in respect of excise duty needs to be made on the face of the Statement of Profit and Loss Account instead of the Notes. Therefore, the company may disclose revenue from products, sale of services and other operating revenues also on the face of the Statement of Profit and Loss instead of the Notes.

Indirect taxes such as sales tax, service tax etc. are collected by an enterprise from the customer on behalf of the government in most of the cases. However, in some cases the entity may be acting as principal rather than as an agent in collecting these taxes. *Revenue should be presented net of taxes if the company is acting as an agent in collecting these taxes. Revenue should be presented gross if the company is acting as a principal and therefore responsible for paying tax on its own account to the government. In the latter case, the tax payable is shown as an expense.* However, as per the Guidance Note on **Value Added Tax**, "Value Added Tax" (VAT) should not be recorded as revenue of the enterprise as it is collected by the enterprise on behalf of the VAT authorities and thus collection of VAT is not an economic benefit of the enterprise. At the same time, payment of VAT should not be treated as an expense. The Guidance Note on VAT further states, "Where the enterprise has not charged VAT separately but has made a composite charge, it should segregate the portion of sales which is attributable to tax and should credit the same to "VAT" payable Account at periodic intervals."

The term "**other operating revenues**" is not defined. This would include revenue from operating activities but which is not revenue from sale of products or rendering of services. **Whether a particular revenue is "other operating revenue" or "other income" is to be decided on the facts and circumstances of each case.** For example, profit from the sale of fixed assets should be classified as "other income" and not "other operating revenue". On the other hand, amount realised from sale of scrap arising from operations of a manufacturing company should be classified as "other operating revenue". All kinds of interest income should be disclosed by a non-finance company under "Other income". Net foreign exchange gain should be classified under the head "Other income".

In respect of a **finance company** (i.e. a company carrying on activities in the nature of "business of non-banking financial institution" including a "non-banking financial company" as defined in Reserve Bank of India Act, revenue from operations shall include revenue from :

- (a) Interest; and
- (b) Other financial services.

4. Presentation of Expenses: As per Revised Schedule VI, the aggregate of the following expenses are to be disclosed on the face of the Statement of Profit and Loss Account:

- Cost of materials consumed
- Purchases of Stock-in-Trade
- Changes in inventories of finished goods, work-in-progress and stock in trade.
- Employee benefits expense
- Finance cost
- Depreciation and amortisation expense
- Other expenses.

Cost of materials consumed needs to be disclosed in case of manufacturing companies. Materials consumed would consist of raw materials, primary packing materials, if any, and other materials such as purchased intermediates and components which are consumed in the manufacturing process. However, raw materials does not include intermediates and components which are internally manufactured. Where internally manufactured components are sold without further processing they are to be disclosed under the head "finished goods".

Where internally manufactured components are sold only after further processing they may be disclosed under the head "work-in-progress" or under any other suitable description such as "semi-finished products" or "intermediate products" or "manufactured components" subject to further processing.

Changes in inventories of finished goods, work-in-progress and stock-in-trade should be disclosed separately for finished goods, work-in-progress and stock-in-trade.

Employee benefit expense should be disclosed separately under the following heads :

- (i) Salaries and Wages
- (ii) Contribution to provident and other funds
- (iii) Expense on Employee Stock Option Scheme and Employee Stock Option Plan—as per Guidance Note on Accounting for Employee Share based Payments and/or SEBI (Employee Stock Option Scheme and Employee Stock Option Purchase Scheme) Guidelines, 1999.
- (iv) Staff Welfare expenses.

Finance costs is to be disclosed under the following heads :

- Interest expense
- Other borrowing costs
- Applicable net gain/loss on foreign currency transactions and translation, i.e., exchange differences to the extent considered as an adjustment to borrowing cost.

Depreciation on depreciable assets and *amortisation* of intangible assets are to be disclosed under the head "Depreciation and amortisation expense."

All other expenses not classified under aforesaid heads will be classified under the head "**Other expenses**". As per the Revised Schedule VI, any item of expense which exceeds one per cent of the revenue from operations or Rs. 1,00,000, whichever is higher is to be disclosed separately. The Old Schedule VI required separate disclosure of an item of expense if it exceeded one per cent of total revenue or 75,000 whichever is higher. Further, the Revised Schedule requires separate disclosure of each of the following items under the head "Other expenses" :

- Consumption of stores and spare parts
- Power and fuel

- Rent
- Repairs to buildings
- Repairs to machinery
- Insurance
- Rates and taxes, excluding, taxes on income
- Miscellaneous expenses
- Provisions for losses of subsidiary companies
- Payment to the auditor as :
 - (a) Auditor
 - (b) For taxation matters
 - (c) For company law matters
 - (d) For other services
 - (e) For reimbursement of expenses

5. Disclosure of Prior Period Items AS-5 : "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that the nature and amount of prior period items to be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived (Para 15). Prior period can be disclosed either as a separate line item in the Statement of Profit and Loss or the amount of prior period item included in a specific line item can be disclosed separately.

6. Exceptional items and Extraordinary items: The term "Exceptional items" has not been defined in the notified accounting standards or in Revised Schedule VI. However, AS-5 can be referred to disclose items under the head "Exceptional items". Para 12 of AS-5 states : "When items of income and expense within profit or loss from ordinary activities are of such size, nature and incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately." It includes write down of inventories to net realisable value and reversal of such write downs; disposals of items of fixed assets; disposals of long-term investments; legislative changes having retrospective application; litigation settlements; and other reversal of provisions.

The term **Extraordinary items** is not defined in the Revised Schedule VI. However, AS-5 : "*Net Profit or Loss for the period, Prior period items and changes in Accounting Policies*" defines "Extraordinary items" as follows :

Extraordinary items are income or expense that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

According to AS-5, "Extraordinary items should be disclosed in the Statement of Profit and Loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of Profit and Loss in a manner that its impact on current profit or loss can be perceived."

Extraordinary items include loss due to attachment of property of the enterprise; loss due to an earthquake (except in case of an insurance company); and write back of self-insurance reserve no longer required.

The aggregate of extraordinary items should be disclosed, in case of more than one such items, on the face of the Statement of Profit and Loss and the details of all the items should be disclosed in Notes to Accounts.

7. Tax expense: Tax expense is to be disclosed on the face of the Statement of Profit and Loss as follows :

- (1) Current tax
- (2) Deferred tax.

AS-22 ; "Accounting for Taxes on Income" states that tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or Loss for the period.

According to AS-22 "Accounting for taxes on Income" , "*Current tax is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.*"

AS-22 also defines **deferred tax**. According to it, *deferred tax is the tax effect of timing differences. Timing differences* are defined as "*differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods*"

According to AS-22, "*Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving.*" AS-22, "*Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income payable (recoverable) is determined.*"

Taxable income is calculated in accordance with tax laws. In some cases, the requirements, of these laws to compute taxable income are different from the accounting policies applied to determine accounting income. The effect of this difference *is* that the taxable income and accounting income may not be the same (Para 5 of AS-22).

The differences between taxable income and accounting income can be classified into permanent differences and timing differences. **Permanent difference are those differences between taxable income and accounting income which originate in one period and do not reverse subsequently.** For instance, if for the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure, the disallowed amount would result in a permanent difference (para 6 of AS-22).

Timing differences are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. Timing difference arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income. For example, machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would be charged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as deduction for tax purposes will ultimately be the same, but periods over which the depreciation is charged and the deduction is allowed will differ (Para 7 of AS-22).

Accounting Treatment of Deferred Tax

If accounting income is more than taxable income and due to the tax effect of timing difference, tax on accounting income is more whereas tax payable is less as per income tax law for the period, create **deferred tax liability** by debiting (*i.e.* adjusting in) Statement of Profit and Loss and crediting deferred tax liability by the differential amount in the initial period. This will be reversed in the subsequent year(s) by the appropriate amount(s). On the other hand, if accounting income is less than tax income and due to the tax effect of timing difference, tax on accounting income is less whereas tax payable is more as

per income-tax law, create **deferred tax asset** by debiting deferred tax asset and crediting (*i.e.* adjusting in) the Statement of Profit and Loss. *The purpose of doing this is to calculate tax expense accrual basis and not on liability to pay basis.*

EXAMPLE 1

A Ltd. purchases a machine in the beginning of an year at a cost of Rs. 15,00,000. The machine has a useful life of three years and the expected scrap value is zero. The company charges depreciation on straight line basis. However, it is eligible for 100% depreciation allowance in the year of purchase as per income tax law. Profit before depreciation and tax is Rs. 20,00,000 and the corporate tax rate is 30% for each year.

Statement of Profit and Loss for the three years will be as follows :

	Year 1	Year 2	Year 3
	Rs.	Rs.	Rs.
Profit before depreciation and taxes	20,00,000	20,00,000	20,00,000
Less : Depreciation	5,00,000	5,00,000	5,00,000
Profit before tax	15,00,000	15,00,000	15,00,000
Less : Tax expense			
Current Tax			
$\frac{30}{100}(20,00,000 - 15,00,000)$	1,50,000		
$\frac{30}{100}(20,00,000)$		6,00,000	6,00,000
Deferred Tax			
$\frac{30}{100}(10,00,000)$	3,00,000		
$\frac{30}{100}(0 - 5,00,000)$		(1,50,000)	(1,50,000)
Profit after Tax	10,50,000	10,50,000	10,50,000

Any interest on shortfall in payment of advance income-tax should be disclosed as a finance cost. It should not be clubbed with current tax. Any penalties levied under the income tax laws which are compensatory in nature should also be disclosed under finance costs. However, other tax penalties should be classified under other expenses.

The excess/short tax expense provided in the previous year(s) should be separately disclosed before calculating net profit in the Statement of Profit and Loss. It is not an appropriation term.

8. Earnings Per Share. A company is also required to disclose Basic EPS and Diluted EPS in the Statement of Profit and Loss. Basic EPS and Diluted EPS are calculated, as per AS-20 : "Earnings Per Share." Basic EPS is calculated as follows :

$$\text{Basic Earnings Per Share} = \frac{\text{Profit or loss for the period attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the period}}$$

For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period.

For the purpose of calculating **diluted earnings per share**, net profit or loss for the period attributable to equity shareholders and the weighted average number of equity shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares. For details see chapter on Financial Statement Analysis.

9. Discontinuing Operations: Disclosure relating to discontinuing operations have been included in the Statement of Profit and Loss, which were not included in the pre-revised or Old Schedule VI.

Accounting Treatment of certain items while preparing the Statement of Profit and Loss and Balance Sheet

1. Interest on Debentures

A fixed rate of interest is paid on debentures issued by a company. The interest is usually payable half-yearly. The total finance cost is shown in the Statement of Profit and Loss. The detail of the various items of finance cost is shown in the Notes to Accounts. Interest on debentures will be calculated on accrual basis, *i.e.*, interest paid, interest accrued but not due and interest accrued and due will be taken into account. As per Revised Schedule VI both interest accrued but not due and interest accrued and due will be disclosed under the head "Other current liabilities" in the Balance Sheet. The detail of "Other current liabilities" will be disclosed in the Notes to Accounts.

Interest accrued and due: Suppose a company has issued Rs. 10,00,000 12% Debentures on which interest is payable on 30th September and 31st March. If accounts are closed by the company on 31st March and interest due on 31st March is not yet paid, then interest for *six* months (1st October to 31st March) is interest accrued and due.

Interest accrued but not due: Suppose in the aforesaid example, the company closes its books on 31st December and interest upto 30th September has been paid by the company, then the interest for the months of October, November and December has accrued on 31st December but it is not payable on 31st December.

A company is required to deduct tax at source before paying interest to the debentureholders at the prescribed rates where gross amount of interest payable for a year to a debentureholder exceeds the prescribed limit. The tax rates vary depending on the type of person (*i.e.* individual, partnership firm, company etc.) and residential status of the debentureholder. Gross amount of interest expense shown in the Statement of Profit and Loss. If the tax deducted at source has not been paid to the Government it will be shown in the Balance Sheet in the Notes to Accounts under "Other current liabilities". The journal entries for tax deducted at source from interest are similar to the entries for tax deducted at source from salary. The journal entries for tax deducted at source from salaries are discussed in the next point.

2. Tax Deducted at Source from Salaries

It is the duty of an employer to deduct tax at source from salary of the employees taking into account their taxable income and deposit the tax so deducted to the credit of the Income Tax Department of the Central Government within a specified time. The unpaid balance is shown as part of the "Current Liabilities" in the Balance Sheet and under "Other Current Liabilities" in the Notes to Accounts. The journal entries are as follows :

For pay merit of Salaries and TDS

Salaries Account

To Bank Account

To Tax Deducted at Source (Salaries) Account

(Being the salaries paid and tax deducted at source)

Dr. (With gross amount

(With actual payment)

(With tax deducted)

For deposit of tax to the Government

Tax deducted at Source (Salaries) Account Dr.
 To Bank Account
 (Being the payment of TDS)

3. Tax Deducted at Source on interest Income

Interest on investment is shown on the credit side of the Trial Balance. Gross amount of interest income is shown in the statement of Profit and Loss. If the company receives interest income after deduction of tax at source, then the trial balance may show net amount of interest on investments. In such a case, the net amount is grossed up and then the grossed up amount is shown in the statement of profit and Loss under the head "Other income" in case of non-finance company and tax deducted at source on interest income is shown in the Balance Sheet under the head "Other Short-term loans and advances". Details will be given in the Notes to Accounts. Tax deducted at source on interest income may appear in the trial balance or may be given by way of express or implied adjustment.

Entry for interest on investment are as follows :

(a) *At the time of receipt of interest on investments*

Bank A/c Dr.
 To Interest on Investment A/c
 (Being interest received on investments)

(b) *At the end of the year, entry for interest accrued for but not received*

Interest Accrued on Investments A/c Dr.
 To Interest on Investment A/c
 (Being interest accrued on investments)

(c) *For tax deducted at source*

Tax Deducted at Source (Interest Income) A/c Dr.
 To Interest on Investment A/c
 (Being tax deducted at source)

4. Share Suspense Account

Sometimes the entries which should be made are not passed and instead a particular suspense account is debited or credited. In such a case adjustment must be made atleast at the time of preparation of Final Accounts.

EXAMPLE 2

Trial Balance (extract)

as on 31-3-2012

	Dr. Rs.	Cr. Rs.
Calls in Arrears A/c	2,000	
Share Suspense A/c		6,000

Additional Information :

The company forfeited 1,000 equity shares of Rs.10 each on which Rs. 2,000 remained unpaid and these shares were reissued for Rs. 6,000 as fully paid. No entry was passed for forfeiture of shares and for reissue of shares. However, bank account was debited and share suspense account credited with the amount.

In this case following rectifying entry will be passed :

	Dr.	Rs.	Rs.
Share Suspense A/c		6,000	
To Calls in Arrears A/c			2,000
To Capital Reserve A/c			4,000

(Being the rectifying entry passed)

Working Note:

Entry already passed :

	Dr.	Rs.	Rs.
Bank A/c		6,000	
To Share Suspense A/c			6,000

Entries which should have been passed

(i) Equity Share Capital A/c	Dr.	10,000	
To Forfeited Shares A/c			8,000
To Calls in Arrears A/c			2,000
(ii) Bank A/c	Dr.	6,000	
Forfeited Share Capital A/c	Dr.	4,000	
To Equity Shares A/c			10,000
(iii) Forfeited Shares A/c	Dr.	4,000	
To Capital Reserve A/c			4,000

5. Corporate Income-tax

(a) **Advance Tax.** A company is liable to pay tax on its income. Income of the "Previous Year" is assessed in the "Assessment Year". Assessment year means a period of 12 months starting from 1st April to 31st March next. "Previous year" is the financial year immediately preceding the assessment year. Income tax is payable on "pay-as-you-earn" basis. Therefore, a company has to pay tax in advance in the "previous year", i.e., in the accounting year itself against the estimated tax liability for the assessment year. For example, though the income earned during the "previous year" 2011-12 is taxable in the assessment year 2012-13, tax on such income is payable in advance during the financial year 2011-12. The amount of advance tax is calculated as per the provisions of the income tax law. When the advance tax is paid, the following journal entry is passed :

Advance Tax A/c	Dr.
To Bank A/c	

(Being the advance tax paid)

Advance tax is shown in the Balance Sheet as an item of "Current Assets" until the assessment is complete. Alternatively, it may be shown by way of deduction from Provision for Current Tax if the latter

amount exceeds the former amount. If the amount of provision for current tax is less than the amount of advance tax, then provision for current tax is shown by way of deduction from the amount of advance tax.

(b) Current Tax Expense/Provision for Current Tax: AS-22 provides that current Income tax is a charge against the profits in case of a company. In the Statement of Profit and Loss provision for current tax or simply current tax is treated as an expense. It is also shown in the Balance Sheet. In the questions it is usually required to be calculated as a certain percentage of profit before tax.

The journal entry for current tax expense is :

Profit and Loss A/c Dr.
 To Current Tax Account/Provision for Current Tax A/c

(c) Prior Period Tax Expense. When income tax assessment is finalised which happens in the next or subsequent financial year, the actual tax liability is determined. It may be more/less than the current tax provided. If the tax as determined by tax authorities is more than the tax provided, then the differential amount is shown as prior *period tax expense*, as a separate item, in the Statement of Profit and Loss in which the assessment is finalised as per AS-5. The journal entry for prior period tax expense is as follows :

Profit and Loss A/c Dr.
 To Prior Period Tax Expense A/c

Prior period tax expense account is closed by transferring to Income Tax (Payable/Refund) Account by passing the following entry :

Prior Period Tax Expense A/c
 To Income Tax (Payable/Refund) A/c

In case- the tax as determined by tax authorities is less than the tax provided in the concerned year, the accounting entries will be opposite to what is stated above.

(d) Income Tax Payable/Income Tax Refund Receivable. If the advance tax paid for the previous year is less than the actual tax as determined by tax authorities, the differential amount is tax payable. If this amount has not been paid by the end of the accounting period, it is shown under the head "Other current liabilities" in the Balance Sheet by way of Notes to Accounts.

Formats of the aforesaid accounts is as follows :

Dr.		ADVANCE TAX ACCOUNT				Cr.
Date	Particulars	₹	Date	Particulars	₹	
	To Balance b/d	xxx		By Income Tax		
	To Bank A/c	xxx		(Payable/Refund) A/c	xxx	
		xxx		By Balance c/d	xxx	
		xxx			xxx	

Dr.		CURRENT TAX ACCOUNT (OR PROVISION FOR CURRENT TAX ACCOUNT)				Cr.
Date	Particulars	₹	Date	Particulars	₹	
	To Income Tax (Payable/ Refund A/c	xxx		By Balance b/d	xxx	
	(Transfer after comple- tion of assessment)	xxx		By Profit and Loss A/c		
	To Balance c/d	xxx		(Current year's provision) (for current tax expense)	xxx	
		xxx			xxx	

Dr. PRIOR PERIOD TAX EXPENSE ACCOUNT Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Profit and Loss A/c*	xxx		By Profit and Loss A/c*	xxx
	To Income Tax (Payable/Refund) A/c	xxx		By Income Tax (Payable/Refund) A/c	xxx
		xxx			xxx

Dr. INCOME TAX (PAYABLE/REFUND) ACCOUNT Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Advance Tax A/c (Advance tax of the concerned year)	xxx		By Current Tax A/c (Provision for tax of the concerned year)	xxx
	To Prior Period Tax Expense A/c**	xxx		By Prior Period Tax Expense A/c**	xxx
	To Balance c/d** (balancing figure)	xxx		By Balance c/d*** (balancing figure)	xxx
		xxx			xxx

- * Either of the two will appear as the case may be
- ** Either of the two will appear as the case may be
- *** Either of the two will appear as the case may be. Credit balance shows amount of income tax payable; and debit balance shows amount of income tax refund receivable.

If the Income Tax (Payable/Refund) Account shows credit balance, it will be shown as Income Tax Payable (if yet not paid) in the Balance Sheet. If the Income Tax (Payable/Refund) Account shows debit balance, it will be shown as Income Tax Refund Receivable in the Balance Sheet.

ILLUSTRATION 1

A Ltd. started business on April J, 2006. It paid advance tax for 2006-07 ₹ 1,00,000 and current tax provided for 2006-07 was ₹ 90,000. It paid advance tax for 2007-08 ₹ 1,20,000 and current tax provided for 2007-08 was ₹ 1,20,000. It paid advance tax for 2008-09 ₹ 1,50,000 and current tax provided for 2008-09 was ₹ 1,20,000. Income tax assessment was not complete yet. Prepare Advance Tax Account and Current Tax Account for 2006-07, 2007-08 and 2008-09

SOLUTION

Dr. ADVANCE TAX ACCOUNT Cr.

Date	Particulars	₹	Date	Particulars	₹
2006-07	To Bank A/c	1,00,000	2006-07	By Balance c/d	1,00,000
2006-07	To Balance b/d	1,00,000	2007-08	By Balance c/d	2,20,000
"	To Bank A/c	1,20,000			
		2,20,000			2,20,000
2008-09	To Balance b/d	2,20,000	2008-09	By Balance c/d	3,70,000
"	To Bank A/c	1,50,000			
		3,70,000			3,70,000

Dr.			CURRENT TAX ACCOUNT			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
2006-07	To Bank A/c	90,000	2006-07	By Profit and loss A/c	90,000			
2006-07	To Balance c/d	2,10,000	2007-08	By Balance b/d	90,000			
		2,10,000	2007-08	By Profit and Loss /Ac	1,20,000			
2008-09	To Bank c/d	3,30,000	2008-09	By Balance b/d	2,10,000			
		3,30,000	2008-09	By Profit and Loss A/c	1,20,000			
					3,30,000			

ILLUSTRATION 2

Continuing with the information given in illustration 1, the following further information for 2009-10 is given :

— Advance tax paid for 2009-10 ₹ 1,60,000 and current tax provided for 2009-10 was ₹ 1,50,000 assessment for 2006-07 was finalised at ₹ 94,000.

Prepare Advance Tax Account and Current Tax Account for 2009-10. Also prepare Income Tax (Payable/Refund) Account.

SOLUTION

Dr.			ADVANCE TAX ACCOUNT			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
2009-10	To Balance b/d		2009-10	By Income Tax				
	2006-07 ₹1,00,000			(Payable/Refund) A/c	1,00,000			
	2007-08 ₹1,20,000		2009-10	By Balance c/d	4,30,000			
	2008-09 ₹1,50,000	3,70,000						
2009-10	To Bank A/c 2009-10	1,60,000						
		5,30,000			5,30,000			

Dr.			CURRENT TAX ACCOUNT			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
2009-10	To Income Tax		2009-10	By Balance b/d				
	(Payable/Refund) A/c	90,000		2006-07 ₹90,000				
2009-10	To Balance c/d	3,90,000		2007-08 ₹1,20,000				
				2008-09 ₹1,20,000	3,30,000			
			2009-10	By Profit and Loss A/c	1,50,000			
		4,80,000			4,80,000			

Dr.

INCOME TAX (PAYABLE/REFUND) ACCOUNT

Cr.

Date	Particulars	₹	Date	Particulars	₹
2009-10	To advance tax A/c (Advance tax for 2006-07)	1,00,000	2009-10	By Current Tax A/c (Provision for tax for 2006-07)	90,000
				By Prior Period (2006-07) Tax Expense A/c (or Profit and Loss A/c) (Tax liability for 2006-07 -Provision for Current tax for 2006-07, i.e., 94,000 – 90,000)	4,000
				By Balance c/d	6,000
		1,00,000			1,00,000

Note : (1) Advance Tax ₹ 7 4,30,000 and Income Tax Refund Receivable Rs. 6,000 will be shown in the Assets category in the Balance Sheet under the head "Short-term loans and advances".

(2) Current tax balance ₹ 3,90,000 will be shown in the Equity and Liabilities category in the Balance Sheet under the head "Short-term provisions".

(3) ₹ 1,50,000 and ₹ 4,000 will be shown as current tax expense and prior period (2006-07) tax expense in the Statement of Profit and Loss Account.

