ISSUE OF BONUS SHARES

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

SEBI Guidelines with Respect to Issue of Bonus Shares

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

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

Accounting Treatment:

- On Issue of Bonus Shares:

Source/Reserve used: A/c	Dr. ...	[With the Amount for which Bonus Shares are Issued]
(Capitalization of Profit—General Reserve or Securities of Premium A/c)		
To Bonus to Equity Shareholder's A/c	...	

- On Distribution of Bonus Shares:

Bonus to Equity Shareholders A/c Dr. ...
To Equity Share Capital A/c ...

In Balance Sheet

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

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

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

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

Example 1:

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

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

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

Pass journal entries regarding the issue of bonus shares.

Solution

Note:

For every three equity shareholders, 1 bonus share is issued

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

Total amount needed: Rs. 10 × 10,000 = Rs. 1,00,000

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

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

i.e. Next, Rs. 40,000 is to be taken from general reserve.

Journal

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

Example 2:
Rajesh Ltd. presents the following balance sheet:

Liabilities	₹	Assets	₹
SHARE CAPITAL:		FIXED ASSETS:	
Authorized	30,00,000	Plant & Machinery	12,00,000
Issued & Subscribed:		Furniture & Fixtures	1,50,000
5,000, 14% Pref. Shares of ₹100 Each Fully Paid up	5,00,000	Patents & Trademarks	50,000
		CURRENT ASSETS, LOANS & ADVANCES:	
1,00,000 Equity Shares of ₹ 10 Each, Fully Paid up	10,00,000	(A) CURRENT ASSETS:	
		Stock	11,00,000
RESERVES & SURPLUS:		Debtors	1,50,000
Capital Reserve	1,50,000	Cash in Hand	5,000
Securities Premium	1,00,000	Cash at Bank	3,15,000
General Reserve	7,50,000	(B) LOANS & ADVANCES:	
Profit & Loss Account	1,50,000	Bills of Exchange	70,000
CURRENT LIABILITIES & PROVISIONS:			
(A) Current Liabilities:			
Sundry Creditors	1,80,000		
(B) Provisions:			
Provision for Taxation	2,10,000		
	30,40,000		30,40,000

The company purchased new machinery for Rs. 1, 50,000 for which it paid Rs. 50,000 by cheque and allotted 15% preference shares (1,000) of Rs. 100 each as fully paid up to the vendors.

The company then issued one fully paid BONUS equity share of Rs. 10 each for every five equity shares held to its equity shareholders. For this purpose, the balances in profit and loss account and general reserve are utilized to the necessary extent.

You are required to pass necessary journal entries to record the above transactions. Redraft the company's balance sheet.

Solution

Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Machinery A/c	Dr.		1,50,000	
	To Vendor A/c				1,50,000
	(New Machinery Purchased)				
	Vendor A/c	Dr.		1,50,000	
	To Bank A/c				50,000
	To 15% Preference Share Capital A/c				1,00,000
	(₹ 50,000 Paid by Cheque and 1,000 15% Preference Shares are Allotted to the Vendor for the Machinery Purchased)				
	Profit and Loss A/c	Dr.		1,50,000	
	General Reserve A/c	Dr.		50,000	
	To Bonus to Equity Shareholders A/c				2,00,000
	(Profit & Loss A/c and General Reserve Utilized for Issue of Bonus Shares of ₹ 2,00,000 to Holders of Equity Shareholders, i.e., in the Ratio of 5:1)				
	Bonus to Equity Shareholders A/c	Dr.		2,00,000	
	To Equity Share Capital A/c				2,00,000
	(Bonus Shares Distributed)				

Note: Issue of Bonus shares:

For every FIVE equity holders ONE BONUS SHARE was allotted; issued & subscribed equity shares were Rs. 10,00,000.

$$\therefore \text{ Bonus shares allotted: } \frac{10,00,000}{5} = ₹\,2,00,000$$

20,000 bonus shares of Rs. 10 each as fully paid up.

For this purpose, P&L A/c amount Rs. 1, 50,000—Refer balance sheet & general reserve (Rs. 2, 00,000 – Rs. 50,000) Rs. 50,000 were utilized.

Balance Sheet Reconstructed After Issue of Bonus Shares

Liabilities	₹	**Assets**	₹
SHARE CAPITAL:		FIXED ASSETS:	
Authorized Capital Issued & Subscribed:	30,00,000	Plant & Machinery (₹ 12, 00,000 + ₹ 1,50,000)	13,50,000
5,000, 14% Pref. Shares of ₹ 100 Each Fully Paid up	5,00,000	New	
		Furniture & Fixtures	1,50,000
		Patents & Trademarks	50,000
1,000 15% Pref. Shares of ₹ 100 Each Fully Paid up (Allotted to Vendor)	1,00,000	CURRENT ASSETS, LOANS & ADVANCES:	
		(A) CURRENT ASSETS:	
1,20,000 Equity Shares of ₹ 10 Each Fully Paid-up (of the Above Shares, 20,000 Equity Shares of ₹ 10 Each, Allotted by Way of Bonus Shares)	12,00,000	Stock	11,00,000
		Debtors	1,50,000
		Cash in Hand	5,000
		Cash at Bank	2,65,000
RESERVES & SURPLUS:		₹ 3,15,000 – ₹ 50,000	
Capital Reserve	1,50,000	Vendor	
Securities Premium	1,00,000	(B) LOANS & ADVANES:	
General Reserve	7,00,000	Bills of Exchang	70,000
(₹ 7, 50,000 – ₹ 50,000)			
P&L A/c (1,50,000 – 1, 50,000)	—		
CURRENT LIABILITIES & PROVISIONS:			
(A) Current Liabilities:			
Sundry Creditors	1,80,000		
(B) Provisions:			
Provision for Taxation	2,10,000		
	31,40,00		31,40,000

Contents

VALUATION OF SHARES

Valuation of shares of a company is not an easy task. A number of factors are associated with it. All such factors may not be taken into account for ascertaining the exact value of shares. For example, if the shares of a company are not quoted on the stock exchange, their value cannot be determined precisely. Some shares, especially private company shares possess no market value as their transferability is restricted.

Notwithstanding such inherent features, the necessity to ascertain the value of these shares has become utmost important.

Valuation of shares is essential for the following purposes:

1. When amalgamation or absorption of companies occurs.
2. When reconstruction scheme takes place.
3. When preference shares are converted into equity shares.
4. For assessment of tax.
5. To meet shareholder's demands in certain contingencies.

METHODS OF VALUATION OF SHARES

The methods of valuation of shares may be categorized as follows:

1.1 Net Assets Method

There are so many alternative names to this method such as intrinsic value method, net worth method, equity method, asset backing method, break-up value method, real value method, asset basis method, Exchange Ratio Method.

Under this method, value of the net assets of the company is measured against each share. Here, the emphasis is on the value of net assets. Further, the shares are valued on the basis of internal value of the assets.

Step 1:

Add: All the Assets at Market Value

Step 2:

Deduct: All Liabilities (Including Debentures and Preference Shares)

Step 3:

Result = Net Assets

Step 4:

Divide Net Assets (As Arrived at Step 3) by Number of Equity Shares. The Formula to Ascertain the Value of a Share,

Formula

$$\text{Net Asset Value} = \frac{\text{Net Value of asset – Liabilities-PrefShare holder claims}}{\text{No of Equity Shares}}$$

While Evaluating the Assets, the Factors that Should be Considered are as Follows

1. Goodwill: Goodwill should be valued at current cost. Book value on account of purchase of goodwill should be eliminated.
2. Inventory:
    a. Raw materials, stocks and work-in-progress should be valued at cost price.
    b. Finished goods should be valued as market price.
3. Fictitious assets: Fictitious assets should be eliminated, e.g., debit balance of P&L A/c, preliminary expenses, discount on issue of shares and debentures.
4. Non-trading assets: They should be valued at market price.
5. Book debts: Book debts should be valued after earmarking provisions for bad and doubtful debts.
6. All other assets: If the market value of assets are not given in the question, they should be valued at book value.

Factors that should be considered for valuation of liabilities are as follows:

1. Share capital: If both equity shares and preference shares are given, preference share capital should be deducted from the assets.
2. Provisions: Provision for taxation, provision for dividend, etc. should be included in liabilities.
3. Outstanding expenses: Adequate provision should be made.
4. Contingent liabilities: Adequate provision should be made for all contingent liabilities.

Example 1:
The following is the balance sheet of QUEST Ltd. as on 31 March 20XX:

Liabilities	Amount	Asset	Amount
50,000 Equity Shares of Rs. 10 Each	5,00,000	Sundry Asset	10,00,000
3,000 10% Pref Share of Rs. 100 Each	3,00,000		
Bills Payable	80,000		
Creditors	1,20,000		
	10,00,000		10,00,000

The market value of 70% of the assets is estimated to be 20% more than the book value and that of the remaining 30% at 10% less than the book value. There is an unrecorded liability of ₹ 10,000.

Find the value of each equity share assuming that preference shares have no prior claim as to payment of dividend or as to payment of capital.

Solution:

Step 1: Assets Should be Valued At Market Value:

		₹
(i) 70% of Assets $= \frac{70}{100} \times 10,00,000$	=	7,00,000
(ii) ₹ 7,00,000 Estimated as 20% More than Book Value	=	8,40,000
₹ $7,00,000 \times \frac{120}{100} = 8,40,000$		
(iii) 30% of Assets $= \frac{30}{100} \times 10,00,000$	=	3,00,000
(iv) ₹ 3,00,000 Estimated as 10% Less than Book Value	=	2,70,000
₹ $3,00,000 \times \frac{90}{100} =$ ₹ 2,70,000		
(v) Total Assets at Market Value	=	11,10,000

Step 2: Current Liabilities Should be Deducted:

Less: Current Liabilities:	₹	₹
Bills Payable	80,000	
Creditors	1,20,000	
Unrecorded Liability	10,000	2,10,000
		9,00,000

Step 3: Less: Preference Share Capital = 3,00,000

Step 4: Net Assets Available for Equity Shareholders = 6,00,000

Step 5: Computation of Intrinsic Value Per Share:

Formula:

$$\text{Intrinsic Value Per Share} = \frac{\text{Net Assets Available for Equity Share Holders}}{\text{Number of Equity Shares}}$$

$$\text{Substituting the Values, We get} = ₹\frac{6,00,000 \text{ (Step 4)}}{50,000 \text{ (Given)}}$$
$$= ₹\ 12$$

Note: Preference shareholders not having preference will not make any difference.

Example 2:

The following is the balance sheet of Wings Ltd. as on March 31, 2018:

Liabilities	₹	Assets	₹
Share Capital:		Land & Buildings	5,00,000
1,50,000 Equity Shares of ₹ 10 Each Fully Paid	15,00,000	Plant & Machinery	3,00,000
		Stock	10,00,000
P&L A/c	2,00,000	Sundry Debtors	4,50,000
Sundry Creditors	2,50,000		
Bank Overdraft	50,000		
Provision for Taxation	1,00,000		
Dividend Equalization Fund	1,50,000		
	22,50,000		22,50,000

On March 31, 2018, land and buildings were valued at Rs. 6,25,000 and plant and machinery at Rs. 3,75,000.

In view of the nature of business, it is considered that 10% is reasonable on capital.

You are required to calculate the value of the company's share after taking into account the revised values on fixed assets and your own valuation of goodwill Rs. 1,90,000.

Solution

Step 1: Net Asset Employed

Net Asset of Entity

a.	Land & Building	6,25,000
b.	Plant & Machinery	3,75,000
c.	Stock	10,00,000
d.	Sundry Debtors	4,50,000
Less *Liabilities*		
e.	Sundry Creditors	(-) 2,50,000
f.	Bank Overdraft	(-) 50,000
g.	Provision for Taxation	(-) 4,50,000

Net Asset of Entity (Total Asset Less Liabilities)	$\boxed{20,50,000}$
Step 2: Add Goodwill	1,90,000
Step 3: Net Asset Available for Share Holder	22,40,000
Step 4: Intrinsic Value of Share	

Formula:

$$\text{Intrinsic Value of Each Share} = \frac{\text{Net Assets Available for Equity Shareholders}}{\text{Number of Equity Shares}}$$

$$= ₹\,\frac{22{,}40{,}000 \text{ (Step 3)}}{1{,}50{,}000 \text{ (Given)}}$$

$$= ₹\,14.93$$

Example 3:
On March 2017, the balance sheet of Bheem Pvt Ltd. was as follows:

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	50,000
10% Preference Shares (1,000) of ₹ 100 Each Fully Paid	1,00,000	Land & Buildings	2,00,000
		Machinery	2,50,000
50,000 Equity Shares of ₹ 10 Each Fully Paid	5,00,000	Furniture	20,000
		Investment in 5% Govt. Securities at Cost (Face Value of ₹ 60,000)	75,000
General Reserve	1,00,000		
Capital Reserve	20,000	Stock	4,00,000
P&L A/c	80,000	Book Debts	80,000
6% Debentures	1,60,000	Cash at Bank	25,000
Sundry Creditors	1,00,000		
Provision for Taxation	40,000		
	11,00,000		11,00,000

The asset is revalued as follows:

Land & Building	Rs. 2,80,000
Machinery	Rs. 2,20,000
Furniture	Rs. 30,000
Goodwill	Rs. 1,96,500

Stage II: Valuation of Share:

Step 1:	Net Assets: (At Market Value)		₹
	(i) Goodwill (Step 4)		1,96,500
	(ii) Land & Building (Revalued)		2,80,000
	(iii) Machinery (Revalued)		2,20,000
	(iv) Furniture (Revalued)		30,000
	(v) Investments (Given in b/s)		75,000
	(vi) Stock (Given in b/s)		4,00,000
	(vii) Book Debts		80,000
	(viii) Cash at Bank		25,000
			13,06,500
Step 2:	Less: Liabilities & Provisions:	₹	
	(i) 6% Debentures:	1,60,000	
	(ii) Sundry Creditors:	1,00,000	
	(iii) Provision For Taxation:	40,000	3,00,000
			10,06,500
	Less: 10% Preference Share Capital		1,00,000
Step 3:	Net Assets Available =		9,06,500
Step 4:	Computation of Intrinsic Value of Share:		

$$\text{Formula} = \frac{\text{Net Assets}}{\text{Number of Equity Shares}}$$

$$= ₹\frac{9,06,500}{50,000}$$

Intrinsic Value of Each Equity Share = ₹ 18.13

Example 4: Valuation of fully paid and partly paid shares
Following is an extract of the balance sheet of SRK Ltd. as on 31 March 2017:

Share Capital	6,75,000
10,000 Equity Share of Rs. 10 Each (Rs 5 Paid up)	50,000
10,000 Equity Share of Rs. 10 Each (Rs 10 Paid up)	1,00,000
10,000 Equity Share of Rs. 10 Each (Rs 2.5 Paid up)	25,000
5,000 Pref Share @Rs. 100 Each	5,00,000
Reserve & Surplus	2,00,000
P&L A/c	1,25,000
	10,00,000

On revaluation of assets, on 31 March, it was found that they had appreciated by Rs. 1,00,000 over their value in the aggregate.

The Articles of Association of the Company state that in case of liquidation, the preference shareholders would have a further claim of the surplus assets, if any.

You are required to ascertain the value of each equity share assuming that liquidation of the company has to take place on 31 March 2017 and that the expenses of winding up are NIL.

Solution

STAGE I: Computation of surplus assets available to equity shareholders:

		₹
Step 1:	Net Assets	
	(i) Preference Share Capital	5,00,000
	(ii) Equity Share Capital (₹ 50,000 + ₹ 25,000 + ₹ 1,00,000)	1,75,000
	(iii) General Reserve	2,00,000
	(iv) P&L A/c	1,25,000
	(v) Appreciation on Revaluation	1,00,000
Step 2:	Total Net Assets	11,00,000
Step 3:	Less: Preference Share Capital:	5,00,000
		6,00,000
Step 4:	Less: Equity Share Capital	1,75,000
Step 5:	Surplus Assets Available to Share Holders =	4,25,000
Step 6:	Less: Surplus to Pref. Shareholders As per Direction Given in Question 10% of Surplus Assets 4,25,000:	42,500
Step 7:	Surplus Assets Available to Equity Shareholders}=	3,82,500

STAGE II: Computation of Total Amount Available to Equity Shareholders:

		₹
Step 1:	Equity Share Capital (Given):	1,75,000
Step 2:	Add: Surplus Assets Available to Equity: Shareholders (Step 6)	3,82,500
Step 3:	Total Amount Available:	5,52,500

STAGE III: Computation of Value of Each Equity Share:

Step 1: Value of ₹ 1 of Paid-up Capital

$$= \frac{\text{Total Amount Available}}{\text{Paid-Up Capital}} = \frac{₹\,5{,}52{,}500 (\text{Step 3})}{₹\,1{,}75{,}000 (\text{Step 1})}$$

$= ₹\,3.16$

Step 2: Value of Each ₹ 5 Paid-up Share:

$$= \underset{(\text{Given})}{₹\,5} \times \underset{(\text{Step 1})}{₹\,3.16} = ₹\,15.80$$

Step 3: Value of Each ₹ 2.50 Paid-up Share:

$$= \underset{(\text{Given})}{₹\,2.50} \times \underset{(\text{Step 1})}{₹\,3.16} = ₹\,7.90$$

Example 5:
The following is the balance sheet of CSK Ltd. as on 31 December 2018:

Liabilities	₹	**Assets**	₹
Share Capital:		Sundry Assets	10,00,000
2,000, 10 % Preference Shares of ₹100 Each Fully Paid	2,00,000	Discount on Debentures	5,000
		Preliminary Expenses	15,000
50,000 Equity Shares of ₹10 Each Fully Paid	5,00,000	Profit and Loss A/c	80,000
General Reserve	25,000		
Debenture Redemption Reserve	50,000		
5% Debentures	1,00,000		
Depreciation Fund	25,000		
Sundry Creditors	2,00,000		
	11,00,000		11,00,000

The debenture interest is outstanding for one year and dividends and preference shares are in arrears for 2 years.

The sundry assets are worth their book values.

You are required to ascertain the value of preference shares and equity shares in each of the following alternative cases: if,

1. Preference shares are preferential as to capital and arrears are payable
2. Preference shares are preferential as to capital but arrears are not payable
3. Preference shares do not carry priority of capital but arrears are payable
4. Neither preference shares enjoy priority of capital nor do the articles permit the payment of arrears.

Solution

First, value of net assets has to be calculated as:

Step 1:	Assets (As Market Value):		₹
	Sundry Assets (Given)		10,00,000
Step 2:	Less: Liabilities:	₹	
	(i) Depreciation Fund	25,000	
	(ii) 5% Debentures	1,00,000	
	(iii) Outstanding Debenture Interest for 1 Year (₹ 1,00,000 × 5/100)	5,000	
	(iv) Sundry Creditors:	2,00,000	3,30,000
Step 3:	Net Assets:		6,70,000

Case I: When preference shares are preferential as to capital and arrears are payable: (in winding up)

Step 1: Net Asset		6,70,000
Step 2: Less:		2,40,000
i) Preference Share Capital	2,00,000	
ii) Preference Dividend for 2 yrs (Rs. 2,00,000 x 10/100 x 2)	40,000	
Step 3: Net Asset Available for Equity Share Holder		$\boxed{4,30,000}$
Step 4: Intrinsic Value per Equity Share **(Step 3/50,000)**	8.60	
Value of Preference Share Rs. 100/Share		

Case II: Preference shares are preferential as to capital but arrears are not payable

Step 1: Net Asset		6,70,000
Step 2: Less:		2,00,000
i) Preference Share Capital	2,00,000	
Step 3: Net Asset Available for Equity Share Holder		$\boxed{4,70,000}$
Step 4: Intrinsic Value per Equity Share **(Step 3/50,000)**	9.20	
Value of Preference Share Rs. 100/Share		

Case III: Preference shares do not carry priority of capital but arrears are payable

Step 1: Net Asset		6,70,000
Step 2: Less:		40,000
i) Preference Dividend for 2 yrs (Rs. 2,00,000 x 10/100 x 2)	40,000	

Step 3: Net Asset Available for Equity Share Holder $\boxed{6,30,000}$

Step 4: Intrinsic Value per Equity & Pref **(Step 3/52,000)** 12.11
(Equity Share 50,000 & Pref Share 2,000)

Case VI: Neither preference shares enjoy priority of capital nor do the articles permit the payment of arrears.

Step 1: Net Asset Available for Equity & Pref $\boxed{6,70,000}$

Step 2: Intrinsic Value per Share **(6,70,000/52,000)** 12.88
(Equity Share 50,000 & Pref Share 2,000)

Example 6:

Model: Fair value of shares—on the basis of majority and minority holdings

Determine the fair value of 200 shares held by Mr. Sharukh in Red Chillies Pvt Ltd. to be transferred to Mr. Salman on the basis of majority and minority holdings. The balance sheet of Red Chillies Pvt Ltd. as on 31 March 2017 is as follows:

Liabilities	₹	**Assets**	₹
Share Capital:		Goodwill	40,000
80,000 Equity Shares of ₹ 10 Each Fully Paid Up	8,00,000	Buildings	3,00,000
		Machinery	3,60,000
General Reserve	2,60,000	Debtors	4,00,000
P&L A/c	1,60,000	Stock	1,60,000
Sundry Creditors	80,000	Cash at Bank	20,000
		Preliminary Expenses	20,000
	13,00,000		13,00,000

Debtors are estimated to be 10% below book value and goodwill is valued at its book value. Profit and loss account shows the net profit of the year after transfer to general reserve and payment of income tax.

Dividend was paid for the last 3 years at the rate of 14%, 18% and 16%, respectively. Normal expected return is 10%.

Solution:

Stage I: Valuation of Shares (Net Assets Method):

		₹
Step 1:	Assets (at Market Value):	
	(i) Goodwill	40,000
	(ii) Buildings	3,00,000
	(iii) Machinery	3,60,000
	(iv) Debtors (10% Below Book Value)	3,60,000
	(₹ 4,00,000 – 10% → 40,000)	
	(v) Stock	1,60,000
	(vi) Cash at Bank	20,000
Step 2:	Total Net Assets	12,40,000
Step 3:	Less: Liabilities:	
	Creditors	80,000
Step 4:	Net Assets Available to Equity Shareholders:	11,60,000

Step 5: Intrinsic Value of Each Share:

Formula:

$$\text{Intrinsic Value of Each Share} = \frac{\text{Net Assets Available}}{\text{Number of Equity Shares}} = \frac{₹\,11{,}60{,}000}{80{,}000} = ₹\,14.50$$

Step 6: Intrinsic Value of 200 Shares = 200 × ₹ 14.50 = ₹ 2,900.

Stage II: Valuation of shares under yield method

Step 1: Profits of the Year After Tax and Transfer to General Reserve (Given in b/s) = ₹ 1,60,000

Step 2: Expected Rate of Return =

$$\text{Formula: } \frac{\text{Profit}}{\text{Share Capital}} \times 100 = \frac{₹\,1{,}60{,}000}{₹\,8{,}00{,}000} \times 100 = 20\%$$

Step 3: Yield Value Per Equity Share:

Formula:

$$\frac{\text{Expected Rate of Return}}{\text{Normal Rate of Return}} \times \text{Paid-up Value of Equity Share} = \frac{20\%\ (\text{Step 2})}{10\%\ (\text{Given})} \times ₹\,10 = ₹\,20$$

Step 4: Yield Value of 200 Shares = 200 × ₹ 20 = ₹ 4,000

Stage III: Determination of Yield Value of Minority Holding and Majority Holding:

Step 1: Average Rate of Actual Dividend = $\frac{14\% + 18\% + 16\%}{3} = \frac{48\%}{3} = 16\%$

Step 2: Value of Each Share = $\frac{16\%}{10\%} \times ₹\,10 = ₹\,16$

Step 3: Yield Value of 200 Shares: 200 × ₹ 16 = ₹ 3,200

Step 4: Fair Value of Majority Holding:

Formula:

$$= \frac{\text{Intrinsic Value} + \text{Yield Value}}{2} = \frac{₹2{,}900 + ₹4{,}000}{2} = ₹\frac{6{,}900}{2}$$

$$= ₹3{,}450$$

Step 5: Fair Value of Minority Holding:

$$= \frac{₹2{,}900 + ₹3{,}200}{2} = ₹\frac{6{,}100}{2}$$

$$= ₹3{,}050$$

Practice Question

The Following is the Balance Sheet of Prem Pvt Ltd. as on 31 March 20185:

Liabilities:	₹
1,00,000 Equity Shares of ₹ 10 Each, Fully Paid	10,00,000
1,00,000 Equity Shares of ₹ 10 Each, ₹ 5 Paid Up	5,00,000
80,000 14% Cumulative Pref. Shares of ₹ 10 Each, Fully Paid	8,00,000
Long-Term Secured Loan	12,00,000
Sundry Creditors	3,00,000
	38,00,000
Assets:	
Land & Buildings	20,00,000
Furniture, Fixtures & Fittings	1,00,000
Stock	5,00,000
Debtors	3,00,000
Cash at Bank	1,00,000
P&L A/c	8,00,000
	38,00,000

The current value of land and buildings is Rs. 27,00,000 and that of furniture, fixture and fittings is Rs. 60,000. Stock is valued at Rs. 7,00,000. Debtors are expected to realize only 80% of their book value. You are informed that the preference dividend has not been paid for the last 5 years. Calculate the intrinsic value of equity share by the net assets method.

Solution: *Intrinsic Value of Fully Paid up Share is Rs. 10/-*

1.2 Yield Basis

<u>Method—Yield Basis or Market Value or Earning Capacity Valuation or Income Method</u>

Yield denotes the income that the investors get for their investments. Naturally, the price of share depends on the quantum of dividends.

Here, yield may represent (i) the entire earnings or the (ii) dividend paid by the company. The normal procedure is that dividend is taken as a basis for calculating the yield and not the entire earnings.

Valuation of shares on the basis of yield is determined as follows:

Step 1: Future Maintainable Profits are Ascertained.
Step 2: The Normal Rate of Return is Computed.
Step 3: The Multiplier or the Capitalization Factor is to Be Ascertained

$$= \left(\frac{100}{\text{Normal Rate of Return}}\right)$$

Step 4: Capitalized Value of Maintainable Profits is Determined by Multiplying Maintainable Profit by the Multiplier (i.e., Step 1 × Step 3)

Step 5: Finally, the Yield Value of Shae is Compared by dividing the Capitalized Value of Maintainable Profits (Compared in Step 4) By the Number of Equity Shares.

$$\text{Yield} = \frac{\text{Step 4}}{\text{Number of Equity Shares}}$$

Example 7:

From the following information, calculate the value of an equity share:

1. The paid-up share capital of a company consists of 2,000 12% preference shares of Rs 100 each and 50,000 equity shares of Rs. 10 each.
2. The average annual profits of the company after providing for depreciation and taxation amounted to Rs. 64,000.
3. The normal return expected by investors on equity shares from the type of business carried on by the company is 10%.

Solution:
Step 1: Future Maintainable profits are Ascertained:

(i) Net Profit After Depreciation and Taxation: (Given) — ₹ 64,000

(ii) Less: Dividend to Be Paid to Pref. Share Holders: (12% on 2,000 × 100) — ₹ 24,000

(iii) Profit Available to Equity Share Holders — ₹ 40,000

Step 2: Normal Rate of Return is to be Determined:
It is 10% (Given in the Question Itself)

Step 3: Capitalization Factor is Ascertained $= \frac{100}{10} = 10$

Step 4: Capitalized Value of Maintainable Profit is Calculated:
Maintainable Profits × Multiplier (Capitalization Factor)
$= ₹\,40{,}000 \times 10 = ₹\,4{,}00{,}000$
(Step 1 (iii)) (Step 3)

Step 5: Yield Value of Equity Share is Determined as:

$$\text{Formula: Value of Equity Share} = \frac{\text{Capitalized Value}}{\text{Number of Equity Shares}}$$

$$= \frac{₹\,4{,}00{,}000}{\underset{\text{(Given)}}{50{,}000}} = ₹\,8 \text{ Per Share}$$

$$= \left(\frac{\text{Step 4}}{\text{Number of Equity Shares}}\right)$$

This can be calculated in another way as follows:

$$\text{Formula: Expected rate} = \frac{\text{Profit Available}}{\text{Total Paid-Up Equity Share Capital}} \times 100 = 8\%$$

$$= \frac{₹\,40{,}000}{₹\,5{,}00{,}000} \times 100 = 8\%$$

$$\text{Value per share} = \frac{\text{Expected Rate}}{\text{Normal Rate}} \times \text{Paid-up Value of Shares}$$

$$= \frac{8}{10} \times ₹\,10 = ₹\,8$$

Earnings per Share Basis

Earnings per share is determined by dividing the earnings with the number of equity shares.

$$\text{Earnings per Share (EPS)} = \frac{\text{Earning Available to Equity Shareholder}}{\text{Number of Equity Shares}}$$

After determining the EPS of the company, value of share on EPS is calculated by using the formula:

$$\text{Value of the share} = \frac{\text{EPS of the Company}}{\text{Average EPS}} \times \text{Paid-up value of equity share}$$

By using the same figures as in the above illustration,

EPS is determined by using the formula:

$$\text{EPS} = \frac{\text{Earnings}}{\text{Number of Equity Shares}} = \frac{₹\,40{,}000}{50{,}000} = ₹\,0.80.$$

Average EPS Rs. (paid up value is Rs 10 and normal rate of return is 10) $= \frac{₹10}{10} = ₹\,1$

Thus, we can see that the yield value of shares, under various methods, is the same, i.e., Rs. 8 only.

Example 8:
XMAS Ltd. started its business on 1 April 2015. On 31 March 2018, its balance sheet in a summarized form was as follows:

Liabilities	₹	**Assets**	₹
Share Capital: 10,000, 12% Preference Shares of ₹ 100 Each, Fully Paid	10,00,000	Fixed Costs (Less Depreciation)	25,00,000
2,50,000 Equity Shares of ₹ 10 Each, Fully Paid	25,00,000	Current Assets	35,00,000
Profit Prior to Incorporation	25,000	Preliminary Expenses	25,000
P&L A/c	5,00,000		
15% Debentures	4,00,000		
Sundry Creditors	14,00,000		
Provision for Income Tax	2,00,000		
	60,25,000		60,25,000

The company is yet to declare its maiden dividend. A revaluation reveals that the fixed assets as on 31 March 2018 are really worth Rs. 30,00,000. Calculate the intrinsic value of two classes of shares.

Solution:

Step 1:	Add: Assets		₹
	(i) Fixed Assets (as on 31 March 2010)		30,00,000
	(ii) Current Assets		35,00,000
			65,00,000
Step 2:	Less: Liabilities & Provision	₹	
(i)	15% Debentures	4,00,000	
(ii)	Sundry Creditors	14,00,000	
(iii)	Provision for Income Tax	2,00,000	
		20,00,000	
Step 3:	Net Assets (Step 1 – Step 2)	45,00,000	
Step 4:	Preference Shares:		
	Preference Share Capital:		10,00,000
	Add: Dividend @ 12% for 3 Years:		3,60,000
			13,60,000

Value of One Preference Share:

$$\frac{\text{Pref. Share Capital + Dividend}}{\text{Number of Pref. Shares}}$$

$$\frac{₹\,13{,}60{,}000 \text{ (Ref. Step 4)}}{10{,}000 \text{ (Given)}} = ₹\,136$$

Step 5: Equity Shares

Net Assets After Satisfying Preference Shareholders' Claim

= Net Assets – Pref. Shareholders' Claim

= ₹ 45,00,000 – ₹ 13,60,000

(Step 3) (Step 4)

= ₹ 31,40,000

Value of One Equity Share $= \dfrac{₹\,31{,}40{,}000}{2{,}50{,}000} = ₹\,1256$

Example 9 :

From the following particulars, calculate the fair value of an equity share assuming that out of the total assets, those amounting to Rs. 19,50,000 are fictitious.

1. Share capital:
    a. 2,00,000 15% Preference shares of Rs. 100 each, fully paid
    b. 20,00,000 Equity shares of Rs. 10 each, fully paid
2. Liabilities to outsiders: Rs 34,50,000
3. Reserves & Surplus: Rs. 17,50,000
4. The average normal profit after taxation earned every year by the company during the last 5 years: Rs. 40,00,000
5. The normal profit earned on the market value of fully paid equity shares of similar companies is 10%

Solution

STAGE I: Computation of Intrinsic Value of Shares.