ILLUSTRATION 3

The trial balance (extract) of GG Ltd. as on 31st March, 2011 was as follows :

	Dr. (Rs.)	Cr. (Rs.)
Advance Tax for 2009-2010	2,20,000	—
Advance Tax for 2010-2011 (paid on 15-3-2011)	2,30,000	—
Provision for Current Tax for 2009-2020	—	2,00,000

Adjustments :

(a) The income tax assessment for 2009-2010 completed during the year 2010-2011 showed gross tax demand of ₹ 2,40,000 but no effect has been given to this in the accounts.

(b) Current tax ₹ 2,60,000 for 2010-2011 Rs. 2,60,000.

Pass adjusting entries and prepare ledger accounts. Explain how they will be shown in the Statement of Profit and Loss and Balance Sheet as per Revised Schedule VI.

JOURNAN

Date	Particulars	L.F.	Debit (Rs.)	Creadir (Rs.)
2010-11				
Mar. 31	Profit and Loss A/c To Current Tax A/c (for 2010-11) (Being the current tax expense for 2010-11)	Dr.	2,60,00	2,60,000

2010-11					
Mar. 31	Profit and Loss A/c	Dr.	40,000		
	To Prior Period (2009-10) Tax Expense A/c (Being the difference between gross tax demand ₹2,40,00 for-2009-10 and provision for tax made in 2009-10 ₹2,00,000)				4,000
2010-11					
Mar. 31	Provision for Current Tax (2009-10) A/c	Dr.	2,00,000		
	Prior Period (2009-10) Tax Expense A/c	Dr.	40,000		
	To Income Tax (Payable/Reund) A/c (Being the transfer of the Income Tax (Payable/Refund) A/c)				2,40,000
2010-11					
Mar. 31	Income Tax (Payable/Refund) A/c	Dr.	2,20,000		
	To Advance Tax (2009-10) A/c (Being transfer to Income Tax (Payable/Refund) A/c)				2,20,000

Ledger Accounts

<i>Dr.</i>		ADVANCE INCOME TAX ACCOUNT				<i>Cr.</i>
<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	
1-4-10	To Balance b/d	2,20,00	31-3-11	By Income Tax (Payable/Refund) A/c	2,20,000	
15-3-11	To Bank A/c	2,30,00	31-3-11	By Balance c/d	2,30,00	
		4,50,000			4,50,000	

<i>Dr.</i>		CURRENT TAX ACCOUNT				<i>Cr.</i>
<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	
31-3-11	To Income Tax (Payable/Refund) A/c	2,00,000	1-4-2010	By Balance b/d	2,00,000	
31-3-11	To Balance c/d	2,60,000	31-3-11	By Profit and Loss A/c	2,60,000	
		4,60,000			4,60,000	

<i>Dr.</i>		PRIOR PERIOD (2009-10) TAX EXPENSE ACCOUNT				<i>Cr.</i>
<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	<i>Date</i>	<i>Particulars</i>	<i>Rs.</i>	
31-3-11	To Income Tax (Payable/Refund) A/c	40,000	31-3-2011	By Profit and Loss A/c	40,000	

Dr.		INCOME TAX (PAYABLE/REFUND) ACCOUNT		Cr.	
Date	Particulars	Rs.	Date	Particulars	Rs.
31-3-11	To Advance Tax (for 2009-10)	2,20,000	31-3-2011	By Prior Period (2009-10) Tax Expense A/c	40,000
31-3-11	To Balance c/d (<i>bal. fig.</i>) (Income tax payable)	20,000	31-3-2011	(Rs. 2,40,000 – Rs 2,00,000) By Current Tax A/c (for 2009-10)	2,00,000
		2,40,000			2,40,000

Disclosure

(1) Tax Expense to be shown in the Statement of Profit and Loss for the year ended 31-3-2011 will be as follows:

Current Tax Rs. 2,60,000

Prior Period (2009-10) Tax Rs. 40,000

(2) Income tax payable Rs. 20,000 will be shown in the Balance Sheet as at 31-3-2011 under the head "Other current liabilities."

(3) Current tax provided for 2010-11 Rs. 2,60,000 will also be shown in the Balance Sheet as at 31-3-2011 under the head "Short-term provisions".

(4) Advance tax for 2010-11 Rs. 2,30,000 will be shown in the Balance Sheet as an asset as at 31-3-2011 under the head "Short-term loans and advances."

Accounting treatment in case of Appeal

If the company files an appeal against the assessment order, then the accounting treatment depends on the probability of losing/winning the case.

Case I : If there is high probability of losing the case and the tax demand relates to prior period, then provide for additional prior period tax. The journal entry will be :

Profit and Loss Account Dr.

To Prior Period Tax Expense Account

(Being the additional tax expense provided for)

Case II : If there is high probability of winning the case, then there is no need of providing for additional prior period tax expense. However, contingent liability will be shown to the extent of additional amount of tax demand.

If the question is silent about the chances of losing/winning the case then apply principle of conservatism.

(e) **Deferred Tax.** As stated earlier, as per AS-22, *deferred tax is the effect of timing difference. Timing differences are the difference between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.*

Taxable income is calculated in according with tax laws. In some circumstances, the requirements of these laws to compute taxable income differ from the accounting policies applied to determine accounting income. Thus the accounting income and taxable income may not be the same. **The differences between taxable income and accounting income can be classified into permanent differences**

and timing differences. Permanent difference are those differences between taxable income and accounting income which originate in one period and do not reverse subsequently. For example, if for the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure the disallowed amount would result in permanent difference (AS-22, para 5 and 6).

Timing differences arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income. For example machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purpose whereas same would be recharged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as deduction for tax purpose will ultimately be the same, but the periods over which the depreciation is charged and the deduction allowed will differ. Another example of timing difference is a situation where, for the purpose of computing taxable income, tax law allow depreciation on the basis of the written down value method, whereas for accounting purposes, straight line method is used. (AS-22, para 7)

Carry forward of losses which can be set-off against future taxable income are also considered as timing differences and result in deferred tax assets, subject to consideration of prudence (An-22, para 81).

AS-22 provides that tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets or as deferred tax liabilities, in the balance sheet. Deferred tax should be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets.

An example of tax effect of timing difference that results in an *deferred tax asset* is an expense provided in the statement of profit and loss but not allowed as a deduction under section 43B of the Income-tax Act, 1961. (S. 43B allowed certain expenses such as tax, duty, cess, employer's contribution to provident fund as deductible expenses on actual payment.) The timing difference will reverse when the deduction of that expense is allowed under section 43B in subsequent year(s). An example of tax effect of a timing difference resulting in a *deferred tax liability* is the higher charge of depreciation allowed under the Income-tax Act, 1961, compared to the depreciation provided in the statement of profit and loss. In subsequent years, the differential will reverse when subsequently lower depreciation will be allowed for tax purposes. Permanent differences do not result in deferred tax assets or deferred tax liability (AS-22, para 10 and 11).

Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. **Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.** (AS-22, paragraph 30).

ILLUSTRATION 4. (Appendix 2 to AS-22)

A company, ABC Ltd., prepares its accounts annually on 1st March. On 1st April, 2011, it purchases a machine at a cost of Rs. 1,50,000. The machine has a useful life of three years and an expected, scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of Rs. 2,00,000 each year and the corporate tax rate is 40 per cent each year.

The purpose of machine at a cost of ₹ 1,50,000 in 2011 gives rise to a tax saving of ₹ 60,000. If the cost of the machine is spread over three years of its life for accounting purposes, the amount of tax saving should also be spread over the same period as shown given below :

STATEMENT OF PROFIT AND LOSS

(for the three years ending 31st March, 20X1, 20X2, 20X3)

(₹ 000)

	20X1	20X2	20X3
Profit before Depreciation and Taxes	200	200	200
Less : Depreciation for Accounting Purposes	50	50	50
Profit before Tax	150	150	150
Less : Tax Expense			
Current Tax			
[(200 - 150) × 40/100]	20	—	—
(200 × 40/100)	—	80	80
Deferred Tax			
Tax effect of timing difference originating during the year [(150 - 50) × 40/100]	40	—	—
Tax effect of timing differences reversing during the year [(0 - 50) × 40/100]	—	(20)	(20)
Tax Expense	60	60	60
Profit after Tax	90	90	90
Net Timing Difference	100	50	0
Deferred Tax Liability	40	20	0

SOLUTION

Tax expense is based on the accounting income of each period. The following journal entries will be passed :

Year 2011

Profit and Loss Account	Dr.	20,000	
To Current Tax Account			20,000

(Being the amount of taxes payable for the year 2011 provided for)

Profit and Loss Account	Dr.	40,000	
To Deferred Tax A/c			40,000

(Being the deferred tax liability created for originating timing difference of ₹ 1,00,000)

Year 2012

Profit and Loss Account	Dr.	40,000	
To Current Tax Account			40,000

(Being the amount of taxes payable for the year 2012 provided for)

Deferred Tax Account	Dr.	20,000	
To Profit and Loss Account			20,000

(Being the deferred tax liability adjusted for reversing timing difference of ₹ 50,000)

Year 2013

Profit and Loss Account	Dr.	80,000	
To Current Tax Account			80,000
(Being the amount of taxes payable for the year 2013 provided for)			
Deferred Tax Account	Dr.	20,000	
To Profit and Loss Account			20,000
(Being the deferred tax liability adjusting for reversing timing difference of ₹ 50,000)			

6. Calls-in-Arrear

Calls-in-arrear represents the amount paid by the shareholders in respect of the allotment money and/or call money(s). It usually appears in the trial balance as a debit item. In this case trial balance shows called up capital. If it appears as an adjustment item, then trial balance shows paid up capital. In the latter case, calls in arrear can be added to paid up share capital and deducted also to calculate paid-up share capital. Calls-in-arrears is shown in the Notes to Account under the head "Share Capital." *According to Revised Schedule VI, for each class of share capital, a separate disclosure is required for the aggregate value of calls-in-arrears by directors and also officers of the company.* The Old Schedule VI requires disclosure of calls-in-arrears by directors only. The total calls-in-arrears should be disclosed.

7. Share Forfeited Account

If a shareholder has not paid the allotment money or call money() or both allotment money and call money(), the company can forfeit his shares after fulfilling the provisions of company law. When shares are forfeited, Share Capital Account is debited with the called amount of the shares forfeited and Calls-in-Arrear Account is credited with the money due but not received and Share Forfeited Account is credited with the money received excluding the money received towards securities premium account. In the trial balance, Share Forfeited Account appears as a credit item. In the Balance Sheet it will be shown in the Notes to Accounts under the head "Share Capital".

8. Preliminary Expenses, Discount on Issue of Shares/Debentures, etc.

Preliminary expenses, share issue expenses, discount on issue of shares/debentures can be written off through securities premium account. Alternatively, they can be written off through Profit and Loss Account over a certain number of years. In the latter case, the amount written off in a certain year will be shown in the Statement of Profit and Loss of that year. The unamortised portion of these expenses is shown in the Balance Sheet under the head "Other non-current assets" if they are to be amortised over more than 12 months. If the unamortised portion is to be written off within a period of 12 months, then their disclosure will be made under the head "other current assets".

In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, as per AS-26, expenditure is recognised when it is incurred. For example, expenditure on research is recognised as an expense when it is incurred. Examples of other expenditure that is recognised is an expense when it is incurred include : preliminary expenses in establishing a legal entity such as legal and secretarial costs; expenditure on advertising and promotional activities; expenditure on training activities; and expenditure on relocating or reorganising an enterprise.

9. Transfer of Profits to Reserves

Disposition of profits means distribution of profits by way of dividends, transfer of profits to reserves, bonus to shareholders etc. Section 205 (2A) of the Companies Act, 1956 provides that before declaration and payment of dividend out of current year's profit, a company required to transfer such percentage of its profit for the current year to reserves, not exceeding ten per cent, as may be prescribed. The Central

Government has framed Companies (Transfer of Profit to Reserve) Rules, 1975. According to these rules, no dividend can be declared or paid by the company for any financial year out of the profits of the company for that year after providing for depreciation as per Sec. 205 unless it transfers a percentage of its profits for that year to reserves as specified below :

	<i>Amount to be Transferred to Reserves</i>
1. Where the proposed dividend exceeds 10% but does not exceed 12.5% of the paid-up capital	Not less than 2.5% of the current profits
2. Where the proposed dividend exceeds 12.5% but does not exceed 15% of the paid-up capital	Not less than 5% of the current profits
3. Where the proposed dividend exceeds 15% but does not exceed 20% of the paid-up capital	Not less than 7.5% of the current profits
4. Where the proposed dividend exceeds 20% of the paid-up capital	Not less than 10% of the current profits
The above rules may be stated as follows :	
<i>Proposed dividend as % of paid up capital</i>	<i>Amount to be transferred to reserves as % of current profits</i>
> 10% but ≤ 12.5%	≥ 2.5%
> 12.5% but ≤ 15%	≥ 5%
> 15% but ≤ 20%	≥ 7.5%
> 20%	≥ 10%

Current profits means profit after tax, 'Reserve' means free reserves. Transfer of profits to reserves is appropriation and not charge.

Conditions governing voluntary transfer of higher percentage. A company may voluntarily transfer a percentage higher than 10% to its reserves for any financial year. However, in such a case, the following conditions must be satisfied :

(i) Where a dividend is declared :

(a) a minimum distribution sufficient for the maintenance of dividends to shareholders at a rate equal to the average of the rates at which dividends declared by it over the three years immediately preceding the financial year; or

(b) in a case where bonus shares have been issued in the financial year in which the dividend is declared or in the three years immediately preceding the financial year, a minimum distribution sufficient for the maintenance of dividend to shareholders at an amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial year is ensured.

However, in a case, the net profit after tax are lower by 20% or more than the average net profits after tax of the two financial years immediately preceding, it shall not be necessary to ensure such minimum distribution.

(ii) Where no dividend is declared, the amount proposed to be transferred to its reserves from the current profit shall be lower than the average amount of the dividends to the shareholders declared by it over the three years immediately preceding the financial year.

Purpose- The purpose of transferring profits to reserves is to ensure that such reserves would be available to the company for ploughing them back for expansion of the business and would also be

available for declaration of dividends in a lean year subject to rules frame by the Central Government.

Divisible Profits

Divisible profits means the profits available for distribution as dividend. Determination of the amount profits which is available for distribution is necessary because the amount of profit disclosed by the Statement of Profit and Loss, in every case, is not available for distribution. *Dividends can be declared or paid out of profits available for distribution, arrived at after providing for depreciation on assets, not only for the year in which the profits inert- earned but also for any arrears of depreciation of the past years, calculated in the manner prescribed by sub-section (2) of section 205 of the Companies Act, 1956.* The balance of undistributed profits of the past years is also available for distribution, provided the same has been arrived at in the manner stated above.

Dividends can be paid out of the money provided by the Central or State Government in pursuance of guarantee given by the Government.

Capital, cannot be returned to shareholders by way of dividends.

Provision for Depreciation

(1) Section 205(2) provides that depreciation must be provided either—

(a) to the extent specified in section 350;

(b) equal to an amount arrived at by dividing 95% of the original cost of the asset by the specified period in respect of that asset; or

(c) on any other basis approved by the Central Government by which 95% of the cost or each depreciable asset will be written off on the expiry of the specified period; or

(d) as regards any other depreciable asset for which no rate of depreciation has been laid down by the Companies Act, 1956 or any rules made thereunder, on such basis as may be approved by the Central Government by any general order published in the Official Gazette or by special order in a particular case.

(2) According to Section 350 of the Companies Act, 1956, depreciation should be written off at the rates specified for different assets in Schedule XIV to the Companies Act, 1956. It may be noted that the Income-tax Act, 1961 allows different and higher rate of depreciation for most of the assets. Section 350 of the Companies Act, 1956, further provides that if any asset is sold, discarded, demolished or destroyed for any reason before depreciation of such asset has been provided for in full, the excess, if any, of the written down value of such asset over its sale proceeds or, as the case may be, its scrap value, shall be written off in the financial year in which the asset is sold, discarded, demolished or destroyed.

(3) Section 205 provides that depreciation must be written off or provided for if dividends are to be declared. It means that a company need not provide depreciation if it does not to declare dividends. In such a case, the fact that depreciation has not been provided for or written off, together with the quantum of arrears of depreciation must be stated in the Statement of Profit and Loss.

(4) Loss suffered in the past may not be made good. If the company has suffered any loss in any previous financial year or year (which falls or fall after the commencement of Companies (Amendment) Act, 1960) then, *the amount of loss or an amount equal to the amount provided for depreciation for that year or those years whichever is less, shall be set off against the profits of the company for the year for which dividend is proposed to be declared or paid.* Thus, *the losses suffered in the past or at least amount of depreciation on assets comprised therein, must first be made good out of the profits of the year before any part thereof in distributed as dividend.*

ILLUSTRATION 5

Calculate distributable profits from the following information :

Particulars	Year ended 31st December (in ₹ lakhs)			
	2008	2009	2010	Total
A. Depreciation as provided in books	15	10	40	65
B. Depreciation chargeable under Section 205	65	50	40	155
C. Profit/ (Loss) before charging depreciation	(75)	(35)	185	75
D. Profit / (Loss) after charging depreciation as in A	(90)	(45)	145	10
E. Profit after charging depreciation as in B	(140)	(85)	145	(80)

SOLUTION

The amount available for dividend in 2010 is Rs. 30 lakhs as shown below ;

	in ₹ Lakhs
F. Past losses (as per D) for 2008 and 2009 (90 + 45)	135
G. Depreciation previously provided for 2008 and 2009 (15 + 10) (as per (A))	25
H. Arrears of Depreciation (B - A)	
for 2008	50
for 2009	40
for 2010	Nil
	90
Profit for 2010 (as per D)	145
Less : Arrears of depreciation not provided for as per S. 205, which must now be provided	90
	55
Less : Amount of depreciation previously provided (15 + 10) or amount of past losses (90 + 45), whichever is less	25
Distributable profit	30
Alternatively, this can also be calculated as follows :	
Profit before charging depreciation for 2010	185
Less : Total depreciation for 2008, 2009 and 2010 as per Section 205 of the Companies Act, 1956 (65 + 50 + 40)	155
	30

It is not necessary for the company to provide for arrears of depreciation where dividend for any financial year is declared or paid out of the profits of any previous financial year or years which falls or fall before 28th December, 1960.

Surplus in the Statement of Profit and Loss (Profit and Loss Appropriations Account)

The Revised Schedule VI prescribes only the vertical format of the Balance Sheet and Statement of Profit and Loss. Further details of various items are to be in the Notes to Accounts (i.e. Notes to Financial Statements). Appropriations are to be shown in Note "Reserves and Surplus". Format of Surplus in the Statement of Profit and Loss is as follows :

Note No. ... Surplus in Statement of Profit and Loss

	Current Year	Previous Year
	₹	₹
Opening Balance	xxx	xxx
Add : Profit for the year	xxx	xxx
Less : Transfer to General Reserve	xxx	xxx
Less : Transfer to other reserve (specify nature)	xxx	xxx
Less : Interim Dividend	xxx	xxx
Less : Proposed Preference Dividend	xxx	xxx
Less : Proposed Equity Dividend	xxx	xxx
Less ; Corporate Dividend Tax	xxx	xxx
Closing Balance	xxx	xxx

Revised Schedule requires debit balance of Statement of Profit and Loss to be shown as a negative figure under the head "Surplus."

Proposed dividends, being appropriation items, are to be disclosed in the Notes under (a) Reserves and Surplus as explained above and as a part of current liability under (b) Short-term provisions in the Balance Sheet. The details are to be shown in the Notes to Accounts.

Similarly, negative balance of "Reserves and Surplus", after adjusting negative balance of surplus, if any, is to be disclosed under the head Reserves and Surplus.

Dividends

The term "dividend" refers to that part of the profits of a company which is distributed by the company among its shareholders by way of return on their investments in the shares of the company. In other words, dividend is the distribution of divisible profits of the company among its shareholders. It is paid on the basis of number of shares held by them and the rights attached to the various classes of shares.

Legal provisions relating to Dividends

1. Dividends can be declared or paid by a company *out of profits available for distribution*, arrived at after providing for depreciation on the assets not only in the year in which the profits were earned but also for any arrears of depreciation of the past years, calculated in the manner prescribed by sub-section (2) of Section 205 of the Companies Act, 1956. The balance of undistributed profits of the past years is also available for distribution, provided the same has been arrived at in the manner stated above.
2. Dividends can also be declared or paid *out of money provided by the Central Government or State Government* for payment of dividend in pursuance of a guarantee given by that Government.
3. Dividend is payable *only to the registered shareholder or to his order to his banker* (S. 206). However, where the company has issued share warrants as provided in S. 114, dividend is to be paid to the bearer of such warrants.
4. Dividend must be paid *within 30 days of declaration* (S. 207).
5. Articles of the company normally provide (as provided in Table A) that dividends may be paid *in proportion to the amount paid-up on each share* (S. 93). In the absence of any indication to

the contrary in the Articles the rate of dividend applies to the paid-up capital. Where Articles are silent and Table A has been excluded the dividend will be paid on nominal value of shares. Articles may provide for declaration of dividend on nominal value of the share even if the amount paid-up is less.

6. No dividend is paid on *calls-in-advance*.
7. Dividends on shares on which there are *calls-in-arrear* should be calculated on the amount actually paid. However, the articles may forbid the payment of dividend on shares on which there are calls-in-arrear.
8. According to Table A, unless otherwise provided in the terms of the issue, the period has also to be taken into consideration. Suppose 1,00,000 shares of ₹ 10 each were ₹ 7.50 paid-up on 1st April, 2000 and the call of ₹ 2.50 was made on 1st October, 2000, a dividend of 10% for 2000-01 will be calculated as follows :
10% on Rs. 7,50,000 for full year Rs. 75,000 and
10% on Rs. 2,50,000 for six months Rs. 12,500.
9. In case of fresh issue of capital the holders thereof, unless precluded by the terms of the issue, are entitled to receive dividend *pari passu* with the shares already issued.
10. According to Table A, the Board of Directors may apply the dividend payable to a shareholder towards any amount due from him on account of calls or otherwise in relation to the shares of the company.
11. *The Board of Directors recommend the rate of dividend and the shareholders in the annual general meeting may declare the dividend recommended by the Board.* The shareholders may declare a dividend less than recommended by the Board, but they cannot declare higher dividend than recommended by the board. An interim dividend may be declared by the Board if articles authorise them to do so.
12. Dividend cannot be paid out of capital.
13. Dividend is payable *in cash*. However, the company may adjust dividend payable to a shareholder against the unpaid amount on shares.
14. The dividends declared must be deposits in a *separate bank account* within 5 days of its declaration, for the purpose of paying dividend. Where any amount of dividend remain unclaimed or unpaid after the expiry of 30 days of its declaration, the company must transfer the balance to unclaimed dividend bank account within 7 days after the expiry of aforesaid 30 days.

Dividends on Preference Shares

Dividend on Preference Shares. Preference shareholders are entitled to a preferential dividend calculated at a fixed rate or amount before any dividend is paid to equity shareholders. Preference shareholders are usually entitled to dividend at a fixed rate on the nominal value of the shares. It must be noted that the preference shareholders are entitled to preferential treatment when dividend is declared. Dividend is paid first to preference shareholders before payment to equity shareholders. But such right can be exercised subject to there being profits and the Board of Directors recommending payment of dividend. Unless there is clear provision in the articles of association that preference shares are non-cumulative, they are presumed to be cumulative preference shares. Thus accumulation of dividend can be excluded only by a clear provision in the articles of association. Preference shareholders cannot compel the directors to pay dividends whatever be the amount of accumulation. In case of cumulative preference shares the preference shareholders are entitled to receive all the dividends which are in arrear before any

dividend is paid on equity shares. If the right to participate in the surplus profit and/or surplus assets is not specified in terms of the issue, preference shares are presumed to be non-participating. All such rights attached to preference shares, terms of redemption, etc. have to be disclosed separately.

Revised Schedule VI requires separate disclosure of arrears of fixed cumulative dividends on preference shares.

Proposed Dividends

The dividends recommended by the Board of Directors are known as proposed dividends. As per Revised Schedule VI, the amount of dividends proposed to be distributed to equity and preference shareholders for the period and the amount of dividend per share are to be disclosed separately.

As per Revised Schedule VI, proposed dividend are to be disclosed under short-term Provisions. In the notes to financial statements proposed dividend will appear under the sub-head : Surplus in Statement of Profit and Loss or Profit and Loss Account. Profit and Loss Account; and Surplus in Statement of Profit and Loss or Profit and Loss Account will appear under the head : Reserve and Surplus.

The following journal entry is passed when dividend is recommended by the Board of Directors :

Profit and Loss Appropriation Account or Surplus Dr.

To Proposed Dividend Account

To Corporate Dividend Tax

(Being the dividend proposed by directors)

If there are both equity shares and proposed dividend then the above entry will be modified as follows :

Profit and Loss Appropriation Account Dr.

To Proposed Preference Dividend

To Proposed Equity Dividend

To Corporate Dividend Tax

(Being dividend proposed on preference and equity shares)

Interim Dividend and Final Dividend

Interim dividend- The dividend declared by the Board of Directors before the preparation of financial statements is known as interim dividend. Articles of Association usually authorise the Board to pay interim dividend. Table A also contains such a power. It provides that the Board may from time to time pay to the members such interim dividend as appear it to be justified by the profits of the company. Section 205 (1A) gives statutory power to the Board of directors to declare interim dividend w.e.f. 13-12-2000 subject to compliance of legal provisions. The profits of the company cannot be known exactly till the accounts closed and, therefore, the directors have to be extremely careful while declaring interim dividend. If interim dividend is paid and it is found later on that the profit of the company are not sufficient to cover the dividend, it will amount to payment of dividend out of capital which is forbidden by law. The directors will have to reimburse the amount. As the interim dividend is paid during the current year it will appear in the Trial Balance. The journal entry for payment of interim dividend and dividend tax is as follows :

Interim Dividend Account Dr.

Corporate Dividend Tax Account Dr.

To Bank Account

(Being interim dividend paid)

At the time of preparation of financial statements (final accounts), interim dividend and corporate dividend tax will be disclosed in the Notes to Financial Statements (or Notes to Accounts) under the sub-head Profit and Loss Account [or Surplus/(Deficit) in the Statement of profit and loss] which in turn will appear under the head reserves and surplus. The journal entry passed for transfer of interim dividend and corporate dividend is as follows :

Profit and Loss Appropriation Account	Dr.
To Interim Dividend Account	
To Corporate Dividend Tax Account	

Interim dividend may be declared and paid more than once in a year.

The Board of Directors may recommend another dividend when final figures of net profit are available. This dividend is termed as *final dividend*. Interim dividend is not adjusted when final dividend is declared unless the resolution mentions it specifically.

Regulation 86 of Table A provides that "Board may from time to time pay to the members such interim dividend as it appear to be justified by the profits of the company." Companies (Amendment) Act 2000 has given statutory recognition to the right of the directors to declare and pay interim dividend. Sub-Section (1A), (1B) and (1C) of Section 205 were inserted by this Act. **These sub-sections provide that Board of Directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited in a separate bank account within five days from the data of declaration of such dividend and the amount of dividend including interim dividend so deposited as aforesaid shall be used for payment of the dividend.** It is further provided that provisions contained in Section 205 (dividend to be paid only out of profits), 205A (unpaid dividend to be transferred to special dividend account), 205C (establishment of investor education and protection fund), 206 (dividend not be paid except to registered shareholders or their order or to bankers) and 206A (right to dividend, rights shares and bonus shares to be held in abeyance pending registration of transfer of shares) shall, as far as may be also to any interim dividend.

Thus the provisions of the Companies act, 1956 relating to depreciation areas of depreciation past losses, transfer of profits to reserves etc. which apply to dividends, are also applicable to interim dividend(s).

Final dividend. The Board of directors may recommend another dividend when final figure of net profit for the year is available. This dividend is termed as final dividend. The interim dividend is not adjusted when final dividend is declared unless the resolution mentions it specifically.

Difference between interim dividend and final dividend. The following are the points of distinction between interim dividend and final dividend.

(a) **Declaration.** Interim dividend is declared by the board of directors, while final dividend is declared in the annual general meeting of the shareholders on the recommendation of the board of directors.

(b) **Number of times in a year.** Interim dividend may be paid more than once in a year, while final dividend, if any, is paid only once in a year.

Corporate Dividend Tax

The Finance Act, 1997 introduced with effect from June, 1997 tax at 10% of the dividends on companies declaring, distributing or paying dividends (whether interim or otherwise). *The rate of corporate dividend tax for the assessment year 2013-14 is 15% of the dividends.* Further the companies are liable to pay surcharge on corporate dividend tax and then on the total of the two they are liable to pay education cess. The rates of corporate dividend tax, surcharge (5% for assessment year 2013-14), and

education cess (3% for assessment year 2013-14) may vary from year to year. The students should calculate the tax liability based on the applicable rate(s) or the rate as specified in the question. The corporate dividend tax is also known as dividend distribution tax. The tax is payable by the companies. Thus dividend income is now tax free in the hands of shareholders.

According to the Guidance issued by the Institute of Chartered Accountants of India, the liability in respect of corporate dividend tax arises only if the profits are distributed as dividends whereas the income tax liability arises on the earning of the taxable profits.

As the liability in respect of corporate dividend tax is related to distribution of profits as dividends (whether interim or final dividend) which are disclosed in the Profit and Loss Appropriation Account, it would be appropriate to debit the Profit and Loss Appropriation Account with the amount of corporate dividend tax as a separate item. It is felt that such disclosure would give proper picture regarding payments involved with reference to dividends. The Guidance note further recommends that corporate dividend tax liability should be recognised in the accounts of the same financial year in which the dividend concerned is recognised. Dividend and corporate dividend tax should be disclosed separately in the profit and loss appropriation account (*now as per revised schedule VI in the notes on financial statements relating to surplus in statement of profit and loss*) as follows :

Dividend	xxx
Corporate Dividend Tax thereon	xxx
	xxx

In the Balance Sheet, provision for corporate dividend tax on proposed dividends should be disclosed under the head "Short-term provisions" and if it has become payable and not yet paid it should be shown under the head "Other current liabilities".

Corporate dividend tax is payable to the credit of the Central Government within a short period of declaration of dividend, distribution of dividend, or payment whichever is earliest.

Declaration of Dividend out of Capital Profits

Capital profits may be distributed as dividend if following conditions are satisfied :

- (a) The profit has been realised in cash.
- (b) The revaluation of all the assets discloses a surplus.
- (c) The article of association of the company do not forbid such a distribution.

However, Securities Premium, profit on reissue of forfeited shares, capital redemption reserve account created at the time of redemption of preference shares and buyback of shares, profits transferred to capital reserve are not available for declaration of dividend.

Declaration of Dividend Out of Reserves

Section 205A(3) inserted by the Companies (Amendment) Act, 1974 authorises the Central Government to make rules for declaration of dividend out of accumulated profits earned by the company in the previous years and *transferred to its reserves*. The prescribed rules framed by the Central Government in this respect are known as companies (Declaration Dividend out Reserves) Rules, 1975. Rule 2 of the rules provides that in the event of inadequacy or absence of profit in any year dividend may be declared by company for that year out of the accumulated profits earned by it in the previous years and *transferred by it to reserves*, subject to the following conditions :

- (a) The **rate of dividend** declared shall not exceed the **average** of the rates at which dividend was declared by it in five years immediately preceding that year or **10% of its paid up capital**, whichever is less.

(b) The total amount to be drawn from the accumulated profits earned in previous years and transferred to reserves shall not exceed an amount equal to one-tenth of the sum of its paid-up capital and free reserves and the amount so drawn shall first be utilised to set-off the losses incurred in the financial year before any dividend in respect of preference or equity shares is declared.

(c) The balance of reserves after such withdrawal shall not be below 15% of its paid up capital.

Explanation. For the purposes of aforesaid rule, "profits earned by a company in previous years and transferred to its reserves" shall mean the total amount of net profits after tax, transferred to reserves as at the beginning of the year for which dividend is to be calculated and in computing the said amount, all items of capital reserves including reserve created by revaluation of assets shall be excluded.

ILLUSTRATION 6

Calculate maximum amount that can be distributed as dividend for the year 2012 according to the Companies (Declaration of Dividend out of Reserves) Rules, 1975 from the following information :

	₹
Paid-up Equity Share Capital	40,00,00
Free Reserves	20,00,000
Loss in 2012	2,00,000

Dividend declared in 2007 : 15%, 2008 : 13%, 2009 : 14%, 2010 : 16%; and 2011 : 12%.

Solution

Maximum amount that can be distributed as dividend will be minimum of the following three amounts :

First Condition : Average dividend of the preceding five year is = $(15 + 13 + 14 + 16 + 12)/5 = 14\%$. The maximum rate at which dividend can be paid will 10% in this case as 10% is lower than the average rate of 14%. The amount is 10% of 40,00,000 i.e., ₹ 4,00,000.

Second condition : 10% of the paid up capital and free reserves is 10% of $(40,00,000 + 20,00,000)$ equal to ₹ 6,00,000. Out of this ₹ 2,00,000 will be used to write off the loss for the year 2012. The balance ₹ 4,00,000 can be used for distribution as dividend.

Third condition : 15% of paid up capital (₹ 40,00,000) is equal to ₹ 6,00,000. Therefore, as per this condition ₹ 20,00,000 less ₹ 6,00,000 i.e., ₹ 14,00,000 can be used to distribution as dividend.

Therefore the answer is ₹ 4, 00,000.

Payment of Interest out of Capital

As pointed out above, dividends can be paid out of profits only. In other words, dividends cannot be paid out of capital. However, Section 208 of the Companies Act, 1956 permits payment of interest to shareholders out of capital even when there is no profit in certain cases.

Section 208 allows payment of interest on such shares are issued for purpose of defraying the expenses of the construction of any works or building or providing for any plant which cannot be made profitable for a lengthy period. This will be subject to the following conditions :

- The payment must be authorised by the articles of association of the company or by a special resolution
- Prior sanction of the Central Government must be obtained.
- The rate of interest must not exceed 4% per annum or such other rate as may be prescribed by the Central Government.

- (d) Interest is paid only for such period as may be determined by the Central Government. But period cannot extend beyond the close of the half-year next after the half-year in which the works, building etc. have been completed. For example, if the construction is over on 8th October 2012 interest cannot be paid after 30th June 2013.

Journal Entries for Recommendation Declaration and Payment of Dividends.

The following entries are required to be passed for recommendation. Declaration and payment of dividends :

1. On recommendation of dividends :

Profit and Loss Appropriation A/c		
or Surplus	Dr.	(With the total of dividend and CDT)
To Proposed Dividend A/c		(With the amount of proposed dividends)
To Corporate Dividend Tax A/c		(With the amount of CDT)

In case the profits are less the balance lying in the dividend Equalisation Reserve or General Reserve may be utilised subject to the provisions of the Companies Act, 1956. In such a case Dividend Equalisation Reserve Account and/or general reserve Account should be debited and Profit and Loss Appropriation account should be credited with the required amount. If there are preference shares also then instead of one Proposed Dividend account two accounts are opened namely, Proposed Preference dividend account and proposed equity dividend account. Corporate Dividend tax is calculated on the total dividend.

As per Revised Schedule VI aforesaid entry will be shown in the Notes to Financial Statements : Surplus in Statement or Profit and Loss/Profit and Loss Appropriation Account.

2. On declaration of dividend :

(a) Proposed Dividend A/c	Dr.	
To Dividend Payable A/c		
(b) Corporate Dividend Tax A/c	Dr.	
To Corporate Dividend Tax Payable A/c		

3. On opening separate bank account for paying dividend :

Dividend Bank A/c	Dr.	(With the amount of dividend payable)
To Bank A/c		

4. On payment of dividend :

Dividend Payable A/c	Dr.	(With the actual amount paid)
To Dividend Bank A/c		

5. For payment of corporate dividend tax ;

Corporate Dividend Tax Payable A/c	Dr.	(With the actual amount paid)
To Bank A/c		

6. For unpaid or unclaimed dividend after 30 days of declaration :

(a) dividend Payable A/c	Dr.	(With the amount of unpaid or unclaimed dividend)
To Unpaid Dividend A/c		

(b) Unpaid Dividend Bank A/c	Dr.	
To Dividend Bank A/c		

7. For payment of unpaid or unclaimed dividend within seven year from the data of transfer.

Unpaid Dividend A/c Dr. (With the actual amount paid)

To Unpaid Dividend Bank A/c

8. For transfer of unpaid dividend account after seven year from the data of transfer.

(a) Unpaid Dividend A/c Dr. (With the balance in unpaid dividend account)

To Central Government Investor

Eduction and Protection Fund A/c

(b) Central Government Investor Eduction

and Protection fund A/c

To Unpaid dividend Bank A/c

Illustrations on preparation of statement of Profit and Loss and Balance Sheet (including Notes to Accounts)

ILLUSTRATION 7

Given main heading of the formate of Balance Sheet of company as per revised schedule VI.

SOLUTION

Particulars	Note No.	Figure for Current reporting period	Figure for previous reporting period
I. EQUITY AND LIABILITIES			
(1) Shareholders Funds			
(2) Share application money pending allotment			
(3) Non-current liabilities			
(4) Current liabilities			
Total			
II. ASSETS			
(1) Non-current assets			
(2) Current Assets			
Total			

ILLUSTRATION 8

Prepare formate of note : Reserve and Surplus as per Revised Schedule VI.

SOLUTION

Note No. RESERVES AND SURPLUS

<i>Particulars</i>	<i>As at the end of current reporting period</i> ₹	<i>As at the end of previous reporting period</i> ₹
Capital Reserve		
Balance as at the beginning of the year	xxx	xxx
Add : Addition during the year (specify source)	xxx	xxx
Less : Utilised during the year (specify use)	xxx	xxx
Balance as at the end of the year	xxx	xxx
Capital Redemption Reserve		
Balance as at the beginning of the year	xxx	xxx
Add : Addition during the year (specify source)	xxx	xxx
Less : Utilised during the year (specify use)	xxx	xxx
Balance on at the end of the year	xxx	xxx
Securities Premium Reserve		
Balance as at the beginning of the year	xxx	xxx
Add : Addition during the year (specify source)	xxx	xxx
Less : Utilised during the year (specify use)	xxx	xxx
	xxx	xxx
Debenture Redemption Reserve		
Balance as at the beginning of the year	xxx	xxx
Add : Addition during the year (specify source)	xxx	xxx
Less : Utilised during the year (specify use)	xxx	xxx
	xxx	xxx
Revaluation Reserve		
Balance as at the beginning of the year	xxx	xxx
Add : Addition during the year (specify source)	xxx	xxx
Less : Utilised during the year (specify use)	xxx	xxx
	xxx	xxx
Employee Stock Options Outstanding		
Options granted till date	xxx	xxx
Add : compensation for options granted during the year	xxx	xxx
Less : Transfer to Securities premium on exercise of stock option during the year	xxx	xxx
Less : Deferred Employee Stock Compensation	xxx	xxx
Balance as at the end of the year	xxx	xxx

General Reserve

Balance as at the beginning of the year	xxx	xxx
Add : Addition during the year (specify source)	xxx	xxx
Less : Utilised during the year (specify use)	xxx	xxx
Balance as at the end of the year	xxx	xxx

Surplus i.e. Balance in Statement of Profit and Loss

Balance as at the beginning of the year	xxx	xxx
Add : Profit for the year	xxx	xxx
Less : Appropriations		
Proposed dividend on preference shares	xxx	xxx
Proposed dividend on equity shares	xxx	xxx
Interim dividend	xxx	xxx
Corporate dividend tax	xxx	xxx
Transfer to Debenture Redemption Reserve	xxx	xxx
Transfer to General Reserve	xxx	xxx
Balance as at the end of the year	xxx	xxx

ILLUSTRATION 9 (Preparation of Surplus/(Deficit) in the Statement of Profit and Loss or Profit and Loss Appropriation Account)

	₹
Net profit for the year	50,00,000
Balance of Statement of Profit and Loss of previous year	20,00,000
14% Preference share capital	10,00,000
Equity share capital	9,00,000

The board of directors has proposed 15% dividend on equity shares.

Assume corporate dividend tax rate 15% surcharge 5% and education cess 3%

Transfer rs. 80,388 to debenture Sinking fund.

Prepare notes to accounts surplus/(Deficit) in the statement of Profit and Loss or prepare profit and loss appropriation account.

SOLUTION

**Surplus/(Deficit) in statement of Profit and Loss
(or Profit and Loss Appropriation Account)**

	₹
Balance of Statement of Profit and Loss for previous year	20,00,000
Net Profit for the year	50,00,000
Less : Appropriation	70,00,000
Preference Dividend (14% of 10,00,000)	1,40,000

Equity Dividends (15% of 9,00,000)		1,35,000	
Corporate Dividend Tax :			
CDT (15% of 2,75,000)	41,250		
Surcharge (5% of 4,250)	2,063		
	43,313		
Education Cess (3% of 43,313)	1,299	44,612	
General Reserve (5% of 50,00,000)		2,50,000	
Debenture Sinking Fund		80,388	
			6,50,000
Balance carried forward to next year			63,50,000

ILLUSTRATION 10

How will you disclose the following items while preparing the Balance Sheet of a company :

1. Land and Building;
2. Discount/Loss on Issue of Debentures;
3. Computer Software;
4. Building under Construction;
5. Loose Tools;
6. Proposed Dividend;
7. Prepaid Expenses;
8. Interest Accrued and Due on Debentures;
9. Interest Accrued but Not Due on Debentures;
10. Provision for Doubtful Debts;
11. Debentures payable after 12 months;
12. Long-term debt which has now become payable within 12 months;
13. Arrears of preference dividend;
14. Cheques/Drafts in hand;
15. Unpaid/Unclaimed Dividend;
16. Debit balance of the Statement of Profit and Loss;
17. Goodwill;
18. Uncalled liability on partly paid shares held as investment;
19. Bank Overdrafts;
20. Capital advances;
21. Bills discounted but not yet matured;
22. Trade Debtors;
23. Outstanding expenses;
24. Interest accrued on investments;
25. Preliminary expenses.

SOLUTION

Item	Main Head	Line Item	Sub-line Item
1. Land and Buildings	Non-current assets	Other non-current assets	
2. Discount/Loss on	Non-current assets	Other non-current assets	
3. Computer Software	Non-current assets	Fixed assets	Intangible assets
4. Building under Construction	Non-current assets	Fixed assets	Capital Work-in Progress
5. Loose Tools	Current assets	Inventories	
6. Proposed Dividend	Current liabilities	Short-term provisions	
7. Prepaid Expenses	Current assets	Other current assets	
8. Interest Accrued and Due on Debentures	Current liabilities	Other current liabilities	
9. Interest Accrued but Not Due on Debentures	Current liabilities	Other current liabilities	
10. Provision for Doubtful Debts	Current assets	Trade receivable (to be show by way of deduction)	
11. Debentures payable after 12 months	Non-current liabilities	Long-term borrowings	Bonds/ Debentures

12. Long-term debt which has now become payable within 12 months	Current liabilities	Other current liabilities	Current maturities of long-term debt
13. Arrears of preference dividend	Notes of Accounts	Contingent liabilities and commitments	Commitments
14. Cheques/Draft in hand	Current assets	Cash and cash equivalents	
15. Unpaid/Unclaimed dividend	Current liabilities	Other current liabilities	Unpaid dividends
16. Debit balance in Statement of Profit and Loss	Shareholder's funds	Reserves and surplus	Surplus (shown as negative balance)
17. Goodwill	Non-current assets	Fixed assets	Intangible assets
18. Uncalled liability on partly paid held as investment.	Notes to Accounts	Contingents liabilities and commitments	Commitments
19. Bank overdraft	Current liability	Other current liabilities	
20. Capital advances	Non-current assets	Long-term loans and advances	Capital advances
21. Bills discounted but not yet matured	Notes to Accounts	Contingent liabilities and commitments	Contingents liabilities
22. Trade debtors	Current assets	Trade Receivables	
23. Outstanding expenses	Current liabilities	Other current liabilities	
24. Interest accrued on investements	Current assets	Other current assets	
25. Preliminary expenses	<p>AS-26 : Intangible Assets, provides that preliminary expenses incurred in establishing legal entity such as legal and secretarial costs should be recognised as an expense in the year in which these are incurred. Therefore, these expenses should be written off in the year in which these are incurred. Therefore preliminary expenses, as per AS-26 should not appear in the Balance Sheet. However if the question states that only a portion of the preliminary expenses are to be written off then preliminary expenses to the extent not written off may be shown under other non-current assets if these are not be written off within 12 months of the balance sheet date. The students should also given a note explaining the accounting treatment of preliminary expenses as per AS-26.</p>		

ILLUSTRATION 11

The following is the trial balance of P.K. Limited as at 31st March, 2012 :

Items	Debit ₹	Items	Credit ₹
Opening stock-in-trade	1,50,000	Equity share capital	5,00,000
Purchase	3,82,000	Purchase return	10,000
Wages	60,000	Sales	11,50,000
Furniture	25,000	Discount	6,300
Salaries	12,000	Profit and Loss Account	1,70,000
Rent	15,000	Trade creditors	33,700
Trade expenses	11,000	General reserve	82,000
Trade debtors	54,000	Provision for doubtful debts	3,000
Plant and machinery	12,00,000	Bills payable	13,000
Cash at bank	21,500		
Computer software	9,000		
Bills receivable	14,000		
Bad debts	6,500		
Discount allowed	8,000		
	<u>19,68,000</u>		<u>19,68,000</u>

Additional information :

- (1) Stock-in-trade on 31 March, 2012 ₹ 2,00,000.
- (2) Depreciate plant and machinery at 12%, furniture at 10% and computer software at 20%.
- (3) Further bad debts amounted to ₹ 4,000. Provide 5% on debtors for bad debts.
- (4) Provide for income tax @ 35% and for corporate dividend tax @ 17%
- (5) The Board of directors recommended a dividend of 25%.
- (6) Equity share capital comprise of 50,000 equity shares of ₹ 10 each, fully paid up
Authorised share capital consists of 60,000 equity shares of ₹ 10 each.

Prepare statement of Profit and Loss for the year ended 31st March, 2012 Balance Sheet as at 31st March 2012 and Notes to Accounts.

SOLUTION

P.K. Ltd

STATEMENT OF PROFIT AND LOSS

<i>Particulars</i>	<i>Note</i>	<i>Year ended 31st March 2012</i>
Revenue from operations	10	11,50,000
Other income	11	6,300
Total revenue		11,56,300
Expenses :		
Purchase of stock-in-trade (net)		3,72,000
Changes in inventory of stock-in-trade	12	(50,000)
Employee benefit expenses	13	72,000
Depreciation and amortisation	14	1,48,300
Other expenses	15	44,000
Total expenses		5,86,300
Profit before tax		5,70,000
Tax expense : Current tax (5,70,000 × 35/100)		1,99,500
Profit for the period		3,70,500
Earnings per share : (Nominal value per share Rs. 10) Basic		7.41
Diluted		7.41

Notes are an integral part of these financial statements.

BALANCE SHEET
as at 31st March, 2012

<i>Particulars</i>	<i>Notes</i>	<i>₹</i>
EQUITY AND LIABILITY		
Shareholders Funds		
Share Capital	1	5,00,000
Reserves and Surplus	2	4,76,250
Current Liabilities		
Trade Payables	3	46,700
Short Term Provisions	4	3,45,750
		13,68,700
Assets		
Non-current Assets		
Fixed Assets		
Tangible Assets	5	10,78,500
Intangible Assets	6	7,200
Current Assets		
Inventories	7	2,00,000

Trade Receivables	8	61,500
Cash and Bank Balances*	9	21,500
		<u>13,68,700</u>

Notes are an integral part of these financial statements.