Step 1:	Add: (Assets)		
			₹
	(i) Preference Share Capital (2,00,000 × ₹ 100):		2,00,00,000
	(ii) Equity Share Capital (20,00,000 × ₹ 10):		2,00,00,000
	(iii) Reserve & Surplus:		17,50,000
	(iv) Liabilities to Outsiders:		34,50,000
Step 2:	Gross Assets:		4,52,00,000
Step 3:	Less:		
	(i) Liabilities to Outsiders:	34,50,000	
	(ii) Fictious Assets:	19,50,000	54,00,000
Step 4:	Assets Available to Shareholders:		3,98,00,000
Step 5:	Less: Amount Due to Pref. Shareholders:		2,00,00,000

Step 6: Net Assets Available to Equity Shareholders: 1,98,00,000

Step 7: Intrinsic Value of Equity Shares = $\frac{\text{Net Assets Available to Equity Shareholders}}{\text{Number of Equity Shares}}$

$$= \frac{₹\,1,98,00,000}{20,00,000} = ₹\,9.90$$

Stage II: Computation of Market Value of An Equity Shares By Capitalization of Profits:

		₹
Step 1:	Average Profits: (Given):	40,00,000
Step 2:	Less: Preference Dividend (15% of ₹ 2,00,000):	30,00,000
Step 3:	Profit Available to Equity Shareholders:	10,00,000
Step 4:	Capitalization of Profit at 10%:	1,00,00,000

$$₹\,10,00,000 \times \frac{100}{10}$$

Step 5: Value of One Equity Share:

$$\frac{\text{Capitalized Profits}}{\text{Number of Equity Shares}} = \frac{₹\,1,00,00,000}{20,00,000} = ₹\,5.00$$

Stage III: Fair Value: $\frac{\text{Intrinsic Value + Market Value}}{2}$

$$= (\underbrace{₹\,9.90}_{\text{(Stage I: Step 1)}} + \underbrace{₹\,5.00}_{\text{(Stage II: Step 5)}})/2$$

$$= \frac{₹\,14.90}{2} = ₹\,7.45$$

Example 10:

Balance Sheet of Super Hero Ltd. As on 31 March 2018

Liabilities	Amount	Assets	Amount
Share Capital		Land & Buildings	200,000.00
5,000 Shares of Rs. 100 each	500,000.00	Plant & Machinery	300,000.00
General Reserve	100,000.00	Patents & Trade Marks	25,000.00
Profit and Loss Account	70,000.00	Stocks	75,000.00
Sundry Creditors	145,000.00	Debtors	200,000.00
Income Tax Reserve	35,000.00	Bank balance	35,000.00
		Preliminary expenses	15,000.00
Total	850,000.00	Total	850,000.00

The expert valuer valued the land and buildings at Rs. 2,50,000; plant and machinery at Rs. 2,80,000 and Goodwill at Rs. 2,00,000. Out of the total debtors, it is found that debtors of Rs. 20,000 are bad. The profits of the company were as follows:

2015-16: Rs. 1,00,000 2016-17: Rs. 1,30,000

2017-18: Rs.1,50,000

The Company follows the practice of transferring 25% to general reserve. Similar types of companies earn at 10% of the value of their shares.

You are required to ascertain the value of the shares of the company as follows:

1. Intrinsic value method
2. Yield value method
3. Fair value method

Solution

1. Intrinsic value method

			₹
Step 1:	Add: Assets		
	(i)	Land & Buildings (Market Value)	2,50,000
	(ii)	Goodwill	2,00,000
	(iii)	Plant & Machinery (Market Value)	2,80,000
	(iv)	Stock	75,000
	(v)	Debtors (2,00,000 – Bad Debts 20,000)	1,80,000
	(vi)	Patents & Trade Marks	25,000
	(vii)	Bank Balance	35,000
			10,45,000
Step 2:	Less: Liabilities:		
	Sundry Creditors		1,45,000
Step 3:	Net Assets:		9,00,000

Step 4: Intrinsic Value of One Equity Share $= \frac{\text{Net assets}}{\text{Number of shares}}$

$$= ₹\frac{9,00,000}{5,000} = ₹180$$

2. Yield value method

		₹
Step 1:	Total Profit For Three Year:	3,80,000
	(₹ 1,00,000 + ₹ 1,30,000 + ₹ 1,50,000	
Step 2:	Less: Bad Debts (Given)	20,000
		3,60,000

Step 3: Average Profit: $\frac{₹ 3,60,000}{3} = ₹ 1,20,000$

Step 4:	Add: Decrease in Depreciation	
	On Plant & Machinery:	₹ 1,20,000
	Assume @ 10% on ₹ 20,000	₹ 2,000
		₹ 1,22,000
Step 5:	Less: Increase in Depreciation	₹ 5,000
	On Land & Buildings	
	Assume @ 10% on ₹ 50,000	
Step 6:	Average Profit =	₹ 1,17,000
Step 7:	Less: Transfer to Reserve	₹ 29,250
	@ 25% on ₹ 1,17,000:	
Step 8:	Profit Available For Dividend =	₹ 87,750

Step 9: Rate of Dividend $= \frac{\text{Profit Available from Dividend}}{\text{Total Value of Shares}} \times 100$

$$= \frac{₹ 87,750}{₹ 5,00,000} \times 100$$

$$= 17.55\%$$

Step 10: Yield Value Per Share $= \frac{\text{Rate of Dividend}}{\text{Normal Rate of Return} \times \text{Paid-up Value Per Share}}$

$$= \frac{17.55}{10} \times ₹100$$

$$= ₹ 175.50$$

3. Fair value method

$$\text{Fair Value of Each Share} = \frac{\text{Intrinsic Value} + \text{Yield Value}}{2}$$

$$= \frac{₹ 180 + ₹ 175.50}{2}$$

$$= ₹ 177.75$$

Example 11:

From the following balance sheet, you are required to compare the value of
(i) one preference share and
(ii) one equity share

Liability	₹	Assets	₹
4,000 14% Preference Shares of ₹ 100 Each	4,00,000	Assets at Book Value	12,00,000
60,000 Equity Shares of ₹ 10 Each	6,00,000		
Liabilities	2,00,000		
	12,00,000		12,00,000

The market value of 50% of the assets is considered at 10% more than the book value and that of remaining assets at 5% less than the book value. There was a liability of Rs. 20,000 which remain unrecorded. Assume that the preference shares have no priority as to repayment of capital or dividend.

Solution

Net assets available for equity and preference shareholders have to be calculated by using net assets:

		₹	₹
Step 1:	Assets at Book Value (First 50%):	6,00,000	
	Add: Increase of 10%:	60,000	6,60,000
Step 2:	Assets at Book Value (Remaining 50%) :	6,00,000	
	Less: Decrease of 5%:	30,000	5,70,000
Step 3:	(Step 1 + Step 2) Assets at Market Value:	12,30,000	
Step 4:	Less: Liabilities (Book Value):	2,00,000	10,30,000
Step 5:	Less: Unrecorded Liabilities		20,000
Step 6:	Net Assets Available for Preference and Equity Shareholders:		10,10,000

Step 7: This has to be Divided in the Ratio of their Paid Capital, i.e. 40,00,000:6,00,000 4: 6 or 2:3

(i) Amount Available to Preference Shareholders:

₹ 10,10,000 × 2/5 = ₹ 2,02,000 × 2 = ₹ 4,04,000

(ii) Amount Available to Equity Shareholders:

₹ 10,10,000 × 3/5 = ₹ 2,02,000 × 3 = ₹ 6,06,000

Step 8: Value of Preference Share: $= \dfrac{\text{Amount Available to Preference Shareholder}}{\text{Number of Perference Shares}}$

$$= \frac{₹\,4{,}04{,}000}{4{,}000} = ₹\,101 \text{ Per Share}$$

Step 9: Value of Equity Shares: $= \dfrac{\text{Amount Available to Equity Equity Shareholders}}{\text{Number of Equity Shares}}$

$$= \frac{₹\,6{,}060{,}000}{60{,}000} = ₹\,10.10 \text{ Per Share}$$

Valuation When Only a Few Shares are to be Sold

In case shares are valued on the basis of dividend declared and expected normal rate of return:

$$\text{Value of each equity share} = \frac{\text{Weighted Average Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid-Up Value of Share}$$

Valuation When Majority Shares are to be Sold

In this case, shares are valued on the basis of weighted average profits of the business and expected normal earnings of similar companies in the same industry.

$$\text{Value of each equity share} = \frac{\text{Weighted Averge Rate of Earnigs(Profit)}}{\text{Normal Return}} \times \text{Paid-up Value of Each Share}$$

Example 12:
From the data given below, you are required to compare the value of each share when (a) only a few shares are to be sold and if (b) majority shares are to be sold:

(i) Share capital: 10,000 shares of Rs. 100 each, fully paid
(ii) Profits after tax and dividends
(iii) Normal rate of return 12%

Year	2008	2009	2010
Profits	3,00,000	4,00,000	5,00,000
Dividends	12%	16%	20%

Solution:
1. When Only a Few Shares are Sold:

Step 1: Average Rate of Dividend has to be Computed.

$$\text{Average Dividend rate} = \frac{\text{Sum of Doividend Rates}}{\text{Number of Years}}$$

$$= \frac{12\% + 16\% + 20\%}{3} = \frac{48\%}{3} = 16\%$$

Step 2: Value of Each Equity Share

$$\text{Formula: } \frac{\text{Average Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid-Up Value of Each Share}$$

Step 3: Substituting the Figures in the Formula, We Get:

$$\frac{16}{12} \times ₹\,100 = \frac{₹\,400}{3} = ₹\,133.33$$

2. When Majority Share are Sold:

Step 1: Average Profit is to Be Calculated as

$$\text{Average Profit for 3 Years} = \frac{₹\,3{,}00{,}000 + ₹\,4{,}00{,}000 + ₹\,5{,}00{,}000}{3}$$

$$= \frac{₹\,12{,}00{,}000}{3} = ₹\,4{,}00{,}000$$

Step 2: $$\text{Rate of Earning} = \frac{\text{Average Profit}}{\text{Total Value of Shares}}$$

$$= \frac{₹\,4{,}00{,}000}{₹\,10{,}00{,}00} \times 100 = 40\%$$

Step 3: Value of Each Equity Share:

$$\text{Formula: } \frac{\text{Weighted Average Rate of Earning}}{\text{Normal Rate of Earning}} \times \text{Paid-Up Value of Each Share}$$

$$\frac{40\%}{12} \times ₹\,100 = \frac{4{,}000}{12} = ₹\,333.33$$

Example 13:

The profit of a company, limited by shares, for the year ended 31 March 2018 was Rs. 50,00,000. After setting apart amounts for interest on borrowings, taxation and other provisions, the net surplus available capital base consisted of:

- 1,00,000 equity shares of Rs. 100 each, Rs. 75 per share fully paid up
- 30,000 10% cumulative redeemable preference shares of Rs. 100 each, fully paid up

Enquiries in the stock market reveal that shares of companies engaged in similar business and declaring dividend of 15% on equity shares are quoted at a premium of 20%.

Based on your working on the yield method, what do you expect the market value of the company's share to be?

Solution

		₹
Step 1:	Net Surplus Available to Equity Shareholders =	18,00,000
Step 2:	Less: Preference Dividend @ 10% on ₹ 30,00,000 =	3,00,000
Step 3:	Amount Available For Equity Shareholders =	15,00,000

Step 4: Rate of Equity Dividend $= \dfrac{\text{Amount Available for Equity Dividend}}{\text{Paid-Up Equity Capital}}$

$$= \frac{₹\,15,00,000}{₹\,75,00,000} \times 100 = 20\%$$

Step 5: Expected Market Value at 15% Dividend = ₹ 75 + Premium 20%

$$= ₹\,75 + ₹\,15 = ₹\,90$$

Step 6: Market Value At 20% Dividend $= \dfrac{₹\,90\ (\text{Step 5})}{15} \times 20$

$$= \frac{1,800}{15} = ₹\,120$$

1.3 PRICE-EARNINGS RATIO (PE RATIO)

Price–earnings ratio is the ratio of market price to earnings per share, where earnings per share (EPS) is the earnings available to equity shareholders dividend by number of shares. It may also be said that it is the multiple of earnings which an investor paid for a share. This ratio is an important yardstick to measure whether a share is over-priced or under-priced. Price-earnings ratio of comparable firms may also be used as an important tool to measure the value of share of a firm.

Formula for computing price-earnings ratio is:

$$\text{PE ratio} = \frac{\text{Market Price of Share}}{\text{Earning per Share}}$$

The same formula can be rearranged as:

$$\text{Market price of share} = \text{PE ratio} \times \text{EPS}$$

We know that the normal rate of return is the earning rate of a company, which is determined by using the formula:

$$\text{Earning rate} = \frac{\text{EPS}}{\text{Market Price per Share}} \times 100$$

Studying these two formulae, we can understand that PE ratio is the reciprocal of normal rate of return.

Hence, PE ratio may be expressed as:

$$\text{PE ratio} = \frac{1}{\text{Normal Rate of Return}}$$

As normal rate of return is expressed in percentage

$$\text{PE ratio} = \frac{1 \times 100}{\text{Normal Rate of Return}}$$

or

$$\text{Normal rate of return} = \frac{100}{\text{PE Ratio}}$$

There is much similarly between capitalization factor and PE ratio. Even we may go to the extent that PE ratio = Capitalization factor.

Example 14:

The share of Shreeman Ltd. is quoted in the market at Rs. 120. Its earnings per share (EPS) is 15. Compute its normal rate of return, PE ratio and capitalization factor. If the future maintainable profits are Rs. 15,00,000 and there are 1,00,000 equity shareholders, determine the value of share on yield basis.

Solution

Calculation of normal rate of return Formula->

$$\text{Normal Rate of Return} = \frac{\text{Earnings}}{\text{Market Price}} \times 100$$
$$= \frac{15\text{ (Given)}}{120\text{ (Given)}} \times 100 = 12.5\%$$

Calculation of capitalization factor Formula->

$$\text{Capitalization Factor} = \frac{100}{\text{Normal Rate of Return}}$$
$$= \frac{100}{12.5\%\text{ (Step 1)}} = 8$$

Determination of PE ratio Formula->

$$\text{PE Ratio} = \frac{\text{Market Price}}{\text{Earnings per Share}}$$
$$= \frac{120}{15} = 8$$

PE ratio can also be determined dividend 100 by normal rate of return as:

$$\text{PE Ratio} = \frac{100}{12.5\%} = 8$$

Hence PE ratio = Capitalization factor

$$\begin{array}{ccc} \text{i.e., } 8 & = & 8 \\ \downarrow & & \downarrow \\ \text{(Step 3)} & : & \text{(Step 2)} \end{array}$$

Determination of value of each equity share on yield basis:

1. Calculation of capitalized value of earnings:

Formula = Future maintainable Profits × Capitalization Factor

=Rs. 15,00,00 × 8

Capitalized value of earnings = ₹ 1,20,00,000

$$\text{Value of each equity share} = \frac{\text{Capitalized Value of Earnings}}{\text{Number of Equity Shares}}$$

$$= \frac{₹\,1,20,00,000}{1,00,000} = ₹\,120$$

Example 15:

'EX' Ltd. has earning per share of Rs. 25 and is quoted at Rs. 225. WHY Ltd., a similar firm, has earnings per share of Rs. 20. Determine the value of the share of 'WHY' Ltd.

Solution:

Step 1: First, Determine the Value of Share of X Ltd as:

$$\text{Formula: PE Ratio} = \frac{\text{Market Price}}{\text{EPS}} = \frac{₹\,225}{₹\,25} = 9$$

PE Ratio of 'X' Ltd. = 9

Step 2: Value of Share of 'Y' Ltd:

= EPS (of Y Ltd) × PE Ratio (of Similar Firm ×)

= ₹ 20 × 9 = ₹ 180

Example 16:

Prabhu Dev Ltd. is a going concern and its directors who are also owners have decided to sell their business. They have approached you to make an assessment of the price per equity share a purchaser might offer. The relevant information is as follows:

Balance Sheet as on 31 March 2018

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets (Net Book Value)	
50,000 Equity Shares of ₹ 10 Each	5,00,000	Land & Buildings	14,00,000
Reserves Dividend Equalization Fund	12,00,000	Plant & Equipment	7,50,000
Secured Loan	1,50,000	Motor Vehicle	1,40,000
Staff Welfare Fund	6,00,000	Intangible Assets	10,000
Current Liabilities	50,000	Current Assets:	
Creditors	2,75,000	Stock	3,00,000
Accrued Expenses	1,25,000	Debtors	2,50,000
Proposed Dividend	75,000	Cash and Bank	50,000
		Deferred Advertisement Cost	75,000
	29,75,000		29,75,000

Net profits after tax and interest but before payment of dividends were: 2013–14: Rs. 1,50,000; 2014–15: Rs. 1,60,000; 2015-16: Rs. 1,20,000; 2016–17: Rs. 1,50,000; 2017–18: Rs. 1,70,000.

The fixed assets of the company have been valued by independent experts as follows:
Land & Buildings Rs. 17,40,000 **Plant & Equipment** Rs. 8,60,000 **Motor Vehicle** Rs. 1,00,000

The applicable price earnings PE ratio is 10. You are required to compute the value per equity share of the company based on:

1. Net assets
2. PE ratio

Solution:

1. Computation of value per equity share: Net assets method

Step 1:	Assets (At Market Value)		₹
	(i) Land & Buildings		17,40,000
	(ii) Plant & Equipment		8,60,000
	(iii) Motor Vehicles		1,00,000
	(iv) Stock		3,00,000
	(v) Debtors		2,50,000
	(vi) Cash & Bank		50,000
	Total Assets		33,00,000
Step 2:	Less: Liabilities:	₹	
	(i) Secured Loan	6,00,000	
	(ii) Creditors	2,75,000	
	(iii) Accrued Expenses	1,25,000	10,00,000
Step 3:	Net Assets (Step 1 – Step 2)		23,00,000

Step 4: Value Per Equity Share: (Including Dividend)

$$\text{Formula} = \frac{\text{Net Assets Available}}{\text{Number of Equity Shares}} \text{ (Including Dividend)}$$

$$= ₹\frac{23,00,000}{50,000} = ₹46$$

Value Per Equity Share (Cum Dividend) = ₹46

Step 5: Value Per Equity Share Excluding Dividend:

$$= \frac{\text{Net Assets Available Excluding Dividend}}{\text{Number of Equity Shares}}$$

$$= ₹23,00,000 - ₹75,000$$

$$= \frac{\text{(Step 3) (Given)}}{50,000} = \frac{22,25,000}{50,000} = ₹44.50$$

Value Per Equity Share (Excluding Dividend) = ₹44.50

2. Computation of Value of Each Equity Share: PE Ratio Method

Step 1: Profits Before Dividend for Last 5 Years:

₹1,50,000 + ₹1,60,000 + ₹1,20,000 + ₹1,50,000 + ₹1,70,000 = ₹7,50,000

i.e., Total Profits = ₹7,50,000

Step 2: $\text{Average Profit} = \frac{\text{Total Profit}}{\text{Number of Years}} = \frac{₹7,50,000}{5} = ₹1,50,000$

Step 3: Earnings Per Share:

$$\text{Formula: } \frac{\text{Average Profits}}{\text{Number of Shares}} = \frac{₹1,50,000}{50,000} = ₹3$$

Step 4: PE Ratio

Step 5: Value Per Equity Share = EPS × PE Ratio = ₹3 × 10

= ₹30

Assumptions:

- Intangible assets—no market value—ignored
- No liabilities with respect to staff welfare as it is a free reserve.
- Deferred advertisement cost—not categorized as asset.

ISSUE AND REDEMPTION OF PREFERENCE SHARES

Subject to the provisions of Section 80 of the Companies Act, a company limited by shares may, if so authorized by its articles, issue preference shares which are, or at the option of the company are to be liable, to be redeemed. Some of the important provisions of this section are as follows:

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.

No such shares shall be redeemed unless they are fully paid. To redeem partly paid preference shares, a Call has to be made to make them fully paid.

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

Where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have seen available for dividend, be transferred to a reserve fund, to be called the "capital redemption reserve fund (account)", a sum equal to the nominal amount of the shares redeemed.

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

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

Where in pursuance of this section, a company has redeemed or is about to redeem any preference shares, it shall have power to issue shares up to the nominal amount of the shares redeemed or to be redeemed as if those shares had never been issued; and accordingly, the share capital of the company shall not be deemed to be increased by the issue of shares in pursuance of this sub-section. (Section 611).

Provided that, where new shares are issued before the redemption of the old shares, the new shares shall not, so far as it relates to stamp duty, be deemed to have been issued in pursuance of this subsection unless the old shares are redeemed within one month after the issue of the new shares.

The capital redemption reserve (CRR) account may be applied by the company in paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares. CRR cannot be utilized for any other purpose.

Notwithstanding anything contained in this Act, no company limited by shares shall, after the commencement of the Companies (Amendment) Act, 1996, issue any preference share which is irredeemable or is redeemable after the expiry of a period of 20 years from the date of its issue.

According to Section 80A, every preference share issued before the commencement of the Companied (Amendment) Act 1988, which is irredeemable, shall be redeemed by the Company within a period not exceeding 5 years from such commencement, (i.e., on or before 1993).

If it is not redeemable before the expiry of 10 years from the date of issue thereon in accordance with the terms of its issue and which had not been redeemed before such commencement, shall be redeemed by the company on the date on which such share is due for redemption or within a period of not exceeding 10 years from such commencement, whichever is earlier. That means all the existing redeemable preference shares shall be redeemed on their due dates or within 10 years (i.e., on or before 1998).

Provided that, where a company is not in a position to redeem any such share within the aforesaid period and to pay the dividend, if any, due thereon (such shares being here after referred to as unredeemed preference shares), it may with the consent of the Tribunal, issue further redeemable preference shares equal to the amounts due.

DETERMINATION OF THE AMOUNT OF NEW ISSUE

After familiarizing with the legal provisions with respect to issue and redemption of preference shares, we have to understand the term "minimum fresh issue of shares". In general, companies decide to utilize all the permissible reserves, for the redemption and for the balance amount, if any required, to make new issue of shares. The main objective is to minimize the quantum of new issue of shares:

That minimum new issue shall be made

At par (or)

At a premium (or)

At a discount

The amount of such new issue is ascertained by using the following formula:

$$\begin{Bmatrix}\text{Minimum issue}\\ \text{to be made}\end{Bmatrix} = \begin{Bmatrix}\text{Face value of redeemable preference shares + Premimum payable on redemption}\\ \text{– Securities premium in balance sheet – Revenue reserves in balance sheet}\end{Bmatrix} \times \frac{100}{\text{Premium percentage on new issue (or) 100 – Discount percentage on new issue}}$$

Illustration 1

Model: Minimum fresh issue of shares

From the following particulars, determine minimum fresh issue of shares when the fresh issue is (i) at par; (ii) at a premium of 10% and (iii) at discount of 10%.

Redeemable preference shares to be redeemed are images 3,00,000; premium payable on redemption is 5%; securities premium in balance sheet is images 20,000. Revenue reserve in balance sheet is images 1,30,000.

Solution

(i) When fresh issue is made at par:

1. The formula is $\begin{Bmatrix}\text{Minimum fresh}\\ \text{issue}\end{Bmatrix} = \begin{Bmatrix}\text{Face value of redeemable preference shares + Premimum payable on redemption}\\ \text{– Securities premium in balance sheet – Revenue reserves in balance sheet}\end{Bmatrix}$
2. Substitute the values (given in problem) in the formula Minimum fresh issue
$= \left\{3,00,000 + \left(\frac{5}{100} \times 3,00,000\right) - 20,000 - 1,30,000\right\}$
$= ₹\,3,00,000 + ₹\,15,000 - ₹\,20,000 - ₹\,1,30,000$
$= ₹\,3,15,000 - ₹\,1,50,000$
$= ₹\,1,65,000$

Face value of fresh issue = Rs. 1,50,000
Premium on the fresh issue = Rs. 1,50,000 × 10/100
= 15,000
3. When fresh issue is at 10% discount:
Formula is $\begin{Bmatrix}\text{Minimum fresh}\\ \text{issue}\end{Bmatrix} = \begin{Bmatrix}\text{Face value of share + Premimum on redemption}\\ \text{– Securities premium – Revenue reserves}\end{Bmatrix} \times \frac{100}{100 - \text{Discount percentage}}$

Substitute the values in the formula, Minimum fresh issue:
$= \left\{3,00,000 + \left(\frac{5}{100} \times 3,00,000\right) - 20,000 - 1,30,000\right\} \times \frac{100}{100 - 10\%}$
$= ₹\,1,65,000 \times \frac{100}{90}$
$= ₹\,1,83,333$

Face value of fresh issue = Rs. 1,83,333
Discount on fresh issue = Rs. 1,83,333 × 10/100
= Rs. 18,333
Hence, net proceeds = Rs. 1,83,333 – Rs. 18,333
= Rs. 1,65,000

NOTE: Adjustment for fresh issue of shares:

The fresh issue will be adjusted for higher ten, if the face value is Rs. 10 and adjusted for higher hundred, if the face value is Rs. 100.

To illustrate, in the above illustration—when fresh issue is issued at discount—the number of shares will be 18,340 if the issue price is Rs. 10,the number of shares to be issued will be 18,400 if the face value is Rs. 100. It is to be noted here that adjustment should not be made to the nearest ten or hundred rupees. It must be adjusted for higher ten or higher hundred as illustrated above. The reason is that it will result in complications as the entire permissible reserve is already utilized to ascertain fresh issue.

Journal entries to be passed for issue and redemption of preference shares:

I: Entries for receiving cash:

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
(i)	Final Call On Partly Paid Preference Shares:				
	Redeemable Preference Share Final Call A/c	Dr.		—	
	To Redeemable Preference Share Final Call A/c				—
	(Final Call Money Due or to be Received)				
(ii)	On Receipt of Final Call Amount:				
	Bank A/c	Dr.		—	
	To Redeemable Preference Share Final Call A/c				—
	(Final Call Amount Received)				
(iii)	(a) On Sale of Assets at a Loss:				
	Bank A/c (Actual Cash Received)	Dr.		—	
	Profit & Loss A/c (Loss on Sale)	Dr.		—	
	To Asset A/c (Book Value)				—
	or				
	To Investment A/c				—
	(Sale of Investment/Assets as a Loss)				
(iii)	(b) On Sale of Assets at a Profit:				
	Bank A/c (Actual Cash Received)	Dr.		—	
	To Profit & Loss A/c (Profit)				—
	To Asset A/c (Book Value)				—
	or				
	(Sale of Asset at a Profit Investment A/c)				—
(iv)	New Issue of Debentures or Bonds:				
	Bank A/c	Dr.		—	
	To … % Debentures A/c				—
	To … % Bonds A/c				—
	(Issue of Bonds/Debentures)				
(v)	New Issue of Shares at a Premium:				
	Bank A/c	Dr.		—	
	To Share Capital A/c				—
	To Securities Premium A/c				—
	(New Issue of Share at a Premium for Redemption of Preference Shares)				

II: Entries for Transfers:

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
(i)	For Transfer to Capital Redemption Reserve:				
	General Reserve A/c	Dr.		—	
	Profit & Loss A/c	Dr.		—	
	To Capital Redemption Reserve A/c				—
	(Transfer of Revenue Reserves to Capital Redemption Reserve A/c for Redemption)				
(ii)	For Redeemable Preference Share Capital and Premium Payable on Redemption:				
	Redeemable Preference Share Capital A/c	Dr.		—	
	Premium on Redemption A/c	Dr.		—	
	To Redeemable Preference Shareholders A/c				—
	(Transfer of Share Capital and Premium Payable to Shareholders)				
(iii)	For Adjustment of Premium Payable on Redemption:				
	Securities Premium A/c	Dr.		—	
	Profit and Loss A/c	Dr.		—	
	To Premium on Redemption A/c				—
	(Premium Payable Adjusted from Securities Premium or Profit and Loss A/c)				
III:	Entry for Cash Payment:				
	Redeemable Preference Shareholders A/c	Dr.		—	
	To Bank A/c				—
	(Final Payment Made to Shareholders)				
IV:	Entries for Bonus Issue:				
(i)	For Ddeclaration of Bonus:				
	Capital Redemption Reserve A/c	Dr.		—	
	General Reserve A/c	Dr.		—	
	Profit & Loss A/c	Dr.		—	
	To Bonus to Shareholders A/c				—
	(Bonus Payable to Shareholders)				
(ii)	For Issue of Bonus Shares:				
	Bonus to Shareholders A/c	Dr.		—	
	To Equity Share Capital A/c				—
	(Issue of Bonus Shares to the Equity Shareholders)				

STAGES IN SOLVING PROBLEMS

The following are the important stages in solving problems with respect to redemption of preference shares:

Stage 1—Ascertainment of Amount of Capital Redemption Reserve (CRR)

Preference shares may be redeemed in one of the following ways:

1. Out of revenue reserves
2. Out of the proceeds of a fresh issue of shares
3. Combination of (1) and (2)

The amount to be transferred to CRR may be ascertained by using the following formula:

Amount to be transferred to CRR = Face value of preference shares to be redeemed −Amount received from new issue of shares (excluding premium)

In case if new issue is not given in the problem, minimum fresh issue must be ascertained before ascertaining the transfer to CRR.

NOTE: If revenue reserves are used, an equal amount has to be transferred to CRR.

Stage 2—Premium on Redemption of Preference Shares

Premium on the redemption of preference shares, if any, has to be provided in the following order:

Source (i): Securities premium existing in the balance sheet
Source (ii): Premium on new issue of shares
Source (iii): Revenue reserves

Stage 3—Tackling "Cash Problem"

Cash position may not be strong even in reputed companies. Cash problem, i.e., shortage of cash, may arise in certain companies. Shortage of cash is to be determined in the following way:

Step 1:	Face value of preference shares to be redeemed:	…
Step 2:	Add: Premium payable on redemption:	…
Step 3:	Total cash required for redemption	xxx
Step 4:	Less: Final call received on partly paid redeemable preference shares	…
		xxx
Step 5:	Less: Cash received from new issue of shares or debentures	…
		xxx
Step 6:	Less: Cash or bank balance given in the balance sheet	…
Step 7:	Shortage of cash to redeem preference shares	xxx

Shortage of cash is determined one of the following orders, which are based on assumption:

Investments in balance sheet are sold at par
Trade debtors are realized at par
Bank overdraft is utilized to the possible limit

Stage 4—Transfers and Payment

Step 1:	Revenue reserves that are used for redemption of preference shares have to be transferred to CRR account.
Step 2:	Premium on redemption has to be provided out of appropriate source of accumulated profits.
Step 3:	These two, i.e., redeemable preference share capital and premium payable on redemption, have to be transferred to each preference shareholders' account individually.
Step 4:	In general, cash payment has to be made to the shareholder

Stage 5: Bonus Issue of Shares

If bonus issue is mentioned in the question, then bonus issue has to be made. Bonus issue is primarily made out of CRR. In case CRR is insufficient, capital profits has to be utilized for issue of bonus shares. Even then, if it is not sufficient, revenue profits can also be utilized for issue of bonus shares. In general, bonus shares are issued to the existing equity shareholders in an appropriate ratio, to be decided by the Board of Directors.

At this stage, one has to understand the terms "revenue profits" and "capital profits" and their inherent characteristics constituents:

Revenue profits (or) profits that are transferable to CRR are as follows:

1. It generally represents or forms part of general reserve
2. It is dividend equalization reserve
3. It is also a reserve fund
4. It represents revenue portion of profit on sale of investment and fixed assets
5. Profits available for dividend
6. Profits that can be transferable to CRR are revenue profits
7. Workmen's compensation fund
8. Insurance fund
9. Debenture redemption fund
10. Profit and loss account
11. Workmen's accident fund
12. Debenture redemption account

Capital profits (or) profits which cannot be transferable to CRR are as follows:

1. It represents only capital reserves and not general reserves
2. Profits prior to incorporation
3. It represents capital portion of profit on sale of fixed assets and investments
4. Securities premium account
5. Depreciation reserve
6. Forfeited shares account
7. Existing CRR

8. Development rebate reserve

Illustration 2

Redemption of preference shares out of revenue reserves

Papa & Beta Ltd. issued 1,00,000 equity shares of Rs. 10 each and 7,500 redeemable preference Shares of Rs. 100 each, all shares being fully called and paid up on 31 March 2018. Profit and loss account showed undistributed profits of Rs. 5,00,000 and general reserve stood at Rs. 4,00,000. On 1 April 2018, the directors decided to redeem the existing preference shares at Rs. 110 utilizing as much profits as would be required for the purpose.
You are required to pass the necessary journal entries in the books of the company.

Solution
NOTE:
General reserve account has to be exhausted for creating CRR account and any balance required has to be utilized from P&L A/c.
In this question, amount equal to nominal value is 7,500 × Rs. 100—Rs. 7,50,000. General reserve account stood at Rs. 4,00,000 Balance to be made from P&L at Rs. 3,50,000.

As securities premium account is not given in the question, premium payable on redemption of preference shares has to be adjusted against P&L A/c.
In this question, premium is Rs. (110 - 100) Rs. 7,500 = Rs. 75,000.