*This line item has been termed as 'Cash and Cash Equivalents' in Revised Schedule VI. However this has been altered to 'Cash and Bank Balances' in order to comply with the Revised Schedule VI as well as notified counting standard (AS-3: Cash Flow Statement).

Notes to Accounts

1. Share Capital

Authorised

60,000 Equity Shares of Rs. 10 each

Issued, Subscribed and Fully Paid up

50,000 Equity Shares of Rs. 10 each

As at 31-3-2012

Rs.

6,00,000

5,00,000

5,00,000

2. Reserves and Surplus

General Reserve

Balance as at the beginning of the year

82,000

Add : Transfer from Surplus in Statement of Profit and Loss during the year

37,050

(10% of 3,70,500)

1,19,050

Surplus/ (Deficit) in Statement of Profit and Loss

Balance as at the beginning of the year

1,70,000

Profit for the year

3,70,500

5,40,500

Less : Appropriations

Proposed Dividend on Equity Shares (Divident per Share Rs. 2.50)

1,25,000

Divident Distribution Tax on Proposed Divident

21,250

Transfer to General Reserve (10% of 3,70,500)

37,050

Balance as at the end of the year

3,57,200

3. Trade Payables

Trade Creditors

33,700

Bills payable

13,000

46,700

4. Short Term Provisions

Provision for Current Tax

1,99,500

Proposed Divident on Equity Shares

1,25,000

Divident Distribution Tax on Proposed Divident

21,250

3,45,750

5. Tangible Assets

Furniture

25,000

Less : Depreciation

2,500

22,500

Plant and Machinery	12,00,000	
Less : Depreciation	<u>1,44,000</u>	10,56,000
		<u>10,78,500</u>
6. Intangible Assets		
Computer Software	9,000	
Less : Amortised	<u>1,800</u>	7,200
7. Inventories		
Stock-in-trade		<u>2,00,000</u>
8. Trade Receivables		
Trade Debtors	54,000	
Less : Further bad debts	<u>4,000</u>	
	50,000	
Less : Provision for bad and doubtful debts (5% of 50,000)	<u>2,500</u>	40,500
Bills Receivables		<u>14,000</u>
		<u>61,500</u>
9. Cash and Bank Balances		
Cash at Bank		<u>21,500</u>
10. Revenue from operations		
Sale of Products		
Sale of traded goods		<u>11,50,000</u>
11. Other income		
Cash discount (Discount received)		<u>6,300</u>
12. Changes in inventory of stock-in-trade		
(Increase)/Decrease in Stocks		
Stock at the end of the year		
Stock-in-trade (or traded goods)		2,00,000
Less : Stock at the beginning of the year		<u>1,50,000</u>
(Increase)/Decrease in Stock		<u>(50,000)</u>
13. Employee benefit expenses		
Wages		60,000
Salaries		<u>12,000</u>
		<u>72,000</u>
14. Depreciation and amortisation		
Depreciation on tangible assets :		
Depreciation on plant and machinery		1,44,000
Depreciation on furniture		<u>2,500</u>
		<u>1,46,500</u>
Amortisation of intangible assets		<u>1,800</u>

Computer software	1,800
	<u>1,48,300</u>
15. Other expense	
Rent	15,000
Trade expense	11,000
Bad debts written off	10,500
Provision for doubtful debts (Required 2,500 - Existing 3,000)	(500)
Cash discount (Discount allowed)	8,000
	<u>44,000</u>

ILLUSTRATION 12

The following is the Trial Balance of R.S. Ltd. as on 31st March 2013 :

	₹ Dr.	₹ Cr.
Stock of finished goods (1-4-2011)	1,20,000	
Purchase of raw materials	41,00,000	
Sales		58,40,000
Sales returns/Raw materials>Returns	24,000	30,000
Manufacturing expenses	5,30,000	
12% bank loan (long-term)		2,00,000
Salaries	4,49,000	
Director's remuneration	50,000	
Building (cost)	5,00,000	
Plant and machinery (cost)	15,00,000	
Provision of depreciation :		
On building		80,000
On plant and machinery		2,90,000
Trade debtors	5,00,000	
Trade creditors		1,60,000
Advance tax	35,000	
Auditor's fees for audit	60,000	
Interim dividend paid	50,000	
Balance/Surplus in statement of Profit and loss (as at 1-4-11)		3,60,000
Preliminary expenses	4,000	
Cash debts	57,000	
Bad debts	21,000	
Provision for bad debts		40,000
Equity share capital (Fully paid shares of Rs. 10 each)		10,00,000
	<u>80,00,000</u>	<u>80,00,000</u>

Additional Information :

- (1) Stock of finished goods on 31-3-2013 was Rs. 2,00,000.
 - (2) Depreciate building 5% on cost and plant and machinery 10% on cost.
 - (3) Make provision for tax at 40%
 - (4) Provision for bad debts is to be created at 2% on debts.
 - (5) A machine purchased for ₹ 50,000 was wrongly debited to purchases account.
 - (6) Bank loan was raised on 1 October, 2011.
 - (7) Write off preliminary expenses. –
 - (8) The Board of Directors recommended a dividend @ 15% on paid up capital (excluding interim dividend)
 - (9) Corporate dividend tax is 17%.
 - (10) There was neither opening stock of raw materials nor closing stock of raw materials.
 - (11) Director's remuneration includes ₹5,000 for those directors who attend only Board meetings and are not under a contract of service with the company.
 - (12) Authorised capital consists of 1,20,000 equity shares of ₹ 10 each.
 - (13) Manufacturing expenses include wages ₹ 2,00,000.
- Prepare statement of Profit and Loss for the year ended 31st March 2012 the balance sheet as at that data and accompanying notes.

SOLUTION

R.S. Ltd
STATEMENT OF PROFIT AND LOSS
for the year ended 31-3-2012

<i>Particulars</i>	<i>Note No.</i>	<i>₹</i>
Revenue from operations	12	58,16,000
Other income		Nil
Total revenue		58,16,000
Cost of materials consumed	13	40,20,000
Changes in inventories of finished goods	14	(80,000)
Employee benefit expenses	15	6,94,000
Finance cost	16	12,000
Depreciation and amortisation expense	17	1,80,000
Other expenses	18	3,90,000
Total expenses		52,16,000
Profit before tax		6,00,000
Total expenses		
Current tax		2,40,000
Profit after tax		3,60,000
Earnings per share		
Basic and diluted		3.60

Notes are an integral of these financial statements.

BALANCE SHEET

as at 31st March, 2012

Particulars	Note	₹
EQUITY AND LIABILITY		
<i>Shareholders Funds</i>		
Share Capital	1	10,00,000
Reserves and Surplus	2	4,86,000
<i>Non-current liabilities</i>		
Long-term borrowings	3	2,00,000
<i>Current Liabilities</i>		
Trade payables	4	1,60,000
Other current liabilities	5	12,000
Short-term provisions	6	4,24,000
		22,82,000
ASSETS		
<i>Non-current Assets</i>		
<i>Fixed Assets</i>		
Tangible Assets	7	15,00,000
<i>Current Assets</i>		
Inventories	8	2,00,000
Trade Receivables	9	4,90,000
Cash and bank balances	10	57,000
Short term loans and advances	11	35,000
		22,82,000

Notes are an integral part of these financial statements.

Notes to Accounts

1. Share Capital

Authorised

1,20,000 Equity Shares of ₹ 10 each

As at 31-3-2012

₹

12,00,000

Issued

1,00,000 Equity Shares of ₹ 10 each

10,00,000

Subscribed and Fully paid-up

10,00,00 equity shares of ₹ 10 each

10,00,000

2. Reserves and Surplus

General Reserve

Transfer from Surplus in Statement of Profit and Loss during the year

(7.5% of 3,60,500)

27,000

Surplus/ (Deficit) in Statement of Profit and Loss (7.5% of 3,60,000)

Balance as at the beginning of the period

3,60,000

Net Profit for the year

3,60,000

7,20,000

Additional Information :

Less : Appropriations		50,000
Interim dividend		1,50,000
Proposed dividend (15% of 10,00,000)		34,000
Corporate dividend tax (17% 2,00,000)		27,000
Transfer to General Reserve (7.5% of net profit 3,60,500)		4,59,000
Balance as at the end of the period		
3. Long-term Borrowings		2,00,000
12% Bank loan		
4. Trade Payables		1,60,000
Trade Creditors		
5. Other current liabilities		12,000
Interest accrued on bank loan		
6. Short Term Provisions		2,40,000
Provision for Current Tax		1,50,000
Proposed Divident on Equity Shares		34,000
Corporate dividend tax		4,24,050
7. Tangible Assets		
Building	5,00,000	
Less : Accumulated depreciation (80,000 + 25,000)	1,05,000	3,95,000
Plant and machinery	15,00,000	
Add : Purchased during the period	50,000	
	15,50,000	
Less : Accumulated depreciation (2,90,000 + 1,55,000)	4,45,000	11,05,000
		15,00,000
8. Inventories		2,00,000
Finished goods		
9. Trade Receivables		5,00,000
Trade Debtors		10,000
Less : Provision for doubtful debts (@ 2%)		4,90,000
10. Cash and Bank Balances		57,000
Cash at Bank		
11. Short-term Loans and Advances		35,000
Advance tax		
		Year ended
		31-3-2012
		₹
12. Revenue from Operations		58,40,000
Sale of finished goods		24,000
Less : Returns		

	58,16,000
13. Cost of Materials Consumed	
Purchase of raw materials	41,00,000
Less : Wrongly debited	50,000
	40,50,000
Less : Returns	30,000
	40,20,000
14. Changes in Inventories of finished good	
Opening stock of finished goods	1,20,000
Closing stock of finished goods	2,00,000
	80,000
15. Employee Benefit expenses	
Wages	2,00,000
Salaries	4,49,000
Directors' remuneration	45,000
	6,94,000
16. Finance Cost	
Interest on bank loans	12,000
17. Depreciation and Amortisation Expense	
Depreciation on building	25,000
Depreciation on plant and machinery	1,55,000
	1,80,000
18. Other Expenses	
Manufacturing expenses (excluding wages)	3,30,000
Bad debts	21,000
Directors' fees	5,000
Auditor's fees for audit	60,000
Preliminary expenses written off	4,000
Provision for doubtful debts (Old provision 40,000-new provision 10,000)	(30,000)
	3,90,000

AMALGAMATION AND EXTERNAL RECONSTRUCTION

In this lesson, we shall broadly discuss the following:

- I. Meaning of Amalgamation, Absorption and Reconstruction
- II. Amalgamation—Its types
- III. Consideration
- IV. Accounting treatment in the books of transferor Company
 - a) Amalgamation in the nature of merger
 - b) Amalgamation in the nature of purchase
- V. Accounting treatment in the books of transferee Company
- VI. Dissident shareholders
- VII. External Reconstruction

I. Meaning

Amalgamation means taking over by a new company of two or more existing companies. Companies which are taken over go into liquidation and a new company is formed to take over business of these companies e.g., a company XY Ltd. is formed to take over X Ltd. and Y Ltd. Absorption, on the other hand, takes place when an existing company (or companies) takes over the business of other existing Companies. When X Ltd. takes over the business of Y Ltd. Resulting in liquidation of Y Ltd., it is a case of absorption.

Reconstruction is resorted to tide over the difficulties arising out of accumulated past losses or financial stringencies. It is of two types—External and Internal. External reconstruction takes place when a new company is floated to take over an existing company. The later company is wound up. A Ltd. is formed to take over the business of B. Ltd., in this case B. Ltd. Will be wound up. Normally, the shareholders of B. Ltd., will be the shareholders of A Ltd. Subject to the reduction in value of their shares. Under Section 494, the passing of special resolution is necessary for empowering the liquidators, to accept the share in the company in which business is being transferred and to distribute these shares to the shareholders of the company under liquidation.

Internal reconstruction means the reduction of capital without going into liquidation. Thus in internal reconstruction, neither any company goes into liquidation nor a new company is formed. (We will discuss internal reduction the next lesson). The terms Amalgamation and Absorption have been modified by the Accounting Standard 14(AS 14), 'Accounting for Amalgamation' issued by the Institute of Chartered Accounts of India. This Accounting Standard is applicable in respect of accounting periods commencing on or after 1.4.1995. Thus amalgamation may take the form of merging one company with another (earlier known as absorption) or merging of two or more companies to form a new company (earlier also known as amalgamation).

In AS 14, the following terms are used:

- i) **Amalgamation** means an amalgamation pursuant to the provision of the Companies Act, 1956 or any other statute which may be applicable to companies.
- ii) **Transferor Company** means the company, which is amalgamated into another company.
- iii) **Transferee Company** means the company into which a transferor company is amalgamated.
- iv) **Reserve** means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose.

However, this appropriation from earning, receipts or surplus should not be in the nature of provision for depreciation or diminution in the value of an asset or for a known liability.

II. Types of Amalgamation:

AS 14 divides amalgamation into two categories for the purpose of accounting treatment:

- A) Amalgamation in the nature of merger
- B) Amalgamation in the nature of purchase

A) Amalgamation in the nature of merger

Amalgamation in the nature of merger is one which satisfies all the following conditions:

- i) After amalgamation, all the assets and liabilities of the transfer company becomes the assets and liabilities of the transferee company.
- ii) After amalgamation, shareholders holding not less than 90% of the face value of the equity shares of the transferor company become equity shareholders of the transferee company. For this purpose, equity shares already held by the transferee company or its subsidiaries or their nominees are not taken into account;
- iii) The consideration, for the amalgamation receivable by the equity shareholders of the transferor company who agree to become the equity shareholders of the transferee company, is discharged by the transferee company wholly by the issue of equity shares. However, cash may be paid in respect of any fractional shares.
- iv) The business of the transferor company is intended to be carried on by the transferee company after amalgamation;
- v) The Transferee Company will record assets and liabilities of the transferor company at the book values after amalgamation. However, adjustments in their values can be made only to ensure uniformity in the accounting policies.

From the above, it is clear that there is genuine pooling of assets and liabilities of the combining entities.

B) Amalgamation in the nature of purchase

When one or more the above five conditions are not satisfied, for example, if the transferee company has no intention to continue the business or the transferee company revalues the assets/liabilities of the transferor company in its books or more assets of the transferor company is not taken over the transferee company etc., it will be treated as amalgamation in the nature of purchase.

The consideration may consist of shares and other securities, cash and other assets. The amount of consideration depends upon the fair value of its elements. In case the consideration includes securities, the value fixed by the statutory authorities may be taken to be its fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. However, where the market value of the assets given up cannot be reliably assessed, such assets are valued at their respective new book value.

Methods of Calculation of Consideration

Consideration can be ascertained by the following methods:

1. Lump sum Method

In this case, no calculation of consideration is necessary, as it is lump sum amount such as Rs. 5 lakh etc.

2. Net Assets Method

Under Net Assets Method, the consideration is arrived at by:

- a) Adding the agreed values of the assets taken over by the transferee company and b) deducting from (a) above the agreed values of all the liabilities taken over by the transferee company.

However, if the agreed values of the assets/liabilities are not given, the book values are considered for the purpose of arriving at the value of the consideration. For the sake of clarity, the following points should be kept in mind:

- i) The term 'all assets' includes cash and bank balance, but does not include fictitious assets like preliminary expenses, P&L a/c (Dr. balance), Discount on or cost of issue of share/debentures etc.
- ii) The expression 'The business' means all assets and outside liabilities like Trade creditors, B/P, Bank overdraft, Debentures, Provident fund, Provision for taxation, Workmen's savings Bank Deposits, Loans etc.
- iii) Accumulated profits are not liabilities. They belong to equity shareholders. Capital Reserve, Capital Redemption Reserve, Securities Premium, Reserve Fund, Dividend Equalisation Reserve, Debenture Redemption Reserve, Workmen's Compensation Fund (provided there is no liability against it), Share Forfeited A/c, Insurance Fund are examples of accumulated profits.

However, if against Workmen's compensation Fund, there is liability to pay compensation, the extent of this liability will be reduced to the accumulated profits.

Illustration 1: X Ltd. purchased the business of Y Ltd. whose balance-sheet was as follows:

Liabilities	Rs.	Assets	Rs.
80,000 Equity Shares of Rs. 10 each	8,00,000	Goodwill	1,00,000
Capital Reserve	1,00,000	Building	5,00,000
Profit & Loss	2,00,000	Furniture & fixtures	1,00,000
Creditors	1,50,000	Stock	3,30,000
Bills Payable	1,25,000	Debtors	1,25,000
		Bank	2,00,000
		Preliminary Expenses	20,000
	13,75,000		13,75,000

It was agreed that goodwill is to be valued of Rs. 2,00,000 building Rs. 6,00,000. Other assets are worth their book values. X-Ltd. does not take over bank balance. Calculate consideration.

Solution:

Consideration	Rs.
Goodwill	2,00,000
Building	6,00,000
Furniture & Fixture	1,00,000
Stock	3,30,000
Debtors	1,25,000
	13,55,000

Less liabilities taken over:

Creditors	1,50,000	
Bills Payable	<u>1,25,000</u>	<u>2,75,000</u>
		<u><u>10,80,000</u></u>

3. Net payment Method

Under this method, Consideration is the aggregate of shares and other securities issued and payments made in the form of cash or other asset to the shareholders of the transferor company. So the payment made to the debenture-holders and other third parties do not form part of the consideration. Further payment made for the cost of winding up is not be included in it.

Illustration 2: A Ltd. agrees to take over the business of B Ltd. The consideration being the assumption of trade liabilities of Rs. 1,00,000 and discharge of debentures of Rs. 1,00,000 at a premium of 10% by the issue of 10% Debentures; and the payments of Rs. 10 per share in cash and exchange of 2 fully paid Rs. 10 shares in A Ltd., at the market price of Rs. 20 per share in B Ltd. The share capital of B Ltd. consists of 10,000 shares of Rs. 30 each fully paid.

Solution

Consideration		Rs.
Payment to Shareholders in cash	$10,000 \times 10 =$	1,00,000
Payment to Shareholders in shares of the Transferee co.	$10,000 \times 2 \times 20 =$	<u>4,00,000</u>
		<u><u>5,00,000</u></u>

(Debentures received for the debenture holders do not form part of consideration).

4. Intrinsic Worth method or Share exchange method

Under this method the consideration is calculated on the basis of agreed value of shares of the transferor company. (See Illustration VI) Suppose the share capital of the transferor consist of 5,00,000 shares of Rs. 10 each, full paid agreed at Rs. 14 per share. The transferor company does not have the preference share capital.

The consideration in this case shall be $500000 \times 14 =$ Rs. 70,00,000. Assume further the face value (as well as agreed value) of share of the transferee company is Rs. 10. The consideration will be discharged by the issue of 7,00,000 shares i.e. Rs. 70,00,000/10. In case the agreed value of the shares of the transferee company is Rs. 28 (though face value is Rs. 10), it will not affect the amount of consideration which will be Rs. 70,00,000 though the transferee will discharge this consideration by the issue of 2,50,000 shares (70,00,000/28).

IV. Accounting Treatment

AS 14 deals with the accounting mechanism in the books of transferee company. So far as the books of transferor company is concerned, the usual accounting treatment, as was followed before the introduction of AS 14, is to be followed (to be discussed later on in this lesson). So far as books of transferee company is concerned, there are two methods of accounting. These are:

- (i) Pooling interests Method, and
- (ii) Purchase method

i) Pooling of Interest Method

This method is used for amalgamation in the nature of merger. Only minimal changes are made in aggregating the assets and liabilities of the individual amalgamating companies. Thus all items, including reserves in the financial statements of the transferor company are recorded at their book values. Adjustment in the book values are made only to bring uniformity in the accounting policies of the transferor company and transferee company. However, the effect of changes in the book values should be disclosed.

Under this method, the identity of the reserve is maintained. Thus General Reserve of the transferor company becomes the General Reserve of the Transferee company, the Capital Reserve becomes the Capital Reserve of the transferee company etc. It should be noted that free reserves (i.e. which are available for distribution as dividends of the transferor company) do not lose their identity and are available for distribution as they are shown as free reserves in the accounts of the transferee company. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted against the reserves of the transferor company in the books of transferee company.

Journal Entries in the books of Transferee Company

1. On Amalgamation of the business:

Business Purchase	Dr.	(with the Consideration)
To Liquidator of transferor Company		

2. On acquisition of Assets and Liabilities

Sundry Assets (individually)	Dr.	(with their respective book values)
To Sundry liabilities (individually)		(with their respective book values)
To Provision for bad debts etc.		
To Profit and Loss		(Book balance)
To Reserve (individually)		(Book balance)
To Business Purchase		(with consideration)

(The difference in debits and credits, if any, is adjusted against reserves)

3. When the Consideration is satisfied

Liquidator of transferor company	Dr.	(with Consideration)
To Share Capital		(with face value)
To Securities Premium		(with premium amount)
To Bank		(for fractional shares/dissenting shareholders)
To Non-cash consideration (other than cash)		

4. When the liquidation expenses is borne by the transferee Company

(a) Liquidation expense	Dr.	| Or	P&L A/c Dr.
To Bank			
(b) Profit & Loss A/c	Dr.	|	To Bank A/c
To Liquidation Expenses			

5. For the formation expenses of the Transferee Company

Preliminary Expenses	Dr.
To Bank	

ii) Purchase Method:

This method is applicable to the amalgamation in the nature of purchase. In the books of transferee company the assets and liabilities should be incorporated either at book values or the consideration

should be allocated to individuals assets and liabilities at fair value (i.e. revalue) General Reserve, Capital Reserve, Revaluation Reserve should not be included in the financial statements of the transferee company. However, statutory reserves (like Foreign Projects Reserve) should be carried forward in the books of the transferee company. For this purpose, Amalgamation Adjustment Reserve is debited. This Amalgamation Adjustments Reserve is shown under the head 'Misc. Exp.' In the balance sheet. Later on, when Statutory Reserves is not required, it is eliminated. Excess of consideration and net assets is treated Goodwill/ Capital Reserve.

Journal Entries in the books of Transferee company under the Purchase method

1. Consideration becoming due on the amalgamation of business

Business Purchase	Dr.	
To liquidator of Transferor Company		(with the consideration)

2. On acquisition of assets & liabilities

Sundry Assets (individually)	Dr.	(with respective revalued book values)
To Sundry Liabilities		(with respective revalued/book values)
To Business Purchase		(with the amount of consideration)

In case the total of debits is greater than the total of credits, the difference is credited to Capital Reserve A/c. In case of total of debits is less total of credits, it is debited to Goodwill A/c.

3. On discharge of consideration

Liquidator of transferor company	Dr.	(with the consideration)
To Share Capital		(with face value of shares)
To Securities Premium		(with the amount of premium)
To Debentures		(with the face value)
To Bank		
To non-cash consideration		(other than cash)

In case shares/debentures are issued at a discount, discount on issue of shares/debentures is debited.

4. In amalgamation in the nature of purchase, the identity of the reserves of the transferor Company is not maintained. However to get the advantage of provisions of some of the statutes, it is necessary to retain the identity of statutory reserves (eg. Foreign Project Reserve). To record the statutory reserve of the transferor company in the books of the transferee company, the following entry may be passed.

Amalgamation Adjustments Reserve A/c	Dr.	(with the amount of statutory Reserve)
To Statutory Reserve A/c (individually)		

5. When the identity of the statutory Reserve of the transferor company is no longer required, the above entry is reversed, i.e.

Statutory reserve A/c (individually)	Dr.	
To Amalgamation Adjustment Reserve A/c.		

6. When liquidation expenses of the transferor company are borne by the Transferee Co.

Goodwill A/c	Dr.	(with amount of liquidation expenses)
To Bank		

7. For the formation expenses of the transferee company.

Preliminary Expenses	Dr.	
To Bank		

8. Goodwill and Capital reserves should not appear simultaneously in the balance-sheet. They should be set-off by passing the following journal entry.

Capital Reserve	Dr.	
To Goodwill		

Illustration 3: X Ltd. takes over the business of Y Ltd. for a consideration of Rs. 2,00,000 to be discharged in the form of fully paid equity Shares of Rs. 10 each. Their Balance Sheet on the date of acquisition were as follows:

Balance Sheet
as on 31st December, 2002

Liabilities	X Ltd. Rs.	Y Ltd. Rs.	Assets	X Ltd. Rs.	Y Ltd. Rs.
...Shares, of 10 each	2,00,000	1,25,000	Building	2,00,000	1,00,000
General Reserve	75,000	15,000	Machinery	2,00,000	1,00,000
Export Profit Reserve	45,000	25,000	Stock	30,000	40,000
P&L	60,000	45,000	Debtors	30,000	40,000
Creditors	1,00,000	80,000	Debtors	20,000	10,000
	4,80,000	2,90,000		4,80,000	2,90,000

Journalise the transactions in the books of X Ltd. when amalgamation is by way of

(i) Merger; and (ii) Purchase

Also prepare Balance Sheet of X Ltd.

Solution: (1) By way of merger

Journal X Ltd.

Particulars	Dr. Amount Rs.	Cr. Amount Rs.
Business Purchase A/c	Dr.	2,00,000
To liquidation Y Ltd.		2,00,000
(Being consideration payable)		
Building A/c	Dr.	1,00,000
Machinery A/c	Dr.	1,00,000
Stock A/c	Dr.	40,000
Debtors A/c	Dr.	40,000
Bank A/c	Dr.	10,000
General Reserve	Dr.	15,000
(bal. Figure)		80,000
To Creditors		25,000
To Export Profit Reserve A/c		2,00,000
To Business Purchase A/c		
(Being merger of assets and liabilities, adjusting the excess of consideration over share capital, and the General Reserve and P&L A/c)		
Liquidator of Y Ltd	Dr.	2,00,000
To Equity Share Capital		2,00,000
(Discharge of consideration)		

Balance Sheet of X Ltd.
as on 31st December, 1999

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
...Shares of Rs. 10 each	4,00,000	Buildings	3,00,000
Reserves and Surplus		Machinery	3,00,000
General Reserve (75,000-15,000)	60,000	Current Assets	
Export Profit Reserve	70,000	Loans & Advances	
Profit and Loss A/c	60,000	(a) Current Assets	
Current Liabilities		Bank	30,000
Creditors	1,80,000	Debtors	70,000
	<u>7,70,000</u>	Stock	70,000
		(b) Loans & Advances	
			<u>7,70,000</u>

(ii) Amalgamation in the nature of purchase

Journal of X

Particulars		Dr. Amount	Cr. Amount
		Rs.	Rs.
Business Purchase	Dr.	2,00,000	
To Liquidator of Y Ltd.			2,00,000
(for Consideration)			
Building A/c	Dr.	1,00,000	
Machinery A/c	Dr.	1,00,000	
Stock A/c	Dr.	40,000	
Debtors A/c	Dr.	40,000	
Bank A/c	Dr.	10,000	
To Creditors			80,000
To Business Purchase			2,00,000
To Capital Reserve			10,000
(Asset & Liabilities taken over)			
Liquidator of Y Ltd	Dr.	2,00,000	
To Equity Share Capital			2,00,000
(Discharge of Consideration)			
Amalgamation Adjustment A/c	Dr.	25,000	
To Export Profit Reserve A/c			25,000
(Carrying forward of these statutory Reserve in the books of X Ltd.)			

Balance Sheet of X Ltd.

as on December 31, 1999

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
Share of Rs. 10 each	4,00,000	Building	3,00,000
Reserve & Surplus		Machinery	3,00,000
General Reserve	75,000	Current Assets	
Capital Reserve	10,000	Loans & Advances	
Export Profit Reserve	70,000	(a) Current Asset	
Profit & Loss A/c	60,000	Stock	70,000
Current Liabilities		Debtors	70,000
Creditors	1,80,000	Bank	30,000
		Misc. Exp.	
		Amalgamation	
		Adjustment	25,000
	7,95,000		7,95,000

V. Books of Transferor Company

1) Transfer of All Assets to Realization

Realization A/c
 To various Assets (individually)

Dr.

This entry shall close the accounts of these assets

(However if cash/bank is not taken over, they need not be transferred to Realization. Assets should be transferred at their given value e.g. Debtors should be transferred without deducting any provision). The terms assets do not include expenses e.g. discounts on issue of shares, preliminary expenses but includes prepaid expenses.

2) Transfer all liabilities by the transferor Company

Various liabilities (individually)
 To Realization A/c

Dr.

This entry shall close the accounts of these liabilities.

(Liabilities do not include profits and reserve. However, if any fund/reserve denotes liability, it should be transferred to Realization account e.g. Liquidity against Workman Accident Compensation Fund)

3) Consideration Due

Transferee Company
 Realization a/c

Dr.

4) On receipt of Consideration

Bank A/c
Shares in Transferee Company
Debentures in Transferee Company
 To Transferee Company

Dr.

Dr.

Dr.

(with consideration)

5) In case any asset is not taken over by transferee company on sale of that asset. Dr. bank a/c and Credit Realization A/c.

6) Liquidation Expenses

a) If the Transferor Company bears it:

Realization A/c
 To Bank

Dr.

b) If the transferee Company bears it, no entry

c) If the transferee company reimburses it			
i) Transferee company	Dr.	(with the amount of	
To Bank		(liquidation expenses paid)	
ii) Bank A/c	Dr.	On reimbursement of the	
To Transferee company		liquidation exp. by the transferee co.	
7) Transfer preference share capital to preference share holders			
(a) If they get more than their credit balance:			
Preference Share Capital	Dr.	(Credit balance)	
Realization A/c	Dr.	(Excess amount payable)	
To Preference shareholders A/c			
(b) If they get less than their credit balance:			
Preference Share Capital	Dr.		
To Realization A/c			
To Preference shareholders			
8) Payment of Preference Shareholders			
Preference Shareholders A/c	Dr.		
To Bank			
To Debentures in transferee Company			
To Preference shares in transferee company			
To Equity shares in transferee company			
9) Transfer equity share capital, reserves etc. to Equity share holders			
(a) Equity share capital			
To Equity Shareholders	Dr.	with face value	
(b) Equity shareholders			
To Preliminary Expenses	Dr.	With expenses & losses	
To Discount on issue of shares/Debenture			
To Profit & Loss (Dr. balance) etc.			
(iii) General Reserve			
Capital Reserve	Dr.	With accumulated	
P&L A/c (cr. balance)	Dr.	Profit and reserves	
Sinking Fund	Dr.		
Securities Premium etc.	Dr.		
To Equity Shareholders			
(iv) Realization			
To Equity Shareholders	Dr.	With Profit on	
		Realization	
(In case of loss, this entry will be reversed)			
10) Payment to Equity Shareholders			
Equity Shareholders A/c	Dr.		
To Bank			
To Equity Shares in Transferee Company etc.			

Illustration 4: (Amalgamation in the nature of purchase-net payment method)

W. Ltd agreed to acquire the business of G. Ltd. The balance sheet of G. Ltd on that date was as follows:

Liabilities	Rs.	Assets	Rs.
60,000 equity shares of Rs. 10 each	6,00,000	Goodwill	1,00,000
General Reserve	1,70,000	Land & Building	2,30,000
Profit & Loss A/c	1,10,000	Plant & Machinery	4,10,000
12% Debentures	1,00,000	Stock	1,68,000
Creditors	20,000	Bank	56,000
		Debtors	36,000
	<u>10,00,000</u>		<u>10,00,000</u>

The consideration payable by W. Ltd. was as follows:

- A cash payment of Rs. 2.50 for each share of Rs. 10 in G Ltd.
- The issue of 90,000 equity shares of Rs. 10 each fully paid in W Ltd. having an agreed value of Rs. 15 per share.
- W Ltd. agreed to discharge the 12% Debentures of G Ltd. at a premium of 20% by allotment of its 14% Debentures as 96%.

While computing the consideration, the directors of W Ltd. valued the following assets at values noted against them:

Land and building Rs. 7,50,000; Plant and Machinery Rs. 4,50,000 Stock Rs. 1,42,000; Debtors subject to an allowance of 5% for doubtful debts.

The Cost of Liquidation came to Rs. 5,000/- which was borne by W Ltd. Give journal entries in the books of G Ltd. and W Ltd.

Solution:

	Consideration	Rs.
Cash	60,000 × Rs. 2.50	1,50,000
Shares	90,000 × Rs. 15	13,50,000
		<u>15,00,000</u>

G Ltd. Journal

	Dr.	Rs.	Rs.
Realisation A/c	Dr.	10,00,000	
To Goodwill			1,00,000
To Land & Building			2,30,000
To Plant & Machinery			4,10,000
To Stock			1,68,000
To Debtors			36,000
To Bank			56,000
(Transfer of all assets to Realisation A/c)			
12% Debentures A/c	Dr.	1,00,000	
Creditors	Dr.	20,000	
To Realisation A/c			1,20,000
(Transfer of liabilities)			

W Ltd. Dr.		15,00,000	
To Realisation A/c			15,00,000
(Consideration agreed on amalgamation)			
Bank A/c	Dr.	1,50,000	
Equity Shares in W Ltd.	Dr.	13,50,000	
To W Ltd.			15,00,000
(Receipt of equity shares and Cash in satisfaction of Consideration)			
Realisation A/c	Dr.	6,20,000	
To Equity Shareholders			6,20,000
(Profit on Realisation Transferred)			
General Reserve	Dr.	1,70,000	
Profit & Loss A/c	Dr.	1,10,000	
To Equity Shareholders			2,80,000
(Accumulated Profit & Reserves transferred)			
Equity Shareholders	Dr.	15,00,000	
To Equity Shares in W Ltd.			13,50,000
To Bank			1,50,000
(Distribution of Equity Shares and cash to Equity Shareholders)			

W. Ltd. Journal

Date	Particulars	Rs.	Rs.
	Business Purchase	Dr.	15,00,000
	To Liquidator of G. Ltd.		15,00,000
	(Consideration payable to G. Ltd.)		
	Land & Building	Dr.	7,50,000
	Plant & Machinery	Dr.	4,50,000
	Stock	Dr.	1,42,000
	Bank	Dr.	56,000
	Debtors	Dr.	36,000
	Goodwill (bal. Fig.)		2,07,800
	To 12% Debentures (G. Ltd)		1,20,000
	To Creditors		20,000
	To Provision for Doubtful Debts		1,800
	To Business Purchase		15,00,000
	(Assets & liabilities taken over)		
	Liquidator of G. Ltd.	Dr.	15,00,000
	To Bank		1,50,000
	To Equity Share Capital		9,00,000
	To Securities Premium		4,50,000
	(Payment of Cash & allotment of equity shares in discharge of consideration).		
	12% Debentures (G. Ltd.)	Dr.	1,20,000
	Discounts on Issue of Debentures	Dr.	5,000
	To 14% Debentures		1,25,000*
	(Discharge of liability of 12% debenture of G. Ltd.)		
	Securities Premium	Dr.	5,000
	To Discounts on Issue of Debentures		5,000
	(Discounts on issue of Debentures set off against Share Premium)		

Goodwill	Dr.	5,000	
To Bank A/c			5,000
(Cost of Liquidation of G Ltd. Paid)			

* Face value of Debentures = $1,20,000 \times 100/96 = 1,25,000$.

Illustration 5: A Ltd. takes over B Ltd. on 31.12.2002 on which date B's Balance Sheet stood as follows:

Liabilities	Rs.	Assets	Rs.
1,62,500 Equity		Patents	2,12,500
Shares of Rs. 10 Each	16,25,000	Building	18,00,000
5000, 12% Preference		Debtors	1,42,500
Shares of Rs. 100 each	5,00,000	Preliminary Expenses	45,000
10% Debentures	3,75,000	Stock	1,25,000
Creditors	5,75,000	Profit & Loss	7,50,000
	<u>30,75,000</u>		<u>30,75,000</u>

Preference Dividend is in arrears for 2 years. A Ltd. takes over B Ltd. on the following terms:

- take over patents after depreciating 10%; Building at Rs. 82,875 less; Debtors subject to a provision of 5% for bad debts; stock to be written off by Rs. 6,250.
- take over 10% Debentures.
- discharge the consideration by allotment of 50,000 equity shares of Rs. 10 each at an agreed value of Rs. 12 each of B Ltd. and balance in cash.
- Preference shareholders of S Ltd. agreed to accept Rs. 4,50,000 in full settlement of the claim.
- The cost of winding up amounted to Rs. 10,000 to be borne by B Ltd.

Close the books B Ltd. and pass Journal entries, in the books of A Ltd.

Solution:

Calculation of Consideration:

Assets taken over:

	Rs.	Rs.
Patents	2,12,500	
Less 10% depreciation	<u>21,250</u>	1,91,250
Buildings	18,00,000	
Less dep.	<u>82,875</u>	17,17,125
Debtors	1,42,500	
Less Provision for bad debts	<u>7,125</u>	1,35,375
Stock	1,25,000	
Less Written off	<u>6,250</u>	1,18,750
		<u>21,62,500</u>
Less 10% Debentures and Creditors		<u>9,50,000</u>
Consideration		<u>12,12,500</u>

Discharge of Purchase consideration

50,000 equity shares of Rs. 10 each at agreed value of Rs. 12	Rs. 6,00,000
Cash (Balancing figure)	6,12,500
	12,12,500

(As there is agreement between the companies, we take agreed value instead of face value of the shares)

Book of B. Ltd. Realisation A/c

	Rs.		Rs.
To Patents	2,12,500	By Creditors	5,75,000
To Buildings	18,00,000	By 10% Debentures	3,75,000
To Debtors	1,42,500	By A Ltd. (Consideration)	12,12,500
To Stock	1,25,000	By 12% Preference Shareholders	50,000
To Bank (Liquidation Exp.)	10,000	By Equity Shareholders (Loss)	77,500
	22,90,000		22,90,000

Bank A/c

To A Ltd	6,12,500	By Realisation (expenses)	10,000
		By 12% Pref. Shareholders	4,50,000
		By Equity Shareholders	1,52,500
	6,12,500		6,12,500

12% Preference Share Capital A/c

To 12% Pref. Shareholders	5,00,000	By Balance b/d	5,00,000
	5,00,000		5,00,000

12% Preference Shareholders A/c

To Bank A/c	4,50,000	By 12% Share Capital	5,00,000
To Realisation	50,000		
	5,00,000		5,00,000

A Ltd.

To Realisation	12,12,500	By shares in A Ltd	6,00,000
		By Bank	6,12,500
	12,12,500		12,12,500

Equity Shareholders A/c

To Preliminary Expenses	45,000	By Equity Share Capital A/c	16,25,000
To Profit & Loss A/c	7,50,000		
To Realisation A/c (loss)	77,500		
To Shares in A Ltd	6,00,000		
To Bank A/c	1,52,500		
	16,25,000		16,25,000

Books of A Limited A/c

Business Purchase	Dr.	12,12,500	
To Liquidator of B Ltd.			12,12,500
(Consideration due to B on business purchase)			
Patents	Dr.	1,91,250	
Buildings	Dr.	17,17,125	
Debtors	Dr.	1,42,500	
Stock	Dr.	1,18,750	
To Business Purchase			12,12,500
To Provision for Bad Debtors			7,125
To 10% Debentures			3,75,000
To Creditors			5,75,000
(Assets and Liabilities taken over)			
Liquidator of B Ltd.	Dr.	12,12,500	
To Equity Share Capital			5,00,000
To Securities Premium			1,00,000
To Bank A/c			6,12,500
(Allotment of 50,000 equity shares of Rs. 10 each at Rs. 12 and cash in discharges of considerations)			

Illustration 6: The following are the balance sheets of A Ltd. and B Ltd. on 31-3-2002.

Liabilities	A Ltd. Rs.	B. Ltd. Rs.	Assets	A Ltd. Rs.	B Ltd. Rs.
5,000 Shares of Rs. 100 each	5,00,000		Fixed Assets	8,30,000	16,00,000
80,000 Shares of Rs. 10 each		8,00,000	Investments	1,70,000	
Capital Reserve	1,00,000	—	Current Assets	6,90,000	16,80,000
General Reserve	3,60,000	10,00,000	Goodwill	20,000	
Secured Loans	—	4,00,000			
Unsecured Loans	2,20,000	—			
Creditors	4,20,000	4,60,000			
Provision for tax	1,10,000	5,20,000			
Proposed dividend	—	1,00,000			
	<u>17,10,000</u>	<u>32,80,000</u>		<u>17,10,000</u>	<u>32,80,000</u>

A Ltd. was absorbed on this date. For the purpose of absorption, the goodwill of A Ltd. was considered valueless. A Ltd. had arrears of depreciation amounting to Rs. 40,000. The shareholders of A Ltd. are allotted, in full satisfaction of their claims, shares in B Ltd. in the same proportion as the respective intrinsic value of the shares of the two companies bear to each other. Close the books of A Ltd. and Journalise the transaction in B Ltd's Books.

Solution:

Calculation of consideration:

	A. Ltd. Rs.	A. Ltd. Rs.	B. Ltd. Rs.	B. Ltd. Rs.
Fixed Assets	8,30,000		16,00,000	
Investments	1,70,000		—	
Current Assets	6,90,000	16,90,000	16,80,000	32,80,000
Less Liabilities				
Secured loans	—		4,00,000	
Unsecured loans	2,20,000	—	—	
Creditors	4,20,000		4,60,000	
Provision for tax	1,10,000	7,50,000	5,20,000	
Proposed Dividend			1,00,000	14,80,000
		9,40,000		
Less depreciation		40,000		
Net Assets		9,00,000		18,00,000
Numbers of Shares of A Ltd.			5,000	
Value per share of A Ltd.	Rs. 9,000/5000	=	180	
Number of shares of B Ltd.			80,000	
Value per share of B Ltd.	Rs. 18,00,000/80000	=	22.50	
For each share in A Ltd. allotted 8 shares in B Ltd. (i.e. 180/22.50 = 8 shares)				
Number of shares to be issued to A Ltd. = 5000 × 8 = 40,000 shares				
Consideration = 40,000 × 22.50 = 9,00,000				

**Books of A Ltd.
Realisation A/c**

Particulars	Rs.	Particulars	Rs.
To Fixed Assets	8,30,000	By Unsecured loans	2,20,000
To Investments	1,70,000	By Creditors	4,20,000
To Current Assets	6,90,000	By Provision for tax	1,10,000
To Goodwill	20,000	By B Ltd Consideration	9,00,000
		By Shareholders (loss)	60,000
	<u>17,10,000</u>		<u>17,10,000</u>

B. Ltd.

To Realisation A/c Consideration	9,00,000	By Shares in B Ltd.	9,00,000
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Shares in B. Ltd.

To B Ltd.	9,00,000	By Shareholders	9,00,000
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Shareholders A/c

To Realisation (Loss)	60,000	By Share Capital	5,00,000
To Share in B Ltd.	9,00,000	By Capital Reserve	1,00,000
		By General Reserve	3,60,000
	<u>9,60,000</u>		<u>9,60,000</u>

**Books of B Ltd.
Journal**

Business Purchase	Dr.	9,00,000	
To Liquidators of A Ltd.			9,00,000
<u>(Consideration payable to A Ltd.)</u>			
Fixed Assets	Dr.	7,90,000	
Investment	Dr.	1,70,000	
Current Assets	Dr.	6,90,000	
To Unsecured Loans			2,20,000
To Creditors			4,20,000
To Provision for tax			1,10,000
To Business Purchase			9,00,000
<u>(Assets & Liabilities taken over)</u>			
Liquidator of A Ltd.	Dr.	9,00,000	
To Share Capital			4,00,000
To Securities Premium			5,00,000
<u>(Discharge of consideration by issue of 40,000 Share of Rs. 10- each at Rs. 22.50)</u>			

VI. Dissenting Shareholders

These are those shareholders who do not agree to the scheme of amalgamation and refuse to transfer their shares to the transferee company. According to the Companies Act, shares of dissenting shareholders may be acquired by the transferee company:

- a) On the same terms on which willing shareholders transferred their shares; or
- b) On the terms agreed upon between the amalgamated company and dissenting shareholders, or
- c) On terms ordered by the court.

Accounting Treatment:

When a separate settlement is made for dissenting shareholders, the transferor company transfers the share capital of these shareholders by crediting to a separate account, 'Dissentient shareholders A/c'. Any payment made is debited to this account. Balance is transferred to Realisation Account. Profit/Loss on realization is transferred to willing Shareholders A/c.

Illustration 7: X Ltd. took over the business of Y Ltd. on the date of Balance Sheet which stood as follows:

Liabilities	Rs.	Assets	Rs.
24,000 shares of Rs. 50 each, fully paid	12,00,000	Sundry fixed Assets	6,10,000
General Reserve	2,40,000	Bank	50,000
Profit and Loss A/c	1,30,000	Other Current Assets	10,60,000
Creditors	1,50,000		
	<u>17,20,000</u>		<u>17,20,000</u>

X Ltd. took over all the assets and liabilities of Y Ltd. except Rs. 20,000/- to provide for winding up expenses and payment to dissentient shareholders. The Consideration was discharged by the allotment

of the shareholder of the transferor Company of one share of Rs. 100 (Rs. 90 paid up) of X Ltd. for every two shares in Y Ltd. Cost of winding up of Y Ltd. amounted of Rs. 6000/- which was borne by Y Ltd. Dissident shareholders of 200 shares were paid at Rs. 70/- per share. Close the books of Y Ltd. and pass Journal entries in the books of X Ltd.

Solution:

Consideration : $23,800 \times 90 \times 1/2 = \text{Rs. } 10,71,000/-$

**Y Ltd.'s Books
Realisation A/c**

	Rs.		Rs.
To Sundry Fixed Assets	6,10,000	By Creditors	1,50,000
To Bank	30,000	By X Ltd. (consideration)	10,71,000
To other Current Assets	10,60,000	By Shareholders (willing)	4,89,000
To Bank (expenses)	6,000	(Loss)	
To Dissident shareholders	4,000		
	<u>17,10,000</u>		<u>17,10,000</u>

Dissident Shareholders A/c

To Bank	14,000	By Share Capital	10,000
		By Realisation A/c (balance transferred)	4,000

Shareholders A/c (Willing)

To Realisation A/c (Loss)	4,89,000	By Share Capital	11,90,000
To Shares in X Ltd.	10,71,000	By General Reserve	2,40,000
		By Profit & Loss A/c	1,30,000
	<u>15,60,000</u>		<u>15,60,000</u>

X Ltd.

To Realisation A/c (Consideration)	10,71,000	By Shares in X Ltd.	10,71,000
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Shares in X Ltd.

To X Ltd.	10,71,000	By Shareholders (willing)	10,71,000
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Bank A/c

To Balance b/d	50,000	By Realisation (transfer)	30,000
		By Realisation (Expenses)	6,000
		By Dissident Shareholders	14,000
	<u>50,000</u>		<u>50,000</u>

X Ltd.'s Journal

	Dr.	Rs.	Rs.
Business Purchase		10,71,000	
To Liquidator of Y Ltd. (Purchase of Business of Y Ltd.)			10,71,000

undry Fixed Assets	Dr.	6,10,000	
Bank A/c	Dr.	30,000	
Other Current Assets	Dr.	10,60,000	
To Creditors			1,50,000
To Business Purchase			10,71,000
To Capital Reserve			4,79,000
<hr/> (Assets and Liabilities of Y Ltd. taken over)			
Liquidator of Y Ltd.	Dr.	10,71,000	
To Share Capital A/c			10,71,000
<hr/> (Allotment of 11,900 shares of Rs. 100 each (Rs. 90 paid up) in discharge of Consideration)			

VII. External Reconstruction

Meaning

Reconstruction is resorted to when a company has incurred heavy losses and unless some drastic steps are taken, it cannot survive. It is nothing but re-organisation of the financial structure. As discussed earlier, it is of two types-External and Internal Reconstruction. Internal Reconstruction will be discussed in the next chapter. In External Reconstruction, the business of the company is transferred to a newly started company. Briefly, assets and liabilities are revalued and losses suffered are eliminated by sacrifices made by shareholders, creditors, debenture holders' etc.