Now, the necessary journal entries have to be passed in the order as shown below:

Papa & Beta Ltd
Journal Entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 April 2011	(i) For Transfer to CRR:				
	General Reserve A/c	Dr.		4,00,000	
	Profit & Loss A/c	Dr.		3,50,000	
	To Capital Redemption Reserve A/c				7,50,000
	(Transfer Made out of General Reserve and Profit & Loss A/c for Redemption—See Note 1 Above)				
1 April 2011	(ii) For Redeemable Preference Share Capital and Premium Payable On Redemption:				
	Redeemable Preference Share Capital A/c	Dr.		7,50,000	
	Premium On Redemption A/c	Dr.		75,000	
	To Redeemable Preference Share Holders A/c				
	(Transfer of Share Capital and Premium Payable to Preference Shareholders)				8,25,000
1 April 2011	(iii) For Adjustment of Premium Payable On Redemption:				
	Profit & Loss A/c	Dr.		75,000	
	To Premium On Redemption of Pref. Shares A/c				75,000
	(Premium Payable Adjusted from P&L A/c) (See Note 2)				
1 April 2011	(iv) On Cash Payment:				
	Redeemable Preference Shareholders A/c	Dr.		8,25,000	
	To Bank A/c				8,25,000

Illustration 3

Redemption of preference shares—At Par and out of profits

The following is the extract of balance sheet of Shiva Co. Ltd. as on 31 March 2018:

Share Capital	Amount
1,00,00 Equity shares of 10 each	10,00,000
20,000 redeemable preference shares	20,00,000
Capital reserve	8,00,000
General reserve	7,50,000
Profit & Loss A/c	20,00,000

Solution : **BASIC CALCULATION:**

$$\left\{\begin{matrix}\text{Amount to be transferred equal to} \\ \text{nominal value of shares to be redeemed}\end{matrix}\right\} = \text{Number of shares} \times \text{Face value}$$

$$= 20{,}000 \times ₹\,100$$

$$= ₹\,20{,}00{,}000$$

Amount available in general reserve = Rs. 7,50,000

Balance to be met from P&L A/c = (Rs. 20,00,000 – Rs. 7,50,000) = Rs. 12,50,000

Journal Entries

Date	Particulars		L.F	Dr. ₹	Cr. ₹
1 January 2011	(i) For Transfer of an Amount:				
	General Reserve A/c	Dr.		7,50,000	
	Profit & Loss A/c	Dr.		12,50,000	
	To Capital Redemption Reserve A/c				20,00,000
	(Transfer of an Amount to CRR Ref: Basic Calculation)				
	(ii) For Amount Payable On Redemption:				
	Redeemable Preference Share Capital A/c	Dr.		20,00,000	
	To Redeemable Pref. Shareholders A/c				20,00,000
	(Amount Payable On Redemption of Preference Shares)				
	(iii) For Payment Made to Shareholders:				
	Redeemable Preference Shareholders A/c	Dr.		20,00,000	
	To Bank A/c				
	(Payment Made to Preference Shareholders on Redemption)				20,00,000

Illustration 3

Redemption of preference shares—At premium and out of profits

The balance sheet of Krish Ltd. as on 31 March 2018 was as follows:

Liabilities	₹	Assets	₹
1,00,000 Equity Shares of ₹ 10 Each, Fully Paid	10,00,000	Sundry Assets	15,00,000
5,000 Redeemable Preference Shares of ₹ 100 Each, Fully Paid	5,00,000	Bank Balance	9,50,000
Profit & Loss A/c	8,00,000		
Creditors	1,50,000		
	24,50,000		24,50,000

On the above date, the preference shares were redeemed at a premium of 10%.
You are required to:
Pass journal entries
Construct the amended balance sheet

Solution:

NOTE: As general reserve is not given in the problem, entire amount for redemption is to be utilized in P&L A/c only.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
31 March 2011	(i) For Creation of CRR:			
	Profit & Loss A/c Dr.		5,50,000	
	To Capital Redemption Reserve A/c			5,00,000
	To Premium On Redemption of Pref. Shares			50,000
	(Provision of Premium and Creation of CRR)			
	(ii) For Transfer of Amount Due on Redemption to Shareholders A/c:			
	Redeemable Preference Share Capital A/c Dr.		5,00,000	
	Premium On Redemption Pref. Shares A/c Dr.		50,000	
	To Redeemable Pref. Shareholders A/c			5,50,000
	(Amount Due On Redemption Transferred to Pref. Shareholders A/c)			
	(iii) For Payment Made On Redemption:			
	Redeemable Preference Shareholders A/c Dr.		5,50,000	
	To Bank A/c			5,50,000
	(Payment Made On Redemption)			

llustration 5

Redemption at par and out of fresh issue

M/s Aashique Ltd. has part of its share capital as 8,000 redeemable preference shares of Rs. 50 each. When the shares became due for redemption, the company decided that the whole amount will be redeemed out of a fresh issue of equal amount of equity shares of Rs. 10 each.
You are required to pass the journals entries in the books of the company.

Solution

As the entire amount required for redemption of preference shares will have to be met by fresh issue of equity shares, first the amount needed is determined as follows:
Value of preference shares to be redeemed = 8, 000 × Rs. 50
= Rs. 4, 00, 000
∴ Number of fresh issue of equity shares

$$= \frac{₹4,00,000}{₹10}$$

$$= 40,000$$

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) For fresh issue of Equity Shares:			
	Bank A/c Dr.		4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Fresh Issue of 40,000 Equity Shares @ ₹ 10 Each, for Redemption of Preference Shares)			
	(ii) For Amount Due to Pref. Shareholders:			
	Redeemable Preference Share Capital A/c Dr.		4,00,000	
	To Redeemable Preference Shareholders A/c			4,00,000
	(Amount Due to Pref. Shareholders On Redemption of 8,000 Pref. Shares of ₹ 50 Each)			
	(iii) For Payment to Pref. Shareholders:			
	Redeemable Preference Shareholders A/c Dr.		4,00,000	
	To Bank A/c			4,00,000
	(Payment to Pref. Shareholders).			

Illustration 6

Redemption at par partly out of profits and partly out of fresh issue

M/s Laila Ltd. has part of its share capital in 5,000 12% redeemable preference shares of Rs. 100 each. The general reserve of the company shows a credit balance of Rs. 6,00,000. The directors decided to utilize 70% of the reserve in redeeming the preference shares and the balance is to be met from the proceeds of the fresh issue of sufficient number of equity shares of Rs. 10 each.
Give journal entries to record these transactions.

Solution

BASIC CALCULATIONS:

1. CRR to be created = 70% of the reserve (Partly out of profits) = 70% of 6,00,000 = Rs. 4,20,000
2. Number of fresh issue of shares:
   Balance = (Rs. 5,00,000 – Rs. 4,20,000) = Rs. 80,000 $= \frac{₹\,80{,}000}{₹\,10} = ₹\,8,000$

M/s Laila Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) For Creation of CRR:			
	General Reserve A/c Dr.		4,20,000	
	To Capital Redemption Reserve A/c			4,20,000
	(CRR Created Out of General Reserve 70% (Ref: Basic Calculation 1) for Redemption of Preference Shares: Partly Out of Profits)			
	(ii) For Fresh Issue of Equity Shares:			
	Bank A/c Dr.		80,000	
	To Equity Share Capital A/c			80,000
	(8,000 Equity Shares Issued @ ₹ 10 Each for Redemption: Partly Out of Fresh Issue)			
	(iii) For the Amount Due to Pref. Shareholders:			
	Redeemable Preference Share Capital A/c Dr.		5,00,000	
	To Redeemable Preference Shareholders A/c			5,00,000
	(Amount Due to Pref. Shareholders On Redemption of 5,000 Pref. Shares @ ₹ 100 Each)			
	(iv) For Payment to Preference Shareholders:			
	Redeemable Preference Shareholders A/c Dr.		5,00,000	
	To Bank A/c			5,00,000
	(Payment of Amount to Pref. Shareholders)			

Illustration7

Redemption of preference shares at par—Fresh issue at premium
On 31 March 2018, the balance sheet of Majnu Ltd. stood as follows:

Liabilities	₹	Assets	₹
Equity Share Capital	15,00,000	Sundry assets	19,00,000
Redeemable Pref. Share Capital	6,00,000	Bank	8,50,000
Profit & Loss Account	4,00,000		
Sundry Creditors	2,50,000		
	27,50,000		27,50,000

On the above date, the preference shares have to be redeemed. 30,000 Equity shares of Rs. 10 each are issued at Rs. 11. The company also issued 10% debentures totaling Rs. 4,00,000. The shares and debentures are fully subscribed and paid for. The preference shares are duly redeemed.
You are required to give journal entries and the balance sheet after redemption.

Solution

BASIC CALCULATION:
Total amount required for redemption = Rs. 6,00,000

Amount realized on issue of fresh shares = Rs. 3,00,000

∴ Balance required = Rs. 3,00,000

Rs. 3,00,000 has to be transferred to CRR out of profits, i.e., from P&L A/c in this question.

Journal Entries

Date	Particulars		L.F.	Dr. (₹)	Cr.(₹)
31 March 2011	Bank A/c	Dr.		7,30,000	
	To Equity Share Capital A/c (30,000 × ₹ 10)				3,00,000
	To Securities Premium A/c (30,000 × ₹ 1)				30,000
	To 10% Debentures A/c				4,00,000
	(Issue of 30,000 Equity Shares of ₹ 10 Each at a Premium of ₹ 1 and 10% Debentures ₹ 4,00,000)				
	Profit & Loss Account	Dr.		3,00,000	
	To Capital Redemption Reserve A/c				3,00,000
	(Balance Required Transferred to CRR Ref: Basic Calculation)				
	Redeemable Preference Share Capital A/c	Dr.		6,00,000	
	To Redeemable Preference Shareholders A/c				6,00,000
	(Transfer of Amount to Preference Shareholders on redemption)				
	Redeemable Preference Shareholders A/c	Dr.		6,00,000	
	To Bank A/c				6,00,000
	(Payment to Preference Shareholders				

Balance Sheet of Radha Ltd. as on 31 March 2018 (After Redemption)

Liabilities	₹	Assets		₹
Share Capital:		Sundry assets		19,00,000
Equity Share Capital (₹ 15,00,000 + ₹ 3,00,000)	18,00,000			
Reserve & Surplus:		Bank	₹ 8,50,000	
Securities Premium A/c	30,000		+ ₹ 7,30,000	
			₹ 15,80,000	
		Less:	6,00,000	9,80,000
Capital Redemption Reserve A/c	3,00,000			
Profit & Loss A/c (₹ 4,00,000 – ₹ 3,00,000)	1,00,000			
Secured Loan:				
10% Debentures	4,00,000			
Current Liabilities:				
Sundry Creditors	2,50,000			
	28,80,000			28,80,000

Illustration 8

Redemption at a premium—Partly out of profits and partly out of fresh issue of shares at par

Yaari Ltd. have part of their share capital in 4,000 10% redeemable preference shares of Rs. 100 each. The Company decided to redeem the preference shares at premium of 10%. The general reserve of the company stood at Rs. 5,00,000. The directors decided to utilize 50% of the reserve in redeeming the preference shares and the balance is to be met from the proceeds of fresh issue of sufficient number of equity shares of Rs. 10 each. The premium on redemption is to be met from the year's profit and loss appropriation account.

Give journal entries to record the above transactions.

Solution

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	General Reserve A/c Dr.		2,50,000	
	To Capital Redemption Reserve A/c			2,50,000
	(50% of Reserve, i.e., 50% of 5,00,000 ₹ 2,50,000 is Created and Transferred to CRR)			
	Bank A/c Dr.		1,50,000	
	To Equity Share Capital A/c			1,50,000
	(For the Remaining ₹ 1,50,000—15,000 Equity Shares of ₹ 10 Each Issued)			
	Redeemable Preference Share Capital A/c Dr.		4,00,000	
	Premium On Redemption of Preference Shares A/c Dr.		40,000	
	To Redeemable Preference Shareholders A/c			4,40,000
	(Amount Payable to the Redeemable Preference Shareholders)			
	Profit and Loss Appropriation A/c Dr.		40,000	
	To Premium On Redemption of Pref. Shares A/c			40,000
	(Premium On Redemption Provided Out of P&L Appropriation A/c)			
	Redeemable Preference Shareholders A/c Dr.		4,40,000	
	To Bank A/c			4,40,000
	(Payment to Redeemable Pref. Shareholders On Redemption)			

Issue and Redemption of Debentures

MEANING AND DEFINITION OF DEBENTURE

According to Section 2(12) of the Companies Act, 1956, "Debenture" includes, "a debenture stock, bonds and any other securities of the company whether constituting a charge on the assets of a company or not."

The features of a debenture which are given as follows:

- Debenture is a document given by the company in the form of a certificate.
- It is an instrument of debt owed by a company
- Mostly, it is secured by a charge
- Generally, this instrument (Debenture) specifies
    - Value (Normal or par)
    - Rate of interest
    - Periodicity of payment
    - Tenure
    - Terms of Redemption
- Usually, they are issued under the common seal of the company

MEANING OF SOME TERMS

Bond: Bond, like debenture, is also an instrument of debt. Contents and texture are similar to that of debenture. However, the main difference between bond and debenture is with respect to issue condition: A bond can be issued without pre-determined rate of interest.

Example: Deep discount bond, Zero coupon bond.

Debenture stock: Generally, individual debenture certificates are issued. For instance, a single debenture may be issued to one person. Sometimes, a company will create one loan fund. This is intended for a specified group. Each person in the group will be given a debenture stock certificate which specifies the part of the loan to which such person is entitled. Debenture stock is a document representing the loan capital of the company. The loan is consolidated into a single composite unit. This unit may be divided into a number of units of fixed amount, which may be of any denomination. Certificates are issued indicating each debenture stockholder's contribution.

The differences between "debenture" and "debenture stock" are depicted in the following table.:

Basis of Distraction	Debenture	Debenture Stock

1. Nature	Debenture is the description of an instrument.	This is the description of a debt.
2. Creation of charge	Each debenture may create a separate charge.	Charge is created by a “trust deed”.
3. Transferability	Debenture is transferable in its entirety. Transfer in parts may not be possible.	Debenture stock may be transferable in parts, if articles permit.
4. Payment	A debenture may be either fully paid or partly paid.	The debenture stock must be fully paid.
5. Amount	Debenture is always for a fixed sum.	Here, the sum is not a fixed but may be of any amount.

Charge:

A charge is an encumbrance to meet the obligation. That means, the company agrees to mortgage specific part of the assets towards the loan. Lenders have the right to secure their payment from the assets mortgaged. A charge may be first one or second charge. A charge may be either fixed charge or floating charge.

Some charges included in the category of charge are:

- A charge for the purpose of securing any issue of debenture.
- Uncalled share capital of the company.
- Any immovable property
- Any book debts of the company
- Any movable property (not pledged)
- Floating charge or any undertaking of the property
- Charge on calls unpaid
- Goodwill and other patents, copyrights obtained under Copyright Act

The Companies Act stipulates specifically that all charges should be registered with the Registrar of Companies.

Fixed charge: This is also known as “specific charge”. This is created on definite, specific assets of permanent nature.

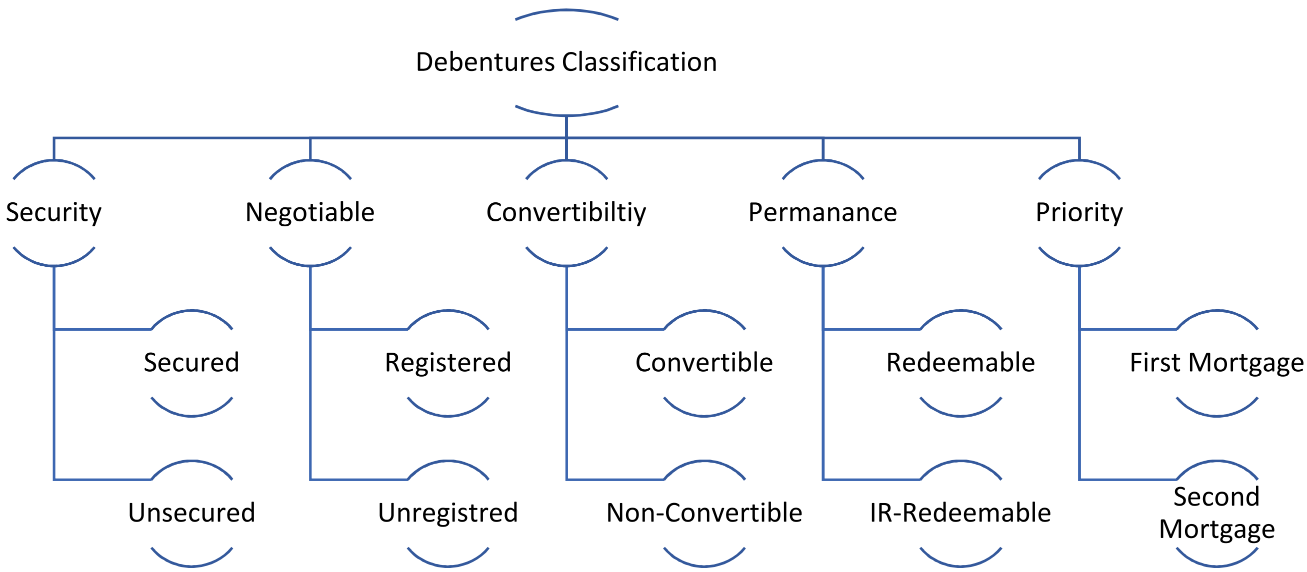
Example: Land, machinery, etc.

Floating charge: A charge is said to be “floating” when no specific asset but all assets are charged as security.

Note: In the event of winding up, this category holders have preference over unsecured creditors to settle the claim.

TYPES OF DEBENTURES

Debentures may be classified as below:



From Security Viewpoint

This may further be classified into two categories: (i) secured debentures and (ii) unsecured debentures.

Secured debentures: When debentures are secured by either a fixed charge or floating charge on the property of the company, they are called mortgage or secured debentures. A "mortgage deed", also known as Trust deed, has to be entered into between the parties.

Unsecured debentures: When debentures are issued without any charge or security, they are called unsecured or naked debentures. They have no security. They do not enjoy any special rights.

From Negotiable Viewpoint

These can also be classified into two categories (i) registered debentures and (ii) bearer debentures.

1. Registered debentures:

    1. Name, address and the required particulars of holders of this kind of debentures are entered in a register known as debenture ledger.
    2. The register is maintained by the Registrar.
    3. These are transferable but transfer requires execution of transfer deed.

2. **Bearer debenture:**

    0. These need not get registered and the company does not maintain any records.
    1. These can be transferred easily by mere delivery like a negotiable instrument.
    2. The interest and the principal amount on these debentures shall be payable upon presentation and delivery of the coupons and debentures.

From Redemption Viewpoint

These also can be classified into two categories: (i) redeemable debenture and (ii) irredeemable debenture.

Redeemable debenture: These debentures are to repaid by the company at the end of the specified period. It is repaid during the existence of the company.

Irredeemable debenture: These are not repayable during the lifetime of the company. They are perpetual. When the company is wound up, these will be repaid.

From Priority Viewpoint

These also may be classified into two categories: (i) first debentures and (ii) second debentures.

First debentures: These debentures will be repaid before and prior to other debentures. They have priority over others.

Second debentures: These debentures will be repaid only after the first debentures are redeemed.

From Convertibility Viewpoint

These also may be classified into two categories: (i) convertible debentures and (ii) non-convertible debentures

Convertible debentures:

- These many be convertible into equity or preference shares of the company.
- This may be done in accordance with the agreement between the debenture holders and the company.
- Partly convertible debentures: These debentures consist of two parts: convertible and non-convertible. The convertible part may be converted into shares at the expiry of specified period whereas the non-convertible part is redeemed in cash or the expiry of specified period. (PCD)
- Fully convertible debenture: When the entire amount of debenture is converted into shares on the expiry of specified period, they are known fully convertible debentures (FCD).

The following table gives the differences between fully convertible debentures (FCD) and party convertible debentures (PCD):

Basis of Difference	Fully Convertible Debenture (FCD)	Party Convertible Debenture (PCD)
1. Classification: As equity and debt	Classified as equity for debt equity computation.	Convertible portion is classified as “equity” and non-convertible part as “debt”.
2. Debt equity ratio	Highly favorable debt–equity ratio.	Not high but favorable debt–equity ratio.
3. Capital base	High equity capital on conversion of debentures.	Lower equity capital on conversion of debentures.
4. Equity servicing	Higher burden of equity servicing.	Lower burden of equity servicing.
5. Suitability	Suitable for companies without established track record.	Not so much suitable as FCD.
6. Creation of redemption reserve	No need arises.	Required to be created for 50% of the face value of non-convertible part of debentures.
7. Buy-back facility	Not needed	Arrangements may be made for buy-back of non-convertible part.
8. Investor’s response	Popular among the investors	Not popular among the investors.

AS per SEBI Guidelines, no company shall issue FCDs having a conversion period of more than 36 months unless conversion is made optional with “put” and “call” option.

“Call” Option: An option to buy is known as “call” option

“Put” Option: An option to sell is known as “put” option.

“Put” & “Call” Option: An option to either buy or sell is known as “put call option”.

DIFFERENCES BETWEEN SHARES AND DEBENTURES

The following table shows the differences between shares and debentures:

Basis of Difference	Debentures	Shares
1. Status	A debenture holder is a lender, i.e., a loan credit or of the company.	A shareholder is a joint owner of the company.
2. Income	Interest on debenture is pre-determined and fixed.	Dividend on shares is neither predetermined nor fixed.
3. Income payable to the holders	Debenture holders are entitled to receive interest and it is immaterial whether the company makes profit or loss.	Shareholders are entitled to receive dividend only when the company earns profit.
4. Nature with respect to profit	Interest on debenture is a charge against profit.	Dividend on shares is an appropriation of profit.
5. Refund	A debenture holder gets back amount at date of maturity.	A shareholder may not be able to get back his money on shares.
6. Safety	Debentures are secured.	Share are unsecured
7. Voting right	A debenture holder has no voting right.	A shareholder has voting right.
8. Discount on issue	Debentures can be issued at a discount. There are no legal restrictions.	Shares can be issued as a discount subject to provisions of Section 79.

9. Purchase its own debenture/share	The company can purchase its own debentures without any legal restrictions.	A company cannot purchase its own shares.
10.Priority on winding up	A debenture holder gets priority in respect of repayment when the company is wound up	Shareholders get back their money only after settlement of all other claims.

At this stage, student should be able to understand about charge—its basic nature, first charge, second charge, PARI PASSU CLAUSE, unsecured creditors, etc.

We have already explained about secured and unsecured debentures. Here, we have to learn more about unsecured debenture. Here, we have to learn more about fixed and floating charge. A "charge" is nothing but mortgage. A fixed charge is generally created on immovable assets such as land, building, machinery and so on. In case a charge is fixed, the company may enjoy the possession of the assets but cannot sell or lease without consent of the charge holders. A floating charge is mostly on movables—properties that are frequently changing. In this case, it is not mortgage of property. Example, stock in trade. The floating charge will become or attain the status of a fixed charge under the following circumstances:

1. When the company fails to pay interest or principal or both
2. When the receiver is appointed
3. When the company ceases to function
4. When the company is being wound up

First charge and second charge: First charge implies the priority of repayment. The assets against which first charge is created are first used in paying the secured lenders holding the first charge. The balance amount is used for satisfying the claims of creditors holding second charge. In case the dues of second charge holders are not fully paid off, the unpaid amount of such lenders is to be treated as unsecured. To that extent they are paid along with unsecured creditors. This concept can be explained with the help of the following illustration:

Illustration 1

Following are the relevant figures extracted from the balance sheet of XZ Ltd. as on 31 March 2011:

(₹ in Lakhs)

Liabilities	₹	Assets		₹
12% A Debentures (Secured by Charge over Land and Building)	3,000	Fixed Assets:		
		Gross Block:	10,000	
12% B Debentures (Secured by Charge over Land and Building)	2,500	Less: Depreciation Accumulated	2,000	8,000
12% C Debentures (Floating Charge)	4,000	Current Assets		4,000
Unsecured Creditors	2,500			
	12,000			12,000

NOTES TO BALANCE SHEET:

Land is valued at ₹ 2,000 lakh (Cost: ₹ 1,250 lakh)

Building is valued at ₹ 2,500 lakh (Book value: ₹ 2,000 lakh) including in gross black. Other fixed assets were estimated to be realized at ₹ 2,750 lakh and current assets are valued at ₹ 3,750 lakh.

You are required to estimate the deficiency of secured creditors who would rank as unsecured creditors. Also ascertain the amount of unsecured creditors.

Solution

	Value of Specific Assets	(₹ in Lakhs)
Part I:		
Step 1:	Calculation of Total Realizable Value of Land & Building: Realizable Value of Land (Given)	2,000
Add:	Realizable Value of Building (Given)	2,500
	Total realizable Value of Land & Building	4,500
Step 2:		
Less:	First Charge Debenture Value, i.e.	3,000
	Amount Due to 12% A Debentures Surplus Amount	1,500
Step 3:	From the Surplus Amount Left out,	

	Second Charge Debentures to Be Deducted, i.e.,	
Less:	Amount Due to 12% B Debentures	2,500
	Deficiency	1,000
Step 4:	This Deficiency (Difference) Has to Be Ranked as Unsecured Creditor	1,000
Part II:	Determination of Total Unsecured Creditors:	
		(₹ in Lakhs)
Step 1:	Unsecured Creditors as Shown in Balance Sheet	2,500
Step 2:	Add: Deficiency Arose (Ref: Part I Step 4)	1,000
Step 3:	Total Unsecured Creditors	3,500

Debentures with Pari Passu Clause

"Pari Passu" means equal in respect of charge and repayment. Debentures issued with "Pari Passu" clause means they are to be ranked together for the purpose of security created. Even though they are issued on different dates, they are to be paid rateably. The amount realized on sale of assets secured is to be divided among the debenture holders in proportion to the amount. Thus, it differs from first charge and second charge.

In case debentures are issued without "Pari Passu" clause, debentures would be paid according to the date of issue. If some of them are issued on the same date, then they will be paid according to their serial number.

DEBENTURE TRUST DEED

In case, when a series of debentures are issued by a company, it will be difficult to create charges on the assets of the company to each individual debenture holder. This necessitates for a company to execute trust deed through which the assets of the company are charged by way of mortgage to the trustees.

Debenture trust deed is a document created by the company to protect the interest of debenture holders. It is a form of a contract between the company and the trustees for the debenture holders. Debenture trust deed is to be prepared before the debentures are offered for public subscription

Who can be trustees?

In case of issue of debenture with maturity of more than 18 months, the issuer shall appoint a debenture trustee for 18 months from the following eligible list:

1. A scheduled bank carrying on commercial activity.
2. A public financial institution within the meaning of Section 4 A(1) of The Companies Act, 1956.
3. An insurance company
4. A body corporate

Who cannot be A TRUSTEE:

The following cannot be appointed as a debenture trustee:

1. A person who benefi cially holds shares in the company.
2. A person who is benefi cially entitled to receive money which are to be paid to/by the company to the debenture trustee.
3. Persons entered into any guarantee in respect of principal debts, secured by debenture or interest thereon.

The primary function and duty of every debenture trustee is to:

1. Call for periodic report from the body corporate
2. Take possession of the trust properly in accordance with the provisions of the trust deed
3. Enforce security in the interest of shareholders
4. Verify that the charge created should be completed within 30 days of issue of allotment letter and dispatch of debenture certifi cated

The following are the advantages of creating a trust deed:

1. The interests of debenture holders are safeguarded
2. Volume of work of creating charge is reduced to a great extent for the corporate body
3. Trustees act effectively by enforcing security properly
4. They act as watch dogs
5. As they are empowered, problems are resolved amicably without delay

SEBI Guidelines

Any company has to comply with the provisions issued by SEBI. Some of the revisions are:

1. Credit rating from authorized credit rating agency will have to be obtained and the same should be disclosed in the document
2. All such credit ratings obtained during the three years preceding such issue have to be disclosed in the offer document
3. A trust deed shall be executed by the company in favour of the trustees within six months of the closure of the issue
4. Trustees shall be vested with requisite powers for protecting the debenture holders
5. Trustees shall ensure the implementation of the conditions regarding creation of security for debentures and debenture redemption reserve

COUPON RATE

Usually debentures are issued with a specific rate of interest, and this specified rate interest, and this specified rate, is termed as "coupon rate". The specified rate may be fixed or floating.

The floating interest rate is usually tagged with the bank rate and yield on treasury bond plus a reward for risk. The bank rate and yield on treasury securities keep on fluctuating over a period of time. So such change is compensated in the risk premium.

Rate of interest in such a case is quoted as "PLR + 50 basis or 100 basis points".

To illustrate:

Suppose if PLR is 9%, the rate of interest will be:

PLR + 50 basis point (0.5) or 100 basis point (1)

9% + 0.5 or 9% + 1%

i.e., 9.5% or 10%

• " + basis points" is determined in relation to risk involved.

Zero Coupon Bond

A zero coupon bond does not carry any specific rate of interest. To compensate the investors, such bonds are issued at a substantial discount. The difference between the face value and issue price is the total amount of interest related to the duration of the bond

Periodic change of interest is calculated by the following formula:

$$Bo = \frac{MV}{(1+i)^n}$$

Where, Bo = Value of zero coupon bond

MV	=	Maturity value of zero coupon bond
n	=	Life of zero coupon bond
i	=	Required rate of return

To determine the value of $(1 + i)^n$, Present value Interest Factor (PVIF) Table is used.

PVIF for "i" rate of interest and "n" years is written as PVIF, i, n.

(It is given in the table—the present value of ₹ 1. To ascertain the factor, the number of years column and rate of interest column may be referred).

From the formula given above, different factors can be computed:

Bo = MV × PVIF i, n.

or

$$MV = \frac{Bo}{PVIF\ i,n}$$

or

$$PVIF\ i,n = \frac{Bo}{MV}$$

Illustration 2

ABZ Ltd. issued a zero coupon bond having 20 years maturity with face value of ₹ 1,000. At what price the company should issue the bond, if the required rate of return is 12%?

Solution

Write the formula

Bo	=	MV × PVIF i, n
i	=	12% & n = 20 years

Refer the table, the present value is given as 0.1037.

Substitute the values in the formula:

Bo	=	₹ 1,000 × 0.1037
	=	₹ 103.70

It implies that the investor will be able to get a zero coupon bond for ₹ 103.70 (today), the face value being ₹ 1,000.

ACCOUNTING FOR ISSUE OF DEBENTURES

The procedure and accounting entries for the issue of debenture are very much similar to that adopted for the issue of shares. After perusing the prospectus, the intending lenders apply for debentures in the prescribed form along with application money. Debentures, like shares, may be issued at par or at a premium or at a discount. If debentures are issued payable by application, allotment and call installments, the same procedure is to be followed as for shares; the required amount may be payable in lump sum or in instalments. Like shares, debentures can also be issued for cash, for consideration other than cash and as a collateral security.

Issue of Debentures for Cash

Accounting entries are same as in the case of shares, the difference being the world “debenture” instead of “share”, i.e., “debenture” has to be inserted in the place of “share”.

Issue of Debentures at Par

Debenture is said to be issued at par, when an investor (prospective debenture holder) pays an amount equal to the face value of the debenture.

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I: 1. On Receipt of Applications: Bank A/c Dr. To …% Debenture Application A/c (Application Money @ ₹ … Received on …. Debenture Received)		…	…
	2. On Transfer to Debenture A/c: [***Note:*** Debenture A/c itself is a debenture capital A/c …% Debenture Application A/c Dr. To Debenture A/c (Application Money Received, Transferred to Debentures A/c)		...	…
	2(a): For Refund of Excess Debenture Application Money: …% Debenture Application A/c Dr. To Bank A/c (Excess Application Money Refunded)		…	…
	Stage II: 1. On Allotment Money Due: …% Debenture Allotment A/c Dr. To Debenture A/c (Allotment Money Due on Debentures)		…	…
	1(a): Excess Debenture Application Money Adjusted on Debenture Allotment A/c: …% Debenture Application A/c Dr. To Debenture Application A/c (Excess Debenture Application Money Adjusted on Debentures Allotment A/c)		…	…
	2. On Receipt of Allotment Money: Bank A/c Dr. To % Debenture Allotment A/c (Allotment Money Received)		…	…
	Stage III: 1. On Making Calls: …% Debenture Call A/c Dr. To …% Debenture A/c (Call Money Due)		…	…
	2. On Receipt of Call Money: Bank A/c Dr. To …% Debenture Call A/c (Call Money Received)		…	…

Note:

1. Now, student may compare these entries with those made for issue of shares and notice the similarity.
2. As in shares, if more than one call is made, the accounts are aptly titled as debenture first call A/c, second call A/c and so on. Accounting entries will be the same as shown is Stage III (1 & 2) for subsequent calls made and money received on them.