Accounting Treatment

So far, accounting treatment is concerned, it is similar to amalgamation in the nature of purchase.

Illustration 8: The following is the balance sheet of A Ltd. on 31st December, 1998.

Liabilities	Rs.	Assets	Rs.
50,000, 12% Cumulative pref. shares of Rs. 10 each	5,00,000	Plant & Machinery	10,00,000
1,50,000 Equity Shares of Rs. 10 each	15,00,000	Furniture & Fixture	3,00,000
10% Debentures	3,00,000	Patent	1,50,000
Creditors	2,00,000	Stock	4,90,000
		Debtors	2,60,000
		Less: Provision for Bad Debts	5,000
		Bank	5,000
		Preliminary Expenses	30,000
		Profit & Loss A/c	2,70,000
	<u>25,00,000</u>		<u>25,00,000</u>

Note: Preference dividends are in arrears for 3 years.

The following external reconstruction scheme was agreed upon:

- (i) A new Company to be formed called B Ltd. with an authorised capital of Rs. 40,00,000 in equity shares of Rs. 10 each.
- (ii) One equity share, Rs. 5 paid, up, in B Ltd. to be allotted for each equity share in A Ltd.
- (iii) Two equity shares, shares, Rs. 5 Paid up in B Ltd. to be allotted for each preference share in A Ltd.
- (iv) Arrears of preference dividends to be cancelled.

- (v) Debenture holders to receive 30,000 equity shares in B Ltd. credited as fully paid.
- (vi) Creditors to be taken over by B Ltd.
- (vii) B Ltd. to take over A Ltd.'s assets except patents, subject to writing down plant & machinery by Rs. 3,00,000 and stock by Rs. 1,00,000.
- (viii) Patents were realised by A Ltd. for Rs. 60,000/-
- (ix) Cost of liquidation Rs. 10,000/-

Close the books of A Ltd. and pass opening entries in the books of B Ltd. and prepare Balance Sheet of B Ltd. after reconstruction.

Consideration:

		Rs.
For 12% Cumulative Preference Shares	(50,000 × 2 × Rs. 5)	5,00,000
For Equity Shares	(1,50,000 × Rs. 5)	7,50,000
(Debentures and creditors are excluded in the consideration)		12,50,000

**Books of A Ltd.
Realisation A/c**

	Rs.		Rs.
To Plant & Machinery	10,00,000	By Provision for Bad Debt	5,000
To furniture & fixture	3,00,000	By Creditors	2,00,000
To Patent	1,50,000	By 10% Debentures	3,00,000
To Stock	4,90,000	By B Ltd. (Consideration)	12,50,000
To Debtors	2,60,000	By Bank (Patents)	60,000
To Bank	5,000	By Equity Shareholders	4,00,000
To Bank (liquidation Expenses)	10,000	(Loss)	
	22,15,000		22,15,000

B. Ltd.

To Realization (consideration)	12,50,000	By Equity Shares in B Ltd.	12,50,000
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Equity Shares in B Ltd. (Rs. 5 paid up)

To B Ltd.	12,50,000	By 12% Cumulative Pref. Shareholders A/c	5,00,000
		By Equity shareholders	7,50,000
	12,50,000		12,50,000

12% Cumulative Preference Shareholders A/c

To Equity Shares in B Ltd.	5,00,000	By 12% Cumulative Pref. Shareholders Capital	5,00,000
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Equity Shareholders A/c			
To Preliminary Expenses	30,000	By Share Capital	15,00,000
To Profit and Loss A/c	2,70,000		
To Realisation A/c (loss)	4,00,000		
To Bank	50,000		
To Equity Shares in B Ltd.	7,50,000		
	<u>15,00,000</u>		<u>15,00,000</u>

Bank A/c			
To Balance b/d	5,000	By Realisation A/c (transfer)	50,000
To Realisation A/c (Patent)	60,000	By Realisation (liq. Exp.)	10,000
		By Equity Shareholders	50,000
	<u>60,000</u>		<u>60,000</u>

B Ltd.'s Journal

	Rs.	Rs.
Business Purchase A/c	Dr.	12,50,000
To Liquidator of A Ltd.		12,50,000
(Amount Payable to A Ltd. on Purchase of business)		
Plant & Machinery	Dr.	7,00,000
Furniture & Fixture	Dr.	3,00,000
Stock	Dr.	3,90,000
Debtors	Dr.	2,60,000
Bank	Dr.	5,000
Goodwill (Balancing Fig.)	Dr.	1,00,000
To Provision for bad debts		5,000
To Creditors		2,00,000
To 10% Debentures (A Ltd.)		3,00,000
To Business Purchase		12,50,000
(Assets & Liabilities taken over)		
Liquidator of A Ltd.	Dr.	12,50,000
To equity Share Capital (Rs. 5 paid up)		12,50,000
(Allotment of 2,50,000 equity Shares (Rs. 5 Paid up) to discharge consideration)		
10% Debentures (A Ltd.)	Dr.	3,00,000
To Equity Share Capital		3,00,000
(Allotment of 30,000 equity shares of Rs. 10 each fully paid at par to discharge the liability on 10% debenture of allotted.)		

- (i) A new Company to be formed called B Ltd. with an authorised share capital of Rs. 10,00,000.
- (ii) One equity share, Rs. 5 paid up, in B Ltd. to be allotted for each equity share in A Ltd.
- (iii) Two equity shares, shares, Rs. 5 Paid up in B Ltd. to be allotted for each equity share in A Ltd.
- (iv) Arrears of preference dividends to be cancelled.

Balance Sheet of B Ltd.
as on 31st December, 1998

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
Authorised Capital		Goodwill	1,00,000
4,00,000 of Rs. 10 each	40,00,000	Plant & Machinery	7,00,000
Issued and Subscribed Capital		Furniture & Fixture	3,00,000
25,00,000 equity share of Rs. 10		Current Assets,	
each, Rs. 5 paid up	12,50,000	Loans and Advances	
30,000 equity share of Rs. 10 each,		(a) Current Assets	
fully paid	3,00,000	Stock	3,90,000
(All these shares was been issued		Debtors	2,60,000
for consideration other than cash)		Less Provision	5,000
Current Liabilities & Provisions			2,55,000
(A) Current Liabilities		Bank	5,000
Creditors	2,00,000	(b) Loan & Advances	—
(B) Provisions	Nil		
	<u>17,50,000</u>		<u>17,50,000</u>

Illustration 9: (Amalgamation in the nature of merger)

The Balance Sheets of P Ltd. and Q Ltd. as on 31.3.2008 were as under:

Liabilities	P Ltd. Rs.	Q Ltd. Rs.
Share Capital		
Equity Shares of Rs. 10 each	5,00,000	4,00,000
10% Preference Shares of Rs. 100 each	4,00,000	2,00,000
General Reserve	1,20,000	—
Security Premium	30,000	20,000
Profit & Loss Account	80,000	50,000
10% Debentures	90,000	60,000
Sundry Creditors	60,000	30,000
	<u>12,80,000</u>	<u>7,60,000</u>
Assets:		
Goodwill	1,00,000	20,000
Land & Buildings	4,80,000	2,80,000
Plant & Machinery	3,00,000	1,07,000
Furniture	1,00,000	60,000
Investments	1,00,000	1,00,000
Stock	1,00,000	80,000
Debtors	80,000	70,000
Bank	20,000	40,000
Discount on Issue of Debentures	—	3,000
	<u>12,80,000</u>	<u>7,60,000</u>

A new company PQ Ltd. was formed on 1.4.2008 to acquire the business of P Ltd. and Q Ltd. with an authorized capital of Rs. 15,00,000 divided in Equity Shares of Rs. 10 each. The terms and conditions of acquisition were as under:

- (i) The business of P Ltd. was considered worth Rs. 11,50,000 and was discharged by issuing 57,500 equity shares at Rs. 20 each.
- (ii) The business of Q Ltd. was considered worth Rs. 5,50,000 and was discharged by issuing 27,500 equity shares at Rs. 20 each.
- (iii) Liquidation Expenses of P Ltd. amounting to Rs. 10,000 were paid by PQ Ltd.
- (iv) 12,000 Equity Shares in PQ Ltd. were issued to the public at Rs. 20 per share. Pass necessary Journal entries in the books of transferee company and prepare its Balance Sheet by the following AS-14 in the nature of merger.

**In the Books of PQ Ltd.
Journal Entries**

S.No.	Particulars		Debit Rs.	Credit Rs.
(i)	Business Purchase Account	Dr.	17,00,000	
	To Liquidators of P Ltd.			11,50,000
	To Liquidators of Q Ltd.			5,50,000
	(Being the amount of purchase considerations)			
(ii)	Goodwill Account	Dr.	1,20,000	
	Land and Building Account	Dr.	7,60,000	
	Plant and Machinery Account	Dr.	4,07,000	
	Furniture Account	Dr.	1,60,000	
	Investments Account	Dr.	2,00,000	
	Stock Account	Dr.	1,80,000	
	Debtors Account	Dr.	1,50,000	
	Bank Account	Dr.	60,000	
	To 10% Debentures Account			1,50,000
	To Security Premium Account			50,000
	To Profit and Loss Account			47,000
	To Sundry Creditors Account			90,000
	To Business Purchase Account			17,00,000
	(Various assets and liabilities taken over and the difference of Rs. 1,20,000 adjusted in the general reserve account to the extent of Rs. 83,000 [See Your Attention Please below])			
(iii)	Liquidators of P Ltd.	Dr.	11,50,000	
	Liquidators of Q Ltd.	Dr.	5,50,000	
	To Equity Share Capital Account			8,50,000
	To Securities Premium Account			8,50,000
	(Discharge of purchase consideration by issuing equity shares of Rs. 10 each at a premium of Rs. 10 per share)			
(iv)	Liquidators Expenses Account	Dr.	10,000	
	To Bank Account			10,000
	(Being payment of liquidation expenses of P Ltd.)			
(v)	Profit and Loss Account	Dr.	10,000	
	To Liquidation Expenses Account			10,000
	(Being writing off liquidation expenses to profit and loss account)			

(vi) Bank Account	Dr.	2,40,000	
To Share Application and Allotment Account			2,40,000
(Being application money received on 12,000 equity shares @ Rs. 20 per share including a premium of Rs. 10 per share)			
(vii) Share Application and Allotment Account	Dr.	2,40,000	
To Equity Share Capital Account			1,20,000
To Securities Premium Account			1,20,000
(Being allotment of 20,000 equity shares)			

Balance Sheet of PQ Ltd.

as on 31 March 2008

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
Authorized:		Goodwill	1,20,000
1,50,000 Equity Shares of		Land and Building	7,60,000
Rs. 10 each	15,00,000	Plant and Machinery	4,07,000
Issued and Subscribed:		Furniture	1,60,000
97,000 Equity Shares of		Investments	2,00,000
Rs. 10 each fully paid	9,70,000	Current Assets	
(of these 85,000 equity shares were issued for consideration other than cash under scheme of amalgamation)		Stock	1,80,000
Reserves and Surplus		Debtors	1,50,000
Securities Premium Account	10,20,000	Bank	2,90,000
Profit and Loss Account	37,000		
Secured Loans			
10% Debentures	1,50,000		
Current Liabilities			
Creditors	90,000		
	22,67,000		22,67,000

Notes:

- (i) Discount on Issue of Debentures has not been taken into account because it is not an asset. AS-14 requires that in an Amalgamation in the nature of merger, all the assets and liabilities of the transferor company become after amalgamation, the assets and liabilities of the transferee company. An asset is defined as a thing of value of possession or property that can be expressed in terms of money including the amount due to business entity from others. The essential feature of all types of assets is that they have money value and carry possible future benefits. None of these conditions is satisfied by Discount on Issue of Debentures. Hence this item is not incorporated.
- (ii) According to the Expert Advisory Committee's opinion published in Chartered Accountant (April 2004), the surplus arising on take over of the business in an amalgamation in the nature of merger should be adjusted in capital reserves. This implies that when the purchase consideration exceeds the capital taken over, the deficit is in the nature of capital loss. In this case the difference between issued capital (Purchase Consideration) and take over capital is Rs. 2,00,000 (Rs. 17,00,000—Rs. 15,00,000) in the nature of capital loss. In the absence of any capital reserves in the books of P Ltd. and Q Ltd. this loss would be adjusted in the following manner: Rs. 1,20,000 against General Reserves and Rs. 80,000

against profit and loss account. Further there is an additional deficit of Rs. 3,000 for not taking over the fictitious asset in the nature of Discount on Issue of Shares for reasons explained in (i) above. Hence the profit and loss account would be further reduced by Rs. 3,000. Since the liquidation expenses have also been transferred to profit and loss account the net balance in this account is Rs. 37,000.

Illustration 10: (Amalgamation in the nature of purchase)

The balance sheets of Star Ltd. and Moon Ltd. as at 31 March 2008 are as under:

Liabilities	Star Ltd. Rs.	Moon Ltd. Rs.	Assets	Star Ltd. Rs.	Moon Ltd. Rs.
Equity Shares of Rs. 10 each	2,10,000	1,50,000	Goodwill	15,000	—
9% Redeemable Preference Shares of Rs. 100 each	90,000	—	Land	—	30,000
Security Premium	10,500	—	Building	—	75,000
Capital Redemption Reserve	60,000	—	Plant	3,00,000	1,35,000
General Reserve	49,500	75,000	Fixtures	5,000	15,000
8% Debentures	60,000	90,000	Vehicles	10,000	15,000
Creditors	1,20,000	1,35,000	Stocks	1,20,000	75,000
			Debtors	80,000	50,000
			Advances	50,000	35,000
			Cash and Bank	20,000	20,000
	6,00,000	4,50,000		6,00,000	4,50,000

On 1 April, 2008, Sun Ltd. was formed by amalgamating Star Ltd. and Moon Ltd. on the following terms:

1. Sun Ltd. to issue 60-12% debentures of Rs. 1,000 each to debenture holders of Star Ltd.
2. The Debenture holders of Moon Ltd. insisted that they should be allotted equity shares in Sun Ltd. Accordingly they were allotted 7,500 equity shares of Rs. 10 at Rs. 12 per share.
3. Preference shareholders of Star Ltd. insisted for allotment of 900-11% redeemable preference shares of Rs. 100 each.
4. The equity shareholders of Star Ltd. are to be allotted 10 equity shares at par for 7 equity shares held by them. The share of Star Ltd. are of Rs. 10 each.
5. The assets of Star Ltd. are taken over at book value.
6. The assets and liabilities of Moon Ltd. are valued as under:

	Rs.
Goodwill	30,000
Land	1,50,000
Building	45,000
Plant	1,20,000
Other Fixed Assets	15,000
All Current Assets	1,50,000
All Current Liabilities	1,50,000

The balance of consideration is to be paid by allotment of equity shares at par to Moon Ltd. You are required to show: (1) Purchase consideration payable to Star Ltd. and Moon Ltd. (2) Opening entries in the books of Sun Ltd. (3) Balance Sheet of Sun Ltd.

Assume that Sun Ltd. does not intend to carry on the same business of Star Ltd.

Calculation of Purchase Consideration

		Rs.
To Star Ltd. (Net Payment Method)		
900-11% Preference Shares of Rs. 100 each		90,000
30,000 Equity Shares of Rs. 10 each		3,00,000
		3,90,000
To Moon Limited (Net Assets Method)		
Assets (After revaluation)		5,10,000
Less: Current liabilities	1,50,000	
8% Debentures	90,000	
		2,40,000
		2,70,000
To be discharged by issue of		
27,000 Equity Shares of Rs. 10 each at par		2,70,000

As per AS-14, consideration for the amalgamation means the aggregate of the shares and other securities issued and payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

In the Books of Sun Ltd. Journal Entries

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
(i)	Business Purchase Account	Dr.	6,60,000	
	To Liquidators of Star Ltd.			3,90,000
	To Liquidators of Moon Ltd.			2,70,000
	(The purchase consideration to be paid to the liquidators of Star Ltd. and Moon Ltd. respectively on acquisition of business).			
(ii)	Goodwill (Balancing figure)	Dr.	15,000	
	Land	Dr.	1,50,000	
	Building	Dr.	45,000	
	Plant	Dr.	4,20,000	
	Other Fixed Assets	Dr.	30,000	
	Current Assets	Dr.	4,20,000	
	To Current Liabilities			2,70,000
	To 8% Debentures of Star Ltd.			60,000
	To 8% Debentures of Moon Ltd.			90,000
	To Business Purchase Account			6,60,000
	(Assets and liabilities of Star Ltd. and Moon Ltd. being taken over on amalgamation, goodwill being the balancing figure)			
(iii)	Liquidators of Star Ltd.	Dr.	3,90,000	
	Liquidators of Moon Ltd.	Dr.	2,70,000	
	To 11% Preference Share Capital Account			90,000
	To Equity Share Capital Account			5,70,000
	(Payment to the liquidators of Star Ltd. and Moon Ltd.)			
(iv)	8% Debentures of Star Ltd. Account	Dr.	60,000	
	To 12% Debentures Account			60,000
	(Issue of 12% Debentures to the 8% Debenture holders of Star Ltd.)			

(v) 8% Debentures of Moon Ltd.	Dr.	90,000	
To Equity Share Capital Account			75,000
To Securities Premium Account			15,000
(Issue of equity shares of Rs. 10 each to the debenture holders of Moon Ltd. at a premium of Rs. 2 per share)			

Balance Sheet of Sun Ltd.
as at 1 April 2008

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
Issued and Paid up:		Goodwill	15,000
64,500 Equity Shares of Rs. 10 each	6,45,000	Land	1,50,000
900-11% Preference Shares of Rs. 100 each	90,000	Building	45,000
[Issued to vendors other than cash]		Plant	4,20,000
Reserves and Surplus		Other Fixed Assets	30,000
Security Premium	15,000	Current Assets	4,20,000
Secured Loan			
60-12% Debentures of Rs. 1,000 each	60,000		
Current Liabilities	2,70,000		
	10,80,000		10,80,000

Illustration 11: (Absorption: Merger and Purchase)

The following are the abridged balance sheets of Aanchal Ltd. and Manvi Ltd. as on 31 March 2008:

('000)

Liabilities	Aanchal Ltd.	Manvi Ltd.
Equity Shares Capital (Rs. 10 each)	8,000	3,000
10% Preference Share Capital (Rs. 100 each)	—	1,000
General Reserve	4,610	980
Statutory Reserves	390	125
Profit and Loss Account	563	355
12% Debentures	—	250
Current Liabilities	1,437	990
	15,000	6,700
Assets		
Fixed Assets	11,000	4,730
Current Assets	4,000	1,970
	15,000	6,700

On 1 April 2008 Aanchal Ltd. takes over Manvi Ltd. on the following terms:

- Aanchal Ltd. will issue 3,50,000 equity shares of Rs. 10 each at par to the equity shareholders of Manvi Ltd.

- (ii) Aanchal Ltd. will issue 11,000, 10% preference shares of Rs. 100 each at par to the preference shareholders of Manvi Ltd.
- (iii) The debenture holders of Manvi Ltd. will be converted into an equal number of 12.5% debentures of the same denomination.

You are informed that statutory reserves of Manvi Ltd. are to be maintained for two more years. You are required to show the balance sheet of Aanchal Ltd. immediately after the above mentioned scheme of amalgamation has been implemented assuming that:

- (a) The amalgamation in the nature of merger.
- (b) The amalgamation in the nature of purchase.

Also give journal entries in the books of Aanchal Ltd. in both the cases.

Solution:

Calculation of Purchase Consideration

(i) 3,50,000 equity shares @ Rs. 10 each	Rs. 35,00,000
(ii) 11,000, 10% preference shares @ Rs. 100 each	11,00,000
	46,00,000

(i) **Amalgamation in the Nature of Merger**
In the Books of Aanchal Ltd.
Journal Entries

S.No.	Particulars		Debit Rs.	Credit Rs.
(i)	Business Purchase Account	Dr.	46,00,000	
	To Liquidators of Manvi Ltd.			46,00,000
	(Being the business of Manvi Ltd. taken over for a purchase consideration of Rs. 46,00,000)			
(ii)	Fixed Assets Account	Dr.	47,30,000	
	Current Assets Account	Dr.	19,70,000	
	To General Reserves (Balancing Figure)			3,80,000
	To Statutory Reserves			1,25,000
	To Profit and Loss Account			3,55,000
	To 12% Debentures Account			2,50,000
	To Current Liabilities			9,90,000
	To Business Purchase Account			46,00,000
	(Recording of assets and liabilities taken over including reserves and purchase consideration, the balance in the nature of merger as per AS-14)			
(iii)	Liquidators of Manvi Ltd.	Dr.	46,00,000	
	To Equity Share Capital Account			35,00,000
	To 10% Preference Share Capital Account			11,00,000
	(Payment to liquidators of Manvi Ltd. on taking over the business of Manvi Ltd.)			
(iv)	12% Debentures Account	Dr.	2,50,000	
	To 12.5% Debentures Account			2,50,000
	(Issue of 12.5% Debentures to the debenture holders of Manvi Ltd.)			

Balance Sheet of Aanchal Ltd.

as on 1 April 2008

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	1,57,30,000
Authorised	?	Current Assets, Loans and Advances	
Issued and Subscribed:		(a) Current Assets	59,70,000
11,50,000 Equity Shares of Rs. 10 each	1,15,00,000	(b) Loans and Advances	
11,000, 10% Preference Shares of Rs. 100 each	11,00,000		
(Of the above, 3,50,000 equity shares of Rs. 10 each and 11,000 10% Preference Shares of Rs. 100 each issued for consideration other than cash on amalgamation)			
Reserves and Surplus			
General Reserve	49,90,000		
Statutory Reserves	5,15,000		
Profit and Loss Account	9,18,000		
Secured Loans			
12.5% Debentures	2,50,000		
Current Liabilities and Provisions			
(a) Current Liabilities	24,27,000		
(b) Provisions	—		
	2,17,00,000		2,17,00,000

Note:

In an amalgamation in the nature of merger, the difference between the amount recorded as share capital issued and the amount of the share capital of the transferor company should be adjusted in the capital reserves because it is in the nature of capital loss. If capital reserves are not available insufficient, the unadjusted difference may be adjusted against revenue reserves and if revenue reserves are insufficient, it is adjusted against profit and loss account.

(ii)

Amalgamation in the Nature of Purchase

In the Books of Aanchal Ltd.