Illustration 3

Model: Issue of debentures at par

ABZ Ltd. issued 5,000, 10% debentures of ₹ 100 each, payable ₹ 25 on application, ₹ 40 on allotment and ₹ 35, two months after allotment. All the debentures were duly applied for and paid.

Pass journal entries in the books of the company and also show how these will appear in the balance sheet.

Solution

Note: ₹ 35 received after allotment is to be received as "call" amount.

In the Books of ABZ Ltd.
Journal

Date		L.F.	Dr. ₹	Cr. ₹
	Stage I:			
	1. On Receipt of Application Money:			
	Bank A/c Dr.		1,25,000	
	To 10% Debenture Application A/c			1,25,000
	(Application Money @ ₹ 25 for 5,000 Debenture Received (5,000 × 25)]			
	2. On Transfer of Application Money to Debenture Capital A/c:			
	10% Debenture Application A/c Dr.		1,25,000	
	To 10 % Debenture A/c			1,25,000
	(Application Money Transferred to Debentures A/c)			
	Stage II:			
	1. On Allotment Money Due:			
	10% Debenture Allotment A/c Dr.		2,00,000	
	To 10 % Debentures A/c			2,00,000
	(Allotment Money @ ₹ 40 on 5,000 Debentures Due) (5,000 × ₹ 40)			
	2. On Receipt of Allotment Money:			
	Bank A/c Dr.		2,00,000	
	To 10% Debenture Allotment A/c			2,00,000
	(Allotment Money Received on 5,000 Debentures @ ₹ 40 per Debenture)			
	Stage III:			
	1. On Call Money Due:			
	10% Debenture Call A/c Dr.		1,75,000	
	To 10% Debentures A/c			1,75,000
	(Call Money @ ₹ 35 on 5,000 Debentures Due) 5,000 × ₹ 35)			
	2. On Receipt Call Money:			
	Bank A/c Dr.		1,75,000	
	To 10% Debenture Call A/c			1,75,000
	(Call Money Received)			

Balance Sheet of ABZ Ltd.
as at …

Liabilities	₹	Assets	₹
10% Debentures	5,00,000	Cash/Bank	5,00,000

Over-subscription of Debenture

- A Company cannot allot more debentures than it has offered for subscription.
- When applications received are more than offered for subscription of debentures, it is termed as “oversubscription” in the case of debentures.
- When applications received are more than offered for subscription of debentures, it is termed as “oversubscription” in the case of debentures.

Treatment of “over-subscription”:

The following are the three alternative approaches for dealing over-subscription:

1. **Outright rejection:** The Board of Directors can reject the excess outright. Hence, the application money received has to be returned in full.
2. **Partial or Pro-rata allotment:** In case debentures are allotted pro-rata, excess application money has to be adjusted along with allotment money.
3. **Full allotment:** The directors may make full allotment to some applicants, partial allotment to some applicants, and no allotment to the rest.

For partial allotment, excess money received on application is adjusted with allotment money. For no allotment, application money is refunded entirely.

Illustration 4

Model: Debenture issued at a premium

BXY Ltd. issued 4,000 14% debenture of ₹ 100 each payable as:

On Application	₹ 20
On Allotment	₹ 50
On First & Final Call	₹ 30 (After 3 months Allotment)

The public applied for 6,000 debentures. Applications for 3,500 debentures were accepted in full. Applicants for 1,000 debentures were allotted 500 debentures and the remaining was rejected. Pass required journal entries.

Solution

Note: This is a case of over-subscription.

Number of Debentures Issued	=	4,000
Number of Debentures Subscribed	=	6,000
∴ Excess	=	2,000
Way of Allotment:		

Fully Accepted Debentures	:	3,500
Partially Accepted Debentures	:	1,000 Debenture Applicants for 500 Debentures
Totally Rejected Debentures	:	1,500
(6,000 – 3,500 – 1,000)		

- For partially accepted, excess application money has to be adjusted to allotment money.
- For totally rejected, application money should be refunded.

Accordingly, the following accounting entries are to be passed:

Books of BXY Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I:			
	1. Bank A/c Dr.		1,20,000	
	To 14% Debenture Application A/c			1,20,000
	(Application Money Received on 6,000 Debentures @ ₹ 20 per Debenture)			
	2. 14% Debenture Application A/c Dr.		80,000	
	To 14% Debentures A/c			80,000
	(Application Money Transferred on 4,000 Debentures to Debentures Capital A/c)			
	2 (a) 14% Debenture Application A/c Dr.		30,000	
	To Bank A/c			30,000
	(Application Money Rejected on 1,500 Applications Refunded)			
	Stage II:			
	1. 14% Debenture Allotment A/c Dr.		2,00,000	
	To 14% Debentures A/c			2,00,000
	(Allotment Money Due on 4,000 Debentures @ ₹ 50 per Debenture)			
	1. (a) 14% Debenture Application A/c Dr.		10,000	
	To 14% Debenture Allotment A/c			10,000
	(Partial Allotment, i.e., Allotment of 500 Debentures, Adjusted to Allotment A/c)			
	2. Bank A/c Dr.		1,90,000	
	To 14% Debentures A/c			1,90,000
	(Allotment Money Received [1 – 1(a)]			
	Stage III:			
	1. 14% Debentures Call A/c Dr.		1,20,000	
	To 14% Debentures A/c			1,20,000
	(Call Amount ₹ 30 Due on 4,000 Debentures)			
	2. Bank A/c Dr.		1,20,000	
	To 14% Debenture Call A/c			1,20,000
	(Call Amount on 4,000 Debentures @ ₹ 30 per Debenture Received)			

Illustration 5

Model: Over-subscription—Issue of debentures at a premium

Govil & Co. Ltd. issued 10,000, 10% debentures of ₹ 50 each at a premium of 20% payable as:

On Application	:	₹ 15
On Allotment	:	₹ 30 (Including Premium)
On First & Final Call	:	₹ 15

Applications were received for 20,000 debentures. All allotment was made proportionately, oversubscription being applied to the amount due on allotment. All money was duly received.

Pass necessary journal entries.

Also pass the entry if the whole amount of debenture is collected in one instalment only.

Solution

Note:

- In this question, the entire surplus application is adjusted towards allotment. Only the remaining balance is received on allotment.
- As in the case of shares, the premium is shown separately as "Securities Premium A/c" along with the due on debenture allotment.

Over-subscription and premium will be treated as above. The required entries will have to be passed in the books of Govil & Co. Ltd. as follows:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Stage I:			
	1. Bank A/c Dr.		3,00,000	
	To 10% Debenture Application A/c			3,00,000
	(Application Money Received on 20,000 Debenture @ ₹ 15 Each)			
	2. 10% Debentures Application A/c Dr.		1,50,000	
	To 10% Debenture A/c			1,50,000
	(Transfer of Application Money on Allotment of 10,000 Debenture @ ₹ 15 Each)			
	Stage II:			
	1. 10% Debenture Allotments A/c Dr.		3,00,000	
	To 10% Debenture A/c			2,00,000
	To Securities Premium A/c			1,00,000
	(Allotment Money Due on 10,000 Debenture @ ₹ 30 Each Including a Premium of ₹ 10)			
	1 (a): 10% Debentures Application A/c Dr.		1,50,000	
	To Debenture Allotment A/c			1,50,000
	(Surplus Money Received Adjusted to Debenture Allotment Amount Due)			
	2. Bank A/c Dr.		1,50,000	
	To 10% Debenture Allotment A/c			1,50,000
	(Balance of Allotment Money Received on 10,000 Debentures)			
	Stage III:			
	1. 10% Debenture First & Final Call A/c Dr.		1,50,000	
	To 10% Debenture A/c			1,50,000
	(First & Final Call Money Due on 10,000 Debenture @ ₹ 15 Each)			
	2. Bank A/c Dr.		1,50,000	
	To 10% Debentures First and Final Call A/c			1,50,000
	(First and Final Call Money Received on 10,000 Debentures @ ₹ 15 Each)			

If the whole amount is collected in one instalment, then entry:

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Bank A/c Dr.		6,00,000	
	To 10% Debentures A/c			5,00,000
	To Premium on Issue of 10% Debentures A/c			1,00,000
	(10,000 Debentures of ₹ 50 Each Issued at a Premium of ₹ 10 Each)			

Issue of Debentures at a Discount

Illustration 6

Model: Debentures issued at discount

Azhar & Co. Ltd. issued 5,000, 10% debentures of ₹ 100 each at on discount of 5% payable ₹ 40 on application and the balance on allotment. Pass the necessary journal entries.

Solution

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	STAGE I:			
	1. Bank A/c Dr.		2,00,000	
	To 10% Debenture Application A/c			2,00,000
	(Application Money Received on 5,000 Debentures @ ₹ 40 per Debentures)			
	2. 10% Debentures Application A/c Dr.		2,00,000	
	To 10% Debentures A/c			2,00,000
	(Application Money Transferred to Debentures A/c)			
	STAGE II:			
	1. 10% Debentures Allotment A/c Dr.		2,75,000	
	Discount on Issue of Debentures A/c Dr.		25,000	
	To 10% Debenture A/c			3,00,000
	(Allotment Money Due to 10% Debentures)			
	2. Bank A/c Dr.		2,75,000	
	To 10% Debentures A/c			2,75,000
	(Allotment Money Received on Debentures)			
	Note: When the entire amount is received in single installment, entry is:			
	Bank A/c Dr.		4,75,000	
	Discount on Issue of Debentures A/c Dr.		25,000	
	To 10% Debentures A/c			5,00,000
	(5,000 10% Debentures A/c Issued at a Discount of 5%, ₹ 100 Each)			

4.7.2 Issue of Debentures for Consideration Other than Cash

At times, a company purchases assets from a vendor and issue debentures is payment of purchase consideration.

Journal Entry:

(i) Assets A/c	Dr.	….	
To Vendor A/c			….
(Purchase of Assets)			
(ii) Vendor A/c	Dr.	….	
To Debentures A/c			….
(Issue of Debentures)			

Purchase consideration: Amount paid by the purchasing company for the purchase of assets is called "purchase consideration."

This is computed as:

Purchase Consideration = Value of Assets – Liabilities

These debentures may also be issued at par or at premium or at a discount.

Illustration 7

Model: Issue of debentures for consideration other than cash

Joy & Co. Ltd. purchased assets of the book value of ₹ 5,40,000 from another firm. It was agreed that the purchase price be paid by issuing 14% debentures of ₹ 100 each.

Pass necessary journal entries if the debentures are issued (a) at par; (b) at a discount of 10% and (c) at a premium of 25%

Solution

Note:

1. Since purchase consideration is given in the problem, no need to compute it.
2. Number of debentures issued to be determined as follows:

1. Number of debentures issued a par

$$= \frac{\text{Purchase Consideration}}{\text{Value of Debenture (Free Value at Par)}} = ₹\frac{5,40,000}{₹\ 100} = 5,400 \text{ debentures}$$

2. Number of debenture to be issued at a discount of 10%

$$= \frac{\text{Price Consideration}}{\text{Discounted Value of Debenture}}$$

$$= \frac{₹\ 5,40,000}{₹\ 100 - 10\%} = \frac{₹\ 5,40,000}{₹\ 90}$$

$$= 6,000 \text{ debentures}$$

3. Number of Debentures to be issued at a premium

$$= \frac{\text{Purchase Consideration}}{\text{Debenture Value with Premium}}$$

$$= \frac{₹\ 5,40,000}{₹\ 100 + 25\%} = \frac{₹\ 5,40,000}{₹\ 125}$$

$$= 4,320 \text{ debentures}$$

In the books of Joe & Co. Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Assets A/c	Dr.		5,40,000	
	To Vendors A/c				5,40,000
	(Assets Purchased from Another Firm)				
	Case (a): Debentures Issued at Par:				
	Vendors A/c	Dr.		5,40,000	
	To 14% Debentures A/c				5,40,000
	(5,400 Debentures (See : Note 2(a)) of ₹ 100 Issued at Par)				
	Case (b): Debentures Issued at Discount:				
	Vendors A/c	Dr.		5,40,000	
	Discount on Issue of Debentures A/c	Dr.		60,000	
	To 14% Debentures A/c				6,00,000
	(6,000 Debentures (See: Note 2(b)) of ₹ 100 Each Issued at a Discount of 10%)				
	Case (c): Debentures Issued at Premium:				
	Vendor's A/c	Dr.		5,40,000	
	To 14% Debentures A/c				4,32,000
	To Premium on Issue of Debentures A/c				1,08,000
	(4,320 Debentures (See: Note 2(c)) of ₹ 100 Each Issued at a Premium of 25%)				

Sometimes, a company purchases the business of another company:

Entry for this will be:

Sundry Assets A/c	Dr.	…	
Goodwill A/c	Dr.	…	
To Sundry Liabilities A/c			…
To Vendor’s A/c			…
To Capital Reserve A/c			…

However, in the entry of the two items—(i) goodwill A/c and (ii) capital reserve A/c—only one item will appear.

In the case, the value of net assets, i.e. Asset – Liabilities will not be equal to purchase consideration. There will be either goodwill A/c or capital reserve A/c.

Goodwill A/c: Payment in excess of the value of net assets is to be treated as goodwill A/c.

Capital Reserve A/c: If value of net assets is greater than purchase price, it results in gain to the company. It is to be treated as capital profit and transferred to capital reserve A/c.

Illustration 8

Model: Issue of debentures for consideration other than cash—Purchases the business of another company.

Vijay Ltd. took over the assets and liabilities of ₹ 50,00,000 and ₹ 5,00,000 of Ajay Ltd. Vijay Ltd. paid the purchase consideration of ₹ 48,00,000 by issuing debentures of ₹ 100 each at a premium of 20%. Pass journal entries in the books of Vijay Ltd.

Solution

Step 1:	This is a case of issue of debentures for consideration other than cash at premium and purchase of business of another company. This is not an individual vendor.
Step 2:	Determination of Amount of Debentures: For Making Payment of ₹ 120 (₹ 100 + 20% Premium), the Number of Debentures Issued by the Company } = 1 Debenture For Making Payment of ₹ 48,00,000, the Number of Debentures to Be Issued by the Company } $= \frac{1}{120} \times$ ₹ 48,00,000 = 40,000 Debentures [*2] Value = 40,000 Debentures × ₹ 100 = ₹ 40,00,000

Step 3: To Determine Goodwill or Capital Reserve:
In This Question, the Purchase Consideration Exceeds the Value of Net Assets, i.e., Purchase Consideration > Net Assets
Hence, Goodwill arises.

* Net Value of Assets	=	₹ 50,00,000 – ₹ 5,00,000
	=	₹ 45,00,000
*[1]Goodwill	=	Purchase Consideration – Value of Net Assets
	=	₹ 48,00,000 – ₹*45,00,000
	=	₹ 3,00,000

Step 4:

Books of Vijay Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Sundry Assets A/c	Dr.		50,00,000	
	*[1]Goodwill A/c			3,00,000	
	To Liabilities A/c				5,00,000
	To Ajay Ltd. A/c				48,00,000
	(Purchase of Assets & Liabilities of Ajay Ltd.)				
	Ajay Ltd. A/c	Dr.		48,00,000	
	*[2]To % Debentures A/c				40,00,000
	To Premium on Issue of Debentures A/c				8,00,000
	(Issue of 40,000 Debentures of ₹ 100 Each at a Premium of 20%)				

Illustration 9

Model: Issue of debentures for other than cash—Assets and liabilities taken over

PQR Ltd. purchased assets of ₹ 4,50,000 and took over liabilities of ₹ 40,000 at an agreed value of ₹4,05,000 of ST Ltd. PQR Ltd. issued debentures of ₹ 100 each at a 10% discount in full satisfaction of the purchase price. Pass necessary journal entries in the books of PQR Ltd.

Solution

Note:

1. Determination of Capital Reserve/Goodwill:

    1. Value of Net Assets = Assets – Liabilities

        = ₹ 4,50,000 – ₹ 40,000
        = ₹ 4,10,000

2. Purchase Consideration = ₹ 4,05,000
3. Value of Net assets is More than Purchase Price, and hence the Difference is Treated as Capital Reserve
4. ∴ Capital Reserve = ₹ 4,10,000 – 4,05,000

    = ₹ 5,000

2. Calculation of Number of Debentures to Be Issued:

For Making the Payment of ₹ 90 (₹ 100 – 10 % discount), the Number of Debentures) Issued by the Company	= 1 Debenture
For Making the Payment of ₹ 4,05,000, the number of Debentures to Be Issued by the Company	$= \frac{1}{90} \times$ ₹ 4,05,000
	= 4,500 Debentures

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Sundry Assets A/c Dr.		4,50,000	
	To Sundry Liabilities A/c			40,000
	*[1]To Capital Reserve A/c			5,000
	To ST Ltd. A/c			4,05,000
	(Purchase of Assets & Liabilities of PQR Ltd. and the Difference Credited to Capital Reserve)			
	ST Ltd. A/c Dr.		4,05,000	
	Discount on Issue of Debentures A/c Dr.		45,000	
	To Debentures A/c			4,50,000
	(Issue of Debentures (4,500) of ₹ 100 Each at a Discount of 10 % Each)			

Issue of Debentures as Collateral Security

It means issue of debentures as a subsidiary or secondary security. In other terms, collateral security means additional security.

- When the loan is repaid, i.e. discharged, such debentures issued as collateral security are returned to the company.
- The lender is not entitled to any interest on such debentures.
- The lender is entitled to interest only on the amount of loan, but never on debentures.
- But in case of any breach of terms and conditions, then the creditor is entitled to have a claim on all rights as a debenture holder.

Accounting Treatment:

- No immediate liability arises by pledging the debenture as a collateral security.
- Hence, no entry is required at the time of issue.
- However, this fact has to be shown in the balance sheet under the head "Secured Loans" on the liabilities side of the balance sheet.
- At times, the issue as a collateral security is entered as:

Debenture Suspense A/c	Dr. …	
To Debentures A/c		…

- At the time of repayment of loan, this entry has to be reversed.

Illustration 10

Model: Issue of debentures as collateral security

Subh Ltd. secured a loan of ₹ 20,00,000 from a Nationalized bank, issuing 30,000, 15% debentures of ₹100 each as collateral security.

Record necessary accounting entries for such issue.

Solution

Approach I: An extract of balance sheet has to be drawn as follows:

Extract of Subh Ltd.'s Balance Sheet as on…

Liabilities	₹	Assets	₹
Secured Loans:			
Loan from Bank …	20,00,000		
(Secured by Issue of 30,000 Debentures of ₹ 100 Each as Collateral Security)			

Approach II:

Journal—Books of Subh Ltd.

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Debenture Suspense A/c Dr.		30,00,000	
	To 15% Debentures A/c			30,00,000
	(Issue of 30,000 15% Debentures of ₹ 100 Each as Collateral Security for Bank Loan)			

An Extract of Balance Sheet

Liabilities	₹	Assets	₹
Secured Loans:		Miscellaneous Expenditure:	
30,000 15% Debentures of ₹ 100 Each Issued as Collateral Security	30,00,000	Debentures Suspense A/c	30,00,000
Loan from Bank	20,00,000		

TERMS OF ISSUE OF DEBENTURES

A limited company issues debenture on certain terms and redeems them under varying categories as follows:

Conditions of Issue	Conditions of Redemption
Issued at Par…	Redeemable at Par
Issued at Par…	Redeemable at Premium
Issued at Discount…	Redeemable at Par
Issued at Premium…	Redeemable at Par
Issued at Premium ….	Redeemable at Premium

Issued at Discount… Redeemable at Premium

Note: Debentures are issued at par or premium or discount but redemption is only at par or premium and not at discount mostly.

Accounting Treatment:

Journal entries for different terms of issue and redemption are as follows:

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
I	Issued at Par and Redeemable at Par:				
	Bank A/c	Dr.		…	
	To Debentures A/c				…
II	Issued at Par and Redeemable at Premium:				
	Bank A/c	Dr.		…	
	Loss on Issue of Debenture A/c	Dr.		…	
	To Debentures A/c				…
	To Premium on Redemption of Debentures A/c				…
III	Issued at Discount and Redeemable at Par:				
	Bank A/c	Dr.		…	
	Discount on Issue of Debentures A/c	Dr.		…	
	To Debentures A/c				…
IV	Issued at Premium and Redeemable at Par:				
	Bank A/c	Dr.		…	
	To Debentures A/c				…
	To Securities Premium A/c				…
V	Issued at Discount and Redeemable at Premium				
	Bank A/c	Dr.		…	
	Discount on Issue of Debentures A/c	Dr.		…	
	Loss on Issue of Debentures A/c	Dr.		…	
	To Debentures A/c				…
	To Premium on Redemption of Debentures A/c				…

Journal Entries for Each Category

Category I: Debenture Issued at Par and Redeemable at Par:

Entry:

(i) Bank A/c	Dr.	…	
To Debenture Application A/c			…

(ii) Debenture Application A/c	Dr. …	
To …% Debenture A/c		…

Illustration 11

Model: Debenture issued at par and redeemable at par

Govil Ltd. issued 20,000, 12% debentures of ₹ 50 each payable on application and redeemable at par any time after 4 years from the date of issue. Pass entries for the issue of debentures in the books of Govil Ltd.

Solution

Books of Govil Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	(i) Bank A/c Dr.		10,00,000	
	To Debenture Application A/c			10,00,000
	(Application Money on 20,000 Debentures @ ₹ 50 Each Received) 20,000 × ₹ 50			
	(ii) Debenture Application A/c Dr.		10,00,000	
	To 12% Debentures A/c			10,00,000
	(Application Money Transferred to 12% Debentures A/c)			

Category II: Debentures Issued at a Discount and Redeemable at Par:

Entry:

(i) Bank A/c	Dr. …	
To Debentures Application A/c		…
(ii) Debenture Application A/c	Dr. …	
Discount on Issue of Debentures A/c	Dr. …	
To …% Debentures A/c		…

Illustration 12

Model: Issue of debenture at discount redeemable at par

Goel Ltd. issued 25,000, 12% debentures of ₹ 100 each at discount of 10% redeemable at par at any time after 5 years. Record entries in the books of Goel Ltd. for the issue of debentures.

Solution

Books of Goel Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	(i) Bank A/c	Dr.		22,50,000	
	To Debenture Application A/c				22,50,000
	(Application Money Received on 25,000 Debentures) (25,000 × ₹ 100 – 10%: ₹ 90)				
	(ii) Debenture Application A/c	Dr.		22,50,000	
	Discount on Issue of Debentures A/c	Dr.		2,50,000	
	To 12% Debentures A/c				25,00,000
	(Transfer of Application Money & Recording Discount)				

Category III: Debentures Issued at Premium, Redeemable at Par:

Entry:

(i) Bank A/c	Dr.	…	
To Debentures Application A/c			…
(ii) Debenture Application A/c	Dr.	…	
To …% Debentures A/c			…
To Securities Premium A/c			…

Illustration 13

Model: Issue of debentures at premium and redeemable at par

AB Ltd. issued 10,000 13% debenture of ₹ 100 at a premium of 10% redeemable at par. Pass journal entries for the issue of debentures.

(OR)

The same question may be asked as:

AB Ltd. issued ₹ 10,00,000 13% debentures at a premium of 10% redeemable at par. Pass necessary journal entries for issue of debentures.

Solution

Books of AB Ltd.
Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Bank A/c Dr.		11,00,000	
	To Debentures Application A/c			11,00,000
	(Application Money Received on 10,000 Debentures Including a Premium of 10%)			
	Debenture Application A/c Dr.		11,00,000	
	To 13% Debentures A/c			10,00,000
	To Securities Premium A/c			1,00,000
	(Debenture Application Money Transferred to Debenture A/c and the Premium to Securities Premium A/c)			

Category IV: Debentures are Issued at Par and Redeemable at Premium:

Entry:

(i) Bank A/c	Dr.	…	
To Debentures Application A/c			…
(ii) Debenture Application A/c	Dr.	…	
To …% Debentures A/c			…
(iii) Loss on Issue of Debentures A/c	Dr.	…	

To Premium on Redemption of Debentures A/c …

(OR)

Entries (ii) and (iii) may be combined into a single entry as:

(ii) + (iii) Debenture Application A/c	Dr.	…	
Loss on Issue of Debentures A/c	Dr.	…	
To …% Debentures A/c			…
To Premium on Redemption of Debentures A/c			…

Illustration 14

Model: Issue of debentures at par and redeemable at premium

X Ltd. issued ₹ 10,00,000 10% debentures at par and redeemable at 25% premium. Pass journal entries in the books of X Ltd.

Solution

Books of X Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	(i) Bank A/c	Dr.		10,00,000	
	To Debenture Application A/c				10,00,000
	(Application Money Received on Debentures)				
	(ii) Debenture Application A/c	Dr.		10,00,000	
	To 10% Debentures A/c				10,00,000
	(Transfer of Application Money to 10% Debentures A/c)				
	(iii) Loss on Issue of Debentures A/c	Dr.		2,50,000	
	To Premium on Redemption of Debenture A/c				2,50,000
	(Premium on Redemption Recorded)				
	(OR)				
	(ii + iii): Debenture Application A/c	Dr.		10,00,00	
	Loss on Issue of Debenture A/c	Dr.		2,50,000	
	To 10% Debentures A/c				10,00,000
	To Premium on Redemption of Debentures A/c				2,50,000
	(Debenture Issued at Par and Redeemable at 25% Premium)				

Category V: Debentures are Issued at a Discount and Redeemable at a Premium:

Entry:

(i) Bank A/c	Dr.	…	
To Debenture Application A/c		…	
(ii) Debenture Application A/c	Dr.	…	
Discount on Issue of Debentures A/c	Dr.	…	
To …% Debentures A/c			…
(iii) Loss on Issue of Debenture A/c	Dr.	…	
To Premium on Redemption of Debentures A/c			…

Illustration 15

AZ Ltd. issued ₹ 10,00,000 9% debentures at a discount of 5% but redeemable at a premium of 5%. Give journal entry.

Solution

Books of AZ Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Bank A/c	Dr.		9,50,000	
	Loss on Issue of Debentures A/c	Dr.		1,00,000	
	To 9% Debentures A/c				10,00,000
	To Premium on Redemption of Debentures A/c				50,000
	(Issue of Debentures at a Discount and Redeemable at Premium)				
	Note: The entry may also be passed as above.				

Category VI: Debentures are Issued at a Premium and Redeemable (Repayable) at Premium:

Entry:

(i) Bank A/c	Dr.	…	
To Debenture Application A/c			…
(ii) Debenture Application A/c	Dr.	…	
To … Debentures A/c			…
To Securities Premium A/c			…
(iii) Loss on Issue of Debentures A/c	Dr.	…	
To Premium on Redemption of Debentures A/c			…

(OR)

(ii) & (iii) in the combined form as:

Debenture Application A/c Dr. …

Loss on Issue of Debenture A/c	Dr.	…	
To …% Debentures A/c			…
To Securities Premium A/c			…
To Premium on Redemption of Debentures A/c			…

Illustration 16

Model: Debentures issued at premium and redeemable at premium

A limited company issued 1,000 14% debentures of ₹ 100 each at a premium of 5% and redeemed at 10% premium. Make journal entries.

Solution

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Bank A/c Dr.		1,05,000	
	To Debenture Application A/c			1,05,000
	(Application Money on Debentures Received)			
	Debenture Application A/c Dr.		1,05,000	
	Loss on Issue of Debentures A/c Dr.		10,000	
	To 14 % Debentures A/c			1,00,000
	To Securities Premium A/c			5,000
	To Premium on Redemption of Debentures A/c			10,000
	(Issued of Debentures at 5% Premium & Repayable @ 10% Premium)			
	(OR) AS A SINGLE ENTRY			
	Bank A/c Dr.		1,05,000	
	Loss on Issue of Debentures A/c Dr.		10,000	
	To 14% Debentures A/c			1,00,000
	To Securities Premium A/c			5,000
	To Premium on Redemption of Debentures A/c			10,000

INTEREST ON DEBENTURES

Interest on debentures is payable by a company at a fixed percentage (Coupon rate). The rate of interest is prefixed before the name of debentures. Example: 9% debentures, 10% debentures

It is an acknowledgement of debt and hence interest is payable periodically without default. It is immaterial whether the company earns profit or incurs loss. Generally, interest is payable half-yearly on debentures. It is a charge against the profit of the company.

Interest is computed on the face value (Nominal value) of debentures, and not on the issue price. Hence, no difference on the interest amount will arise if they are issued at par or at a discount or at a premium.

A company has to deduct income tax at the prescribed rate compulsorily (TDS) on the gross amount of debentures interest and deposit with income tax authorities. The rate of tax on debentures interest varies from year to year, as it is notified in the Finance Bill every year.

Accounting Treatment:

The journal entries that are to be passed in the books of the company with respect to interest on debentures are as follows:

1. When Interest on Debentures Becomes DUE:

Debenture Interest A/c	Dr.…	(Gross Amount of Interest Due)
To Income Tax Payable A/c	…	(income Tax Amount Deducted)
To Debenture Holders A/c	…	(Net Amount of Interest After TDS)

2. When Interest Was Paid:

Debenture Holders A/c	Dr.…	(Net Amount of Interest = Gross − TDS)
To Bank A/c	…	

3. When Tax Was Paid to Tax Authorities:

Income Tax Payable A/c	Dr.…	(Amount Deducted at Source − TDS)
To Bank A/c	…	

4. When Debenture Interest A/c is Closed: (Transfer to P&L A/c)

Profit & Loss A/c	Dr.…	(Gross Amount of Interest on Debentures)
To Debenture Interest A/c	…	

Illustration 17

Model: Debenture interest

Riddhu Ltd. issued 10,000 10% debentures of ₹ 100 each on 1 January 2010 at a discount of 5% and redeemable at a premium of 20%. Tax deducted at source is 10% interest payable on 30 June and 31 December as the company adopts calendar year as accounting year.

Pass journal entries for:

1. Issue of debentures
2. Debenture interest for the period ended 31 December 2010

Solution

Note:

1. First, students have to pass journal entries for issue of debentures.
2. Interest on debentures has to be computed as:

   Apply the Formula: Interest = $\frac{Pnr}{100}$

   Where P = Principal—here (10,000 × 100) = ₹10,00,000

   n = Period—here 6 months $= \frac{6}{12}$

   r = rate of interest—10 % $= \frac{10}{100}$

   Interest on debentures $= ₹\ 10{,}00{,}000 \times \frac{6}{12} \times \frac{10}{100}$

   = ₹50,000—payable on 30 June and 31 December every year.

3. Tax Deducted at Source TDS:

   10% (Given) on ₹50,000 (Gross interest: Note 2)

$= \frac{10}{100} \times ₹\ 50{,}000 = ₹\ 5{,}000$

4.

Journal of Riddhu Ltd.

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
1 January 2010	(i) For Issue of Debentures:				
	Bank A/c	Dr.		9,50,000	
	To Debenture Application A/c				9,50,000
	(Application Money Received on 10,000 Debentures @ ₹ 100 – 5% discount 10,000 × ₹ 95: ₹ 9,50,000)				
	Debenture Application A/c	Dr.		9,50,000	
	Loss on Issue of Debentures A/c	Dr.		2,50,000	
	To 10 % Debentures A/c				10,00,000
	To Premium on Redemption of Debentures A/c				2,00,000
	(Issue of Debentures at 5% Discount and Redeemable (Repayable) at 20% Premium)				
30 June 2010	For Interest on Debentures:				
	(a) Debenture Interest A/c	Dr.		50,000	
	To Income Tax Payable A/c				5,000
	To Debenture Holders A/c				45,000
	(Interest Due for 6 months, i.e. up to 30 June 2010 and TDS @ 10 % on Gross Interest)				
30 June 2010	(b) Income Tax Payable A/c	Dr.		5,000	
	To Bank A/c				5,000
	(TDS—Income Tax Paid to Government)				
30 June 2010	(c) Debenture Holders A/c	Dr.		45,000	
	To Bank A/c				45,000
	(Net Interest (Gross – TDS) Paid to Debenture Holders) (a – b)				
31 December 2010	(d) Debenture Interest A/c	Dr.		50,000	
	To Income Tax Payable A/c				5,000
	To Debenture Holders A/c				45,000
	(Interest Due on 31 December 2010 and TDS @ 10% there on Due)				
	(e) Income Tax Payable A/c	Dr.		5,000	
	To Bank A/c				5,000
	(Tax Paid to Government)				
	(f) Debenture Holders A/c	Dr.		45,000	
	To Bank A/c				45,000
	(Interest on Debentures Paid to Debenture Holders) (d – e)				
	Note: Students should note that entries (d), (e) and (f) are repetition of entries (a), (b) and (c).				
31 December 2010	Profit & Loss A/c	Dr.		1,00,000	
	To Debenture Interest A/c				1,00,000
	(Transfer of Interest on Debentures ₹ 50,000 + ₹ 50,000 = ₹ 1,00,000 to P&L A/c)				

Net Effective Rate of Interest

Net effective rate of interest represents the actual amount of interest paid. While determining the effective rate of interest, the actual amount received is to be taken into account. The main difference between the debenture interest calculation and net effective rate of interest is as follows:

Debenture interest is calculated on the nominal value whereas effective rate of interest is calculated on the actual amount received on debentures. That means, it has to be adjusted for premium and discount while determining the actual amount collected on debentures.