Journal Entries

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)	
(i)	Business Purchase Account	Dr.	46,00,000	
	To Liquidators of Manvi Ltd.			46,00,000
	(Purchase consideration for business of S Ltd.)			
(ii)	Fixed Assets Account	Dr.	47,30,000	
	Current Assets Account	Dr.	19,70,000	
	To 12% Debentures			2,50,000
	To Current Liabilities			9,90,000
	To Business Purchase Account			46,00,000
	To Capital Reserve Account (Balancing Figure)			8,60,000

(Recording of assets and liabilities taken over and the balance transferred to Capital Reserve Account being amalgamation in the nature of purchase as per AS-14)		
(iii)	Liquidators of Manvi Ltd. To Equity Share Capital Account To 10% Preference Share Capital Account (Discharge of purchase consideration)	Dr. 46,00,000 35,00,000 11,00,000
(iv)	12% Debentures Account To 12.5% Debentures Account (Issue of 12.5% Debentures to the debenture holders of Manvi Ltd.)	Dr. 2,50,000 2,50,000
(v)	Amalgamation Adjustment Account To Statutory Reserve Account (Entry for maintenance of statutory reserves for two more years)	Dr. 1,25,000 1,25,000

Balance Sheet of Aanchal Ltd.
as on 1 April 2008

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	1,57,30,000
Authorised	?	Current Assets, Loans and Advances	
Issued and Subscribed:		(a) Current Assets	59,70,000
11,50,000 Equity Shares of Rs. 10 each	1,15,00,000	(b) Loans and Advances	—
11,000, 10% Preference Shares of Rs. 100 each	11,00,000	Miscellaneous Expenditure	
(of the above 3,50,000 equity shares of Rs. 10 each and 11,000 10% Preference Shares of Rs. 100 each allotted on amalgamation for consideration other than cash)		Amalgamation Adjustment Account	1,25,000
Reserve and Surplus			
Capital Reserve	8,60,000		
General Reserve	46,10,000		
Statutory Reserves	5,15,000		
Profit and Loss Account	5,63,000		
Secured Loans			
12.5% Debentures	2,50,000		
Current Liabilities and Provisions			
(a) Current Liabilities	24,27,000		
(b) Provisions	—		
	2,18,25,000		2,18,25,000

Note:

Verification of Capital Reserve

	Rs.
Total Assets of S Ltd. taken over	67,00,000
Less: 12% Debentures taken over	(2,50,000)
Current Liabilities taken over	(9,90,000)
	54,60,000

Less: Equity Share Capital	
Issued to Equity Shareholders	(35,00,000)
Preference Share Capital Issued to Preference Shareholders	(11,00,000)
Capital Reserve arising on Amalgamation in the Nature of Purchase	<u>8,60,000</u>

Illustration 12: (Absorption by Way of Merger)

The following were the balance sheets of B Ltd. and D Ltd. as on 31 March 2008:

Liabilities	B Ltd. Rs.	D Ltd. Rs.	Assets	B Ltd. Rs.	D Ltd. Rs.
75,000, 10% preference shares of Rs. 100 each	7,500	—	Goodwill	—	250
30,00,000 Equity Shares of Rs. 10 each	30,000	—	Freehold Premises	12,000	—
5,00,000 Equity Shares of Rs. 10 each	—	5,000	Machinery	34,510	—
Capital Reserve	9,600	—	Furniture and Fittings	1,120	750
General Reserve	12,400	1,450	Trade Marks	100	—
Profit and Loss Account	1,150	220	Stock	12,800	5,010
10% Debentures	5,000	—	Debtors	4,340	1,170
Creditors	1,450	830	Bank	2,230	220
			Bills Receivable	—	100
	<u>67,100</u>	<u>7,500</u>		<u>67,100</u>	<u>7,500</u>

On the above-mentioned date, B Ltd. merged with D Ltd. The absorption by way of merger took place on the following conditions:

- (i) D Ltd. allotted to B Ltd. 75,000, 12% fully paid preference shares of Rs. 100 each and 28,00,000 fully paid equity shares of Rs. 10 each to satisfy the claims of B Ltd.'s preference shareholders and equity shareholders respectively. D Ltd. also agreed to convert 10% Debentures of B Ltd. into 12% Debentures at a discount of 10%.
- (ii) Expenses of liquidation of B Ltd. Rs. 15,000 were borne by D Ltd.

You are required to

- (a) Prepare important ledger accounts pertaining to B Ltd.
- (b) Pass journal entries in the books of D Ltd.
- (c) Prepare a post-absorption balance sheet in the books of D Ltd.

Solution:

**In the Books of B Ltd.
Realisation Account**

	Rs. (000)		Rs. (000)
Freehold Premises	12,000	10% Debentures	5,000
Machinery	34,510	Creditors	1,450
Furniture and Fittings	1,120	D Ltd. (Purchase Consideration)	35,500
Trade Marks	100	Equity Shareholders Account	25,150
Stock	12,800		
Debtors	4,340		
Cash at Bank	2,230		
	<u>67,100</u>		<u>67,100</u>

D Ltd.' Account

	Rs. (000)		Rs. (000)
Realisation Account	35,500	12% Preference Shares in D Ltd.	7,500
		Equity Shares in D Ltd.	28,000
	35,500		35,500

10% Preference Share Capital Account

	Rs. (000)		Rs. (000)
Preference Shareholders Account	7,500	Balance b/d	7,500

Preference Shareholders Account

	Rs. (000)		Rs. (000)
12% Preference Shares in D Ltd.	7,500	10% Preference Share Capital Account	7,500

Equity Share Capital Account

	Rs. (000)		Rs. (000)
Equity Shareholders	30,000	Balance b/d	30,000

Equity Shareholders Account

	Rs. (000)		Rs. (000)
Realisation Account	25,150	Equity Share Capital Account	30,000
Equity Shares in D Ltd.	28,000	Capital Reserve Account	9,600
		General Reserve Account	12,400
		Profit and Loss Account	1,150
	53,150		53,150

In the Books of D Ltd.

Journal Entries

S. No.	Particulars		Debit (Rs. 000)	Credit (Rs. 000)
(i)	Business Purchase Account To Liquidators of B Ltd. (Being the purchase consideration payable on taking over business of B Ltd.)	Dr.	35,500	35,500
(ii)	Freehold Premises Account	Dr.	12,000	
	Machinery Account	Dr.	34,510	
	Furniture and Fixtures Account	Dr.	1,120	
	Trade Marks Account	Dr.	100	
	Stock Account	Dr.	12,800	
	Debtors Account	Dr.	4,340	
	Cash at Bank Account	Dr.	2,230	
	To 10% Debentures Account			4,500

To Creditors Account			1,450
To General Reserve Account			12,400
To Profit and Loss Account			1,150
To Business Purchase Account			35,500
To Capital Reserve Account (Balancing Figure)			12,100
(Being assets, liabilities and reserves of B Ltd. taken over, the difference transferred to Capital reserve account)			
(iii) Liquidators of B Ltd.	Dr.	35,500	
To 12% Preference Share Capital Account			7,500
To Equity Share Capital Account			28,000
(Allotment of 75,000, 14% fully paid preference shares and 28 lakhs fully paid equity shares for business taken over)			
(iv) 10% Debentures Account	Dr.	4,500	
To 12% Debentures Account			4,500
(Being allotment of 12% debentures to discharge the liability on 10% Debentures at a discount of 10%)			
(v) Profit and Loss Account	Dr.	15	
To Bank Account			15
(Being the expenses on liquidation)			
(vi) Capital Reserve Account	Dr.	250	
To Goodwill Account			250
(Goodwill account written off to Capital Reserve)			

Balance Sheet of D Ltd.

as on 1 April 2008

Liabilities	Rs. (000)	Assets	Rs. (000)
Share Capital		Fixed Assets	
Authorised	?	Freehold Premises	12,000
Issued and Subscribed:		Machinery	34,150
75,000, 12% Preference		Furniture and Fittings	1,870
Shares of Rs. 100 each	7,500	Trade Marks	100
33,00,000 Equity Shares of		Current Assets	
Rs. 10 each	33,000	Stock	17,810
(of the above, all the preference		Debtors	5,510
shares and 28 lakh equity shares		Cash at Bank (2,230+220-15)	2,435
issued for consideration other		Loans and Advances	
than cash to the Vendors in		Bills Receivable	100
pursuant to scheme for merger).			
Reserves and Surplus			
Capital Reserve (12,100-250)	11,850		
General Reserve	13,850		
Profit and Loss Account	1,355		
Secured Loans			
12% Debentures	4,500		
Current Liabilities			
Creditors	2,280		
	74,335		74,335

Notes:

(i)	Amount to be adjusted in reserves	Rs. (000)
	Share Capital Taken over	37,500
	Less: Share Capital issued	35,500
	Surplus on taken over	<u>2,000</u>

(ii) **Credit to Capital Reserve**

This surplus on take over arises because share capital of Rs. 3,75,00,000 is taken over by issuing lower amount of share capital i.e. only Rs. 3,55,00,000.

AS-14 requires adjustment of difference in Reserves but it does not specifically mention how surplus on take over, as in the above case, is to be adjusted. According to Expert Advisory Committee's opinion published in Chartered Accountant (April 2004) such surplus is like Share Premium and should be credited to Capital Reserve.

Illustration 13: (External Reconstruction—Net Payment Method)

On 31 March 2008, the balance sheet of H Ltd. was as follows:

Liabilities	Rs.	Assets	Rs.
Authorised and Issued Share Capital:		Goodwill	40,000
5,000, 10% Cumulative Preference Shares of Rs. 10 each fully paid up	50,000	Patents	15,000
15,000 Equity Shares of Rs. 10 each fully paid	1,50,000	Sundry other assets	1,64,500
11% Debentures	30,000	Bank	500
Creditors	20,000	Profit and Loss Account	28,000
Preference dividends in arrears for four years		Preliminary expenses	2,000
	<u>2,50,000</u>		<u>2,50,000</u>

A scheme of reconstruction was agreed upon as follows: (i) A new company to be formed called J Ltd. with an authorised capital of Rs. 3,25,000 all in equity shares of Rs. 10 each. (ii) One equity share Rs. 5 paid, in the new company to be issued for each equity share in the old company. (iii) Two equity shares, Rs. 5 paid, in the new company to be issued for each preference share in the old company. (iv) Arrears of preference dividend to be cancelled (v) Debentureholders to receive 3,000 equity shares in the new company credited as fully paid. (vi) Creditors to be taken up by the new company. (viii) The new company to take over the old company's assets except patents, subject to writing down of 'sundry assets' by Rs. 35,000 (ix) Patents were realised by H Ltd. of Rs. 1,000. Close the books of H Ltd. and open the books of J Ltd. by means of journal entries and give the balance sheet of J Ltd. Expenses of H Ltd. came to Rs. 1,000. Ignore narration.

Solution:

Calculation of Purchase Consideration

Payment to Preference Shareholders	Rs.
10,000 Equity Shares credited as Rs. 5 paid	50,000
Payment to Equity Shareholders	
15,000 Equity Shares credited as Rs. 5 paid	75,000
	<u>1,25,000</u>

**In the Books of H Ltd.
Journal Entries**

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
(i)	Realisation Account	Dr.	2,20,000	
	To Goodwill			40,000
	To Patents			15,000
	To Sundry Assets			1,64,500
	To Bank			500
(ii)	11% Debentures Account	Dr.	30,000	
	Creditors	Dr.	20,000	
	To Realisation Account			50,000
(iii)	J Ltd.	Dr.	1,25,000	
	To Realisation Account			1,25,000
(iv)	Bank Account	Dr.	1,000	
	To Realisation Account			1,000
	(Amount realized on disposal of patents)			
(v)	Equity Shares (partly paid) in J Ltd.	Dr.	1,25,000	
	To J Ltd.			1,25,000
(vi)	Realisation Account	Dr.	1,000	
	To Bank			1,000
	(Expenses on realisation)			
(vii)	10% Cumulative Preference Share Capital Account	Dr.	50,000	
	To Preference Shareholders' Account			50,000
(viii)	Preference Shareholders' Account	Dr.	50,000	
	To Equity Shares (partly paid) in J Ltd.			50,000
(ix)	Equity Share Capital Account	Dr.	1,50,000	
	To Equity Shareholders' Account			1,50,000
(x)	Equity Shareholders' Account	Dr.	75,000	
	To Profit and Loss Account			28,000
	To Preliminary Expenses Account			2,000
	To Realisation Account			45,000
(xi)	Equity Shareholders' Account	Dr.	75,000	
	To Equity Shares (partly paid) in J Ltd.			75,000

**In the Books of J Ltd.
Journal Entries**

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
(i)	Business Purchase Account	Dr.	1,25,000	
	To Liquidators of H Ltd.			1,25,000
	(The purchase consideration of H Ltd.'s business)			
(ii)	Sundry Assets Account	Dr.	1,29,500	
	Goodwill Account	Dr.	45,000	
	Bank Account	Dr.	500	
	To 11% Debentures in H Ltd. Account			30,000
	To Sundry Creditors Account			20,000
	To Business Purchase Account			1,25,000
	(Being various assets and liabilities taken over)			

(iii)	Liquidators of H Ltd. To Equity Share Capital (partly paid) (Allotment of shares as per agreement)	Dr.	1,25,000	1,25,000
(iv)	Bank Account To Share Capital Account (fully paid) (Subscription for cash of 4,500 shares by the directors)	Dr.	45,000	45,000
(v)	11% Debentures in H Ltd. Account To Equity Share Capital Account (Issue of fully paid equity shares to debenture holders of H Ltd.)	Dr.	30,000	30,000

Balance Sheet of J Ltd.

as on 1 April 2008

Liabilities	Rs.	Assets	Rs.
Authorised and Issued Capital: 25,000 Equity Shares of Rs. 10 each, Rs. 5 paid 7,500 Equity Shares of Rs. 10 each fully paid (of these 28,000 shares have been issued for consideration other than cash)	1,25,000 75,000	Goodwill Sundry Assets Bank Note: Prepare the balance sheet in prescribed form	45,000 1,29,500 45,500
Sundry Créditors	20,000		
	2,20,000		2,20,000

Illustration 14: (Absorption in the Nature of Purchase)

The summarized balance sheet of Gunjan Limited on 30 June, 2008 was as follows:

Liabilities	Rs.	Assets	Rs.
Share Capital Shares of Rs. 10 fully paid	6,00,000	Goodwill Land, Building and Plant	1,00,000 6,40,000
General Reserve	1,70,000	Stock	1,68,000
Profit and Loss Account	1,10,000	Debtors	36,000
12% Debentures	1,00,000	Cash	56,000
Creditors	20,000		
	10,00,000		10,00,000

Konark Limited agreed to absorb the business of Gunjan Limited with effect from 1 July, 2008. The purchase consideration payable by Konark Limited was agreed as follows:

- (a) A cash payment equivalent to Rs. 2.50 for every Rs. 10 share in Gunjan Limited.
- (b) The issue of 90,000 Equity Shares of Rs. 10 each fully paid in Konark Limited having an agreed value of Rs. 15 per share.
- (c) The issue of such an amount of fully paid 14% Debentures in Konark Limited at 96 per cent as is sufficient to discharge 12% Debentures in Gunjan Limited at a premium of 20 per cent.

When computing purchase consideration, Konark Limited valued Land, Building and Plant at Rs. 12,00,000, Stock at Rs. 1,42,000 and Debtors at their face value subject to a reserve of 5 per cent for doubtful debts. The cost of liquidation of Gunjan Limited was Rs. 5,000. You are required to:

- (i) Close the books of Gunjan Limited by preparing Realisation Account, Konark Limited Account, Shareholders' Account and Debentures Account; and
- (ii) Pass journal entries in the books of Konark Ltd. regarding acquisition of business.

Solution:

Calculation of Purchase Consideration

		Rs.
Cash	Rs. 2.50 × 60,000	1,50,000
Equity Shares	Rs. 15 × 90,000	13,50,000
		15,00,000

In the Books of Gunjan Ltd.

Realisation Account

	Rs.		Rs.
Goodwill Account	1,00,000	Creditors Account	20,000
Land, Building & Plant Account	6,40,000	Konark Ltd. Account	15,00,000
Stock Account	1,68,000	12% Debentures Account	1,00,000
Debtors Account	36,000		
Cash Account	51,000		
Cash (Expenses) Account	5,000		
Shareholders (Profit)	6,20,000		
	16,20,000		16,20,000

Konark Limited Account

	Rs.		Rs.
Realisation Account	15,00,000	Bank Account	1,50,000
		Equity Shares in Konark Ltd.	13,50,000
	15,00,000		15,00,000

Shareholders' Account

	Rs.		Rs.
Bank Account	1,50,000	Share Capital Account	6,00,000
Equity Shares in Konark Limited Account	13,50,000	General Reserve Account	1,70,000
		Profit & Loss Account	1,10,000
		Realisation Account	6,20,000
	15,00,000		15,00,000

12% Debentures Account

	Rs.		Rs.
Realisation Account	1,00,000	Balance b/d	1,00,000

Bank Account

	Rs.		Rs.
Cash Account	56,000	Realisation Account (Transfer)	51,000
Konark Ltd.	1,50,000	Realisation Account (Expenses)	5,000
		Shareholders' Account	1,50,000
	2,06,000		2,06,000

SELF TEST CHECK

State true/false

- (i) Distinction between amalgamation and absorption for accounting purpose is of no significance as per AS 14.
- (ii) Consideration means shares etc. received for shareholders or the transferor company.
- (iii) So far as accounting treatment in the books of transferor Company is concerned, there is no difference between amalgamation in the nature of merger and amalgamation in the nature of purchase.
- (iv) Provident Fund represents accumulated past profits.
- (v) External Reconstruction involves two existing companies.
- (vi) In amalgamation in the nature of merger, assets and liabilities are revalued in the books of transferee company.
- (vii) The term 'all assets' includes discount on issue of shares also.
- (viii) Consideration does not include payment for debenture holders, and creditors.
- (ix) Workmen's compensation fund always represent accumulated profits.
- (x) Amalgamation Reserve appears in the book of the transferor company.
- (xi) Consideration includes payment for preference shareholders also.

Answer: IV, V, VI, VII, IX, X are wrong.

AMALGAMATION AND RECONSTRUCTION (II)

After discussing amalgamation and external reconstruction in the previous lesson, we shall now discuss internal reconstruction. Internal reconstruction leads to redeuction in the capital. Of course, it does not result in liquidation of the company. Reduction in capital is carried out in any of the following ways:

- i) By reducing the liability of the shareholders in respect of any unpaid amount on the shares.
- ii) By canceling the paid up capital which is not represented by assets.
- iii) By paying of surplus capital, if any which is in excess of the needs of the company.

The amount made available is utilized to write off fictitious assets and debit balance of Profit and Loss A/c.

While preparing the Balance Sheet of the company after reconstruction, the word 'And Reduced' Should be added if the court so directs. Under the scheme of reconstruction if the fixed assets are written off, the amount so written off should be shown in the Balance Sheet for five years.

The major points of difference between internal and external reconstruction are:

- 1) Under internal reconstruction, the existing company is not liquidated whereas under external reconstruction the existing company is liquidated.
- 2) No new company is formed under internal reconstruction only the rights of shareholders and creditors change. But under external reconstruction, a new company is formed to take over the liquidated company.
- 3) There is a reduction of capital and sometimes the outside liabilities like creditors and debenture holders may have to reduce their claims under Internal reconstruction. But under external reconstruction there is no reduction of capital.
- 4) Internal reconstruction is done as per provisions of Section 100 of the Companies Act. External reconstruction is regulated by Section 494 of the Companies Act.

Accounting Treatment:

I. (a) When the liability of the shareholders as regard unpaid amount on the shares is reduced.	
Share Capital (partly paid up) A/c	Dr. With the paid up amount
To Share Capital (fully paid) A/c	to the shares.
<hr/>	
(b) In case of surplus capital being paid off	
Share Capital A/c	Dr. With the amount refunded
To Shareholders' A/c	to the shareholders
Shareholders A/c	Dr.
To Bank	
<hr/>	
(c) When Share Capital is cancelled.	
(i) When face value of shares is changed by the reduction of capital—	
Share Capital (old) A/c	Dr. With the paid up value of old shares
To Share Capital (New) A/c	.... With the paid up value of new shares
To Capital Reduction or Reconstruction A/c	.... with the difference
<hr/>	
(ii) In case face value of shares remains unchanged by the reduction of capital.	
Share Capital A/c	Dr. With the amount of reduction
To Capital Reduction or Reconstruction A/c	

Solution:

		Rs.	Rs.
10% Preference Share Capital A/c	Dr.	6,00,000	
To 11% Pref. Share Capital A/c			4,20,000
To Reconstruction A/c			1,80,000
(Conversion of 10% Pref. Shares into 11% Pref. Shares and reduction of 30% amount)			
Equity Share Capital (100) A/c	Dr.	8,00,000	
To Equity Share Capital (50) A/c			4,00,000
To Reconstruction A/c			4,00,000
(Reduction of 8,000 equity shares of Rs. 100 fully paid to 800 equity shares of Rs. 50 each fully paid)			
11% Debentures A/c	Dr.	1,20,000	
To Reconstruction A/c			1,20,000
(Reduction in the liability towards 11% Debentures by 20%)			
Building A/c	Dr.	60,000	
To Reconstruction A/c			60,000
(Increase in the value of Building)			
Reconstruction A/c	Dr.	7,60,000	
Capital Reserve	Dr.	10,000	
To Profit and Loss A/c			5,40,000
To Preliminary Expenses			50,000
To Goodwill A/c			1,20,000
To Patents			60,000
(Balance in reconstruction A/c and Rs. 10,000 from Cap. Reserve utilized to write off fictitious and intangible assets as per the reconstruction scheme).			

Balance Sheet of Minerals Ltd. (And Reduced)

as on 30th June, 2000

Liabilities	Rs.	Assets	Rs.
Share capital		Fixed Assets	
Authorised			
Issued Sub. & paid up Capital			Rs.
8,000 Eq. Shares of Rs. 50 each fully paid	4,00,000	Building	3,00,000
10% 6,000 Pref. Shares of Rs. 70 each fully paid	4,20,000	Add increase in value	60,000
Reserve & Surplus		Machinery	6,00,000
Capital Reserve	10,000	Investments	Nil
Secured Loan		current, Assets, Loans & Advances	
11% Debentures	4,80,000	(a) Current Assets	
Unsecured Loan	Nil	Stock	4,40,000
Current Liab. & Provisions		Debtors	3,00,000
(a) Current Liability	4,00,000	Bank	10,000
Sundry Creditors	Nil	(b) Loan & Advances	Nil
(b) Provisions		Misc. Expenditure	Nil
	<u>17,10,000</u>		<u>17,10,000</u>

Illustration 2: Balance Sheet of Alpha Ltd. as on 31st December, 2000 is as follows:

Liabilities		Rs.	Assets	Rs.
Share Capital			Immovable Assets	42,90,000
Issued Capital			Stock	2,40,000
24,000 Equity Shares of			Debtors	90,000
Rs. 100 each fully paid		24,00,000	Investments	51,000
Debentures	42,00,000		Bank	3,09,000
Add Accrued Interest	2,10,000	44,10,000	Preliminary Expenses	5,00,000
Sundry Creditors		13,50,000	Profit & Loss A/c	27,10,000
Bills Payable		30,000		
		<u>81,90,000</u>		<u>81,90,000</u>

The Company has lost its capital because of huge losses. The following scheme of reconstruction was approved:

- Each share will be sub-divided into ten fully paid equity shares of Rs. 10 each.
- After sub-division, each shareholder should surrender 90% of his holding, for the purpose of re-issue of debenture holders, creditors as far as required, otherwise for cancellation.
- Of these shares 69,000 shares of Rs. 10 each shall be converted into 10% Preference Shares of Rs. 10 each fully paid.
- The debenture holders claim shall be reduced to Rs. 6,90,000. They will be given 69,000 Preference Shares of Rs. 10 each fully paid.
- The liability for Bills Payable is not be reduced and is not yet paid.
- Unsecured creditors will get 20% of their claim. They will get fully paid Equity shares of Rs. 10 each for the purpose.
- Share surrendered and not re-issued to be cancelled. Journalise it.

Solution:

		Rs.	Rs.
Share Capital (Rs. 100) A/c	Dr.	24,00,000	
To Equity Share Capital (Rs. 10) A/c			24,00,000
(Conversion 24,000 shares of Rs. 100 into 2,40,000 Shares of Rs. 10 each, fully paid).			
Equity Share Capital (Rs. 10) A/c	Dr.	21,60,000	
To Share Surrendered A/c			21,60,000
(Surrender of 90% of shares i.e. 24,000 shares)			
Shares Surrendered A/c	Dr.	6,90,000	
To 10% Pref. Share Capital A/c			6,90,000
(Conversion of 6,900 surrendered shares into 10% Pref. share of Rs. 10 each fully paid and issue of them to debenture holders).			
Shares Surrendered A/c	Dr.	2,70,000	
To Equity Share Capital A/c			2,70,000
(Re-issue of 27,000 eq. share to sundry creditors in fully satisfaction of their claim).			

Share Surrendered A/c	Dr.	12,00,000	
Debentures A/c	Dr.	42,00,000	
Interest Accrued A/c	Dr.	2,10,000	
Sundry Creditors	Dr.	13,50,000	
To Capital Reduction Ac			69,60,000
(Cancellation of the balance of shares surrendered A/c and transfer of other liabilities to capital reduction A/c)			
Capital Reduction A/c	Dr.	69,60,000	
To Profit & Loss A/c			27,10,000
To Preliminary Expenses A/c			5,00,000
To Capital Reserve A/c			37,50,000
(Writing of accumulated losses and prel. Expenses and transfer of balance in capital reduction to capital Reserve)			

Illustration 3: The following is the Balance Sheet of Nav Bharat Co. Ltd. on 31st December, 2000:

Liabilities	Rs.	Assets	Rs.
<i>Authorised Capital</i>		Patents at cost	8,50,000
10,000 Pref. Shares of P.s. 100 each	10,00,000	Leasehold Premises	1,30,800
10,000 Equity Shares Rs. 100 each	10,00,000	Plant & Machinery	42,200
	20,00,000	Sundry Debtors	76,500
		Stock in Trade	55,000
<i>Subscribed Capital</i>		Discount on Issue of shares	18,000
7,500 Pref. Shares of Rs. 100 each	7,50,000	Preliminary Expenses	12,000
fully paid		Profit & Loss A/c	1,15,000
5,000 Equity shares of Rs. 100 each	5,00,000	Cash in hand	500
fully paid			
Sundry Creditors	30,000		
Bank Overdraft	20,000		
	13,00,000		13,00,000

The Company suffered huge losses and was not getting well. The following scheme of reduction of capital was adopted:

1. The Preference Shares be reduced to an equal number of fully paid shares of Rs. 50 each.
2. The Equity shares reduced to an equal number of fully paid shares of Rs. 25 each.
3. The Preference Dividend is in arrears for the last five years and they are not to get anything for it.
4. The amount available be used to write off preliminary expenses. Profit & Loss account, discount on issue of shares completely and also to write off Rs. 30,800 on the leasehold premises. Rs. 15,000 of stock, 20% of Plant & Machinery and Sundry Debtors and the balance available of patents.

Journalise the transaction and prepare the Balance Sheet after the reconstruction scheme has been carried out.

Solution:

	Rs.	Rs.
Equity share Capital (Rs. 100) A/c	Dr.	5,00,000
Pref. Share Capital (Rs. 100) A/c	Dr.	7,50,000
To Equity Share Capital (Rs. 25) A/c		1,25,000
To Pref. Share Capital (Rs. 50) A/c		3,75,000
To Capital Reduction A/c		7,50,000
(Face value equity Pref. Shares reduction Rs. 50 each fully paid).		
Capital Reduction A/c	Dr.	7,50,000
To Discount of Issue of Shares A/c		18,000
To Preliminary Expenses A/c		12,000
To Profit & Loss A/c		1,15,000
To Leasehold Premise A/c		30,800
To Stock A/c		15,000
To Plant & Machinery A/c		8,440
A Provision for Bad Debts A/c		15,300
To Patents A/c		5,35,460
(Capital reduction utilized in writing off various assets)		

* Note: As arrears of preference dividend does not appear in the balance sheet, so this will be ignored.

Balance Sheet of Nav Bharat Ltd. (And Reduced)
as on 31st Dec. 2000

Liabilities	Rs.	Assets	Rs.
<i>Shares Capital</i>		<i>Fixed Assets</i>	
<i>Authorised</i>		Leasehold Premise	1,30,800
10,000 Equity Shares of		Less written off	30,800
Rs. 25 each	2,50,000		1,00,000
10,000 Pref. Shares of		Plant & Machinery	42,200
Rs. 50 each	5,00,000	Less written off	8,440
	7,50,000	Patents	8,50,000
<i>Issued & Subscribed Capital</i>		Less written off	5,35,460
5,000 Equity Shares of		<i>Investment</i>	Nil
Rs. 25 each, fully paid	1,25,000	<i>Current Assets, Loans &</i>	
7,500 Pref. Shares of		<i>Advances</i>	
Rs. 50 each fully paid	3,75,000	(a) <i>Current Assets:</i>	
Secured Loan	Nil	Cash in hand	500
<i>Unsecured Loan</i>	Nil	Stock	40,000
<i>Current Liabilities & Provisions</i>		Sundry Debtors	76,500
Sundry Creditors	30,000	Less provision	15,300
Bank Overdraft	20,000	(b) <i>Loan & Advances</i>	Nil
	5,50,000	<i>Misc. Expenditure</i>	Nil
			5,50,000

Illustration 4: The following is the balance sheet of Madam Marina Ltd. as on 31 March 20....

Liabilities	Rs.	Assets	Rs.
Issued and fully paid Equity Shares of Rs. 10 each	50,00,000	Fixed Assets	23,35,000
10% preference shares of Rs. 100 each	20,00,000	Current Assets:	
General Reserves	22,67,500	Debtors	23,37,500
10% Debentures of Rs. 100 each	10,00,000	Stock	40,62,000
Creditors	13,72,500	Cash	1,23,000
		Profit and Loss Account	27,82,500
	1,16,40,000		1,16,40,000

The company after obtaining sanction of the court adopted the following scheme of reconstruction:

- Each existing preference share is to be reduced to Rs. 35 of which Rs. 20 will be represented by new 12% preference shares and Rs. 15 by new equity shares.
- Each debenture of Rs. 100 is to be exchanged for Rs. 50 of new 13% debenture, one new 12% preference share of Rs. 25 each and four new equity shares of Rs. 2.50 each.
- Each equity share is to be reduced to Rs. 2.50 each. The reduction of capital and reserves are utilised for writing off losses, 50% stock and debtors and balance, if any, is to be used for writing down fixed assets.

Solution:

**Madam Marina Ltd.
Journal Entries**

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
(i)	10% Preference Share Capital Account To 12% Preference Share Capital Account (Rs. 25) To Equity Shares Capital Account (Rs. 2.50) To Reconstruction Account (Being conversion of 10% preference shares of Rs. 100 each into 20,000, 12% preference shares of Rs. 25 each, of Rs. 20 paid and 1,20,000 equity shares of Rs. 2.50 each fully paid).	Dr. 20,00,000	4,00,000 3,00,000 13,00,000
(ii)	10% Debentures Account To 13% Debentures Account To 12% Preference Share Capital Account To Equity Share Capital Account To Reconstruction Account (Being conversion of Rs. 10,00,000, 10% debentures into Rs. 5,00,000, 13% Debentures (10,000×50), Rs. 2,50,000, 12% preference shares, (10,000×25) and Rs. 1,50,000 equity shares (60,000×2.5) and the balance transferred to reconstruction account).	Dr. 10,00,000	5,00,000 2,50,000 1,00,000 1,50,000
(iii)	Equity Share Capital Account (Rs. 10) To Equity Share Capital Account (Rs. 2.50) To Reconstruction Account (Being conversion of Rs. 10 equity shares to Rs. 2.50 equity share)	Dr. 50,000,000	12,50,000 37,50,000

(iv)	General Reserve Account	Dr.	22,67,000	
	To Reconstruction Account			22,67,000
	(Being transfer of general reserve to reconstruction account)			
(v)	Reconstruction Account	Dr.	74,67,500	
	To Profit and Loss Account			27,82,500
	To Stock Account			20,31,000
	To Debtors Account			11,68,750
	To Fixed Assets			14,85,250
	(Being utilisation of reconstruction account to write off overvalued assets and debit balance in the profit and loss account)			

Balance Sheet of Madam Marine (And Reduced)
as On 31 March 20....

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	23,35,000
Authorised		Less: Written off	<u>14,85,250</u>
Preference Share of Rs. 25 each	?	Investments	Nil
Equity Share of Rs. 2.5 each	?	Current Assets, Loans and Advances	
Issued and Subscribed:		(A) Current Assets:	
10,000, 12% Preference Shares of Rs. 25 each fully paid	2,50,000	Stock	40,62,000
20,000, 12% Preference Shares of 25 each, Rs. 20 paid	4,00,000	Less: Written off	<u>20,31,000</u>
6,60,000 Equity Shares of Rs. 2.50 each, fully paid	16,50,000	Debtors	23,37,500
Reserves and Surplus	Nil	Less: Written off	<u>11,68,750</u>
Secured Loans		Cash	1,23,000
10,000, 13% Debentures of Rs. 50 each	5,00,000	(B) Loans and Advances	Nil
Unsecured Loans	Nil		
Current Liabilities and Provisions			
(A) Current Liabilities:			
Creditors	13,72,500		
(B) Provisions	Nil		
	<u>41,72,500</u>		<u>41,72,500</u>

Illustration 5: Paradise Ltd. which had experienced trading difficulties decided to reorganise its finance on 31 March, 20.....on which date a final total balance was extracted from the books of the company showing the final position.

Credit	Rs.	Debit	Rs.
Share Capital, Authorised and issued:		Profit and Loss Account	11,03,750
15,000, 6% Cumulative Preference Shares of Rs. 100 each	15,00,000	Preliminary Expenses	72,500
20,000 Equity Shares of Rs. 100 each	20,00,000	Goodwill at cost	5,00,000
Capital Reserve	3,60,000	Debtors	3,02,000
Trade Creditors	4,25,000	Leasehold property at cost	8,00,000
Bank Overdraft	5,10,000	Plant and Machinery at cost	21,00,000
Leasehold property—		Stock in trade	7,91,750
Provision for depreciation Plant and Machinery	3,00,000		
Provisions for Depreciation	5,75,000		
	56,70,000		56,70,000

The approval of the court was obtained for following scheme for reduction of capital:

- The preference shares to be reduced to Rs. 75 per share.
- The equity shares are to be reduced to Rs. 12.50 per share.
- One Rs. 12.50 equity shares to be issued for each Rs. 100 of gross preference dividend arrears, the preference dividend had not been paid for three years.
- The balance in capital reserve is to be utilised.
- Plant and machinery to be written down to Rs. 7,50,000.
- The profit and loss account balance and all intangible assets to be written off.

At the same time as the resolution to reduce capital was passed another resolution was approved restoring the total authorised capital to Rs. 35,00,000 consisting of 15,000, 6% cumulative preference shares of Rs. 75 each and the balance in equity shares of Rs. 12.50 each. As soon as above resolution had been passed, 50,000 equity shares were issued at par, for cash, payable full on application. The same were fully subscribed and paid. You are required:

- To show the journal entries necessary to record the above transactions in the company's books;
- To prepare the balance sheet of the company, after completion of the scheme.

Solution:

**Paradise Limited
Journal Entries**

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
(i)	6% Preference Share Capital (Rs. 100) Account Dr. To 6% Preference Share Capital Account (Rs. 75) To Reconstruction Account (Being reduction in the face value of 6% preference shares from Rs. 100 to Rs. 75).	15,00,000 11,25,000	3,75,000
(ii)	Equity Share Capital Account (Rs. 100) Dr. To Equity Share Capital Account (Rs. 12.50) To Reconstruction Account (Being reduction in the face and paid up value and paid up value of equity shares of Rs. 100 each to Rs. 12.5 per share each)	20,00,000	2,50,000 17,50,000

(iii)	Reconstruction Account	Dr.	33,750	-
	To Equity Share Capital Account			33,750
	(Being issue of equity share capital in lieu of preference dividend @ one share of Rs. 12.50 for Rs. 100 arrears of dividend)			
(iv)	Capital Reserve Account	Dr.	3,60,000	
	To Reconstruction Account			3,60,000
	(Being transfer of capital reserve to reconstruction account).			
(v)	Reconstruction Account	Dr.	24,51,250	
	To Plant and Machinery Account			7,75,000
	To Profit and Loss Account			11,03,750
	To Preliminary Expenses Account			72,500
	To Goodwill Account			5,00,000
	(Being the utilisation of reconstruction account for writing off fictitious assets, overvalue plant and machinery and useless goodwill account.)			
(vi)	Bank Account	Dr.	6,25,000	
	To Equity Share Application and Allotment Account			6,25,000
	(Being application money received)			
(vii)	Equity Share Application and Allotment A/c	Dr.	6,25,000	
	To Equity Share Capital Account			6,25,000
	(Being allotment of 50,000 equity shares of Rs. 12.50 each fully paid.)			

Balance Sheet of Ltd.
as on 1 April, 20.....(And Reduced)

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
Authorised		Leasehold Property	8,00,000
15,000, 6% Cumulative		Less: Provision for	
Preference Shares of		Depreciation	<u>3,00,000</u>
Rs. 75 each	11,25,000	Plant & Machinery	21,00,000
Equity Share Capital:	1,90,000	Less: Provision for	
Equity Share of Rs. 12.50 each	23,75,000	Depreciation	<u>5,75,000</u>
	35,00,000		15,25,000
Issued and Subscribed		Less: Written off	<u>7,75,000</u>
15,000, 6% Preference Shares			7,50,000
of Rs. 75 fully paid	11,25,000	Investments	Nil
72,700 Equity Shares of		Current Assets, Loans and	
Rs. 12.50 each	9,08,750	Advances	
Reserves and Surplus		(A) Current Assets	
Secured Loans	Nil	Debtors	3,02,000
Unsecured Loans	Nil	Stock	7,91,750
Current Liabilities and		Bank	1,15,000
Provisions			
(A) Current Liabilities			
Trade Creditors	4,25,000		
	<u>24,58,750</u>		
			<u>24,58,750</u>

Illustration 6: (Preparation of Opening Balance Sheet)

The ledger-balances of J Company Ltd. as at 31 March, include: Fixed Assets Rs. 7,00,000, Investments—Rs. 10,000. Inventories—Rs. 3,90,000, Trade Debtors—Rs.4,60,000, Preliminary Expenses—Rs. 20,000. Equity Share Capital—(60% paid-up) Rs. 6,00,000. 10% First Debentures—Rs. 2,00,000 Overdraft—Rs. 50,000, Trade Creditors—(including Y for Rs. 8,50,000) Rs. 11,50,000, Outstanding interest for one year on Debentures—Rs. 80,000, 12% Second Debentures—Rs. 5,00,000. For the last several years, the company has incurred heavy losses. However if appropriately reconstructed, it is expected to earn good profits in the next few years. Accordingly, the following scheme of reconstruction is agreed upon:

- To make the existing Rs. 100 equity shares fully paid-up, and then to reduce them to Rs. 20 each;
- to settle the claims of the holders of the First Debentures by issuing 2,000—13½% Debentures of Rs. 100 each;
- To discharge the claims of the holders of the Second Debentures by issuing 4,000, 15% Debentures of Rs. 100 each;
- To pay Rs. 3,00,000 to Y in full settlement of his account;
- To allot 15,000 fresh equity shares of Rs. 20 each to discharge the remaining trade creditors;
- To write off the fictitious assets and to reduce the fixed assets.

Pass the necessary journal entries to give effect to the aforesaid scheme and show the post-reconstruction balance sheet. Assume that: (i) all the formalities are duly complied with, and (ii) the company has only one bank account to transact all the receipts and payments.

Solution:

Balance Sheet of J. Company Ltd. (Before Reconstruction)

as at 31 March, 20.....

Liabilities	Rs.	Assets	Rs.
Equity Share Capital (60% Paid-up)	6,00,000	Fixed Assets	7,00,000
10% First Debentures	2,00,000	Investments	10,000
12% Second Debentures	5,00,000	Inventories	3,90,000
Bank Overdraft	50,000	Trade Debtors	4,60,000
Trade Creditors (including Y for Rs. 8,50,000)	11,50,000	Preliminary Expenses	20,000
Outstanding Interest on Debentures for one year	80,000	Profit and Loss Account (Balancing Figure)	10,00,000
	25,80,000		25,80,000

J. Co. Ltd. Journal Entries

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
(i)	Share Final Call Account To Equity Share Capital Account (Final call made for the balance on equity shares)	Dr.	4,00,000	4,00,000
(ii)	Bank Account To Share Final Call Account (Receipt of Final Call money)	Dr.	4,00,000	4,00,000

(iii)	Equity Share Capital (Rs. 100 Shares) Account	Dr.	10,00,000	
	To Equity Share Capital (Rs. 20 Shares) Account			2,00,000
	To Reconstruction Account			8,00,000
	(Reduction of Rs. 100 share capital to Rs. 20 each)			
(iv)	10% First Debentures Account	Dr.	2,00,000	
	To Debenture holders Account			2,00,000
	(Redemption due for First Debentures)			
(v)	Debenture holders Account	Dr.	2,00,000	
	To 13½% Debentures Account			2,00,000
	(Redemption of First Debentures)			
(vi)	12% Second Debentures Account	Dr.	5,00,000	
	To Debenture holders Account			5,00,000
	(Transfer of second debentures capital account to debenture holders account)			
(vii)	Debenture holders Account	Dr.	5,00,000	
	To 15% Debentures Account			4,00,000
	To Reconstruction Account			1,00,000
	(Settlement of second debenture holder's claims)			
(viii)	Sundry Creditors Account	Dr.	11,50,000	
	To Bank Account			3,00,000
	To Equity Share Capital Account			3,00,000
	To Reconstruction Account			5,50,000
	(Settlement of creditor's account)			
(ix)	Debenture Interest (outstanding) Account	Dr.	80,000	
	To Reconstruction Account			80,000
	(Writing off the interest on debentures on settlement of account of debenture holders)			
(x)	Reconstruction Account	Dr.	15,30,000	
	To Profit and Loss Account			10,00,000
	To Preliminary Expenses Account			20,000
	To Fixed Assets Account			5,10,000
	(Utilisation of reconstruction account for writing off past losses and fixed assets)			

Balance Sheet* of J. Co. Ltd. (After Reconstruction)

as at 1 April, 20.....

Liabilities	Rs.	Assets	Rs.
Equity Share Capital of Rs. 20 Share		Fixed Assets	1,90,000
13½% Debentures	5,00,000	Investments	10,000
15% Debentures	2,00,000	Inventories	3,90,000
	4,00,000	Trade Debtors	4,60,000
		Bank	50,000
	11,00,000		11,00,000

* (Not in Prescribed Form)

Illustration 7: The following is the Balance Sheet of Rohini Industrial Construction Ltd. as on 31st March, 20.....

Liabilities	Rs.	Assets	Rs.
20,000 Equity Shares of Rs. 100 each, fully paid	20,00,000	Virar Works	16,00,000
18,000, 7% Preference Shares of Rs. 100 each fully paid	18,00,000	Churchgate Works	12,00,000
"A" 8% Debentures (Secured on Virar Works)	3,00,000	Stock on hand	9,00,000
"B" 8% Debentures (Secured on Churchgate Works)	3,50,000	Sales Ledger Adjustment A/c	5,00,000
Creditors	2,50,000	Cash at Bank	1,00,000
Bills Payable	2,00,000	Invention Expenses	2,00,000
	49,00,000	Profit and Loss Account	4,00,000
			49,00,000

A scheme of Reconstruction was duly prepared and sanctioned whereby:

- Equity Shares were to be reduced to Rs. 10 each fully paid.
- Preference Shares were to be reduced to Shares of Rs. 80 each fully paid, dividend being raised to 10%.
- Debenture holders forego their interest Rs. 52,000 which is included in creditors.
- "B" Debenture holders agreed to take over Churchgate Works at Rs. 5,00,000 and to accept an allotment of 3,000 Equity Shares in Rohini Industrial Construction Ltd. of Rs. 10 each at par. They settled their account by paying necessary amount by a crossed cheque to the company.
- Stock on hand was to be written down by Rs. 2,00,000 and a provision for doubtful debts be created to the extent of Rs. 25,000.

Any balance arising out of the above points to be applied as to 2/3rd to write off the value of Virar works and 1/3rd to Capital Reserve.

- Capital Reduction Account
- Balance Sheet after the above scheme is implemented.

Solution:

**Rohini Industrial Construction Ltd.
Journal Entries**

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
(i)	Equity Share Capital Account (Rs. 100)	Dr.	20,00,000	
	To Equity Share Capital (Rs. 10)			2,00,000
	To Capital Reduction Account			18,00,000
	(Being the conversion of Rs. 100 equity Shares to Rs. 10 equity shares)			
(ii)	7% Preference Share Capital Account (Rs. 100)	Dr.	18,00,000	
	To 10% Preference Share Capital (Rs. 80)			14,40,000
	To Capital Reduction Account			3,60,000
	(Being conversion of 7% preference shares of Rs. 100 each to 10% preference shares of Rs. 80 each)			

(iii)	Creditors Account	Dr.	52,000	
	To Capital Reduction Account			52,000
	(Being interest on debentures included in creditors eliminated as per agreement with debenture holders)			
(iv)	B-8% Debentures Account	Dr.	3,50,000	
	To Debenture holders Account			3,50,000
	(Being amount payable to debenture holders)			
(v)	Capital Reduction Account	Dr.	7,00,000	
	To Churchgate Works Account			7,00,000
	[Being the reduction in the value of Churchgate works transferred to capital reduction account (12,00,000-5,00,000)]			
(vi)	Bank Account	Dr.	1,80,000	
	B-8 Debenture holders Account	Dr.	3,50,000	
	To Churchgate Works Account			5,00,000
	To Equity Share Capital Account			30,000
	[Being the transfer of Churchgate Works to B-8% debentures for Rs. 5,00,000 and issue Rs. 30,000 equity shares to debenture holders the balance received from debenture holders by crossed cheque (5,00,000+30,000 - 3,50,000 = 1,80,000)]			
(vii)	Capital Reduction Account	Dr.	15,12,000	
	To Stock Account			2,00,000
	To Provision for Doubtful Debts Account			25,000
	To Profit and Loss Account			4,00,000
	To Invention Expenses Account			2,00,000
	To Virar Works Account			4,58,000
	To Capital Reserve Account			2,29,000
	(Being utilisation of capital reduction account to write off stock provided for provision for doubtful debts, write off profit and loss account (debit balance), invention expenses account; the balance transferred to Virar Works and Capital Reserve Accounts in the ratio of 2/3 and 1/3 respectively.)			

Capital Reduction Account

		Rs.			Rs.
Profit and Loss Account		4,00,000	Equity Share Capital Account		18,00,000
Invention Expenses Account		2,00,000	(20,000 × 90)		
Churchgate Works Account		7,00,000	7% Preference Share Capital		
(12,00,000 - 5,00,000)			Account (18,000 × 20)		3,60,000
Stock Account		2,00,000	Creditors		52,000
Provision for Doubtful Debts		25,000	(Debenture interest foregone)		
		15,25,000			
Virar Works (2/3)	4,58,000				
Capital Reserve (1/3)	2,29,000	6,87,000			
		22,12,000			22,12,000

Balance Sheet As On 31.3.20.....

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
Authorised	?	Virar Works	16,00,000
Issued, Subscribed & Paid up		<i>Less:</i> Written of	4,58,000
18,000, 10% Preference		Investments	11,42,000
Shares of Rs. 80 each	14,40,000	Current Assets	Nil
23,000 Equity Shares		Stock (9,00,000 – 2,00,000)	Nil
of Rs. 10 each	2,30,000	Sales Ledger Adj. A/c	7,00,000
Reserve and Surplus		(Debtors)	5,00,000
Capital Reserves	2,29,000	<i>Less:</i> Provisions for	
Secured Loans		Doubtful debts	25,000
'A' 8% Debentures	3,00,000	Bank Balance	4,75,000
Unsecured Loans	Nil	(1,00,000 + 1,80,000; See Note)	2,80,000
Current Liabilities and Provisions		Loans and Advances	Nil
(A) Current Liabilities		Miscellaneous Expenditure	Nil
Bill Payable	2,00,000	(Not Written Off)	
Sundry Creditors	1,98,000		
(2,50,000 – 52,000)			
(B) Provisions	Nil		
	25,97,000		25,97,000

Working Notes

Calculation of amount due from B-8% Debentures

	Rs.
For takeover of Churchgate Works	5,00,000
For 3,000 Equity Shares of Rs. 10 each	30,000
	<u>5,30,000</u>
<i>Less:</i> Balance due as per Balance Sheet	3,50,000
	<u>1,80,000</u>