Illustration 18

Model: Net effective rate of interest

X Ltd. issued ₹ 10,00,000 12 % debentures of ₹ 100 each. Assuming that the debentures were issued (a) at par; (b) at a premium of 20% and (c) at a discount of 10%, calculate the net effective rate of interest on debentures.

Solution

Debentures Issued at: (1)	Normal Value (2) ₹	Amount Collected (3) ₹	Interest @ 12% on Debentures (4) ₹	Effective Rate of Interest (5) = (4) ÷ (3) × 100 %
(a) At Par	10,00,000	10,00,000 (Same)	1,20,000	$\frac{1,20,000}{10,00,000} \times 100 = 12\%$
(b) At Premium	10,00,000	12,00,000 (+20% Premium)	1,20,000	$\frac{1,20,000}{12,00,000} \times 100 = 10\%$
(c) At Discount	10,00,000	9,00,000 (−10% Discount)	1,20,000	$\frac{1,20,000}{9,00,000} \times 100 = 13.33\%$

One should note that the amount of interest on debentures is ₹ 1,20,000 in all the three cases because interest payable is calculated on the nominal value, i.e. ₹ 10,00,000 $\times \frac{12}{100} = 1,20,000$. But the effective rate of interest varies in each case, because it is calculated on the amount collected, i.e., ₹ 10,00,000 at par, ₹ 12,00,000 at premium and ₹ 9,00,000 at discount.

Interest Accrued and Due

Generally, interest on debentures is paid, every six months, periodically. Depending on the accounting policy, the date of payment of debentures varies. Suppose the accounting period ends on 31 March, a company pays interest on 30 September (first half-year) and 31 March (second half-year). That means, the company has an accounting policy of paying interest on 30 September and 31 March. Further assume that the company paid interest on 30 September but did not pay an 31 March, then in such a case, the debentures interest is accrued and due. This is technically called “outstanding interest”. It is important to note here that the debenture holder cannot demand the payment of interest before 31 March. If it remains unpaid only on or after such specified dates, such interest accrued and due is referred to “outstanding interest”.

Entry will be:

Debenture Interest A/c	Dr.	…	
To Outstanding Debenture Interest A/c			…

In the balance sheet it will be shown as:

The outstanding interest on debenture is to be shown along with the nominal value of debentures on the liabilities side of the balance sheet under the head “Secured Loans”.

Interest Accrued but Not Due

As already said, payment of debenture interest depends on the accounting policy. Assume that a company pays interest on debentures on 30 June and 31 December and it closes its accounts on 31 March (i.e., financial accounting year) in such a case, after six months, i.e., 30 June. Technically speaking, interest from 1 January to 31 March has to be properly accounted for. This is technically termed as “interest accrued but not due” or simply “accrued interest.”

Entry:

Debenture Interest A/c	Dr.	…	
To Accrued Debenture Interest A/c			…

Even in such a situation, a debenture holder cannot claim his right to pay interest for these 3 months.

The “accrued interest” has to be shown as “Current Liability” in the balance sheet.

Students should remember that “outstanding interest” is to be shown under “Secured Loans” and “accrued interest” is to be shown under “Current Liabilities”.

DISCOUNT OR LOSS ON ISSUE OF DEBENTURES

The discount on the issue of debentures or any loss on debentures is a fictitious asset. Hence, it has to be written off at an early date, by late before the expiry of the lifetime of debentures.

The following are the methods available to write off discount/loss on issue of debentures:

1. Fixed instalment method
2. Equated method

Fixed Instalment Method

This method is applicable when the debentures are redeemed at the end of a specified period. Under this method, the total amount of discount is to be written off by equal instalments.

To illustrate, assume that the total discount allowed is ₹ 30,000 and the debentures are to be redeemed at the end of 6 years, then the amount to be written off annually will be $\frac{₹\ 30,000}{6\text{ years}} = ₹\ 5,000.$ At the end of sixth year, discount will be written off completely.

Equated Method, Fluctuating or Variable Instalment Method

Under this method, the discount is to be written off by proportionately reducing instalments. This method may be explained by the following illustration:

Illustration 19

Model: Discount on issue of debentures—Variable instalment method

A public limited company issued 10% debenture of the face value of ₹ 10,00,000 at a discount of 6%. The debentures were repayable by annual drawings of ₹ 2,00,000.

How would you deal with the discount on issue of debentures? Show the discount account in the company's ledger for the duration of debentures.

Solution

Note: As it is given in the problem that "the debentures were repayable by annual drawings", variable instalment method is to be adopted.

Step 1: Computation of Total Amount of Discount on Issue of Debentures:

Face Value of Debenture	= ₹ 10,00,000
Discount Rate	= 6%
∴ Discount Amount	$= ₹\,10{,}00{,}000 \times \frac{6}{100}$
	= ₹ 60,000

Step 2: This Total Amount ₹ 60,000 is to be Written Off in Proportion to the Debentures Outstanding at the Beginning of Each Year.

The Ratio of the Amount in Use for Each Year is to be Determined as:

Year		**Amount**
End of		₹
First Year	10,00,000 →	10,00,000
Second Year	₹ (10,00,000 – 2,00,000)	8,00,000
Third Year	₹ (8,00,000 – 2,00,000)	6,00,000
Fourth Year	₹ (6,00,000 – 2,00,000)	4,00,000
Fifth Year	₹ (4,00,000 – 2,00,000)	2,00,000

Outstanding Balance Ratio = 10,00,000 : 8,00,000 : 6,00,000 : 4,00,000 : 2,00,000

= 10 : 8 : 6 : 4 : 2

or

= 5 : 4 : 3 : 2 : 1

Step 3: Amount of Discount to be Written off Every Year:

		₹
First Year	$₹\,60{,}000 \times \frac{1}{15}$	20,000

Second Year	₹ $60{,}000 \times \frac{4}{15}$	16,000
Third Year	₹ $60{,}000 \times \frac{3}{15}$	12,000
Forth Year:	₹ $60{,}000 \times \frac{2}{15}$	8,000
Fifth Year:	₹ $60{,}000 \times \frac{1}{15}$	4,000
	Total	60,000

Step 4: Preparation of Debenture Discount A/c:

Debenture Discount Account

Date	Particulars	₹	Date	Particulars	₹
Ist Year 1 January	10% Debentures A/c	60,000	Ist Year 31 December	P&L A/c	20,000
			31 December	Balance c/d	40,000
		60,000			60,000
IInd Year 1 January	Balance b/d	40,000	IInd Year 31 December	P&L A/c	16,000
				Balance c/d	24,000
		40,000			40,000
IIIrd Year 1 January	Balance b/d	24,000	IIIrd Year 31 December	P&L A/c	12,000
				Balance c/d	12,000
		24,000			24,000
IVth Year 1 January	Balance b/d	12,000	IVth Year 31 December	P&L A/c	8,000
				Balance c/d	4,000
		12,000			12,000
Vth Year 1 January	Balance b/d	4,000	Vth Year 31 December	P&L A/c	4,000

Illustration 20

Model: Fixed installment method

Usha Ltd. issued ₹ 1,00,000 debentures at a discount of 10% repayable at the end of 5 years.

Prepare the discount account in the ledger for the period.

Solution

Debentures are to be redeemed at the end of 5 years.

Step 1:	Determination of Total Discount Amount:	
	Face Value of Debentures	= ₹ 1,00,000
	Discount Rate	= 10%
	Discount Amount	$= ₹\, 1{,}00{,}000 \times \frac{10}{100} = ₹\, 10{,}000$
Step 2:	Amount to be Written for 1 year is to be Computed: $= \frac{\text{Total Value of Discount}}{\text{Number of Years}}$ $= ₹\, \frac{10{,}000}{5} = ₹\, 2{,}000$	
	Every Year ₹ 2,000 Has to Be Written off.	
Step 3:	Preparation of Debenture Discount A/c:	

Debenture Discount Account

Date	Particulars	₹	Date	Particulars	₹
Ist Year 1 January	…% Debentures A/c	10,000	Ist Year 31 December	P&L A/c	2,000
			31 December	Balance c/d	8,000
		10,000			10,000
IInd Year 1 January	Balance b/d	8,000	IInd Year 31 December	P&L A/c	2,000
				Balance c/d	6,000
		8,000			8,000
IIIrd Year 1 January	Balance b/d	6,000	IIIrd Year 31 December	P&L A/c	2,000
				Balance c/d	4,000
		6,000			6,000
IVth Year 1 January	Balance b/d	4,000	IVth Year 31 December	P&L A/c	2,000
				Balance c/d	2,000
		4,000			4,000
Vth Year 1 January	Balance b/d	2,000	Vth Year 31 December	P&L A/c	2,000

LOSS ON ISSUE OF DEBENTURES

Loss on issue of debentures is incurred at the time of issue of debentures and also on redemption of debentures. This is a capital loss.

The loss occurs thus:

1. When the debentures are issued at par but redeemable at premium. Here,
   Loss = Premium payable on redemption
2. When the debentures are issued at discount and redeemable at premium → Loss = Amount of discount on the issue of debentures + Premium payable on redemption

Students should clearly distinguish this with "discount on issue of debentures" where it is the amount of loss incurred at the time of issue of debentures only.

Accounting treatment is very much similar to that of discount on issue of debentures. Entry will be:

Entry will be:

P&L A/c	Dr. …	{Amount Written off}
To Loss on Issue of Debenture A/c	…	

Illustration 23

Model: Loss on issue of debentures

Bala & Co. Ltd. issued 8,000 12% debentures of ₹ 50 each payable at a discount of 10% repayable after 5 years at a premium of 10%.

You are required to record:

1. Journal entries at the time of issue and at the time of redemption
2. Loss on issue of debentures account for the period

Solution

In this question,

Loss	=	Amount of Discount on Issue of Debenture + Premium on Redemption
	=	(10% of ₹50 × 8,000) + (10% of ₹50 × 8,000)
	=	(₹5 × 8,000) + (₹5 × 8,000)
	=	₹40,000 + ₹40,000
	=	₹80,000

Bala & Co. Ltd.
Journal

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	(A) 1. At the Time of Issue of Debentures:				
	Bank A/c	Dr.		3,60,000	
	To Debentures Application A/c				3,60,000
	(Application Money Received on Debentures)				
	Debentures Application A/c	Dr.		3,60,000	
	*1Loss on Issue of Debentures A/c	Dr.		80,000	
	To 12% Debentures A/c				4,00,000
	To Premium or Redemption of Debentures A/c				40,000
	(8,000 12% Debentures of ₹ 50 Each Issued as 10% Discount and Repayable @ 10% Premium)				
	2. At the Time of Redemption:				
	12% Debentures A/c	Dr.		4,00,000	
	Premium on Redemption of Debentures A/c	Dr.		40,000	
	To Debenture Holders A/c				4,40,000
	(12% Debentures Repayable @ 10% Premium)				
	Debenture Holders A/c	Dr.		4,40,000	
	To Bank A/c				4,40,000
	(Amount Paid off at the End of 5 years)				

(B) Loss on Issue of Debenture:

Debenture life, i.e., to be redeemed at the end of 5 years

Loss has to be written off equally for these years.

Loss Amount to be Written off :

$$\frac{\text{Total Loss}}{\text{Number of Years}}$$

$$= \frac{₹\ 80,000}{5\ \text{Years}}$$

= ₹ 16,000 every year.

Loss on Issue of Debenture Account

End of Year	Particulars	₹	End of Year	Particulars	₹
1	12% Debentures A/c	40,000	1	Profit & Loss A/c	16,000
	Premium on Redemption of Debenture A/c	40,000		Balance c/d	64,000
		80,000			80,000
2	Balance b/d	64,000	2	P&L A/c	16,000
				Balance c/d	48,000
		64,000			64,000
3	Balance b/d	48,000	3	P&L A/c	16,000
				Balance c/d	32,000
		48,000			48,000
4	Balance b/d	32,000	4	P&L A/c	16,000
				Balance c/d	16,000
		32,000			32,000
5	Balance b/d	16,000	5	P&L A/c	16,000

REDEMPTION OF DEBENTURES

Meaning and Features

Redemption of debentures means repayment of the amount due on debentures to debenture holders.

Its features are as follows:

- It is a discharge of liability
- It should be redeemed as per the terms and conditions of issue.
- Generally, debentures are to be redeemed at the expiry of the specified period mentioned in the debenture certificate or trust deed.
- At times, the debentures may be redeemed before the expiry period.
- The redemption may be made in instalments or by purchasing them in open market.
- A company can purchase is own debentures, cancel and re-issue them.
- When redeemed debentures are re-issued, no fresh mortgage is necessary
- However, a company cannot redeem and re-issue them with a different redemption date.
- Failure to redeem debentures on maturity will result in disqualification of a director for 5 years.

Methods of Redemption of Debentures

Debentures may be redeemed by the following methods:

1. Redemption on maturity in one lump sum
2. Redemption may be made in annual instalments or by draw of lots
3. By purchase of its own debentures in the open market
4. By conversion into shares

Sources of Redemption of Debentures

The following are the main sources for redeeming debentures:

1. Capital
2. Profits
3. Sale of assets
4. Fresh issue of shares and debentures
5. Surplus funds

Debenture Redemption Reserve (DRR)

In accordance with the provisions of Section 117 C of the Companies (Amendment) Act 2000, a company must create Debentures Redemption Reserve (DRR) for the redemption of debentures that have a maturity period of 18 months or more.

Some of the important provisions envisaged in the Companies Act with respect to DRR are as follows:

1. DRR must be created to which adequate amounts shall be credited from out of profits every year until such debentures are redeemed.
2. The DRR should not be utilized for any other purposes.
3. Transfer to DRR should be done every year continuously till the complete redemption of all debentures.
4. In case debentures are issued for project finance, DRR can be created up to the date of commercial production. DRR may be created in equal instalments or higher amounts of profits so permit.
5. Creation of DRR is obligatory only for non-convertible debentures and non-convertible portion of party convertible debentures. No need arises to create DRR for fully convertible debentures.
6. DRR is treated as a part of "general reserve" for bonus issues and price fixation.
7. A company should create DRR equivalent to 50% of the amount of debenture issue before redemption begins.

8. Drawal from DRR is permitted only after 10% of the debentures are redeemed actually.

Accounting Entry to Create DRR:

Profit and Loss Appropriation A/c	Dr.	…
To Debenture Redemption Reserve A/c		…

Now, let us discuss the methods of redemptions of debentures one by one.

Redemptions in One Lump Sum After the Expiry of the Specified Period

Under this method, the repayment is made in one lump sum at the expiry of specified period, mentioned in debenture certificate. The debentures are redeemed either at par or at premium as per the terms of issue. In practice, debentures are NOT redeemed at discount.

Accounting Entries:

(A) When the Debentures are Redeemed at Par:

1. When Debentures Become DUE for Payment on Redemption:

Debentures A/c	Dr. …		
To Debenture Holders A/c		…	{Face Value}

2. On Redemption (Amount Paid off):

Debenture Holders A/c	Dr. …		
To Bank A/c		…	{With the Amount Paid}

(B) When the Debentures are Redeemed at Premium:

1. When Payment is Due:

Debentures A/c	Dr.	…	{Face Value}
Premium on Redemption of Debentures A/c	Dr.	…	{Premium}
To Debenture Holders A/c		…	{Total}

2. On Redemption (Amount Paid off):

Debenture Holders A/c	Dr.	…

To Bank A/c	…

Under this method, the following two approaches are available for redemption of debentures:

1. Redemption out of capital
2. Redemption out of profit

1. **Redemption out of capital:** Debentures may be redeemed out of capital. Profits or money earned in course of the business is not utilized here. In such a case, no transfer is required to general reserve or DRR. Redemption out of capital results in reduction of capital.
   But, according to Section 117 C of the Companies (Amendment) Act 2000 and the SEBI Guidelines, 50% of the amount of issue of debenture is to be created under DRR before the commencement of debentures redemption. Hence, it is not possible to redeem debentures entirely out of capital. As such, this method is not in vogue.
2. **Redemption out of profit:** Redemption of debentures out of profit means redemption through DRR A/c. A certain sum of money is transferred from profit and loss appropriation A/c (Divisible profits) to a newly created account: DRR A/c. This is to be utilized exclusively for redemption of debentures.

   Accounting Treatment: When redemption of debentures is made out of profits, entries will be as follows:

   The first two entries, i.e., when debentures are redeemed at par and at premium, are the same as those discussed under the head: Redemption in One Lump Sum: A & B entries. Repeat those entries here and then proceed:

(C) On Appropriation of Divisible Profits:

P&L Appropriation A/c	Dr.	…	
To DRR A/c			…

(D) On Payment to Debentures:

Debenture Holders A/c	Dr.	…	

To Bank A/c		…

(E) Transfer of Balance in DRR A/c to General Reserve A/c:

Debentures Redemption Reserve A/c	Dr.	…	
(DRR)			
To General Reserve A/c			…

(F) On Closing of Premium on Redemption of Debentures A/c:

In case no entry was made for premium on redemption of debenture at the time of issue, now the following entry is to be made to close the same.

Securities Premium A/c	Dr.	…	
Profit & Loss A/c	Dr.	…	
General Reserve A/c	Dr.	…	
To Premium on Redemption of Debentures A/c			…

Note:

1. DRR A/c is to be shown on the liabilities side of the balance sheet under the head: “Reserves & Surplus”.
2. When redemption is fully completed, this account is closed and transferred to “General Reserve”.

Illustration 24

Model: Redemption out of profits

U.V.R Ltd. had issued ₹ 10,00,000 12% debentures in 2006 and the same were to be redeemed on 1 January 2011, out of the profits. The DRR stood at ₹ 2,75,000. Show the entries assuming that the debentures were redeemed at a premium of 10%.

Solution

U.V.R. Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1 January 2011	12% Debentures A/c Dr.		10,00,000	
	Premium on Redemption of Debentures A/c Dr. (10% of ₹ 10,00,000)		1,00,000	
	To Debenture Holders A/c			11,00,000
	(Amount Due to Debenture Holders at a Premium of 10%)			
1 January 2011	Profit and Loss Appropriation A/c Dr.		2,25,000	
	To Debenture Redemption Reserve A/c			2,25,000
	(50% of Nominal Value of Debentures to Be Redeemed, i.e., 50% of ₹ 10,00,000 is ₹ 5,00,000. Already Existing as Shown in the Problem ₹ 2,75,000 ∴ Balance = ₹ 2,25,000 Transferred to DRR)			
1 January 2011	Profit & Loss Appropriation A/c Dr.		5,00,000	
	To General Reserve A/c			5,00,000
	(Appropriation of Profits to the Extent of 50% of the Face Value of Debentures)			
1 January 2011	Debentures A/c Dr.		11,00,000	
	To Bank A/c			11,00,000
	(Amount Paid to Debenture Holders on Redemption)			
	Profit and Loss A/c Dr.		1,00,000	
	To Premium on Redemption of Debentures A/c			1,00,000
	(Premium on Redemption of Debenture Account is Transferred to P&L A/c and Thereby Closed)			
	Debentures Redemption Reserve A/c Dr.		5,00,000	
	To General Reserve A/c			5,00,000
	(Balance of DRR A/c Is Transferred to General Reserve Account) (₹ 10,00,000 – ₹ 5,00,000)			

Illustration 25

Model: Redemption out of profit

XZ Ltd. has a balance of ₹ 12,00,000 in P&L A/c. The company decided to forego payment of dividend and instead utilize the profits to repay 12% ₹ 10,50,000 debentures on 30 June 2009 as a premium of 10%. Debentures interest is payable annually on 31 December every year when the accounts are closed. The company also has a balance of ₹ 6,00,000 in the debenture redemption reserve account.

Journalize the transactions.

Solution

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
30 June 2009	* Debenture Interest A/c Dr.		63,000	
	To Bank A/c			63,000
	(Payment of Interest to Debenture Holders)			
	Note: Interest has to be paid and debentures are to be redeemed on 30 June.			
	12% Debentures A/c Dr.		10,50,000	
	Premium on Redemption of Debentures A/c Dr.		1,05,000	
	To Debenture Holders A/c			11,55,000
	(Amount Payable on Redemption Including Premium on Redemption)			
	Profit and Loss Appropriation A/c Dr.		4,50,000	
	To Debentures Redemption Reserve A/c			4,50,000
	(Appropriation of Profits to Redeem the Debentures)			
	Note: Since the debentures have been redeemed fully out of profits, transfer of ₹ 4,50,000 to DRR is made, even though the balance in DRR is more than 50% of the nominal value of debentures.			
	Debenture Holders A/c Dr.		11,55,000	
	To Bank A/c			11,55,000
	(On Redemption, the Debenture Holders Are Paid off)			
	Debenture Interest Is Calculated as:			
	$₹10,50,000 \times \frac{6}{12} \times \frac{2}{100} = ₹63,000$			
	Interest for 6 months upto 30 June			

PROFITS PRIOR TO INCORPORATION

MEANING

A company, generally, is floated by promoters. Sometimes, a running business may be acquired by another company. A new company may also be formed by acquiring the running business of a sole trader or partnership firms. A public limited company has to get (1) Certificate of Incorporation and (2) Certificate of Commencement of Business. So, it is natural that some momentary transactions will occur resulting in profit/loss even before the company attains the legal status. Only after getting the Certificate of Incorporation that the company comes into existence. But it should be noted here that a public limited company cannot commence its business till the Certificate of Commencement of Business is obtained. Under such circumstances, the new company is entitled to all profits earned after the purchase or conversion of business till the date of incorporation. Such profit is referred to as "profit prior to incorporation".

Such profit is not to be taken as "normal trading profit" or "revenue profit". All profits/losses before the commencement of business are treated as "capital" item, which will increase/decrease the "net assets" of the company. For all practical accounting purposes, "Profit prior to incorporation denotes the profits earned up to the date of incorporation and not up to the date of commencement of business". Though the requirement of Certificate of Commencement of Business is a legal necessity, the profits are ascertained up to the date of incorporation. This is due to the reason that a company has got inherent powers to carry on a business "relates back" to the date of incorporation, once the certificate to commence business is obtained.

ACCOUNTING TREATMENT OF PROFITS/LOSSES PRIOR TO INCORPORATION IN THE BOOKS OF THE COMPANY

Profits Prior to Incorporation

1. Such profit should not be taken to profit and loss account of the company, the reason being capital in nature.
2. (i) Such profit should be credited to "Capital Reserve Account". (This is utilized to write off: (a) capital losses, (b) preliminary expenses, (c) discount on issue of debentures and (d) undertaking commission) (ii) Unutilized part of capital reserve is to be shown on the liabilities side of the balance sheet under the head, "Reserves & Surpluses".

Losses Prior to Incorporation

1. Such loss should not be taken to profit and loss account because it is a capital loss and not revenue loss.
2. This may be treated in one of the following ways:

1. This may be debited to "Loss prior to incorporation account" as a separate account.

   This should be shown on the assets side of the balance sheet under the head "Miscellaneous Expenditure."

(OR)

2. The loss may be treated as goodwill and debited to goodwill account.

(OR)

3. Such loss may be treated as "Deferred Revenue Expenditure" to be written off out of the profits of the company over a number of accounting years.

METHODS OF ASCERTAINING PROFIT OR LOSS PRIOR TO INCORPORATION

Method 1: Period: Up to the Date of Incorporation

Desired Account: Trial balance and profit and loss account. Under this method, first a trial balance is to be prepared up to the date of incorporation of the company. On that date, closing stock is to be valued. Then in usual way, trading and P&L A/c is to be prepared to ascertain profit or loss. Again, at the end of the year, P&L A/c is to be prepared to ascertain profit/loss for the post-incorporation period. Although an accurate way of ascertaining the net result, this method is not in practice as it affects the normal course of business operations.

Method 2: Period: For the Whole Year up to the End of an Accounting Year

Desired Account: Trading and profit and loss account. Under this method, only at the end of the accounting period, trading and profit and loss account is prepared in the usual manner.

A separate statement (depicting pre- and post-incorporation profit) is to be prepared in which the expenses incurred are apportioned between the pre- and post-incorporation periods.

The profit or loss (post-incorporation period) is to be incorporated in the P&L A/c and the profit (prior to incorporation) is to be shown as Capital Reserve A/c in the balance sheet. The loss prior to incorporation may either be separately shown in the balance sheet or debited to goodwill account.

Method 3: Period: For the Whole Year up to the End of the Accounting Year

Under this method, Trial balance and trading account are prepared.

Here, profit and loss account is prepared in columnar form, with columns for pre- and post-incorporation periods. All expenses and gross profit are to be apportioned on a suitable basis for pre- and post-incorporation periods.

BASIS OF APPORTIONMENT OF EXPENSES

Sales Ratio

Sales ratio is the ratio of sales of the company prior to incorporation and post-incorporation.

To illustrate: sales before incorporation are ₹ 2,00,000 and sales after incorporation are ₹ 3,00,000, sales ratio is 2,00,000:3,00,000 (or) 2:3.

All expenses associated with sales are to be allocated in the ratio of the sales. For example, carriage outwards, discount allowed, commission to salesman, sales promotion expenses, bad debts, etc.

Gross profit is to be allocated on the basis of sales ratio.

Weighted Sales Ratio

In case sales are not uniform throughout the accounting year, weightage should be given to the trends observed in the sales. Adjustments have to be made based on the charge in trend. The resultant is due to weighted sales ratio.

Time Ratio

Time ratio is the ratio of periods (months or days) prior incorporation and post-incorporation in an accounting period.

To illustrate: A company was acquired on 1 April 2010, incorporated on 1 June 2010 and accounts closed on 31 March 2011, the time ratio is:

1 April 2010 to 1 June 2010:	2 months
(Prior incorporation)	
1 July 2010 to 31 March 2011:	10 months
(Post-incorporation)	
The time ratio is	2:10 or 1:5

Expenses incurred with respect to time are to be allocated on the basis of the time ratio, e.g., salaries, rent, interest, depreciation, bank charges, stationery postage, etc.

Weighted Time Ratio

In case of any changes made to the number of employees, weightage should be give to such changes by arriving at the time ratio. Also, when some expenses are incurred specifically pertaining to a part of the accounting period, separate ratio has to be ascertained.

Specific Expenses and Specific Allocation

Some specific expenses which are related to the respective period (pre- or post-incorporation) may be allocated to the respective period. For example, preliminary expenses written off, debenture interest, director's fees and the like are associated only with post-incorporation period and hence should be allocated only to post-incorporation period. Similarly, interest or purchase price is to be allocated entirely to the pre-incorporation period.

Actual Expenses with Respect to Items

In case of availability of details on how much was spent on each item or activity in pre- or post-incorporation period specifically, then that actual expense should be directly allotted to that particular period.

Various Items and Their Bases of Apportionment

Various items and their bases for apportionment are shown in the following:

Item	Basis for Apportionment
1. Gross profit/loss	Sales ratio/weighted sales ration
2. Variable expenses that vary in direct proportion to sales	Sales ratio/weighed sales ratio
3. All fixed expenses	Time ratio/weighted time ratio
4. Expenses specifically related to pre-incorporation period	Allocation to the pre-incorporation period only
5. All expenses specifically related to post-incorporation period	Allocation to post-incorporation period only
6. Actual expenses that are explicitly and specifically related to pre- or post-incorporation period	Allocation to respective periods only

Amalgamation, Absorption, External Reconstruction & Internal Reconstruction

Contents

AMALGAMATION

Merger & Acquisition in simple terms, it is nothing but the joining together of companies. The underlying motive behind such combination of companies is to enhance the resources of capital, to enjoy the fruits of economies of large-scale production, to reduce competition, to increase efficiency and so on.

MEANING

Amalgamation: When two or more companies that exist as on date combine together to form a new company, then it is called "amalgamation".

In this case, all the combining companies will get liquidated. A new company will be formed to take over their business.

To illustrate, X Ltd. and Y Ltd., the two existing companies, combine together to form Z Ltd., a new company. X Ltd. and Y Ltd. will get liquidated. A new company Z Ltd. is formed to run the business.

Absorption: When one existing company takes over the business of two or more older existing companies, it is called "absorption". The other two or more existing companies (i.e., companies whose business are taken over) will get liquidated. At the same time, no new company will be floated.

To illustrate, X Ltd., one existing company, takes over other two existing companies Y Ltd. and Z Ltd. Y Ltd. and Z Ltd. will get liquidated. X Ltd. continues to do its business and no new company will be formed. In other words, X Ltd. absorbs the other two companies Y Ltd. and Z Ltd. X Ltd. continues to do its business whereas Y Ltd. and Z Ltd. will be liquidated.

External reconstruction: When an existing company is liquidated and in its place, a new company is floated but with the same shareholders, it is known as "external reconstruction". Shareholders will remain unaltered but company's name and structure will be new.

To illustrate, X Ltd. is liquidated. But the existing shareholders continue their status as shareholders and a new company Y Ltd. is formed.

Legal Meaning

The Companies Act, 1956 remain silent on this, i.e., the term "amalgamation" has not been defined specifically. However, the Courts have interpreted the term to include amalgamation as well as absorption. In *S. Somayajulu* vs. *Hop Prudhommee and Company Ltd.*, (1963, Com. L.J61), amalgamation has been defined as "a state of things under which either two companies are joined so as to form a third entity or one is absorbed into or blended with another".

According to Halsburg's laws of England, amalgamation is a blending of two or more existing undertakings into one undertaking, the shareholders of each blending company becoming substantially the shareholders of the company which is to carry on the blended undertakings. There may be amalgamation either by transfer of two or more undertakings to a new company or by the transfer of one or more undertakings to an existing company.

Sections 390 to 396(A) of the Companies Act envisage certain provisions relating to amalgamation.

Accordingly, any scheme of amalgamation necessitates the approval of the Court. The Court wields enormous powers on this matter.

Section 494 of the Companies Act facilitates amalgamation, absorption and reconstruction of a company. It provides that the liquidator of a company can accept shares, policies or other like interests in the transferee company for distribution among the members of the transferor company, provided, the following two conditions are satisfied:

1. A special resolution is passed by the Company to the effect
2. The liquidator purchases the interest of any dissenting member at a price to be determined by agreement or by arbitration

Accounting Meaning

Accounting for amalgamation: Standard AS-14, issued by the Institute of Chartered Accountants of India, deals with the accounting for amalgamation and the treatment of any resultant goodwill or reserves. This standard was issued in 1994. This is mandatory to all companies with effect from the accounting year commencing on or after 1 April 1995.

According to AS-14, amalgamation means an amalgamation pursuant to the provisions of the Companies Act 1956, or any other statute which may be applicable to companies.

The Standard uses the term "transferor company" for the company which is amalgamated into another company.

The Company selling its business is also called "vendor company".

The Company into which a transferor company is amalgamated is called "transferee company".

The Company which acquires the business is also called the "vendee company".

It is important to note that:

1. The term amalgamation includes "absorption" also
2. The term amalgamation does not apply to acquisitions in the nature of controlling interest (Because in such cases, the acquired company will not be dissolved and its separate entity will continue to exist).

TYPES OF AMALGAMATION

The Standard AS-14 classifies amalgamation into two categories:

1. Amalgamation in the nature of merger
2. Amalgamation in the nature of purchase

Amalgamation in the Nature of Merger

Amalgamation should be considered to be an amalgamation in the nature of merger if the following conditions are satisfied:

1. All the assets and liabilities of the transferor company become the assets and liabilities of the transferee company after amalgamation.
2. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than equity shares already held therein, immediately before the amalgamation of the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of an amalgamation.
3. The consideration to the shareholders of the transferor company (willing to become equity shareholders of the transferee company) is discharged by the transferee company wholly by issue of equity shares in the transferee company except that cash may be paid in respect of any fractional shares.
4. The business of the transferee company is intended to be carried on after amalgamation by the transferee company.

5. No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Amalgamation in the Nature of Purchase

The amalgamation is in the nature of purchase, if any one or more of the conditions stipulated for the merger are not satisfied.

Hence, in the amalgamation in the nature of purchase:

1. Selling company's business will not be carried on in future
2. Shareholders holding 90% of the transferor company will not become shareholders of the transferee company
3. All the assets and liabilities of the selling company will not be taken over by the transferee company
4. Consideration payable to shareholders of transferor company may be in the form of shares or cash or in any other agreed form
5. Assets and liabilities taken over by the transferee company may be shown at values other than book values at the discretion of the transferee company

Note: Transferor company is the "selling company" and transferee company is the "purchasing company".

The Accounting Standard, for the purpose of accounting, recommends the "pooling of interests method" in the case of "amalgamation in the nature of merger" and the "purchase method" for "amalgamation in the nature of purchase". These methods will be discussed in detail later.

ACCOUNTING TREATMENT AS PER AS-14

Notwithstanding the fact that amalgamation, absorption and external reconstruction differ in many aspects, all have some common accounting problems.

They are as follows:

1. In all the cases, the transferor company and the transferee company must first agree the purchase consideration, i.e., the purchase price that should be acceptable by both parties
2. In all the cases, accounting entries have to be passed in the books of companies that will be liquidated in order to close the accounting books.
3. In all the cases, accounting entries have to be passed in the books of the transferee (purchasing) company to record the transactions pertaining to acquisition of business.

4. In all the cases, if the amalgamation is in the nature of merger "pooling of interest" method has to be adopted and if it is in the nature of purchase "purchase method" has to be adopted.

Before trying to solve problems relating to amalgamation, one has to understand some of the important terms associated with amalgamation, absorption and external reconstruction. They are discussed as follows:

Taking over the business: This term refers to take over of all the assets and liabilities of the business entity.

All assets: This term comprises fixed assets, current assets, goodwill, prepaid expenses, cash (in hand and at bank). But this term does not include fictitious assets shown on the assets side of the balance sheet under the heading "Miscellaneous Expenditure".

Example: Preliminary expenses, profit and loss account (debit balance), discount on the issue of shares or debentures.

Trade liabilities: Example: Creditors, bills payable—They are to be grouped under liabilities.

Liabilities: This term is used to refer all liabilities to *third* parties. First party is the company and second party is the shareholders. Liabilities include the following:

1. Creditors
2. Trade creditors
3. Bills payable
4. Bank overdraft
5. Loans
6. Outstanding expenses
7. Unclaimed dividends
8. Provision for taxation
9. Provision for gratuity
10. Pension fund
11. Provident fund
12. Superannuation fund
13. Workmen savings bank accounts (Deposit)
14. Workmen profit sharing fund
15. Workmen compensation
16. Debentures
17. Employees' deposit
18. Public deposits

19. Creditors for expenses

Provisions: Provisions for certain items may be shown separate item on the liabilities side of the balance sheet. But mostly, provisions are shown as deduction from respective assets on the assets side of the balance sheet. Both the assets and the provision on the assets are to be transferred to realization account.

Example: Provision for depreciation, provision for doubtful debts, provision for repairs and renewals, investment fluctuation fund.

Accumulated profits and losses: Undistributed profits of both revenue and capital nature are shown on the liabilities side of the balance sheet. Accumulated losses appear on the assets side of the balance sheet.

The purchasing company (transferee company) is neither entitled to accumulated profit nor accumulated loss. They belong to the equity shareholders of the transferor company (selling or vendor company). They should be transferred to the equity shareholders. Accumulated profits would be credited and accumulated losses would be debited to that account.

Accumulated profits include the following:

1. Profit and loss A/c—credit balance
2. General reserve
3. Capital reserve
4. Capital redemption reserve
5. Dividend equalization reserve
6. Sinking fund
7. Development rebate reserve
8. Investment allowance reserve
9. Securities premium
10. Share forfeited account
11. Fund—some items only, e.g., insurance fund
12. Revaluation reserve
13. Export profit reserve
14. Project export reserve
15. Contingency reserve

Accumulated losses include the following items:

1. Profit & loss A/c (Debit balance)
2. Preliminary expenses

3. Discount on issue of shares and debentures
4. Deferred revenue expenditure
5. Underwriting commission
6. Fictitious assets

Fund: Fund items may belong to any category— assets or liabilities, depending on its nature.

1. Fully accumulated profits category:

    1. Sinking fund
    2. Insurance fund
    3. Dividend equalization fund
    4. Debenture redemption fund

2. Purely liabilities category:
    1. Employee's provident fund
    2. Employee's profit-sharing fund
    3. Employee's pension fund
    4. Employee's superannuation fund
    5. Partly profit and partly liability funds:
    6. Employees compensation fund
    7. Contingency fund
    8. Employee insurance fund

If there is any balance in the workmen compensation fund, insurance fund and accident fund (after completely meeting out the liability), it should be transferred to equity shareholders account.

Important note:

1. In case, when some of the assets are not taken over, they are not to be included in take over even if the term "business" is given in the question.
2. In case, if any liability is not taken over, it will not form part of net assets method. Now, we will discuss the first stage: purchase consideration.

Purchase Consideration

In general, "purchase consideration" means the cash and non-cash payments made to the shareholders of the transferor (vendor) company. Accounting Standard AS-14, issued by the ICA1, defines the term consideration as, "Consideration for the amalgamation means the aggregate of shares and other securities issued and the payment made in the form of cash and other assets by the transferee company to the shareholders of the transferor company".

Salient Features of "Purchase Consideration"

The following are the salient features of purchase consideration:

1. Purchase consideration is confined to payments (cash and non-cash) to the shareholders of the transferor company (Selling company).
2. This amount payable has to be made by the transferee company which is to be treated as consideration for the acquisition of business.
3. Any amount paid to debenture holders, creditors and cost of absorption should not be included in purchase consideration.
4. Non-cash elements of purchase consideration should be determined at the fair value.
5. AS-14 recognizes the consideration payable to equity as well as preference shareholders of the transferor company.

Computation of Purchase Consideration

The following are the different methods of computing purchase consideration:

1. Lumpsum method
2. Net payments method
3. Net assets method
4. Ratio of exchange method

It is to be noted that as per AS-14, purchase consideration means only payment made to shareholders, irrespective of the method applied to compute purchase consideration.

Lumpsum Method

At times, the purchase consideration is mentioned (as a lump sum) straightaway in the agreement. In such a case, no necessity arises to compute purchase consideration.

Net Payment Method

Only those agreed payments specified in the agreement have to be added to determine the purchase consideration. That means, the quantum of amount payable in cash or shares or debentures are all to be added. The aggregate of the amount is referred to as "net payment" made by the purchasing company. It has to be paid to shareholders of the selling company.

Some of the important factors to be observed while determining the purchase consideration are as follows:

1. Only the agreed amount specified in the agreement should be included in the consideration.
2. In general, purchase consideration will not include payments to debenture holders and creditors. For this, a separate adjustment has to be made: such liabilities should be transferred to the books of the transferee company and then payment of liabilities should be shown in the books of the transferee company.
3. Liquidation expenses of the transferor company are met by the transferee company. Accountants differ in the treatment of liquidation expenses. If they are payable by the purchasing company, it is to be added to purchase consideration. But some accountants exclude the liquidation expenses in determining purchase consideration.
4. Shares issued by the transferee company should be valued at market price if the "purchase method" is adopted and at par value (fully paid only) if "the pooling of interests" method is adopted.

Net Assets Method

This method will be used if the "net payment method" cannot be used. When payment made is not crystal clear for various items, this method can be used. That means, if some form of cash payment is missing in the problem, this method can be adopted.

Under this method, purchase consideration is to be determined by adding the agreed values of assets taken over and deducting the agreed value of liabilities. This can be put in the form of equation as:

Sum of value of net assets = Agreed value of assets taken over – Sum of agreed value of liabilities taken over

Some of the important factors to be observed while determining purchase consideration under this method are:

1. The term "Assets" includes cash and bank balances.
2. The term "Assets" excludes items such as preliminary expenses, profit & loss A/c (Dr.), discount on issue of shares.
3. Items shown on the assets side of balance sheet under the head "Miscellaneous Expenditure" should not be included in the category of assets.
4. Any other asset specially mentioned as "not taken over" should not be included.
5. Similarly, liabilities not taken over should not be included.
6. All credit balances should be excluded.
7. Items shown on the liabilities side of the balance sheet under the head "Reserves & Surplus" should not be included.
8. Accumulated profits are not liabilities. They should be excluded.

9. Liabilities included are amounts to third parties.
10. Any “fund”—for example, workmen’s savings, profit sharing fund, PF—should be included under liabilities category.
11. “Trade creditors” comprises only creditors and bills payable. All other liabilities such as tax payable overdraft, any outstanding expenses are not a form of liability.

Share Exchange Method (or) Intrinsic Value Method

Under this method, the purchase consideration is determined on the basis of the ratio in which the shares of the transferee company are exchanged with those of the transferor company. The ratio of exchange is to be decided on the basis of intrinsic or market value of the shares concerned. To illustrate, X Ltd. merged with Y Ltd. and allotted 7 shares for every 25 shares held by shareholders of X Ltd. If a shareholder holds 500 shares in X Ltd., he receives in exchange 140 shares in Y Ltd. (i.e., $\frac{500}{25} \times 7 = 140$ shares).

Intrinsic value is determined by using the formula:

$$\text{Intrinsic value} = \frac{\text{Assets Available for Equity Shareholder}}{\text{Number of Equity Shares}}$$

Then purchase consideration is determined by using the formula:

Purchase consideration = Number of shares issued to the shareholders of the transferor company × Intrinsic value of the shares of the transferee company

At this juncture, one has to understand how fractional shares will have to be treated. Take the case illustrated in the share exchange method above. One Mr. Khan holds 60 shares in X Ltd. He is entitled to have $\frac{60}{25} \times 7 = 16.8$ shares. As shares will have to be issued in whole numbers only, 16 shares can be issued to him. Mr. Khan will have to be compensated in cash for 0.8 share. It is based on market price. The transferee company sells such shares at the market price and remits the proceeds to the shareholders of the transferor company.

Accounting Procedure

Accounting Treatment in the Books of Transferor (Selling or Vendor) Company

Important note: The accounting procedure is SAME for all types of amalgamation, whether it is in the nature of “merger” or “purchase”, in the books of the transferor (vendor) company.

Journal

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Step 1: Transfer of Assets: Realization A/c Dr. To Assets (Individually) Account [Important Hints for transfer of assets: (i) All assets, *whether taken over or not* must be transferred to realization a/c at *book value*. (ii) Provisions should not be deducted, but to be shown separately by crediting realization a/c. (iii) Agreed values should be ignored. (iv) Each and every asset has to be transferred *individually*. (v) Fictitious assets are to be ignored. (They should not be transferred to realization a/c) (vi) When amalgamation is in the nature of purchase, cash in hand and cash at bank are to be transferred to realization a/c *if* they are taken over by the transferee company. When amalgamation is in the nature of merger, these accounts *MUST* be transferred to realization a/c. (vii) All intangible accounts such as goodwill, patent copyrights are to be transferred to realization a/c. In case, they are mentioned as worthless, then they have to be transferred to shareholders A/c as "loss".]		…	…
	Step 2: Transfer of Liabilities: Liabilities (Individually) A/c Dr. To Realization A/c [Important Hints for Transfer of Liabilities: (i) Liabilities not taken over and liabilities to be settled by immediate payment are not to be transferred to realization a/c. (ii) Liabilities should be transferred as their respective book values. (iii) All the items shown under the heads "Secured Loans" and "Unsecured Loans" are to be transferred whether they are taken over or not by the transferee (purchasing) company. This also includes "Debentures", irrespective of the method of calculating purchase consideration. (iv) Any amount in the nature of reserve should not be transferred to realization a/c. **Example**: Accumulated profits (P&L A/c credit balance), sinking fund, dividend equalization fund, debenture redemption fund, i.e., all funds in the nature of profits. (v) Funds which are not reserves are to be transferred to realization A/c. **Example**: Pension fund, PF., superannuation fund. (vi) Funds which are partly profit and partly liability—only liability part is to be transferred to realization A/c and the other part is to be transferred to shareholders A/c.		…	…

	Step 3: Purchase Consideration—DUE:			
	(Purchasing) Transferee Co's A/c Dr.		...	
	To Realization A/c			...
	Step 4: Realization Expenses :			
	(a) If (a) If Liquidation Expenses Are Paid and Borne by the Transferor Company (Selling/Vendor)			
	Realization A/c Dr.		...	
	To Bank A/c			...
	(b) If the Transferor Pays and Later Gets Reimbursed by Transferee Company:			
	(i) Transferee Company's A/c Dr.		...	
	To Bank A/c			
	(ii) Bank A/c Dr.			...
	To Transferee Company's A/c			
	Note: At times, actual expenses paid and the reimbursement amount may vary. In such cases, the difference will be adjusted with realization A/c.			
	(c) If Liquidation Expenses Are Paid and Borne by the Purchasing (Transferee) Company, then No Need to Enter in the Books of the Vendor (Transferor) Company.			
	(However, the Liquidation Expenses Reimbursable Are Not at All to Be Included in the Purchase Consideration According to AS-14)			
	Step 5: Realization of Assets Not Taken Over by the Purchasing Company (Recorded or Not Recorded):			
	Bank A/c [Amount Realized] Dr		...	
	To Realization A/c			...
	Step 6: Payment of Liabilities Not Taken Over:			
	Realization A/c Dr.		...	
	To Bank A/c			...
	[***Note:*** In the settlement of iability, if there is premium, realization A/c is to be debited or credited in case of discount.]			
	Step 7: Discharge of Preference Share Capital:			
	(a) When Payable at Premium:			
	Preference Share Capital A/c [Face Value] Dr.		...	
	Realization A/c (Premium) Dr.		...	
	To Preference Shareholders A/c [Total]			...
	(b) When Payable at Discount:			
	Preference Share Capital A/c (Face Value) Dr.		...	
	To Preference Shareholders A/c (Net Amount Payable)			...
	To Realization A/c (Amount of Discount)			...
	(c) When Payable at Par:			
	Preference Share Capital A/c (Face Value) Dr.		...	
	To Preference Shareholders A/c (Face Value)			...
	[***Note:*** At times, on amalgamation, may be paid as premium or discount. In such cases, they have to be adjusted in realization A/c first and only then their profit/loss is to be determined.]			

	Step 8: Profit/Loss on Realization:			
	(a) When There Is Profit on Realization:			
	Realization A/c [With Profit Amount] Dr.		…	
	To Equity Shareholders A/c			…
	(b) When There is Loss on Realization:			
	Equity Shareholders A/c (With Loss Amount) Dr.		…	
	To Realization A/c			
	Step 9: On Receipt of Purchase Consideration:			
	Bank A/c (In the Form of Cash) Dr.		…	
	Preference Shares in Transferee Company's A/c			…
	(In the Form of Equity Shares) Dr.		…	
	Equity Shares in Transferee Company's A/c Dr.		…	
	(In the Form of Equity Share)			
	To Transferee Company's A/c (Total)			
	[Purchasing Company's A/c Will Be Closed with This Entry]			
	Step 10: Transfer of Equity Share Capital, Accumulated Profits & Reserves:			
	Equity Shares Capital A/c Dr.		…	
	Capital/Revenue A/c Dr.		…	
	General Reserve A/c Dr.		…	
	Any Other Reserve A/c Dr.		…	
	Profit & Loss A/c Dr.		…	
	To Equity Shareholders A/c			…
	Step 11: Transfer of Accumulated Losses and Fictitious Assets:			
	Equity Shareholders A/c Dr.		…	
	To Preliminary Expenses A/c			…
	To Underwriting Commission A/c			…
	To Discount on Issue of Shares/Debentures A/c			…
	To Profit & Loss A/c			…
	Step 12: Final Settlement of Claims to Preference Shareholders.			
	Preference Shareholders A/c (Amount Due) Dr.		…	
	To Bank A/c (Cash Paid)			…
	To Preference Share in Transferee Company A/c			…
	(Paid in the Form of Pref. Shares)			…
	Step 13: Final Payment to Equity Shareholders:			
	Equity Shareholders A/c (Amount Due) Dr.		…	
	To Bank A/c (Cash Paid)			…
	To Equity Share in Transferee Company A/c			…
	(Paid in the Form of Equity Shares)			
	[***Note:*** Vendor company's account will get closed after payment is made to equity shareholders.]			

Accounting Treatment in the Books of Transferee (Purchasing) Company

Accounting treatment in the books of purchasing company is based on the nature of amalgamation. Accounting Standard AS-14 stipulates two methods of accounting for amalgamation:

1. Pooling of interest methods
2. Purchase method

When the amalgamation is in the nature of merger, the transferee company has to apply "pooling of interests method". When the amalgamation is in the nature of purchase, the transferee company has to apply "purchase method".

Pooling of Interests Method

Pooling of assets, liabilities, capital, reserves and business of both companies takes place in this method:

1. The assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (i.e., book values). That means no adjustment is made in the book values of assets and liabilities of the transferor company. Further, fictitious assets are not assets and hence should not be incorporated in the books of transferee company.
2. The effects on the financial statements of any changes in accounting policies are to be reported as per AS-5.
3. The purchase consideration under this method is to be valued at par value of shares issued.
4. The balance in the profit and loss account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve.
5. The difference between the amount recorded as share capital issued + additional consideration in form of cash or other assets and the amount of share capital is to be adjusted in reserves in financial statements of the transferee company. The Expert Advisory Committee of ICAI Recommends:
6. The difference between the issued share capital of the transferee company and share capital of transferor company should be treated as CAPITAL RESERVE.
7. Reserve created on amalgamation is not available for dividend and/or bonus shares issued.

Journal Entries in the Books of Transferee Company (Pooling of Interest Method)

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
	Step 1: Purchase of Business:				
	Business Purchase A/c	Dr.		...	
	(With the Amount of Purchase Consideration.)				
	To Liquidators of Transferor Company				...
	Step 2: Take Over of the Assets, Liabilities and Reserves of the Transferor Company:				
	Sundry Assets A/c (Individually)	Dr.		...	
	To Sundry Liabilities A/c (Individually)				...
	To Profit and Loss A/c				...
	To Reserves A/c (Individually)				...
	To Business Purchase A/c				...
	[***Note:*** All assets and liabilities are to be recorded at their book values separately. But at times, book value gets adjusted according to the accounting policy of purchasing company.]				
	Step 3: Settlement of Purchase Consideration:				
	(i) When Shares Are Issued at Par:				
	Liquidators of Transferor Company A/c	Dr.		...	
	To Equity Share Capital A/c				...
	To Preference Share Capital. A/c				...
	To Bank A/c				...
	(ii) When Shares Are Issued at Premium:				
	Liquidators of Transferor Company A/c	Dr.		...	
	To Equity Share Capital A/c				...
	To Preference Share Capital A/c				...
	To Securities Premium A/c				...
	To Bank A/c				....
	(iii) When Shares Are Issued at Discount:				
	Liquidators of Transferor Company A/c	Dr.		....	
	Discount on Issue of Shares A/c	Dr.		....	
	To Equity Share Capital A/c				....
	To Preference Share Capital A/c				.....
	To Bank A/c				.....
	Step 4: Discharge of Liabilities:				
	(i) When Debentures Are Issued at Par:				
	Debentures of Transferor Company A/c	Dr.		...	
	To Debentures (of Transferee Company) A/c				...
	(ii) When Debentures Are Issued at Premium:				
	Debentures of Transferor Company A/c	Dr.		...	
	To Debentures (of Transferee Company) A/c				....
	To Securities Premium A/c				
	(iii) When Debentures Are Issued as Discount:				
	Debentures of Transferor Company A/c	Dr.		....	
	Discount on Issue of Debentures A/c	Dr.		....	
	To Debentures (of Transferor Company) A/c				....
	Step 5: Liquidation Expenses:				
	(i) Liquidation Expenses A/c	Dr.		...	
	To Bank A/c				...
	(ii) General Reserve/P&L A/c	Dr.		...	
	To Liquidation Expenses A/c				...
	Step 6: Formation Expenses:				
	Preliminary Expenses A/c	Dr.		...	
	To Bank A/c				...
	[***Note:*** At times, preliminary expenses are not written off against general reserve or P&L A/c. In such cases, it will be shown on the assets side of B/S under "Miscellaneous Expenditure".]				

Purchase Method

Accounting for amalgamation: When amalgamation is in nature of purchase, "purchase method" will have to be applied, in accordance with AS-14.

Accounting Entries in the Books of Transferee Company (Purchase Method)

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Step 1: Business Purchase: (Purchase of Business)			
	Business Purchase A/c Dr.			
	To Liquidators of Transferor Company A/c			
	Step 2: Taken Over of Assets of Liabilities:			
	All Assets A/c (Individually) Dr.		...	
	at Agreed Values			
	To Liabilities A/c (Individually) at Agreed Values			....
	To Debentures in Vendor's Company A/c			...
	To Business Purchase A/c			...
	[***Important Hints & Notes*:**			
	Case 1: If total amount of credit accounts is greater than the total amount of debit accounts, the difference is to be treated as a capital loss and is to be debited to goodwill A/c. Then entry will be:			
	Goodwill A/c (Balancing Figure) Dr.		....	
	Assets A/c (Individually) Dr.		...	
	To Liabilities A/c (Individually)			...
	To Business Purchase A/c			...
	Case 2: On the other hand, if total amount of debit accounts is greater than the total amount of credit accounts, then the difference is to be treated as a capital profit and is to be credited to capital reserve A/c. Then entry will be:			
	Assets A/c (Individually) Dr.		...	
	(Excluding Goodwill A/c)			
	To Liabilities A/c (Individually)			...
	To Business Purchase A/c			...
	To Capital Reserve A/c (Balancing Figure)			...
	Case 3: If there are both goodwill & capital reserve, then only net amount has to be shown in the B/S].			
	Step 3: Payment of Purchase Consideration:			
	(i) When Securities Are Issued at Par:			
	Liquidators of Transferor Company A/c Dr.		...	
	To Bank A/c			...
	To Equity Share Capital A/c			...
	To Preference Share Capital A/c			...
	To Debentures A/c			...
	(ii) When Securities Are Issued at Premium:			
	Liquidators of Transferor Company A/c Dr.		...	
	To Bank A/c			...
	To Equity Share Capital A/c			...
	To Preference Share Capital A/c			...
	To Debentures A/c			...
	To Securities Premium A/c			...
	(iii) When Securities Are Issued at Discount:			
	Liquidator of Transferor Company A/c Dr.		...	
	Discount on Issue of Shares A/c Dr.		...	
	Discount on Issue of Debentures A/c Dr.		...	
	To Bank A/c			...
	To Equity Share Capital A/c			...
	To Preference Share Capital A/c			...
	To Debentures A/c			...
	Step 4: Statutory Reserves:			
	Amalgamation Adjustment A/c Dr.		...	
	(Total Amount of Statutory Reserves)			
	To Particular Statutory Reserve A/c (Individually)			...

	Step 5: Discharge of Debentures:			
	Debentures in Transferor Company A/c Dr.		...	
	To Debentures in Transferee Company A/c			...
	To Securities Premium A/c			...
	To Bank A/c			...
	To Equity Share Capital A/c			...
	To Pref. Share Capital A/c			...
	Step 6: Liquidation Expenses (Paid and Borne by Transferee Company:			
	Goodwill A/c Dr.		...	
	To Bank A/c			...
	Step 7: Formation Expenses (In Case of a New Company)			
	Preliminary Expenses A/c Dr.		...	
	To Bank A/c			...
	[***Note:*** If both goodwill A/c and capital reserve appear in the books of transferee company, then goodwill A/c should be set off against the capital reserve A/c. The entry will be:			
	Capital Reserve A/c Dr.		...	
	To Goodwill A/c]			...

The following table shows the differences between "pooling of interests method" and "purchase method":

Basis of Distinction	Pooling of Interests Method	Purchase Method
1. Applicability	Applicable to amalgamation in the nature of merger.	This is applicable to amalgamation in the nature of purchase.
2. Recording of assets & liabilities	All assets and liabilities are incorporated as their book values.	They are to be recorded as agreed or fair or market values.
3. Treatment of reserves	All reserves are to be taken over by the purchasing company along with assets & liabilities.	Reserves are ignored. except statutory reserves.
4. Status of shareholders	At least 90% of equity shareholders of transferor company will become	Shareholders of transferor company may or may not

	shareholders of transferee company.	become shareholders of transferee company.
5. Difference between consideration and sharecapital of vendor company	Such difference is to be adjusted in capital reserve, revenue reserve or P&L A/c.	The difference is to be adjusted in goodwill or capital reserve.
6. Writing off goodwill	It does not arise in this method.	It should be written off within 5 years.
7. Liquidation expenses	Liquidation expenses are written off to general reserve or P&L A/c of the purchasing company.	Liquidation expenses are to be debited to goodwill A/c.
8. Amalgamation adjustment A/c	No necessicity of such account in this method.	Statutory reserves of selling company should be debited to "amalgamation adjustment A/c". It is to be shown on assets side of B/S.

ABSORPTION

Meaning

If an existing company takes over the business of another existing company or companies, it is termed as absorption. Merger is also absorption. To illustrate, when the business an existing company—say P Ltd.—is taken over by another existing company—Q Ltd.—it is absorption. In this case of absorption, P Ltd. will be liquidated and Q Ltd. will retain its identity.

Mean Features of Absorption

The following are the main features of absorption:

1. No new company will be formed.
2. At least one merged (absorbed) company will get liquidated. That means, more than one existing company can be merged with an existing company. The existing company is called the purchasing company (vendee company) and the merged company is called the vendor company (transferor company or absorbed company or liquidated company).

Accounting Treatment

1. Accounting entries in the books of vendor (transferor) Company: The procedure is same as that of adopted in the case of amalgamation.
2. Accounting entries in the books of purchasing (Transferee) Company: The procedure is same as explained in amalgamation. However, here it is immaterial whether the absorption is in the nature of merger or purchase. For both types, procedure is common in absorption unlike amalgamation.

Specific Problems (Issues) in Absorption

Intercompany Owings

It is natural to note that transferee company and transferor company are debtors and creditors of each other while absorption occurs. The reason is due to any of the following transactions:

1. Purchase of goods
2. Sale of goods

3. Loans
4. Advances
5. Bills of exchange given by one company to another company

After absorption, both the companies, i.e., the absorbing company as well as the absorbed company, become one single enterprise. The result being that the amounts involved in the above-mentionedtransactions are neither receivable nor payable. Then, how can these be dealt with? One such account has to be set off against the other. To illustrate, sundry debtors account have to be set off against sundry creditors. For such inter-company owings, the following journal entries are to be recorded in the books of the purchasing company (transferee or absorbing):

(i) Cancellation of Inter-company Debtors and Creditors			
Sundry Creditors A/c (Amount Payable)	Dr.	….	
To Sundry Debtors A/c (Amount Receivable)			….
(ii) Cancellation of Inter-company Loans:			
Loans Payable A/c (Amount Payable)	Dr.	….	
To Loans Receivable A/c (Amount Receivable)			…
(iii) Cancellation of Inter-company Bills:			
Bills Payable A/c	Dr.	….	
To Bills Receivable A/c			….

Note:

1. Bills payable to third parties cannot be cancelled.
2. No special treatment is needed for transactions with respect to inter-company owings. Such accounts are to be transferred to realization A/c.

Inter-company Stock (Unrealized Profit)

Case 1: Goods Sold by Transferor Company (Vendor):

It is found that some goods sold by the vendor company to the purchasing company may form a part of stock of the purchasing company when absorption takes place. Such goods are generally at sale price of the vendor company. They include the profit element. As stock is to be shown at cost, the profit part must be cancelled. For this, the following entries should be passed:

(a) When Absorption (Amalgamation) Is in the "Nature of Merger":		
Profit and Loss A/c	Dr. …	
(With the Amount of Unrealized Profit)		
Or General Reserve A/c	Dr ….	
To Stock A/c		…
(b) When Absorption Is in the "Nature of Purchase":		
Goodwill A/c	Dr. …	
(With the Amount of Unrealized Profit)		
To Stock A/c		…

Case 2: Goods Sold by the Purchasing Company:

The stock of goods of the transferor company may include some goods sold by transferee company to it. In such a situation, at the time of absorption, vendors stock will become the stock of purchasing company and the value of such stock will be as sale price. This includes the unrealized profit also.

Treatment: At times of absorption, the purchasing company will have to record such stock at its cost price.

Payment of Dividend Before Absorption

- When the company (transferor or transferee) pays dividend to its shareholders, the entry to be passed will be:

Profit & Loss Appropriation A/c Dr. ….

[Amount with the Dividend]		
(Or) General Reserve A/c	Dr.	….
To Bank A/c		….

- When the proposed dividend A/c appears in the balance sheet, the entry to be passed will be:

Proposed Dividend A/c	Dr.	….
To Bank A/c		…

Case 1: When the dividend is paid by the transferor company, then it is to be treated as dividend paid *before absorption.* In that case, reduced cash balance (dividend paid is to be deducted) is *transferred to realization A/c.* Similarly, the reduced balance of P&L appropriation A/c is transferred to equity shareholders account of the transferor company.

Case 2: When the dividend is paid by the purchasing company, the P&L appropriation A/c balance and cash (Bank) balances are reduced by the amount of dividend paid but *after absorption*, to be made in *balance sheet.*

Sale of Shares Received Towards Purchase Consideration

At times, the shareholders of the transferor company may seek the assistance of shareholders to sell some of the shares received as part of purchase consideration. The journal entries will be:

Case 1: Sale of Share in the Purchasing Company:

Bank A/c (With the Sale Value)	Dr.	….
To Shares in Purchasing Company		….
Case 2: Profit on Sale of Shares:		
Shares in Purchasing Company A/c	Dr.	….

(With Profit)		
To Equity Shareholders A/c		....
Case 3: Loss on Sale of Shares:		
Equity Shareholders A/c (Loss)	Dr.	....
To Shares in Purchasing Company		....

Distribution of Balance Shares

The remaining shares (after purchase consideration is discharged) will be distributed among the equity shareholders. They will get the balance in the form of cash. The entry will be:

Equity Shareholders A/c	Dr.	...
To Shares in Purchasing Company		
To Bank A/c		

RECONSTRUCTION

Meaning of Reconstruction

Generally "reconstruction" means the reorganization of financial (Capital) structure of the existing company. Such reorganization may be carried out by winding up or not winding up the existing company.

Types of Reconstruction

Reconstruction may broadly be categorized into:

1. External reconstruction
2. Internal reconstruction

EXTERNAL RECONSTRUCTION

Meaning

When reorganization of a company's financial structure involves winding up of a company and a floatation of a new company (with the same assets and shareholders), then it is referred to as "external reconstruction".

External reconstruction is more or less like "amalgamation in the nature of purchase".

External reconstruction necessitates:

1. Winding up of an existing company
2. Formation of new company

That means, the old company is restructured to form a new company.

In external reconstruction, the new company takes over the assets and liabilities of the old company at its true values. The share capital issued also will reveal the true value of net assets.

Under external reconstruction, the company acquires the status of new legal entity. All the shareholders of the old company need not be the shareholders of the new company. The old company is called the transferor or vendor company and the new company is termed "transferee company" or purchasing company.

Accounting Treatment

As per AS-14, under external reconstruction, the assets and liabilities of the old company are taken over by the new company at their true or revised values and not at their book values.

Accounting entries in the books of account of vendor company (old company):

The accounting entries are made to close the books of vendor company in the same method as discussed in the amalgamation process.

Accounting entries in the books of account of the new company or purchasing company:

The same accounting procedure explained in the case of "amalgamation in the nature of purchase" is to be followed here.

Some Special Items:

1. **Payment to creditors of the old company:** Creditors should be transferred to Realization A/c. After that, they should be paid off by the new company after take over.
2. **Contingent liability:** Contingent liability need not be transferred to Realization A/c. They should be recorded in the books of the purchasing company as taken over and paid off by the new company.

The following table shows the difference between amalgamation and external reconstruction:

Basis of Distinction	**External Reconstruction**	**Amalgamation**
1. Number of companies	In external reconstruction, only one is involved	In amalgamation, two or more companies are involved.
2. Formation	New Company is a restructured old company	Two or more companies are merged or taken over by a new company
3. Types for accounting purposes	It is like amalgamation in the nature of purchase	Here two types:

		(i) Amalgamation in the nature of merger and (2) Amalgamation in the nature of purchase

Inter-company Holdings

Sometimes, companies in the scheme of combination (merger or acquisition or absorption) have financial interest in other companies. Companies' moneys would have interlocked in shares and debentures of other companies. In such cases, the accounting treatment is a tricky affair. For the convenience of accounting, they may be divided into three broad categories as follows:

1. When purchasing company holds shares in vendor company (absorbed company)
2. When the vendor (absorbed) company holds shares in the purchasing company
3. When both the companies hold shares in each other

When Purchasing Company Holds Shares in Vendor Company

In this case, the purchasing company is also a shareholder of the vendor company. Legally, it has rights to have a proportionate amount in the net assets. Hence, the problem arises in the treatment of amount due to shareholders. Because for the amount due to combination, it cannot receive its own shares. The absorbing company, in this case, can buy only the net assets belonging to outside shareholders. Then what can be done with respect to absorbing company for its part of securities in the vendor company. This problem of accounting can be resolved as follows:

Books of Vendor (Absorbed) Company:

Step 1:	Purchase consideration should be computed for the entire business concern. This may be under net assets or payments method, depending on the case
Step 2:	Debit the purchasing company with the full price.
Step 3:	Credit with the amount that is received relating to outsiders.

Step 4:	There will be a debit balance. This represents the amount to be received from purchasing company as the part of purchase consideration.
Step 5:	Similarly, in the shareholders' A/c there will be a credit balance. This amount represents the quantum payable to purchasing company. This is neither paid by the vendor company nor received by it in the capacity as a shareholder.
Step 6:	These two accounts are to be closed by the set-off entry as:

Shareholders' A/c	Dr.......	
Purchasing Company's A/c		......

Books of Purchasing Company:

The same problem is tackled by passing the following entry in the books of the purchasing company as:

Liquidator of Vendor Company Dr. (With Full Purchase Price)
To Share Capital/Debenture/Bank (With Amount Payable to Outsiders)
To Shares in the Vendor Company (With Amount Due to Purchasing Company)

Note: Any difference in shares in the vendor company A/c is to be transferred to goodwill or capital reserve depending on the case.

When Vendor (Transferor/Selling) Company Having (Holds) Shares in Purchasing (Transferee) Company

Net Payment Method:

1. Under this method, the number of shares already held by the vendor company should be deducted from the shares agreed to be issued.
2. The investment of the vendor company in shares of the purchasing company should not be taken over by the purchasing company. That means investments in purchasing company are not to be transferred to realizsation A/c.
3. This method is explained in the following illustration:

II: Net Assets Method:

1. Under this method, the assets in the form of "investment in shares of the purchasing company" should not be taken into account for computing the purchase consideration.
2. This method is explained in the following illustration:

When Shares are Held by the Companies in Each Other

(i)Net Payment Method:

Under this method, the purchase consideration is to be computed under the following steps:

Step 1:	The Number of Shares to Be Issued to Outside Shareholders in the Absorbed Company	=…
Step 2:	Number of Shares Due to Purchasing Company as Shareholder in the Vendor Company	=…
Step 3:	Total Number of Shares (Step 1 + Step 2)	= …
Step 4:	Less: Number of Shares Already Held by the Absorbed Company	= …
Step 5:	Purchase Consideration (Number of Share as per Step 4 × Issue Price per Share) =	₹ …

(ii) Net Assts Method:

Net Assets of a Company Should Be Ascertained by Using Simultaneous Equations.

		₹
Step 1:	Total Value of Assets of Each Company (Applying Algebraic Equation):	...
Less:		
Step 2:	Proportionate Value of Assets (Shares):	...
Less:		
Step 3:	Shares of the Purchasing Company Held by Vendor Company:	...

Summary

Amalgamation: When two or more existing companies combine to form a new company, it is amalgamation.

Absorption: When one existing company takes over the business of one or more existing companies, it is absorption.

External reconstruction: When one existing company is wound up and a new company is floated with the same shareholders, it is external reconstruction.

Legally, amalgamation includes absorption. AS-14 deals with accounting for amalgamation.

Reorganization of a company without winding up (liquidating) the company is internal reconstruction. On the other hand, if it involves the liquidation of the existing company, it is external reconstruction.

Types of amalgamation: (i) Amalgamation in the nature of merger and (ii) Amalgamation in the nature of purchase.

Purchase consideration: It refers to the total amount payable to the shareholders of transferor company.

Methods of computation of purchase consideration: (i) Lump sum method (ii) Net payment method (iii) Net assets method and (iv) Intrinsic value method. Each method is explained with a sufficient number of illustrations (Ref: The text).

Items that are to be treated as liabilities, trade liabilities, provisions, accumulated profits and accumulated losses are explained clearly. (Ref: the text for detail)

Methods of accounting for amalgamation: (i) The pooling of interest method and (ii) Purchase method.

Accounting treatment: Whatever may be the form of combination (i.e., amalgamation, absorption or external reconstruction), the books of the transferor (selling, vendor) company have to be closed. This has to be made by passing necessary entries in the books of journal and preparing the relevant ledger accounts. At the same time, journal entries have to be passed in the books of purchasing company (transferee).

These are all explained by way of illustrations (Ref: text).

Some of the following factors should be taken into account while accounting for amalgamation, absorption and external reconstruction is carried out:

1. Amalgamation adjustment A/c
2. Amalgamation after balance sheet date
3. Dissenting shareholders
4. Inter-company owings
5. Unrealized profit in stock

Accounting treatment for Inter-company holdings:

1. When shares are held by the transferee company in the transferor company
2. When shares are held by the transferor company in the transferee company
3. When shares are held by both the companies in each other (cross holdings)

Each type is explained with illustrations (Ref: text)

Key Terms

Amalgamation: A form of business combination in which two or more companies combine together to form a new company.

Absorption: A form of business combination in which one existing company takes over the business of one or more existing companies.

External Reconstruction: A form of reorganization in which an existing company is liquidated and a new company floated with the same shareholders.

Purchase Consideration: It refers to the total amount payable to the shareholders of the transferor company by the purchasing company.

Amalgamation Adjustment A/c: An account to which any statutory reserve (of the selling company that is to be continued for a few years) should be debited to and to be shown as asset in the balance sheet. Applicable only when purchase method is adopted.

Dissenting Shareholders: Shareholders of the transferor company who have not given their asset to the proposed scheme of amalgamation (or any reorganization scheme).

INTERNAL RECONSTRUCTION

NEED FOR INTERNAL RECONSTRUCTION

1. **True and fair view of financial position:** A company may be incurring losses for several years. In such cases, the financial position cannot reflect a true and fair view. Hence, it necessitates reorganization in order to disclose the actual financial position of an enterprise.
2. **Value of assets:** On a careful analysis, it may reveal that such continuous loss-making companies consist either overvalued tangible assets or insignificant intangible assets. To get rid of these unreal values of assets, they should be updated to their real values by way of reconstruction.
3. **External liabilities:** External liabilities include loan, payment of preference dividends, debentures, etc. These cannot be discharged on stipulated and specified time. These have to be reduced to a great extent to maximize profitability through reorganization.
4. **Share capital:** The capital figure (i.e., the value of net assets) is not reliable as it tends to show a higher figure than the real figure due to various factors such as overvalued tangible assets, idle and valueless intangible assets and fictitious assets, and outstanding liabilities not discharged on maturity date. Because of this, the share capital of such loss-incurring companies will not reflect the real and fair value of the net assets of the company. To set right this sort of over capitalization, reconstruction is of vital importance.
5. **Remedial measure:** If proper reorganization does not take place, it will lead to total disaster. To escape from such a scenario, reconstruction is necessary. To a certain extent, reconstruction is remedy to avoid unforeseen disaster to companies. Proper diagnosis and reorganization may alleviate such evils.

METHODS OF INTERNAL RECONSTRUCTION

The following are the methods employed for internal reconstruction:

1. Alteration of share capital
2. Reduction of share capital
3. Compromise/arrangement as per Sections 391 to 394(A)
4. Variation of shareholder's rights
5. Surrender of shares
6. Cancellation of unissued shares

Alteration of Share Capital

Under this method, alteration of share capital involving increase, consolidation or sub-division of share capital is done according to Section 94, 95 and 97 of the Companies Act.

Alteration will not involve reduction of share capital. Any public limited company can alter the capital clause of its Memorandum of Association (i) if it is authorized by its Articles of Association to carry out alteration and (ii) by an ordinary resolution passed in its general meeting. Alteration of share capital can be carried out in the following ways:

Increase of Share Capital

A company may increase its share capital by issuing new shares:

Accounting Entries:	(Full Amount Payable on Application)	
(i) Bank A/c	Dr. …	
To Share Application & Allotment A/c		…
(ii) Share Application & Allotment A/c	Dr. …	
To Share Capital A/c		…

Consolidation of Shares

In this type, the existing shares of lower denomination are converted into shares of higher denomination.

Accounting Entry:

Share (Equity or…. % Preference) Capital A/c	Dr. …	
To Share (Equity or … … % Preference) Capital A/c		…

Example: A company having 1,00,000 ₹2% preference shares of ₹ 10 each decided to consolidate the shares into shares of 100 each. Pass the needed journal entry.

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	12% Preference Share Capital (1,00,000 × ₹ 10) Dr.		10,00,000	
	To 12% Preference Share Capital (10,000 × ₹ 100)			10,00,000
	(Consolidation of 1,00,000 Pref. Shares of ₹ 10 into 10,000 Preference Shares of ₹ 100 Each)			

One should note here that the paid up share capital remains the same, i.e. ₹ 10,00,000 only, but total number of shares is reduced to 10,000 from 1,00,000 shares. The face value of shares is increased from ₹ 10 to ₹ 100.

Care should be taken in case of partly paid shares to keep the proportion between the paid-up and unpaid amount at the same level after consolidation.

Example: A company with a subscribed capital of ₹ 1,00,000 divided into 10,000 equity shares of ₹ 10 each on which ₹ 6 per share are paid up. The company decides to consolidate equity shares of ₹ 10 each into ₹ 100 each. Pass the journal entry.

Accounting Entry:

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c (10,000 × ₹ 6) Dr.		60,000	
	To Equity Share Capital A/c (1,000 × ₹ 60)			60,000
	(Consolidation of 10,000 Equity Shares of ₹ 10 Each (₹ 6 Paid up) into 1,000 Equity Shares of ₹ 100 Each (₹ 60 Paid up)			

Note: After consolidation, there is no change in the paid-up share capital i.e. ₹ 60,000. But the number of shares and its face value have changed. Paid-up value is also increased proportionately from ₹ 6 to ₹60.

Conversion of Fully Paid Shares into Stock

In this case, all or any of its fully paid shares may be converted into one unit of stock.

Example: A company decided to convert its 10,000 equity shares of ₹ 10 each into ₹ 1,00,000 equity stock.

Pass the entry.

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Capital A/c Dr. To Equity Stock A/c (Conversion of 10,000 Equity Shares of ₹ 10 Each Fully Paid up into ₹ 1,00,000 Equity Stock (One Unit)		1,00,000	 1,00,000

Reconversion of Stock into Shares (Fully Paid up)

Stock (of one unit) may be converted into shares.

Example: ₹ 1,00,000 equity stock is converted into 1,000 equity shares of ₹ 100 each fully paid. Pass the entry.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Capital A/c Dr. To Equity Share Capital A/c (₹ 1,00,000 Equity Stock Is Converted into 1,000 Equity Shares of ₹ 100 Each)		1,00,000	 1,00,000

Sub-division of Shares

A company may sub-divide its shares of higher denomination into shares of smaller denomination.

Example: A company has 5,000 equity shares of ₹ 100 each. It decides to sub-divide these shares into ₹ 10 each. Pass the required journal entry:

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Capital A/c Dr. To Equity Share Capital A/c (₹ 100) (5,000 Equity Shares of ₹ 100 Each Sub-divided into 50,000 Shares of ₹ 10 Each)		5,00,000	 5,00,000

Paid-up capital remains unaffected whereas the face value of shares is reduced and the number of shares is increased.

Cancellation of Unissued Shares

Shares which have not been issued (till date) by the company are cancelled. These unissued shares are neither taken by any person nor agreed to be taken by any one.

On cancellation of unissued shares, the amount of share capital will be reduced to that extent that it only results in diminution of authorized share capital and it does not mean reduction share capital.

Example: A limited company has an authorized capital of ₹ 10,00,000 and issued capital of ₹7,50,000. It decides to alter its authorized capital (for unissued shares cancelled) to ₹ 7,50,000 and issued capital to ₹ 7,50,000.

There is no accounting entry for any cancellation of unissued shares. The reduced authorized capital is to be shown in the balance sheet of next accounting year only.

Capital Reduction

A Company can reduce its share capital as per the provisions of the Companies Act. Sections 100 to 105 of the Act laid down certain provisions with respect to reduction of capital. The following is the procedure to be followed for effecting reduction of share capital:

1. There should be a specific clause relating to reduction of share capital in the Articles of Association.
2. In case the articles of association are silent on this matter, a special resolution has to be passed to effect reduction of share capital in the general meeting.
3. Court order has to be obtained for any reduction in share capital. (It should be observed here that for alteration of share capital, court permission is not necessary.)
4. A copy of special resolution in reduction of share capital and the order of confirming such reduction must be filed with the Registrar of Companies.

Accounting Treatment for Capital Reduction

Reduction of share capital may take place in more than one form.

Form 1: Reducing the liability or extinguishing entirely the liability of the shareholders with respect to uncalled or unpaid amount.

When the uncalled amount of the share capital is reduced or entirely extinguished, the shareholders will be exempted from paying that amount to that extent in future. The shareholders are benefitted by such form of reduction of share capital.

Example: A company whose capital consists of 1,000 shares of ₹ 100 each, ₹ 75 called and paid, decides to reduce the shares into 1,000 shares of ₹ 75 each fully paid. Pass journal entry.

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Share Capital A/c (1,000 × ₹ 75)		75,000	
	To Share Capital A/c			75,000
	(Conversion of 1,000 Shares of ₹ 100 Each ₹ 75 (Partly) Paid up into 1,000 Shares of ₹ 75 Each Fully Paid up)			

Net result: (i) Reduction in nominal value; (ii) No reduction in paid-up value.

Form 2—Refunding surplus capital: At times, some companies may be confronted with the problem of excess capital. Hence the company is forced to refund the excess capital to its members. The members will raise vehement objections because it will affect the security enjoyed by the creditors. Such a scheme of capital requiring the refund of surplus capital needs the approval of the Court.

(i) Share Capital A/c	Dr. …		(With the Amount to
To Sundry Shareholder's A/c		…	Be Refunded)
(ii) Sundry Shareholders' A/c	Dr. …		(With the Amount
To Bank A/c		…	Actually Refunded)

Example: A company whose paid-up capital includes 5,000 equity shares of ₹ 100 each fully paid decides to return ₹ 25 per share to the members, this reducing each share to ₹ 75 each, fully paid. Pass entries.

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)	Equity Share Capital (₹ 100) A/c Dr.		5,00,000	
	To Equity Share Capital (₹ 75) A/c			3,75,000
	To Sundry Shareholders' A/c			1,25,000
	(Conversion of 5,000 Shares of ₹ 100 Each into Shares of ₹ 75 Each and the Balance to Be Refunded Transferred to the Members)			
(ii)	Sundry Shareholders A/c Dr.		1,25,000	
	To Bank A/c			1,25,000
	(Refund of Surplus Capital on Account of Reduction of Capital to the Shareholders)			

Net result: The share capital of the company will be reduced by the amount refunded. In this problem, the share capital is reduced from ₹ 5,00,000 to ₹ 3,75,000 because of the refund of ₹ 1,25,000 to the shareholders.

Form 3—Reducing the paid up capital (Writing off of lost capital not represented by assets): The share capital of the company which has been facing losses for a considerable period, usually continuously for a long period, may not be truly represented by the assets. The extent of loss will also get reflected in the form of goodwill, over-valuation of assets, etc. Hence, in the scheme of capital reduction, it is essential to write off or cancel that portion of capital which is already lost, not represented by assets accounting treatment.

A new account—reconstruction A/c or capital reduction A/c—has to be opened. The amount of reduction has to be credited to this account. This scheme of capital reduction may be carried out in the following two situations:

Situation 1—Reduction in the paid-up value and nominal value: In this case, the nominal value of the shares and the paid-up value is reduced.

Example: In a limited company, the shareholders agree to reduce the paid-up capital of ₹ 100 per share (10,000 shares) to fully paid shares of ₹ 60 per share. Pass entries.

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c (₹ 100) Dr.		10,00,000	
	To Equity Share Capital A/c (₹ 60)			6,00,000
	To Reconstruction A/c			4,00,000
	or			
	To Capital Reduction A/c			
	(Conversion of 10,000 Shares of ₹ 100 Each Into Shares of ₹ 60 Fully paid, and the Balance Transferred to Reconstruction A/c or Capital Reduction A/c)			

Situation 2—Reduction in the paid-up value only: In this case, the nominal value of the shares remains the same. But the paid-up value is reduced.

Example: A company decides to reduce ₹ 30 per share on its 50,000 equity shares of ₹ 100 each fully paid. Pass the required journal entry.

Journal Entry

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Equity Share Capital A/c Dr.		15,00,000	
	To Reconstruction A/c			15,00,000
	(Reduction of ₹ 30 per Share on 50,000 Shares of ₹ 100 Each as per Capital Reduction Scheme)			

Compromise and Arrangement

The scheme of compromise and arrangement is a kind of agreement between a company, its members and outside creditors. They agree to give up their claims. This scheme involves sacrifices by shareholders and creditors. This is dealt with in the Sections 390 to 396(A) of the Companies Act. There are many ways in such a scheme of compromise and arrangement as follows:

1. When equity shareholders give up their claims to the reserves and accumulated profits (Sacrifice their amount due to company's financial crisis):

Accounting Treatment:

Reserves A/c	Dr.	...		{With the Amount of Reserves}
To Reconstruction A/c			...	

2. When there is appreciation in the value of assets on revaluation:

Entry:

Fixed Assets A/c	Dr.	…	
To Reconstruction A/c			…

3. When there is profit on sale of fixed assets:
During internal reconstruction scheme, some fixed assets may be sold to meet the external liabilities. Profit arises on sale of fixed assets is to be credited to capital reduction A/c or reconstruction A/c.

Entry:

Fixed Assets A/c	Dr.	…	
To Reconstruction A/c			…

4. Outside liabilities settled at a lesser amount:
Creditors, debenture holders and others (external liabilities) may accept less amount instead of their original claim (waiting for a long period for final settlement). This difference (sacrifice) between the original claim and agreed amount is to be credited to reconstruction A/c.

Entry:

Outside Liabilities A/c	Dr.	…	
Provisions A/c	Dr.	…	
To Reconstruction A/c			…

5. Payment of outside liabilities:
All the outside liabilities will have to be paid in any one of the following forms to settle their claims: cash, shares, new debentures, assets of the company.

Entry:

Outside Liabilities A/c	Dr.	…	
To Bank A/c			… (In Cash)
To Share Capital A/c			… (In Cash)
To New Debenture A/c			… (In Cash)
To Assets A/c			… (In Cash)

6. Preference dividend:

Case I: Dividend declared (Shown in b/s) but sacrificed:

Entry:

Proposed Preference Dividend A/c	Dr.	…	
To Reconstruction A/c			…

Case II: Arrears of dividend (not shown in b/s) but paid now:

Entry:

Reconstruction A/c	Dr.	…	
To Bank A/c			…

Case III: Dividend neither declared nor paid:

No Entry

Variation of Shareholders' Right

Limited companies issue various classes of shares with different rights. Some of such rights attached to the shares are voting rights, rights as to dividend, repayment of capital. The companies may change rate of dividend (on preference shares), cumulative preference shares into non-cumulative preference shares. These changes can be carried out without change in the amount of share capital.

Accounting Treatment:

1. Entry for Reduction in the Rate of Dividend:

10% Cumulative Preference Share Capital A/c	Dr.	…
To 9% Cumulative Preference Share Capital A/c		…
(10% Cumulative Pref. Shares Are Changed into 9% Cumulative Preference Shares)		

Net result: Rate of dividend is changed from 10% to 9%. But there is no change in the amount of share capital.

2. Entry for Change from Cumulative to Non-cumulative Preference Share:

10% Cumulative Preference Share Capital A/c	Dr.	…
To 10% Non-cumulative Pref. Share Capital A/c		…
(10% Cumulative Pref. Share Is Changed into 10% Non-cumulative Pref. Shares)		

Net result: Only the right to dividend is changed from cumulative to Non-cumulative. But there is no change in the rate of dividend and the amount of share capital.

Surrender of Shares

During internal reconstruction, the shareholders may be asked to surrender their shares. In order to reduce the liabilities of the company, such surrendered shares are allotted to debenture holders and creditors. The balance, if any, i.e. the unutilized surrendered shares, is then cancelled.

HANDLING OF RECONSTRUCTION ACCOUNT

The primary aim of reconstruction is to show the true value of assets, liabilities and share capital of the company. The reconstruction A/c is to be utilized in the following ways one by one:

1. Fictitious assets and intangible assets to be written off:

The first task of internal reconstruction is to write off the fictitious assets and intangible assets from the books of accounts of the sick companies. Miscellaneous expenditures and P&L A/c debit balance are some fictitious assets. Invaluable patents, copyrights, trade marks, goodwill are some examples of intangible assets.

Account Treatment:

Entry:

Reconstruction A/c	Dr. …	
To Fictitious Assets (Individually)		…
To Intangible Assets (Individually)		…

2. Overvalued fixed assets and current assets to be lowered down:
The next step in the task of internal reconstruction is to bring down the particular assets to their correct values. This is done with the help of the following entry:

Entry:

Reconstruction A/c	Dr. …	
To Fixed Assets A/c (Individually)		…
To Current Assets A/c (Individually)		…

Note: Only the amount of reduction is to be entered here.

3. New liability & new provisions to be brought into books of account:
Some liabilities would not have been recorded. Some items may have to be treated as new liabilities. A new provision will have to be created during the course of internal reconstruction. Some unrecorded liability and provisions must be recorded now:

Entry:

Reconstruction A/c	Dr. …	

To Liability A/c (Individually)		…
To Provision A/c (Individually)		…

In case, if unrecorded liability is paid in cash, entry will be:

Reconstruction A/c	Dr. …	
To Bank A/c		…

4. Reconstructions expenses:
All the expenses that are incurred in this process of internal reconstruction should be entered as:

Reconstruction A/c	Dr. …	
To Bank A/c		…

5. Transfer of credit balance to capital reserve A/c:

Finally, the reconstruction account thus prepared has to be balanced like any other ledger accounts. In case, if there is credit balance (more sacrifice than write offs), it should be transferred to capital reserve A/c.

Entry:

Reconstruction A/c	Dr. …	
To Capital Reserve A/c		…

With this entry, the scheme of internal reconstruction comes to an end, from the accounting point of view.

Specimen of Reconstruction Account

Particulars	₹	Particulars	₹
P & L A/c (Loss Written off)	...	Share Capital Account (Reduction in Paid-up Value)	...
Intangible Assets Account (Useless Intangible Assets Written off—Individually)	...	Debentures Account (Amount of Reduction)	...
Miscellaneous Expenditures (Written off—Each Expense Individually)	...	Creditors Account (Amount of Sacrifice)	...
Discount on Issue of Shares (Written off)	...	Fixed Assets Account (Increase in Value)	...
Discount on Issue of Debentures (Written off)	...	Current Assets Account (Increase in Value)	...
Fixed Assets A/c (Decrease in Value—Individually)	...	Bank Account (Sale Amount of Unrecorded Assets)	...
Current Assets A/c (Decrease in Value—Individually)	...	Reserves Account	...
Provision for Doubtful Debts	...	Provisions Account (To the Extent Not Required)	...
Bank Account (Unrecorded Liability—Paid)	...		
Bank Account (Arrears of Pref. Dividend—Paid)	...		
Bank Account (Reconstruction expenses—Paid)	...		
New Liability Account	...		
Bank Account (Directors' Fees Refunded)	...		
Capital Reserve A/c (If Any) (Bal. Fig.)	...		
	xxx		xxx

The next stage is the preparation of balance sheet.

BALANCE SHEET AFTER RECONSTRUCTION

The factors that should be taken into account while preparing the balance sheet after the completion of internal reconstruction are as follows:

1. The words "And Reduced" must be added to the name of the company. This should be continued for certain accounting period as ordered by the court.
2.
    a. The revised appreciated values of the assets on the date of internal reconstruction must be shown in the balance sheet. The book values should be ignored.
    b. The amount of increase in the value of assets on account of revaluation should be shown in the balance sheet.
    c. The revised lower figures, i.e., original cost-depreciation should be shown instead of book values.
8.

a. For fixed assets, the amount written off should be shown separately for a period of 5 years.
b. For current assets, and investments, the amount written off need not be shown. They should be shown only at their revised lower values.
c. For provisions, such amount of provision should be shown as a deduction from the gross amount in the inner column and only the net amount in the outer column.

Holding Company Accounts

HOLDING COMPANY

The Companies Act, 1956 does not lay down any definition on holding company. However, Section 4(4) of the Companies Act stipulates: “A company shall be deemed to be the holding company of another, if, but only if, that the other is its subsidiary.”

- A holding company is a limited company
- It acquires all or majority of equity shares of another limited company—called the subsidiary company
- It controls the composition of Board of Directors of another company (subsidiary)
- The subsidiary company continues to enjoy the status of a separate legal entity
- Even though the subsidiary company is virtually controlled by the holding company, it does not necessitate liquidating subsidiary companies

SUBSIDIARY COMPANY

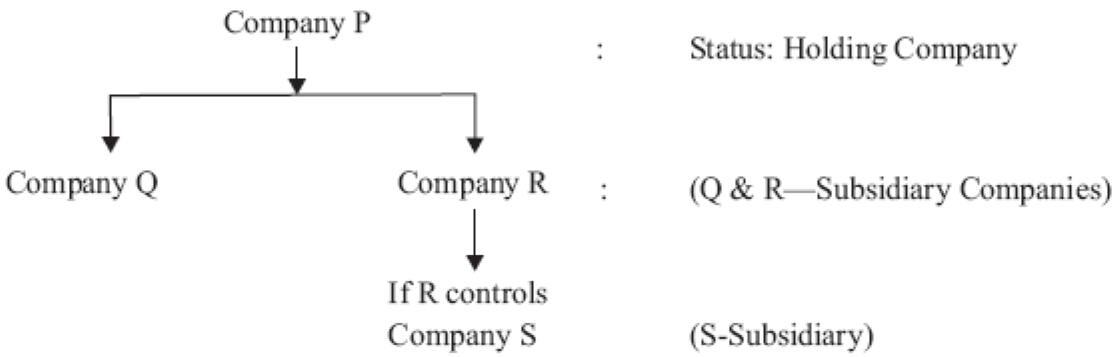
Section 4(1) of the Companies Act defines subsidiary company. Accordingly, a company shall, subject to the provisions of sub-section (3), be deemed to be a subsidiary of another if, but only if:

1. That other controls the composition of its Board of Directors
2. That other
    i. Where the first-mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company;
    ii. The first-mentioned company is a subsidiary of any company which is that other’s subsidiary

By defining subsidiary, it unfolds the characteristics of a holding company, which can be easily comprehended by the following illustration:

Company Q is a subsidiary of Company P. That means Q is a subsidiary company and P is a holding company. Suppose Company R is a subsidiary of Company P, by virtue of clause (c) above. S is a subsidiary of company R, Company S will be a subsidiary of Company Q and consequently also of company P by virtue of clause (c) above, and so on.

This can be schematically represented as:



Company S attains the status of subsidiary companies of both Company P and Company R.

In other words, a company which is the subsidiary of a company, which in turn is a subsidiary of another company is also considered to be subsidiary of the ultimate holding company.

Control means acquiring required amount of equity share capital to ensure a majority vote. This concept of control may be explained by the following illustration.

Share Capital of P Ltd. has been raised as follows:

5,000	Equity Shares of ₹ 100 Each	₹ 5,00,000
5,000	12% Preference Shares of ₹ 100 Each	₹ 5,00,000

If, only equity shareholders have the right to vote at its general meetings as per the provisions of the Company's Articles, and if another company acquires 2,501 equity shares, it will have majority of vote power and can control the Board of Directors thereby resulting a relationship of holding company and subsidiary company. Such an occurrence may be continued as:

				₹
P Ltd.	Total Equity Capital: 5000 Equity Shares of ₹ 100 Each			5,00,000
Q Ltd.	Capital Acquired in 2,501 Shares of P Ltd. (Shares are Rounded off To the Next Hundred even Though a Majority of One Vote Would be Enough)	2,600 Shares	:	2,60,000
P Ltd.	Capital Acquired: 1400 Shares (1301 Shares)		:	1,40,000
S Ltd.	Capital Acquired: 800 Shares (701 Shares)		:	80,000

Suppose, at this juncture, if any company, say T Ltd., acquires 401 shares of S Ltd., then it can exercise control over all companies (P, Q & R Ltd.) and this establishes the relationship of holding company and subsidiary company.

Wholly Owned Subsidiary Company

A company in which all the shares with voting rights (i.e., 100%) are owned by the holding company, it is said to be a wholly owned subsidiary company.

Partly Owned Subsidiary Company

A company in which only the majority of shares (more than 50%) are owned by the holding company, it is said to be a partly owned subsidiary.

Minority shareholders: In partly owned subsidiary companies, shareholders who do not sell their shares to the holding company are termed “minority shareholders”. Shares held by other than holding company, i.e., general public, represent this category.

Minority interest: Minority shareholder’s interest or share in the assets of the subsidiary company is termed “minority interest.”

LEGAL REQUIREMENTS FOR A HOLDING COMPANY

Section 212 of the Companies Act stipulates that the balance sheet of a holding company has to be accompanied by the below-mentioned documents of relating to each of its subsidiaries:

1. A copy of the balance sheet of the subsidiary
2. A copy of the P&L A/c of the subsidiary company
3. A copy of the report of its Board of Directors
4. A copy of the report of its auditors
5. A statement containing the following particulars:
    i. the nature and extent of holding companies’ interest in the subsidiary at the end of the last financial year

   ii. The net aggregate amount of profits or losses in the subsidiary so far as it concerns the members of the holding company and is not dealt within the holding company's accounts

6. If the financial year of the holding company and its subsidiary company coincide with each other, subsidiary company's balance sheet and other documents specified above with respect to the same financial year should be attached to the balance sheet of the holding company
7. If the financial year of the subsidiary company does not coincide with the financial year of the holding company, a statement showing the following should be attached:
    a. Whether, and to what extent, there has been a change in the holding company's interest in the subsidiary company since the close of the financial year of the subsidiary company
    b. Details of any material changes which have occurred between the end of the financial year of the subsidiary company and the end of the financial year of the holding company in respect of:
        1. The subsidiary's fixed assets
        2. Its investments
        3. The moneys lent by it
        4. The moneys borrowed by it for any purpose other than that of meeting its current liabilities
        5. If for any reason, the Board of Directors of the holding company is unable to obtain information on profits (capital or revenue), a report in writing to the effect.

In a nutshell, if the financial years of both the subsidiary and holding companies do not coincide, the preceding year's balance sheet and other statements of the subsidiary company should be attached. The information attached to the balance sheet of a holding company in respect of its subsidiary companies should not be more than 6 months.

CONSOLIDATED FINANCIAL STATEMENTS

"Consolidated financial statements" means the preparation and presentation of Profit and Loss account and balance sheet of a holding company and its subsidiaries in a single format. According to the Companies Act, there is no legal provision insisting a holding company to prepare and present "group accounts" or consolidated financial statements. Even though there is no statutory provision for a holding company to prepare Consolidated financial statements, the ICAI has issued AS-21 on "consolidated financial statements". It is not mandatory. As per AS-21, holding company means a parent company which has one or more subsidiaries. A "group" is a "parent" and all its subsidiaries. The main purpose of the preparation of consolidated statements is to reflect a true and fair view of the position and the profit or loss of the holding company "group". Further, by preparation of consolidated financial statements, the shareholders are in a position to get firsthand information on the company authentically.

The advantages of consolidation of financial statements are as follows:

1. **Facilitates easy comprehension:** Shareholders are in a position to get a clear insight about the financial position of the group (parent and all its subsidiaries) at a glance. Users of the financial statements are better informed through a single source document.
2. **Assists in ascertaining intrinsic value of shares:** For various accounting procedures, intrinsic value of shares serve as an essential tool. This can be attained on the basis of consolidated financial statements of companies.
3. **Proper assessment of return on investment:** Only consolidated financial statements can provide proper information on the total share of holding company in the revenue profit of its subsidiaries.
4. **Minority interests disclosure:** In the consolidated balance sheets, the item shown under the head "Minority Interest" discloses the total amount payable to outside shareholders. This is liability payable to outsiders, i.e., general public. This factor is the main factor to be considered in the process of acquisition of company.
5. **Helps in the "evaluation" of holding company:** As consolidated financial statements reflect a true and fair view of the position of the holding company (parent) as a group, the investors may be able to evaluate the performance of the company. Thereby, it enhances the overall performance of the group.

The following are its limitations:

1. **Varied information:** All the subsidiary companies may not carry the same type of business. As their activities differ from each other, information combined together in a single format may result in confusion and alternatives.
2. **Irrelevant or concealment of facts:** The data got from subsidiary companies may not be relevant in the combined form. Further, to arrive at common figures, some of the facts may be suppressed. In such a situation, a consolidated financial statement may not reflect a true and fair view of the position of the companies.

Contents and Format of Consolidated Balance Sheet

The Company's Act does not specify any standard prescribed format for Consolidated Balance Sheet.

However, Schedule VI of the Company's Act stipulates that a holding company will have to disclose the following items under the respective headings as shown below:

A: On the assets side of the balance sheet:

1. Under the head "Investments": Investments in equity shares, preference shares, debentures or bonds of subsidiary companies in detail.
2. Under the head "Loans and Advances": Loans and advances given to subsidiaries.

B: On the liabilities side of the balance sheet:

1. Under the head "Secured Loans": Loans and advances from subsidiaries against secured properties.
2. Under the head "Unsecured Loans": Other loans and advances from subsidiaries.
3. Under the heads "Current Liabilities" & "Provisions": Any amount due from subsidiaries.

Note: Any form of consolidated balance sheet should be in conformity with Schedule VI to the Companies Act, 1956.

Format

Consolidated Balance Sheet of Holding Company and Its Subsidiaries as on....

Liabilities	₹	₹	Assets	₹	₹
SHARE CAPITAL:			FIXED ASSETS:		
Share Capital of Holding Company		xx	(i) Cost of Control or Goodwill	…	
Reserves & Surplus:			Investments in Shares of Subsidiary	…	
(i) Capital Reserves of Holding Company			Less: Cost of Shares Acquired Excess	…	
Add:					
(a) Share in Pre-acquisition Reserve of Subsidiary	…		Add: Goodwill in B/S of Holding Company	…	
(b) Share in Pre-acquisition Profit of Subsidiary	…		Goodwill in B/S of Subsidiaries Goodwill	…	
Less: Goodwill (As per Contra)	…	xx	Less: Capital Reserve (as per Contra)	…	xx
			(ii) All Other Fixed Assets of Holding Co.	…	
			Add: All Other Fixed Assets of Subsidiaries	…	
				…	xx
(iii) Revenue Reserves of Holding Company	…		Investments:		
Add: Share in Revenue Reserves of Subsidiary	…	xx	(i) Investments of Holding Company (Except Shares in Subsidiaries)	…	
(iv) P&L A/c Balance (Profit) of Holding Company	…		Add:		
			(ii) Investments of Subsidiaries	…	
					xx
Add: Share in Reserve Profits of Subsidiary	…		Current Assets and Loans & Advances:		
Less: Share in Unrealized Profit	…	xx	Current Assets of All Companies (Holding + Subsidiaries)	…	
Secured Loans:			Less: Inter-company Debts (Mutual Indebtedness)	…	
(i) Secured Loans of Holding Company	…			…	
Add: Secured Loans of Subsidiaries	…	xx	Less: Share of Unrealized Profit in Stock	…	xx
Unsecured Loans:					
(i) Unsecured Loans of Holding Company	…				
Add:					
(i) Unsecured Loan of Subsidiaries	…	xx			
Current Liablities & Provisions:					
(i) Current Liabilities & Provisions of Holding Companies	…				
Add: (ii) Current Liabilities & Provisions of Subsidiaries	…				
Less: Inter-company Indebtedness (Liabilities)	…	xx			

Minority Interest:		xx	Miscellaneous Expenditure:		xx
			Profit & Loss Account:		
			P&L A/c of Holding Company Only		xx
		xxx			xxx

NOTE: At times, "minority interest" may also be shown under the head "Share Capital".

Preparation of Consolidated Balance Sheet

Various factors have to be taken into account for the preparation of consolidated balance sheet of a holding company and its subsidiaries. They are explained item wise as follows:

Investment Account—Elimination or Cancellation

In consolidated balance sheet, the financial position of the parent company (holding) and all its subsidiaries is shown. The figures are shown as a single company. In general, a holding company shows the shares acquired in a subsidiary company—on the assets side of balance sheet—as an investment.

The assets shown in the balance sheet denote the resources owned by the group (holding company + all its subsidiaries). The liabilities shown are claims on the assets (resources) of the group. These internal items—that are assets to one and liabilities of another—will not appear in consolidated balance sheet. This type of process is termed as elimination or cancellation of respective items.

In other words, the investment of a holding company in the shares of the subsidiary company is replaced by the assets and liabilities of the subsidiary company by way of cancelling the said item.

The principle of cancellation is based on the following assumptions:

1. It should be a wholly owned subsidiary company
2. The holding company and the subsidiary company do not indulge in trade with each other
3. The shares are purchased at par

Minority Interest

It will be sufficient to attain the status of holding company if that company acquires majority equity shares in a subsidiary. Here, majority means a simple majority in terms of democracy. The remaining shares naturally are in the hands of general public, i.e., outside shareholders. In such a partly owned subsidiary company, the share capital is being jointly held by the holding company and outsiders. The collective interest of such outside shareholders is termed "minority interest".

The minority interest is to be computed and shown as a separate item on the liabilities side of the consolidated balance sheet. Minority interest is the amount payable to the outsiders with respect to share capital and accumulated profits to the extent of their share.

Minority interest may be computed as follows:

Add:	₹
(i) Proportionate Value of Equity Shares Held:	…
(ii) Proportionate Value of Pref. Shares Held:	…
(iii) Proportionate Share in Capital Profits:	…
(iv) Proportionate Share in Revenue Profits:	…
(v) Proportionate Share of Bonus Shares:	…
(vi) Proportionate Share in P&L A/c (Cr.):	…
Step A: Add (i) to (vi):	xxx
(vii) Less: Proportionate Share in P&L A/c (Dr.):	…
(viii) Proportionate Share in Capital Loss:	…
(ix) Proportionate Share in Revenue Loss:	…
Step B: Add (vii) to (ix):	xxx
Step C: Minority Interest (Step A – Step B):	xxx

Cost of Control (or) Goodwill

In general, the shares of a subsidiary company are purchased either as a premium or at a discount by the holding company. When the share capital of the subsidiary company held by the holding company is cancelled against investment in share (cost), difference will arise.

1. When the holding company purchases the shares at a price above the nominal value, the excess price paid represents cost of control or goodwill. It may be said that "cost of control" is the "excess" paid by the holding company to acquire "controlling interest" in the subsidiary company. This may be presented in the form of equation as:

   Cost of control or goodwill = Investment (At cost) – Face or paid-up value of shares purchased

2. When the holding company purchases shares at a price below the face value, the difference represents "capital reserve". This may be presented in the form of equation as:

   Capital reserve = Face or paid-up value of shares purchased – Investment at cost

Method of ascertaining cost of control (or) reserve:

		₹	₹
Step 1:	Amount Paid for Shares Purchased (by the Holding Company in a Subsidiary)		…
Add:			
Step2:	Holding Company's Share of Capital Loss		…
			xx
Less:			
Step3:	(i) Face Value of Shares	…	
	(ii) Holding Company's Share of Capital Loss	…	
	(iii) Holding Company's Share of Bonus Shares Issued by Subsidiary	…	
	(iv) Holding Company's Share of Dividend Paid out of Capital Profit	…	xx
Step 4:	Goodwill (or) capital reserve:		xx

Notes:

1. In Step 4, if the balance is positive it is goodwill. On the other hand, if the balance is negative it is capital reserve
2. This amount will be merged with goodwill in the reserve balance sheets of Holding and Subsidiary companies.

Pre-acquisition Profits–Reserves

The subsidiary company, on the date of acquisition of shares by the holding company, is having balances in the profit and loss and reserves accounts. The holding company not only purchases shares but also is entitled to purchase a certain proportion of profit and reserves. Such accumulated profits of the subsidiary company existing on the date of acquisition are known as “pre-acquisition profits” or “capital profits”. They include capital reserve, general reserve, share premium, P&L A/c reserve fund.

For calculating the share of the holding company, reserves and profits are split into the following:

1. Pre-acquisition profit/reserve
   a. Pre-acquisition profits:
      Treatment: They are treated as capital profits. They are to be included in capital reserves and adjusted against goodwill.
   b. Pre-acquisition reserves:
      Treatment: Same as pre-acquisition profit.

2. Post-acquisition profit/reserve
   a. Post-acquisition profits:
      Treatment: They are treated as revenue profits. They are to be added to the surplus or profits of the company.
   b. Post-acquisition reserves: They are to be added to general reserves.

Important notes:

1. Capital reserves of the holding company must be adjusted with goodwill as both cannot be shown at a time in the balance sheet.
2. When computing the share of minority interest, a distinction should not be made between pre-acquisition and post-acquisition profits/reserves.
3. A distinction between the pre- and post-acquisition profit/reserves has to be made for accumulated profits/reserves of the subsidiary company for determining the share of the holding company.

Pre-acquisition Losses

1. Pre-acquisition losses are like capital losses relating to the share of holding company.
2. In consolidated balance sheets, it will increase the cost of control or decrease the capital reserve.
3. Post-acquisition losses are like revenue losses. Share of the holding company will be debited to accumulated balance in the P&L A/c of the holding company. In case sufficient profits do not exist, it will be shown as a separate item on the assets side of the balance sheet.
4. There is no necessity for distinction between pre- and post-acquisition losses with respect to minority interest.

Inter-company Transactions (Elimination of Common Transactions or Mutual Obligation or Mutual Indebtedness)

The companies in a group, i.e. the holding company and the subsidiary company, may trade each other. They owe money to each other on account of common transactions like buying and selling of goods, lending and borrowing of money, rendering service to each other and the like. This will culminate in common accounts appearing in the balance sheets of holding company as well as its subsidiaries. While preparing consolidated balance sheet, all such mutual obligations should be eliminated.

Debtors and Creditors

Transactions with respect to sale and purchase of goods on credit take place between the holding company and its subsidiaries. This will result in mutual indebtedness as debtors in the balance sheet of the company which sells goods and as creditors in the balance sheet of the company which purchases those goods on credit.

Treatment:

1. If the same amount appears in both the companies, they can be eliminated by deducting common amounts both from the debtors and creditors (thus by reducing on both sides of the consolidated balance sheet).
2. If there is any difference between the two, it may be due to cash-in-transit or goods-in-transit. Such “transit” amount is to be reduced from the side on which higher amount is shown. Further, this item (cash or goods in transit) is to be shown on the assets side of the balance sheet as a separate item.

Loans Payable and Receivable

Loans are advanced to subsidiaries by the holding company or vice versa. It is shown as an asset in the balance sheet of the company which advances the loan and as a liability in the balance sheet of the company which receives that loan.

If interest on the loans is outstanding, the P&L A/c of the lender company will be credited with the amount of interest due. Loan account of the company that borrowed the loan will be debited.

In consolidated balance sheet, both loan and interest should be eliminated.

Bills Receivable and Bills Payable

Bills of exchange of the holding and subsidiary companies will include bills accepted and drawn by each other. To that extent, such bills which are included in the bills-receivable should be eliminated while preparing the consolidated balance sheet. However, any bills endorsed or discounted causing a liability to a third party has to be shown as a separate item on the assets side of the balance sheet.

Services Rendered

Companies owing for services rendered, if entry is already passed by both the companies, should be subtracted from respective items in the balance sheet.

In case no entry is entered till now, such amount should be reduced from revenue profit of the subsidiary company and added to the P&L A/c of the holding company.

Contingent Liabilities

Transactions that may become liabilities in future are contingent liabilities. It may or may not occur. It is not certain.

Example: (i) Bills endorsed to creditors and discounted with Bank (ii) Investment in partly paid shares (iii) Arrears of dividend or cumulative preference shares (iv) Liability under guarantee, etc.

Treatment:

1. Contingent liability involving a third party is to be shown as a “foot note” to the consolidated balance sheet (External contingent liability).
2. Contingent liability involving the holding company and its subsidiaries is not to be shown as a footnote to consolidated balance sheet. (It will be

shown as liability in the consolidated balance sheet) [Internal contingent liability].

Unrealized Profit in Stock

The holding company or the subsidiary, at times, has in its stock goods purchased from the other company that were sold at profit. Hence, the stock includes the unrealized profit charged by the selling company.

Such unrealized profit has to be eliminated from closing stock.

Treatment: First, the unrealized profit value would be deducted from the profit of the subsidiary company. Then it would be deducted from the closing stock. While preparing consolidated balance sheet, the unrealized profit should be reduced from the stock (on the assets side of B/S) and from the P&L A/c (on the liabilities side of B/S)

Unrealized profit may also be deducted from the revenue profit of subsidiary company while determining the share of holding company in the revenue profits of subsidiary company.

Preference Share Capital in Subsidiary Company

Preference shares (part or full) in a subsidiary company may also be acquired by the holding company, in addition to equity shares.

Treatment:

1. Preference share capital in subsidiary company has to be shown in the consolidated balance sheet along with minority interest.
2. While ascertaining the cost of control, amount paid by the holding company is added to the amount paid for equity shares. Face value of preference shares is reduced. Any difference between the face value and the amount paid is adjusted with goodwill/capital reserve.
3. Any dividend due on the preference shares up to the date of acquisition is also reduced while computing cost of controls, after deducting it from capital profits.
4. Any dividend due on the preference shares for the post-acquisition period is treated as revenue dividend payable.
5. Minority share of preference shares is to be included in minority interest along with pre-acquisition dividend payable to the minority.

6. Premium payable on redeemable preference shares has to be provided for by annual instalments over the period between the date of the balance sheet and the date of redemption.
7. In case the profits of subsidiary company are not sufficient to provide for arrears of dividends, then it is not permitted to provide for such arrears from the consolidated profits of the holding and subsidiary companies.

Debentures in Subsidiary Company

1. Debentures of the holding company are to be treated in the same manner as that of share capital, i.e., they are to be shown in the consolidated balance sheet as a separate item
2. Debentures of the subsidiary company also will be treated in the same manner, as (i).
3. In case a part of the debentures of a subsidiary company is held as investments by the holding company, the number of debentures would be reduced to the extent of investments.
4. The remaining part of debentures held by outsiders is to be shown on the liability side of the consolidated balance sheet as a separate item.

Revaluation of Assets

When a holding company acquires shares in a subsidiary company, fixed assets of subsidiary company are revalued in order to assess its correct value of shares. Any profit or loss on revaluation of assets has to be shown in the consolidated balance sheet.

- Any increase in the value of any fixed assets is to be treated as capital profits, whether it is in pre- or post-acquisition period.
- Such capital profits will be apportioned between capital reserve and minority interests.
- The proportion of increase of the holding company is to be taken to investment account. This will reduce the cost of control/goodwill.
- In case, any decrease in the value of fixed assets is to be treated as capital loss. This will increase the cost of control/goodwill or reduce the capital reserve. But it is a revenue loss, if the revaluation occurs in the post-acquisition period.
- Adjustment for depreciation:

1. If the value of fixed assets increases (revaluation profit), depreciation charge also will be increased accordingly. This is to be deducted from the revenue profits of the subsidiary company.
2. If the value of fixed assets decreases, depreciation will also be decreased proportionately. This is to be added to the revenue profits of the subsidiary company.

Bonus Shares Issued by Subsidiary Company

A subsidiary company (after the holding company acquired controlling interest) may issue bonus share out of its profits to all the shareholders. This will increase the number of shares with the holding company. Naturally, the face value of shares held in the subsidiary company will also increase, as the holding company receives such bonus shares.

Treatment: "Source of profit" out of which the bonus issued is the basis of accounting treatment. They are:

1. Bonus shares issued out of capital profits (or) pre-acquisition profits
2. Bonus shares issued out of revenue profits (or) post-acquisition profits

1. **Bonus issue out of capital profits:** This does not have any accounting effect. The reason is that while determining the cost of control/goodwill, the share of the holding company in the pre-acquisition profit is reduced and the paid-up value of shares held is increased. At this juncture, the issue of bonus shares will in no way affect the cost of control. Minority share of the bonus is added to the minority interest.
2. **Bonus issue out of revenue profits:** This has its effect on the consolidated balance sheet. The amount of bonus is reduced from revenue profits before apportioning the revenue profits in the holding minority ratio.

While calculating "cost of control", the holding company's share of bonus is deducted. This will result in decrease in goodwill to the extent of the holding company's share of bonus. Minority share of the bonus is added to the minority interest.

Net result is that the bonus issue is in the nature of capital profits whether they are issued out of capital profits or out of revenue profits.

Insurance Company Accounts

MEANING OF INSURANCE

Life is replete with risk and uncertainty, which may occur due to accident, death, destruction of property by fire or other natural calamities. Losses arising due to such risk may be minimized by way of insurance.

Insurance is an agreement between two parties under which the insurer undertakes to indemnify by the risk of the insured by getting a small sum for a specified period under regular instalments. This sum is called 'premium'. The person or any form of organization, which agrees to indemnify such losses for a sum of money, i.e. premium is known as 'insurer'. The person for whom such a risk is to be borne is known as 'insured'. The document by which the contract to be entered is known as 'insurance policy'.

Insurance is a contract through which the insurer agrees to pay a stipulated amount to the insured on the occurrence of an eventuality in lieu of a sum of premium. One important factor is that the insured must show that one has pecuniary interest in it. Hence, 'insurable interest' is an inevitable element in all insurance contracts.

PRINCIPLES OF INSURANCE

Following are the important underlying principles that govern insurance business:

1. **Principle of indemnity:** Insurance is a contract to protect against risk. It is a contract of indemnity, which is the fundamental principle of insurance. The insured is called the indemnified.

2. **Principle of utmost good faith:** All contracts of insurance are contract of '*uberrimae fidei*', i.e. contract of utmost good faith. This necessitates the proposers to disclose all the material facts known to them in the insurance proposal form. Only on the basis of such frank disclosure the assessment of risk is taken into account by the insurer.

3. **Insurable interest:** Another important principle is 'insurable interest'. As insurance is a contract between the insurer and the insured, this principle is an important ingredient in such contracts.

TYPES OF INSURANCE

Although there are several types of insurance policies (business), they may be broadly divided into two categories:

1. Life insurance

2. General insurance

Life Insurance

It is a contract under which the insurer (life insurance company) agrees to pay a certain amount on the death of the insured (assured) or upon the expiry of predetermined fixed period, whichever is earlier. Under this insurance, 'risk of life' is covered. Life insurance policies may further be classified into the following:

1. **Whole life policy:** Under this policy, premium has to be paid continuously till the death of the insured. The policy amount will be payable only after the death of the insured by the insurer.

2. **Endowment policy:** Under this, the insured gets a specified sum on completion of certain years of age or to a nominee of the insured on the event of death, whichever is earlier. Premium for this type of policies will be higher than those for whole life policies.

3. **With profit policy:** Under this type, the insured, i.e. the policy holders are entitled to participate in the profits of the insurance company besides getting a guaranteed sum of money on maturity of policies.

4. **Without profits policy:** Under this type of policies, the insured are not entitled to participate in the profits of the company. They will get a fixed sum of money.

5. **Annuity:** Under this, the insurer either pays a lump sum or a premium in regular instalment for a specified period. At the end of the period, the insurer will pay back the sum inregular instalments.

General Insurance

All insurance other than life will be grouped under this category. A contract under which the insurer (the company), in consideration of a fixed premium, undertakes to reimburse the insured (policy holder) for the loss due to an uncertain event is called general insurance. Various types of general insurance are as follows:

1. **Fire insurance:** This policy covers risks of fire.
2. **Marine insurance:** Under this type of policy, goods vehicle and freight exposed to marine risks are covered. Here, vehicle means cargo or the ship.
3. **Burglary insurance:** Losses of theft are covered under this insurance.

4. **Other type:** In addition to the above, there are various other policies to insure accidents, fidelity of employees, third party, workmen compensation, consequential loss and so on.

Difference Between Life Insurance and Non-life (General) Insurance

One has to understand the fundamental differences between these two broad categories of insurance, which are tabulated as follows:

Basis of Distinction	Life Insurance	Non-life Insurance (General Insurance)
1. Period	Life insurance contracts are of long-term, covering number of years.	These are of short term, generally, one year only.
2. Determination of actual loss	As human life cannot be valued precisely, the exact quantum of loss cannot be estimated. It depends entirely on the financial capacity of the individuals to pay premium.	These policies are contracts of indemnity. Actual loss can be ascertained. Hence, what ever may be the amount of policy, the insurer will reimburse the actual loss only.
3. Determination of profit	A valuation balance sheet is prepared on the basis of estimate by actuaries to determine the profit. The liability under existing policies are estimated by actuaries, which is a complicated mathematical process.	A portion of premium is carried forward as a provision for unexpired liability and the net balance of claims and expenses is treated as profit/loss.
4. Nomenclature	Life 'insurance' is also called as life 'assurance', as the insured gets an assured sum	These policies are called 'insurance' only and non-assurance.

INSURANCE BUSINESS IN INDIA

The following are the legislations enacted to govern the insurance business in India:

1. The Insurance Act, 1938; Insurance (Amendment) Act, 2000
2. Insurance Rules, 1939
3. The Companies Act, 1956
4. The General Insurance Business (Nationalization) Act, 1972
5. The Marine Insurance Act, 1963

6. The Insurance Regulatory and Development Authority Act, 1999 (IRDA)
7. The Insurance Regulatory and Development Authority Regulations, 2002

The IRDA Act was passed with the following objectives:

1. To protect the interests of policyholders
2. To regulate and promote the orderly growth of insurance business
3. To further amend the Insurance Act and other related acts

The IRDA Regulations, 2002

IRDA has issued, through a notification, regulations, which govern the preparation of financial statements and auditors report of the insurance companies.

1. An insurer carrying on life insurance business shall comply with the requirements of Schedule A (Refer Page 1073).
2. An insurer carrying on general insurance business shall comply with the requirements of Schedule B (Refer Page 1079).
3. The report of the auditors of the financial statements of every insurer and reinsurer shall be in conformity with the requirements of Schedule C (Refer Page 1085).

ACCOUNTS OF INSURANCE COMPANIES

Accounts of insurance companies shall be maintained according to the provisions of the Insurance Act, 1938, as amended in Insurance (Amendment) Act, 2000. The accounts shall comply with the requirements of Schedule A of the IRDA Regulations, 2002 (Refer Page 48)

Books of Accounts

It is obligatory on the part of all insurance companies to maintain the following books, which are called **'statutory books'.**

They are as follows:

1. **Register of policies:** This book contains the following particulars relating to each policy:

1. The name and address of the policyholder
2. The date on which the policy was effected
3. A record of any assignment of the policy

2. **Register of claims:** This contains the following particulars in respect of each claim:
    1. The date of claim
    2. The name and address of the claimant
    3. The date on which the claim was discharged

4. In the case of claim, which is rejected, the date of rejection and the ground for rejection

3. **Register of licensed insurance agents:** This book contains the following particulars in respect of each agent:

    1. Name and address of every insurance agent appointed
    2. The date of appointment
    3. The date on which appointment was ceased, if any

Besides the above-mentioned statutory books, the insurance companies should maintain the following **subsidiary books** also for proper accounting:

1. Register of proposals and proposal advance cash book
2. First year's premium cash book
3. Renewal premium cash book
4. Agency and branch cash book
5. Petty cash book
6. Claims cash book
7. General cash book
8. Bank cash book
9. Agency credit journal
10. Agency dedit journal
11. Commission book
12. Lapsed and cancelled policies book
13. Chief journal
14. Agency ledger
15. Policy loan ledger
16. General loan ledger
17. Investment ledger

Preparation of Final Accounts—Life Insurance Business

The final accounts of a life insurance company consist of: (i) revenue accounts, (ii) profit and loss account and (iii) balance sheet.

Revenue Account

Procedure:

Revenue Account is prepared in Form A—RA as per IRDA Regulations, 2002.

First, the following four Schedules should be prepared:

Schedule 1—under the caption 'Premiums Earned (Net)'

Schedule 2—under the caption 'Commission'

Schedule 3—under the caption 'Operating expenses'

Schedule 4—under the caption —'Claims'

The following are the next procedure in preparation of revenue account:

- Add: Premiums earned, income from investments and other income.
- From the aggregate of the above,
- Deduct: Commission expenses, operating expenses, benefits paid and provisions for debts and taxes.
- The net result will be Surplus or deficit.
- Transfer to shareholders' account and other reserves shall be made from the surplus.
- Balance of surplus is to be transferred to funds for future appropriations, represented by 'life assurance fund'.

Profit and Loss Account

Procedure:

1. Profit is transferred from revenue A/c. Opening balance is shown at the beginning of the P & L A/c.
2. Deduct: Dividends declared and dividend distribution tax.
3. Transfer to specified reserves as per the provisions of IRDA.
4. Remaining balance → to be carried to balance sheet.

Balance Sheet

The balance sheet comprises two parts:

Part I: Sources of funds:

This includes:

1. Shareholders' funds
2. Borrowings
3. Policyholders' funds
4. Funds for future appropriations

Part II: Application of funds:

This includes:

1. Investments
2. Loans
3. Fixed assets
4. Net current assets
5. Miscellaneous expenditure

This should be accompanied by schedules, i.e. Schedules 5–15.

Final Accounts of General Insurance Companies

The final accounts of a general insurance company consist of: (1) revenue account, (2) profit and loss account and (3) balance sheet.

Revenue Account

This account is a summarized in forms of Schedules 1–4.

When the same company is doing various types of insurance businesses such as fire, marine, accident and the like,for each business separate account is prepared and shown in separate column in FORM B-RA as per the IRDA norms.

1. The following items are to be added and shown as Total (A):

1. Premiums
2. Income and profit from investments
3. Other incomes

2. The following items are to be added and shown as Total (B):

    1. Expenditure on claims (net)
    2. Commission
    3. Operating expenses

3. The different (A) – (B) gives the operating profit of the business.
4. After appropriations, operating profit is to be transferred to P & L A/c.

Profit and Loss Account

If a general insurance company is indulged in doing more than one business, a combined P & L A/c is to be prepared.

As stared earlier, the operating profit or loss is to be transferred from revenue account to P & L A/c.

Income not related to specific business is to be added with operating profit and shown as 'Total (A)'.

Similarly, expenses not related to specific business are to be added and shown as 'Total (B)'.

Total (A) – total (B) – profit before tax

Provision for tax and appropriations has to be made.

Finally, balance of profit is to be addedto the balance brought forward from the previous year.

Net balance of profit is to be carried forward to the balance sheet.

Balance Sheet

This consists of two parts.

Part I:	Sources of funds:
	This is a summarized presentation of Schedules 5–7, which reveals share capital, reserves and surplus and borrowings. Part II: Application of funds:
Part II:	Application of funds:
	This is a summarized presentation of Schedules 8–15, which depicts
	investments, loans, fixed assets, net depicts investments, loans, fixed assets, net current assets, current liabilities, provisions and miscellaneous expenditure.

SPECIAL TERMS RELATING TO INSURANCE ACCOUNTS

Insurance business differs from other business undertakings. Even the terms used in insurance business are new and peculiar. Some of such new terms are explained here.

Claims: The risk of the insured covered for a consideration is referred to as premium. When the risk falls on the insured, one makes a claim on the insurer, i.e. on the insurance company.

Claim is to be shown after deducting the reinsurance claim in the revenue account. It is pertinent to note here that the actual loss borne is to be taken into account and 'not' the actual amount paid.

Accounting treatment:

Adjustment entry will be:

Claims A/c	Dr.	…	
To Claims intimated and accepted but not paid A/c			…
To Claims intimated but not accepted and paid A/c			…

At the commencement of the next accounting year, a reverse entry should be passed. The reason is that the claims intimated are paid, generally. However, when the company rejects any claim, the amount is to be transferred to the insurance fund account and 'not' to the claims account.

While determining the loss on account of claim, the claim outstanding at the end should be added and the claim outstanding at the beginning should be deducted. Further, while determining the claim outstanding at the end, (i) the claim intimated and (ii) the claim intimated and accepted should be added.

Bonus in Reduction of Premium

This term is widely used in general insurance. The common practice is that general insurance policy is taken for 1 year. It is renewed after the expiry of the insured period. In case if the insured did not make any claim during the year, the company grants a reduction in premium at prescribed rates. The rate of reduction will increase year after year when no claim is made. Such a type of reduction is referred to as 'bonus in reduction of premium'.

Accounting treatment:

Total premium (without reduction) is to be treated as income and bonus, which is deducted is to be treated as expense.

Entry is:

Bonus in Reduction of Premium A/c Dr. ...
To Premium A/c ...

Example:

Net premium received is ₹ 292. Bonus in reduction of premium is ₹ 28.

This will be treated. Thus:

Income → ₹ (292 + 28) = 320 is to be shown on the credit side of revenue A/c and

Expense → ₹ 28 is to be shown on the debit side of Revenue A/c.

Reversionary Bonus

This term is generally used in life insurance business. If the life policies with profits are opted, policyholders will be given the right to participate in the profits of the company. In general, profit is paid on the maturity of the policy. Such a type of bonus paid at the expiry of the policy with the policy amount is known as 'reversionary bonus'. Policyholders are awarded 95% of profits of LIC by way of bonus.

Reinsurance

When an insurer thinks that a specific risk is so high that he cannot shoulder in his individual capacity, he may reinsure that part of the risk with some other insurer. This is known as reinsurance. In such a situation, proportionate premium has to be ceded by the first insurer. On maturity, both the insurers will share the claim in the ratio agreed by them.

Accounting treatment:

In the books of the first insurer, amountof claim recovered from the second insurer will be subtracted from the total claim payable by him. Premium ceded is to be deducted from the total premium received.

In the books of the second insurer, claims paid include claims paid on account of reinsurance and premium received include premium received on reinsurance business.

Commission on Reinsurance (Ceded and Accepted)

These are two types:

1. Commission on reinsurance accepted: When a company gets reinsurance business, it has to pay commission to other company. This commission is known as ‘commission on reinsurance accepted’. This should be shown as an expense, on the debit side in revenue account.

2. Commission on reinsurance ceded: When a company passes one part of business to some other company, then such a company gets commission, which is referred to as ‘commission on reinsurance ceded’. This should be shown on the credit side of the revenue account as it is treated as ‘income’.

Note: Under Schedule 2: Commission expenses.

Commissions on direct business and reinsurance accepted should be added and commission on reinsurance should be deducted. The net balance should be shown in the revenue account.

Annuities and Consideration for Annuity Granted

‘Annuity’ is an annual payment guaranteed and paid by an insurance company regularly till the life of an insurer or for a specified period in consideration of a ‘lump sum’ received at the beginning. Instead of a lump sum payment, it may be paid over a certain period in regular installments.

Treatment:

Annuity is shown under Schedule 4: It is an expenditure for the insurance company.

On the other hand, consideration for annuities granted is an income for the company. It is shown in revenue A/c

Surrender Value and Surrenders

When an insured is not in a position to pay premiums for the agreed period, he may surrender the policy to the company. The company will pay an amount, which is only a portion of the total premium paid. The surrender value usually will be of small amount and that too only a part of premium, which the insured has remitted to the company. If only one annual premium is paid, then such policyholders will not be eligible to surrender their policies. Surrender value includes the present value of bonus.

Under schedule 4: Surrenders is shown as an expenditure along with claims, annuities, etc.

Paid-up Value

A policy holder may opt to get the policy paid up, if he will not be able to continue paying premiums. It is calculated as:

$$\text{Paid up value} = \frac{\text{Sum Assured} \times \text{Total No. of Premiums Paid}}{\text{Total No. of Premiums Payable}}$$

This is shown like claims.

Life Assurance Fund

This fund is maintained by life insurance company, which represents the excess of revenue income over revenue expenditure. The object of maintaining this fund is to meet the aggregate liability of all policies.

This is depicted under Schedule 6.

Any amount that exceeds the liability is called 'valuation surplus'. This is a profit to the company.

SOME SPECIAL TERMS RELATING TO INSURANCE BUSINESS

Net Liability

Determination of Net Liability

In general, life policies are taken for a longer period. The premium by insurance companies cannot be taken as income for computation of profit for that year. The balance in life assurance fund cannot be taken as profit. Hence, in order to determine the profit, net liability on all outstanding policies is to be calculated. The difference between the present value of future liability and the present value of future premium is known as 'net liability'. The method of calculation is done by highly technical experts called 'actuaries'. It is a highly complicated mathematical calculation. The process by which net liability is ascertained by actuaries is called 'actuarial valuation'.

Computation of Profit

To ascertain profit of the life insurance companies, the life assurance fund on a particulars date is to be determined. Then, net liability on all policies has to be determined, which is done by actuaries. These two values are to be compared.

If the amount of life assurance fund is more than net liability, the excess is treated as surplus (profit).

It net liability is more than life assurance fund, the excess is treated as deficiency (loss).

The surplus or deficiency is ascertained by preparing a statement known as 'valuation balance sheet'.

The former of which is shown as follows:

Valuation Balance Sheet
As on …

Particulars	₹	Particulars	₹
To Net Liability As per Actuary's Valuation To Surplus (Net Profit) (Balancing Figure)	 … …	By Life Assurance Fund As per Balance Sheet By Deficiency (Net Loss) (Balance Figure)	… …
	xx		xx

Note:

1. The result will be either surplus or deficiency, which is arrived as balancing the ledger account.
2. Only surplus will be shown in the final balance sheet.

Distribution of profits:

1. Ninety-five per cent of the surplus (profit) as disclosed in valuation balance sheet should be declared as share of (bonus) policyholders.
2. Interim bonus paid to policyholders is an advance. Payment of bonus should be adjusted with net profit.

3. Any dividend payable, provision for loss on revaluation of investments should be subtracted from surplus.

4. From the adjusted amount, 95% is calculated. Then the interim bonus is deducted. The resultant will be the amount due to policyholders.

5. The balance of 5% is payable to the shareholders.

Final Accounts of Insurance Companies

The final accounts have to be prepared in accordance with the provisions of IRDA Act. 'The forms' and 'schedules' for the preparation of final accounts of insurance as stipulated in the Act are reproduced in the following pages: