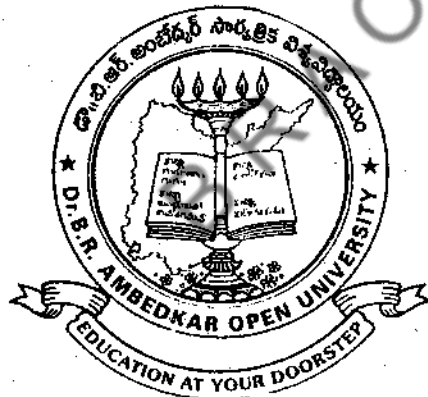


# COMPANY ACCOUNTS

## BLOCKS : I - III

“We may forgo material benefits of civilization, but we cannot forgo right and opportunity to reap the benefits of the highest education to the fullest extent .....”

*-Dr . B.R. Ambedkar*



**Dr. B.R. AMBEDKAR OPEN UNIVERSITY  
HYDERABAD**

**2004**

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Further information on Dr. B.R. Ambedkar Open University programmes/courses may be obtained from the Director (Academic), Dr. B.R. Ambedkar Open University, Prof. G. Ram Reddy Marg, Road No. 46, Jubilee Hills, Hyderabad. - 500 033 (A.P.).

Web: [www.braou.ac.in](http://www.braou.ac.in)

E-mail : [info@braou.ac.in](mailto:info@braou.ac.in)

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## PREFACE

This course deals with the topics in 'Company Accounts' included in the syllabus for the Third Year of the B.Com., Programme offered by Dr. B.R. Ambedkar Open University. These topics generally cover the 'Core' area of the subject to be studied in the 'Third Year' of three Year Degree Course in Commerce (B.Com.). The syllabus for the sake of convenience, is divided into Blocks, each of which comprises a number of Units. The units are prepared by specialists in accordance with a format so designed as to enable the student to study and understand without much difficulty. Each Unit begins with aims and objectives followed by contents. At the end of each Unit, model examination questions are given with an intention to test the student's comprehension of its subject matter. Technical terms with which the student may not be familiar are given at the end of each Unit under the head "Glossary" besides summary of the Unit.

This course intends to record the business transactions with special reference to companies. It presents the student the whole range of company accounts and the analysis of financial statements. The purpose of introducing this course is to ensure that the student on graduating from the University will have acquired adequate familiarity in respect of recording the business transactions pertaining to companies. With this background, the student should be able to understand the method of preparing the company final accounts and methods of analysis of financial statements and adopt them to different situations, if necessary.

The course material of Company Accounts consists of 5 Blocks, which are divided into 18 Units. The first block deals with recording the transactions relating to issue of shares and debentures. The second block covers the preparation of final accounts of companies. Block three deals with the accounting treatment in the case of amalgamation and reconstruction. Blocks four and five are devoted to the analysis of financial statements.

The University hopes that this material will help the student to get acquainted with the methods of preparing company accounts in different situations, which make for its distinctiveness and significance.

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**BLOCK – I**  
**ISSUE OF SHARES AND DEBENTURES**

**Unit – 1 : Company Accounts – An Introduction**

**Unit – 2 : Issue of Shares**

**Unit – 3 : Forfeiture and Re-issue of Shares**

**Unit – 4 : Issue and Redemption of Debentures**

BRAOU

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# UNIT – 1 : COMPANY ACCOUNTS - AN INTRODUCTION

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## Contents

- 1.0 Aims and Objectives
- 1.1 Introduction
- 1.2 Characteristics of a Company
- 1.3 Kinds of Companies
- 1.4 Formation of a Company
- 1.5 Raising the Capital
- 1.6 Books to be Maintained
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- 1.8 Check Your Progress: Model Answers
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## 1.0 AIMS AND OBJECTIVES

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This unit aims at discussing the meaning of a company, its formation and the books to be maintained by a company.

After studying this unit, you will be able to:

- explain the meaning of a company;
- recognize the kinds of companies;
- describe the procedure of company's formation; and
- identify the books to be maintained by a company.

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## 1.1 INTRODUCTION

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You are acquainted with the method of maintaining the books of accounts of sole traders and partnerships. This unit discusses the accounts of another form of business ownerships, viz., limited companies, generally referred to as companies. During the nineteenth century there was rapid growth of trade, commerce and industry resulting in an increase in the size of business concerns. Owing to an increase in the size of business undertakings, sole traders and partnerships could not cope with the problem of supplying the large amount of capital required. This led to the evolution of a new form of business organization known as a 'Joint Stock Company' or 'Company'.

A company is a voluntary association of persons formed for the realization of a common purpose, which may be either a business purpose or any other purpose. It is created by Law for achieving the objects for which it is formed. Therefore, it is also called an 'artificial person' (having no physical existence). The company has a legal personality of its own, which is distinct from that of its members. Right from formation to closure, all its activities are to conform to the provisions of the Companies Act.

L.J. Lindley defines a company as "an association of many persons who contribute money or money's worth to a common stock, and employ it in some common trade or business (i.e., for a common purpose), and who share the profit or loss (as the case may be) arising there from. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs, are members. The proportion of capital to which each member is entitled is his share. Shares are always transferable although the right to transfer them is often more or less restricted".

Section - 3 of the Companies Act 1956 defines a Company as "a company formed and registered under this Act or an existing company". An existing company is referred to as a company formed and registered under any of the former Companies Acts.

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## 1.2 CHARACTERISTICS OF A COMPANY

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The characteristics of a company can be briefly listed as follows:

- i) It is a voluntary association of persons. No one can be compelled to form a company under the provisions of any Law. Once a company is formed, its activities are to conform to the provisions of the Companies Act. Usually, a company is formed for carrying on business with a view to making profits: they can also be formed for promoting art, charity, research, religion, commerce or any other purpose.
- ii) Just as any organization requires capital, the company also needs capital. The capital contributed by the members is called 'Share Capital' which is divided into small units called 'Shares' and these shares can be transferred freely.
- iii) The liability of the members of a company is limited to the amount of capital (number of shares multiplied by their par value) agreed to be subscribed by each member.
- iv) A company has a separate legal entity distinct from its members. It can enter into contracts with others in its own name. It is capable of owning, enjoying and disposing of property in its own name. It can sue and be sued by others in its corporate name.
- v) It has a common seal. Even though it is an artificial person, it acts through natural persons called directors. Its distinct existence is indicated by the common seal. In addition to the signature of the Directors, the common seal is affixed on the documents to signify that they are issued by the company.
- vi) It has perpetual succession. Even though existing shareholders leave and new shareholders join the company, the continuity of its existence is not affected.

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## 1.3 KINDS OF COMPANIES

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In the beginning companies were formed in England through the Royal Charter granted by the King and such companies were called Chartered companies. As ours is a democracy, there is no question of having Chartered Companies in our country. However, the Legislatures, which are the bodies of the elected representatives of the people, viz., Parliament at the center and Legislatures at the state level, can permit formation of companies through special legislation. Such companies are called 'Statutory Companies' and they are not governed by the companies Act. Example of this type are Reserve Bank of India, Life Insurance Corporation of India, etc.

Companies can be classified on the basis of certain characteristics like (i) the manner in which they are formed, (ii) the liability of members, and (iii) membership.

### **i) Classification of companies on the basis of formation**

The basis of this classification is the manner in which the companies are formed. On this basis companies can be classified as (a) Statutory Companies and (b) Registered Companies.

#### **a) Statutory Companies**

As already mentioned, these companies are formed by the enactment of a special Act by the Parliament or the respective State Legislature. For example: State Bank of India, State Financial Corporation, etc.

#### **b) Registered Companies**

All those companies incorporated under the Indian Companies Act, 1956 or any of the previous Acts, come under this category. These companies are known as Joint Stock Companies or merely companies.

### **ii) Classification from the point of view of liability of members**

The basis for this classification is the liability of the members of a company. From this view-point, companies can be classified as (a) Unlimited companies, (b) Companies limited by Shares and (c) Companies limited by Guarantee.

#### **a) Unlimited Companies**

In the case of this category of companies, the liability of members is unlimited. In the event of company being unable to pay to its creditors, the members are personally liable to the creditors and they have to contribute to such deficit from their private properties. As there is no specific advantage to the members in this type of companies, they are very rarely formed.

#### **b) Companies Limited by Shares**

The liability of the members of these companies is limited to the extent of the share capital subscribed by them. For example, if a person subscribes to 100 shares of Rs. 10/- each, his liability is limited to Rs. 1,000/-. Once this amount is paid, he is not liable, even if there were to be any deficiency in meeting the claims of its creditors.

#### **c) Companies Limited by Guarantee**

In this type of companies, the liability of the members will be limited to that amount which they undertake to contribute towards the deficiency of assets of the company at the time of its winding up.

While in case of companies limited by shares, the liability is based on the amount of share capital subscribed, the liability in respect of the companies limited by guarantee is based on the amount of guarantee given by the members. In some cases, if the guarantee is given in addition to share capital, the liability will be the sum total of share capital subscribed and the amount of guarantee given.

### **iii) Classification of companies from the point of view of membership**

Under this head with the scope of membership as the classification, companies can be classified as (a) Private and (b) Public Companies.

#### **a) Private Company**

A company with a minimum paid up capital of Rs. 1 lakh or such a higher paid-up capital if prescribed under the Act and which has the following Characteristics is called a Private Company.

- i) Restrict the transfer of shares by its Articles of Association;
- ii) Can have the minimum number of members as 2 and the maximum number of members as 50 excluding past or present employees;
- iii) Prohibits any invitation to the public to subscribe to its shares or debentures;
- iv) Prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives; and
- v) Has to add the words 'Private Limited' in its name unless the liability of the members is unlimited.

#### **b) Public Companies**

All those companies, which are not private companies, are classified as public companies. Public companies must have a minimum paid-up capital of Rs. 5 lakhs or such higher paid-up capital as may be prescribed and a minimum number of 7 members although there is no maximum limit. The members can transfer their shares freely.

It is to be noted that both private and public companies may be formed either as limited or unlimited companies. Limited companies can be formed either as those limited by shares or limited by guarantee. Further, both private and public companies can be registered with share capital or without share capital. Usually, companies which are formed for carrying on business with profit motive are registered with Share Capital. But those organizations, which are formed for pursuing a philanthropic cause, are registered as companies without Share Capital.

#### **Private company deemed to be a Public Company**

Some times a company might have been registered as Private Company but from the point of view of Act it will be deemed to be a public company under certain conditions. A private company is deemed to be a public company, if

- a) 25% or more of its paid up capital is held by one or more bodies corporate; or
- b) during the three preceding consecutive financial years its average turnover is Rs. One crore or more; or
- c) it holds 25% or more of the paid up share capital of a public company.

It may be noted that in the above mentioned circumstances, a company may be a private company in form but it is a public company from the legal view-point.

In addition to the above classification, companies can be classified on the following basis:

- i) Area of operations of the business, i.e., Indian companies and foreign companies;
- ii) Ownership – by the Government and by the public;

- iii) Control exercised by one company on another company, i.e., Holding company and Subsidiary company.

### **Classification of companies based on the area of operation**

Under this classification, companies can be considered Indian or Foreign on the basis of the situation of its registered office in India or outside India. They are (a) Indian Companies and (b) Foreign Companies.

#### **a) Indian Companies**

Companies registered in India under the provisions of the Companies Act, 1956 and having the principal place of business (registered office) in India are called 'Indian Companies'.

#### **b) Foreign Companies**

Those companies which were incorporated outside India and which established a place of business in India after the commencement of the Companies Act, 1956 or those incorporated outside India with a place of business established in India before the commencement of the above Act which have continued to have the same place of business are called 'foreign companies'.

### **ii) Classification on Ownership basis**

The classification is based on the investment made by the Government or by the public. On this basis, companies can be classified as (a) Government companies and (b) Non-Government companies.

#### **a) Government Companies**

If a majority share in the capital of a company is contributed by the Government, such a company is called 'Government Company'. In other words, if a company has 51 per cent or more of its share capital held by the Central or any State Government or both, it is called a 'Government company'.

#### **b) Non-Government Companies**

Companies, which have majority of their share capital contributed by the general public are called 'Non-Government companies'. These companies are controlled and operated by private individuals.

### **iii) Classification based on control**

Under this classification, a company may be (a) a holding company or (b) a subsidiary company.

#### **a) Holding Company**

The company, which acquires the controlling interest in another company (has control over that company), is called a "Holding Company". Sec. 4(4) of the Companies Act defines a Holding Company as follows: "A company shall be deemed to be the holding company of another if, but only if that the other is its subsidiary". The holding company and its subsidiary companies put together are called a 'Group'.

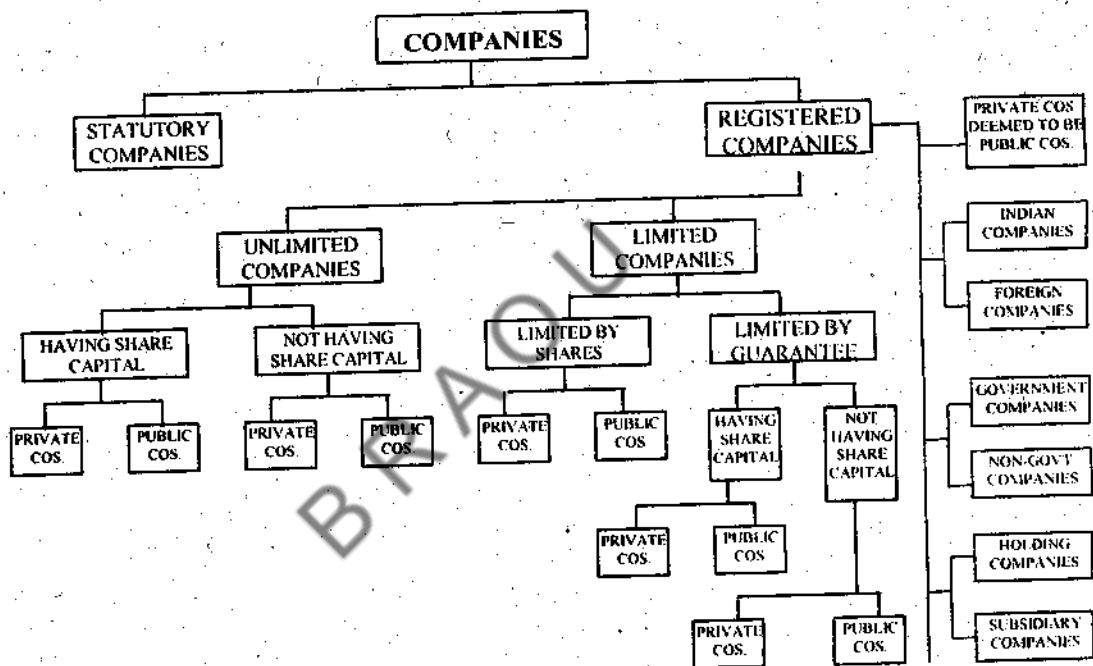
**b) Subsidiary Company**

A company which is under the control of a Holding Company is called a Subsidiary Company. According to the Companies Act, a company is said to be a Subsidiary company, if-

- i) with the object of continuing its management the other company controls the composition of the Board of Directors;
- ii) more than half of the nominal value of its share capital is held by the other company;
- iii) a company has equity and preference shares with the same voting rights and if more than half of its total voting power is held by the other company;
- iv) it is a subsidiary of any other company, which in turn is a subsidiary of another company; e.g., If C is the subsidiary company of B, which is a subsidiary of A, then C is also called the subsidiary company of A.

It may be noted that a company which is controlled by another company is subsidiary of that company.

The following chart gives an idea of the different kinds of companies:



**CHECK YOUR PROGRESS - 1**

i) What do you mean by a private company?

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ii) Under what circumstances a private company will be deemed to be a public company?

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So far we have discussed certain general aspects relating to a company. Let us now consider the procedure involved in forming a company.

## **1.4 FORMATION OF A COMPANY**

We have already noted that the company is an artificial person created under the provisions of the Companies Act, 1956. For establishing a company the persons forming the company (promoters) have to register it with the Registrar of Companies of the State concerned.

The promoters undertake the task of bringing the company into existence. They get the necessary documents prepared and present the same to the Registrar of Companies of the State in which the registered office of the company (its place of business) is situated. They take active part in the selection of Directors, the people who actually run the company, in the purchase of properties for the company required for carrying on the proposed business. After going through the documents presented by the promoters, if the Registrar is satisfied that the required formalities have been complied with, he issues a 'Certificate of Incorporation'. This certificate is the conclusive evidence of the fact that the company has been registered and that the company has actually come into existence. For obtaining the Certificate of Incorporation, the promoters have to submit a number of documents to the Registrar of Companies. Let us consider them now:

### **1. Memorandum of Association**

This is the first and the most important document to be filed with the Registrar. This is called 'the Charter of the Company'. The conditions under which the company exists and its objects are defined by this document. It lays down the relationship of the company with the outsiders, and the scope of its operations. Its main purpose is to enable the shareholders, creditors and others who deal with the company to know what its permitted range of activities is.

The Memorandum of Association contains:

- i) the name of the company with the word, 'limited', as its suffix in the case of a public company and the words, 'private limited', as its suffix, in the case of a private company;
- ii) the State in which its registered office is situated;
- iii) the objectives of the company: main, incidental and others;
- iv) in the case of a limited company the fact that the liability of its members is limited;
- v) the authorized capital of the company and its division into shares, each of a fixed amount; and
- vi) the declaration that the signatories to the memorandum are desirous of forming themselves into an association and the qualification shares, i.e., number of shares to be taken by each of them.

In the case of a company limited by guarantee, the memorandum should state that each member undertakes to contribute to the assets of the company in the event of the winding up of the company while he is a member or within one year after he ceases to be a member undertakes to contribute:

- a) to the payment of the debts of the company,

- b) to the payment of liabilities of the company, the costs, charges and expenses of winding up, and
- c) for the adjustment, of the rights of the contributories among themselves, such an amount as may be required not exceeding a specified amount.

## **2. Articles of Association**

This is another important document to be filed with the Registrar of Companies. It contains the rules and bye-laws which regulate the internal management of the company and the rights and liabilities of its members. It may be noted that all private companies limited by guarantee and unlimited companies, should have their own Articles of Association and file them with the Registrar of Companies. However, a public limited company need not necessarily have its own Articles. In such a case, it will be presumed that it has adopted the model articles provided in Table A, Schedule I of the Companies Act.

Usually, the 'Articles' provide for the following:

(1) Share capital, rights of shareholders, variations on the rights of shareholders, payment of commission, issue of share certificates; (2) Lien on shares; (3) Calls on Shares and forfeiture of shares; (4) Transfer and transmission of shares; (5) Conversion of shares into stock and alteration of share capital; (6) Share warrants; (7) General meeting and proceedings at those meetings; (8) Voting rights of members, voting, poll and proxies; (9) Directors, their appointment, remuneration, qualifications, powers and proceedings of Board of Directors; (10) Manager and Secretary; (11) Dividends and reserves; (12) Accounts, audit and borrowing powers; (13) Capitalization of profits; and (14) Winding up of the company.

## **3. A certificate from the Securities Exchange Board of India**

In the case of a company whose share capital exceeds Rs. 50 lakhs, it has to file a Certificate from the Securities Exchange Board of India permitting the company to issue the capital.

## **4. A List of Persons who have consented to Act as directors**

The list indicating the full names of persons who have given their consent to become Directors, their addresses, occupations and age. If the company does not file a separate list of Directors, it will be presumed that the subscribers to the Memorandum will be the first Directors.

## **5. Written consent of the Directors to Act as such**

In the case of Directors appointed by the Articles or named in the Prospectus, their written consent to act as Directors must be filed with the Registrar of Companies.

## **6. Undertaking of the Directors Regarding Qualification Shares**

This indicates the willingness of the Directors to take up the minimum number of shares to qualify themselves as Directors.

## **7. Notice of Situation of the Registered Office of the Company**

This notice indicates the address of the Registered Office of the company. This can also be filed within 30 days of incorporation or on the date of Certificate of Commencement of Business, whichever is earlier.

## 8. Statutory Declaration

This is the declaration to be signed by a Chartered Accountant or an advocate or any other person named in the Articles as Director, Manager, or Secretary, stating that the requirements of the Companies Act have been complied with.

It may be noted that the Memorandum and Articles are to be signed by at least 7 persons in the case of a public company and 2 persons in the case of a private company. After paying the requisite fees, these documents are to be filed with the Registrar. On going through the documents, if the Registrar is satisfied that everything is in order, he issues the Certificate of Incorporation.

When the Registrar issues the Certificate of Incorporation, three consequences follow. They are:

- a) the company becomes a distinct legal entity, and its life begins from the date indicated in the Certificate of Incorporation;
- b) the company gets a perpetual succession i.e., old members may withdraw and new members may join, but the company goes on till it is wound up;
- c) the properties acquired by the company are not the properties of the shareholders. The shareholders can only have a claim in the profits of the company, when they are realized, and divided. Correspondingly, the liability of the company will not be the liability of shareholders.

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### CHECK YOUR PROGRESS – 2

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List out the documents to be presented to the Registrar of Companies to get the company incorporated.

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## 1.5 RAISING THE CAPITAL

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As soon as the Certificate of Incorporation is issued, a private company or a company having no share capital can commence business. But a public company has to get the Certificate of Commencement of Business. The first step in the direction is the raising of the capital required by the company. For raising the capital, the steps to be taken by the company are:

- a) Issue of prospectus
- b) Application for shares
- c) Allotment of shares
- d) Issue of shares to members

### a) Issues of Prospectus

A public company intending to raise capital by issue of shares or debentures to the public has to issue an invitation to the public to subscribe to its capital, which is called 'prospectus'. In general terms, a prospectus is a document through which a company invites deposits from the public or invites offers from the public for subscription of its shares or debentures.

According to Sec. 2(36) OF THE Companies Act, "Prospectus means any document described or issued as a Prospectus and includes any notice, for the subscription or purchase of any shares in, or debentures of a body corporate".

The prospectus contains the details regarding the validity of the business proposition and the desirability of the proposed investment by the public. In a way it specifies the terms of the issue and forms the basis for the contract between the company and the persons applying for shares based on the information contained in the prospectus. If a company does not issue a prospectus, it has to file a statement in lieu of prospectus with the Registrar.

#### **b) Application for Shares**

After going through the prospectus, the prospective shareholders submit their applications offering subscription for shares invariably to the bankers of the Company. Along with each application, the prescribed amount, called 'application money', which should not be less than 5 per cent of the nominal value of each share should be remitted by the applicant.

At this juncture, it is to be noted that the application for shares is an offer made by the applicant and it is left to the discretion of the Directors of the company whether to accept the application or to reject it. When the company accepts the applications then the process of allotment of shares commences.

#### **c) Allotment of Shares**

After the expiry of the date fixed for receipt of applications, the applications are sent to the company by its Bankers. Then the Board of Directors scrutinizes the applications and allots the shares through a Resolution. It may be noted that allotment means the allocation of a specified number of shares to an applicant in response to his application. Further, the allotment of shares would be valid only when the provisions governing the allotment of shares are fulfilled. They are:

- i) Before the directors proceed with the allotment of shares, at least 5 days must expire from the date of issue of the prospectus;

The amount stated in the prospectus as the minimum subscription must be subscribed and the sum payable on the application for the amount stated as minimum subscription must be received by the company.

- ii) The application money received should be deposited in a schedule bank till the Certificate to Commence the Business is issued.

If for any reason the allotment of shares is not made, the application money has to be returned to the applicants. If the application money is not returned within 130 days after the issue of prospectus, the defaulting directors will be jointly and severally liable to pay interest at 6 per cent per annum from the date on which the stipulated period expires.

#### **d) Issue of Share Certificate of Members**

We have already noted that allotment of shares is the acceptance of the offer made by the prospective shareholders. The acceptance is communicated to the allottee by sending a 'Letter of Allotment'. On allotment of shares, the allottee has to pay a part of the face value of the share, or the balance amount after deducting the application money which is called 'Allotment Money'. After receiving the allotment money, the company issues the 'Share Certificate', which is an acknowledgment of having received the share money.

## **Certificate of Commencement of Business**

After the provisions relating to allotment of shares have been fulfilled and a declaration by one of the directors or the Secretary that the above mentioned provisions have been complied with, the Registrar of Companies issues a 'Certificate of Commencement of Business'. On receipt of the said certificate, the public company commences its business.

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## **1.6 BOOKS TO BE MAINTAINED**

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In discussing the accounting procedures relating to sole trader and partnership organizations, it has been stated that they are under no legal obligations to keep accounts. But in the case of limited companies, it is legally compulsory for every company to maintain proper books of account. It is further required that the accounts shall be kept according to the mercantile system, in conformity with the requirements of the Indian Companies Act, 1956.

The accounts of limited companies may be divided into three sections. Viz., (a) ordinary trading transactions, (b) transactions connected with the formation of companies and raising of capital, and (c) the final accounts and distribution of profits. The units that follow will deal with sections (b) and (c) mentioned above.

As all the activities of a company are subject to the provisions of the Companies Act, they have to maintain certain Books and Registers which are called 'Statutory Books'. The following are the Statutory books to be maintained by every limited company:

### **1. Register of Members**

This register contains the names, addresses and occupations of the members, a statement of shares held by each member, the date on which each person's name was entered in the Register as a member and the date on which any person ceased to be a member. As this is the most important Statutory book, it must be very carefully maintained.

### **2. Index of Members**

This is maintained so that the accounts of individual members in the Register may be readily located.

### **3. Annual List of Members and Summary**

This list gives the particulars of those persons who were members of the company on the day of the first ordinary general meeting of the year and particulars of those persons who ceased to be members after the date of the preceding meeting. The list also gives a summary of the share capital in respect of shares issued for consideration other than cash.

### **4. Minutes Book**

As per the provisions of the Act every company has to maintain the minutes of all proceedings of General Meetings and the Meetings of the Board of Directors. For this purpose, one Minutes Book for the Board Meetings and another Minutes Book for the Shareholders' Meetings are maintained.

### **5. Register of Directors and Managers**

The law stipulates that every company has to maintain a register giving particulars of its Directors and Managers. A copy of the list of particulars of Directors and Managers has to be filed with the Registrar of Companies.

## **6. Register of Contracts**

This Register has to be maintained by every company giving the full details of the contracts or agreements in which any of the Directors have either direct or indirect interest.

## **7. Register of Mortgages and Charges**

This register gives the particulars of mortgages and charges affecting the undertaking or the property of the company. It should give a short description of the property mortgaged or charged, the amount of the charge or mortgage and the names of the persons who are entitled to the charge.

## **8. Register and Index of Debentureholders**

The particulars of the debentureholders of the company are entered in this Register. The index of debentureholders helps in locating the accounts of Debenture holders.

## **9. Register of Investments in Shares and Debentures of Body Corporates of the Same Group**

This register gives the particulars of investments made by the company in the companies belonging to the same group, i.e., in its holding company and its subsidiary companies.

## **10. Register of Investments not held in the Company's Name**

According to law all the investments made by the company should be in its own name except in certain cases like holding shares in a subsidiary in the name of a nominee for ensuring that the number of members of the subsidiary is not less than the minimum stipulated. Particulars of such exceptional investments are maintained in this Register.

## **11. Proper Books of Accounts**

According to the Act every company should keep proper books of accounts at its registered office. They should be maintained in such a way that they disclose:

- i) the sums of money received and expended by the company and the manner in which the receipt and expenditure have taken place;
- ii) all sales and purchases of goods made by the company;
- iii) all assets and liabilities of the company.

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## **1.7 SUMMING UP**

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Modern business enterprises have a tendency to grow in size. Such growth in size involves increase in fixed capital requirements. The problem of securing huge amounts of capital has led to the company form of organization.

A company is a voluntary association of persons formed for carrying on a particular purpose in common, which is generally business (and it can be for any other purpose also). A company is an artificial person.

A company has the following characteristics.

- i) it is a voluntary association of persons;
- ii) its share capital is divided into small units referred to as shares;

- iii) the liability of its members is limited;
- iv) it has separate legal entity;
- v) it has a common seal and perpetual succession.

Classification of companies can be done on the following bases:

(a) formation; (b) members' liability; and (c) membership.

On the basis of formation, companies can be classified as Statutory companies and Registered companies.

Based on liability of members, they are classified as unlimited companies, companies limited by shares and companies limited by guarantee.

Companies are classified as Private and Public companies on the basis of their membership.

Another type of classification can be done on the basis of (a) area of operations, (b) ownership, and (c) control exercised by one company on the other.

Based on the area of operations, companies are classified as Indian companies and Foreign companies. On the basis of ownership, they are classified as Government Companies and Non-government companies.

On the basis of control exercised, companies are classified as Holding Companies and Subsidiary companies. The Holding company and its subsidiaries put together are referred to as a 'Group'.

Promoters bring the company into existence by fulfilling the requirements stipulated by Law. For this purpose, they have to prepare and submit a number of documents. The most important among them are the Memorandum of Association and the Articles of Association. When the Registrar of Companies is satisfied that the required formalities are fulfilled, he issues 'Certificate of Incorporation' signifying the fact that the company has come into existence. On receiving this, a private company can commence business. But a public company has to obtain 'Certificate of Commencement of Business' before it commences business.

The first step involved in getting the Certificate of Commencement of Business is raising the share capital required by the company. It involves the following: (a) issue of a Prospectus inviting public to subscribe to its share capital; (b) receiving the applications and their scrutiny; (c) allotment and issue of shares to the shareholders.

On completion of allotment of shares, certain other formalities are to be complied with. After satisfying himself about the fulfillment of the required formalities, the Registrar of Companies issues a 'Certificate of Commencement of Business', on receipt of which a public company can commence its business. A company has to maintain a number of books and registers as stipulated in the Companies Act.

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## **1.8 CHECK YOUR PROGRESS : MODEL ANSWERS**

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1. i) A private company is one which, by its Articles of Association:

- a) Restricts the right of the members to transfer shares;

- b) limits the minimum number of members as two and the maximum number of members as 50 excluding past or present employees; and has atleast one lakh rupees paid up capital.
  - c) it is a private company in the form, but it is a public company from the legal viewpoint.
- ii) It is a private company in the form, but it is a public company from the legal viewpoint. A private company is deemed to be a public company in the following circumstances:
- a) If 25% or more of its paid up capital is held by one or more corporate bodies; or
  - b) If its average annual turnover during the three preceding consecutive financial years is rupees one crore or more; or
  - c) If it holds not less than 25% capital of a public company.
- 2.
- a) Memorandum of Association,
  - b) Articles of Association,
  - c) A certificate from the Securities Exchange Board of India,
  - d) List of persons who have consented to act as directors,
  - e) Written consent of Directors to act as such,
  - f) Undertaking of the Directors regarding qualification shares,
  - g) Notice of significance of the Registered office of the company,
  - h) Statutory Declaration.

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## 1.9 MODEL EXAMINATION QUESTIONS

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### I. Answer the following questions in about 30 lines each.

1. Explain the characteristic of a company.
2. What are the different types of companies?
3. Explain the procedure for incorporation of a company.
4. Explain the procedure involved in raising the capital of a company.
5. Explain the following:
  - a) Public company
  - b) Private company
  - c) Government company
6. Distinguish between Memorandum of Association and Articles of Association.

### II. Answer the following questions in about 15 lines each.

1. Explain the meaning of a company.
2. What do you understand by statutory company and registered company?
3. Distinguish between company limited by shares and company limited by guarantee.
4. What is the difference between limited company and unlimited company?
5. Distinguish between Government Company and Non-Government Company.
6. When will a private company be deemed to be a public company?
7. Distinguish between Certificate of Incorporation and Certificate of Commencement of Business.

8. What is the difference between Holding company and Subsidiary company?
9. Explain the following:
  - a) Foreign Company; and
  - b) Indian Company
10. Write a short note on:
  - a) Prospectus; and
  - b) Allotment of shares

### 1.10 RECOMMENDED BOOKS

1. R.L. Gupta and M. Radha swamy : **Advanced Accountancy, Volume – II, Sultan Chand & Sons, New Delhi.**
2. S.N. Maheswari : **Advanced Accountancy, Volume – II, Vani Educational Books, New Delhi.**
3. S.P. Jain and K.L. Narang : **Advanced Accountancy, Kalyani Publishers, Ludhiana.**
4. M.C. Shukla and T.S. Grewal : **Advanced Accountancy, S.Chand & Sons, New Delhi.**

### 1.11 GLOSSARY

- Articles of Association** : One of the important documents to be filed by the promoters of a company with the Registrar of Companies. It contains the rules and bye - laws regulating in internal management of a company.
- Government Company** : A company in which a majority share in the capital is contributed by a State Government, Central Government or both.
- Holding Company** : A company which acquires the controlling interest in another company, i.e., in its subsidiary company.
- Join Stock Company** : Generally called a company, is a voluntary association of persons formed for carrying out a particular purpose in common, which may be business purpose or any other purpose.
- Memorandum of Association** : The first and most important document to be filed with the Registrar. This is called the charter of the company, in which the conditions under which the company exists and its objects are defined.
- Private Company** : A company which restricts the transfer of shares by its members, having the minimum number of members as 2 and maximum number of members as 50, and prohibits any invitation to the public to subscribe for its shares or debentures.

**Prospectus**

: A document issued by the company inviting the public to subscribe to its shares or debentures.

**Public Company**

: A company having minimum number of members as seven and having no maximum limit, and which allows its members to transfer their shares freely.

**Subsidiary Company**

: A company which is under the control of Holding company.

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## **UNIT – 2 : ISSUE OF SHARES**

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### **Contents**

- 2.0 Aims and objectives
- 2.1 Introduction
- 2.2 Meaning of Shares
- 2.3 Types of Shares
- 2.4 Presentation of Share Capital in Balance Sheet
- 2.5 Accounting Treatment of Issue of Shares
- 2.6 Issue of shares to Vendors
- 2.7 Issue of shares to Promoters
- 2.8 Issue of shares to Public for Cash
- 2.9 Issue of Shares at Par
- 2.10 Over Subscription
- 2.11 Under Subscription
- 2.12 Calls in Arrears
- 2.13 Calls in Advance
- 2.14 Issue of Shares at Premium
- 2.15 Issue of Shares at Discount
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- 2.17 Summing Up
- 2.18 Check Your Progress: Model Answers
- 2.19 Model Examination Questions
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### **2.0 AIMS AND OBJECTIVES**

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This unit aims at explaining the accounting procedure to record the issue of shares with different terms and conditions.

Having gone through this unit, you should be able to:

- explain different types of shares and their issue;
- present information relating to share capital in the Balance Sheet; and
- record the transactions, relating to the issue of shares, in different conditions.

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### **2.1 INTRODUCTION**

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A private company, as it is already observed, can commence its business immediately after receiving the certificate of incorporation. It means, that it collects the capital from the prospective shareholders without issuing prospectus to the public. A public company has to

get the certificate of commencement of business to commence the business. To get this, it has to raise the required capital from the public subject to a minimum limit and one of the directors or secretary has to submit a declaration with the Registrar of companies that all provisions governing the allotment of shares have been fulfilled. The capital of a public company, it is noted earlier, that is collected, by issuing an invitation to the public, known as prospectus, to subscribe to the share capital offered. Hence, there is a need to know about the different types of shares which can be offered to the public for subscription and also to acquire knowledge of recording the transactions relating to the collection of share capital.

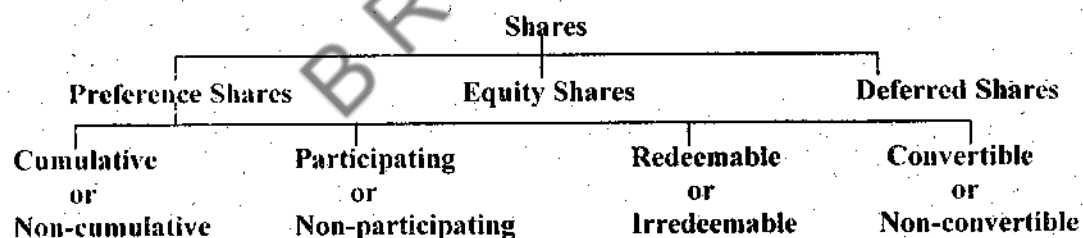
## 2.2 MEANING OF SHARES

Total capital of the company is divided into units of small denomination known as shares. For example, a company has decided to have a capital of Rs. 4,00,000. This amount is divided into 40,000 units known as shares of the value of Rs. 10 each. Therefore, it is to be noted that the face value of each share is Rs. 10. According to section 2(46) of the companies Act, 1956, share has been defined as a share in the share capital of the company, and includes stock except where a distinction between stock is expressed or implied, shares must be serially numbered so that they may be identified and distinguished from each other. They are moveable property and are transferable in the manner provided by the Articles of Association.

A share cannot be sub-divided and cannot be transferred in parts. To overcome this restriction, fully paid up shares may be converted, if permitted by the Articles, into stock in which the ownership of capital is expressed, not in terms of shares, but in terms of money. A stock can be transferred in parts.

## 2.3 TYPES OF SHARES

According to the companies Act, shares can be of three types, viz., Preference shares, Equity shares and Deferred shares. Further preference shares may be of four types. The following chart explains different types of shares that are provided in the companies Act.



Now let us discuss these shares in detail.

### 1. Preference Shares

These shares enjoy a preferential right in respect of payment of dividend and repayment of capital in the event of the winding up of the company. A fixed dividend is payable on these shares as promised at the time of issue. The rate of dividend payable is indicated as a prefix to the share. For example, a company offers 10,000 preference shares carrying a fixed dividend of 8%. Hence they are designated as 8% Preference shares. It may be noted that the preference shareholders have a right to get dividends before the Equity shareholders are paid. However, such a dividend must be declared by the Board of Directors. As shown in the chart preference shares may be (a) Cumulative or Non-cumulative (b) Participating or Non-participating (c) Redeemable or Irredeemable and (d) Convertible or Non-convertible.

Now let us discuss them in detail.

#### **a) Cumulative or Non-cumulative Preference Shares**

In the case of Cumulative Preference Shares, the arrears of dividend (dividend unpaid due to insufficient profits) get accumulated and become payable out of the profits in subsequent years before paying any dividend to Equity shareholders.

In the case of Non-cumulative Preference shares, the arrears of dividend do not accumulate and they get fixed rate of dividend only in the years in which there are profits available for distribution among shareholders.

#### **b) Participating or Non-Participating Preference Shares**

These shares carry the right to share out of the surplus left paying the preference and Equity dividends at a fixed rate.

The Non-Participating Preference shares do not enjoy any right to share the surplus left after paying the Equity dividend.

#### **c) Redeemable or Irredeemable Preference Shares**

Capital raised through the issues of either Equity or Preference shares cannot be repaid during the life time of the Company. Sometimes, a company may issue Preference shares with the promise that it will repay to the shareholders after the expiry of a fixed period. Such Preference shares are called 'Redeemable Preference Shares'. The issue of such shares should be permitted by the Articles and the conditions mentioned there in should be followed. After the commencement of the Companies (Amendment) Act 1988, no company limited by shares can issue any preference share which is irredeemable.

Such of the Preference shares which do not contain provision of redemption are called 'Irredeemable Preference Shares'. Capital raised through irredeemable Preference shares is not refunded to the shareholders during the life time of the company.

#### **d) Convertible or Non-Convertible Preference Shares**

Sometimes a company may issue preference shares with a provision for their conversion into Equity shares. Such Preference shares are called Convertible Preference Shares. Such of those Preference shares which do not have the provision for conversion into Equity shares are called 'Non-Convertible Preference Shares'.

It should be noted that unless specifically stated, a Preference share is always taken to be cumulative, non-participating and non-convertible.

### **2. Equity Shares**

Earlier these shares were called Ordinary or Risk shares. Sec. 85 of the Companies Act defines Equity shares in a negative way, by stating that all those shares which are not Preference shares are Equity shares. The holders of these shares will get dividend only after the dividend on Preference shares is paid. Similarly, even with regard to repayment of capital the Equity shareholders get back their capital only after the Preference capital is returned. There is no fixed rate of dividend attached to these shares and it will be decided by the Board of Directors from year to year depending on the volume of disposable profits. Equity shareholders have voting rights whereas Preference shareholders do not have any voting rights except in the following circumstances:

- a) in the case of Cumulative Preference Shares, when the dividend is in arrears for more than five years, and
- b) in the case of Non-Cumulative Preference Shares, when the dividend is in arrears for more than three years.

### 3. Deferred Shares

Prior to the commencement of the Companies Act, 1956 companies were allowed to issue Deferred Shares also in addition to Equity and preference Shares. Generally, these shares were allotted to promoters in consideration of their services. They are also called 'founders' shares. These shares had a low nominal value but the same voting rights. They used to carry the right to have a substantial part of residual profits left after paying dividend at specified rates to other classes of shareholders as dividend, and they enjoyed disproportionately excessive voting rights as their nominal value is very low. According to the provisions of the Companies Act, 1956 a public company or a subsidiary to a public company or a private company deemed to be a public company cannot issue Deferred shares. Generally these shares are not issued even by independent private companies which are formed after the commencement of this Act.

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## 2.4 PRESENTATION OF SHARE CAPITAL IN BALANCE SHEET

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A company is a socio-economic entity incorporated under the law. Hence it is noted earlier, that it is a legal person. It will also have certain responsibilities like a natural person, to the society, to the shareholders, to the creditors, customers, government etc. Hence a disclosure of share capital in Balance sheet is essential to throw light upon its authority to raise capital as to the amount how much financial power it has use to raise capital and how that authority was honored by the public in respect of share capital. This being an important objective, section 148 and 211 of the Companies Act have stipulated that a statement contained the details of capital should be given as and when necessary.

After raising the capital by issuing the shares, the company at the end of the financial year, has to present the information relating to its share capital in the balance sheet under the following heads:

- a) Authorized Share Capital
- b) Issued Capital
- c) Subscribed Capital
- d) Called up Capital
- e) Paid up Capital

Let us know the meaning of each head of capital.

#### a) Authorized Share Capital

This is also called Nominal or Registered Capital. This is the total amount of capital with which the company is intended to be registered and mentioned in the Memorandum of Association. It is the maximum amount of capital which the Company is empowered to raise through public subscription. There is no legal limitation the extent of the amount of authorized capital.

## **b) Issued Capital**

That part of authorized capital which is offered to the public for subscription is called 'Issued Capital' and the rest of the authorized capital is called 'Un-issued Capital'. The un-issued capital can be issued by the company at any time when it requires additional capital.

## **c) Subscribed Capital**

Out of the issued capital, the portion which is subscribed (applied for) by the public is called 'Subscribed Capital'. In other words, it is that part of the issued capital for which applications are received from the public indicating their willingness to purchase the shares.

If the public does not subscribe the whole of the capital issued then it is said to be under-subscribed, the balance of the issued capital not subscribed by the public is called 'un-subscribed capital'. If the amount of share capital is more than the issued capital, it is said to be "over subscribed".

## **d) Called-up Capital**

Generally, the total amount of each share is called in instalments. If the amount received on application and allotment is less than the nominal value of the share, the balance amount is received in one or more installments. The amount to be paid in such installments is called 'Call Money'.

Called up capital is the amount which the shareholders have been called upon by the Directors to pay. This includes the amount of share capital issued to the vendors.

Sometimes the company keeps a part of the subscribed capital separately which can be called only on the winding up of the company. Such capital is called 'Reserve Capital'. The remaining amount of the subscribed capital is called 'Uncalled Capital'.

## **e) Paid-up Capital**

This is the amount actually received by the company in respect of the Called-up capital which includes the amount of value of shares issued to the vendors.

At time a few shareholders may fail to pay the call money on the shares. Such unpaid amount by shareholders against calls is to be shown as a deduction from called up amount. This unpaid call amount is known as Calls in Arrears which will be discussed later.

Sometimes, a few shareholders may pay the entire share money earlier to the company calling for money which is shown as 'Calls in Advance' in Balance Sheet.

The method of presenting share capital in a classified manner in Balance Sheet is explained with the help of following illustrations.

### **Illustration – 1**

A Company has an authorized capital of Rs. 10,00,000 divided into 1,00,000 shares Rs. 10/- each. It has issued 80,000 shares of Rs. 10/- each for public subscription. The public has subscribed for 60,000 shares. The company has called Rs. 8/- per share. On 500 shares one shareholder has not paid Rs. 2/- per share and another shareholder having 1,000 shares has paid the full amount of Rs. 10/- per share. Show how the share capital is presented in Balance Sheet.

**Solution**

**Balance Sheet**

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Authorized Capital 1,00,000 shares of Rs. 10 each		<u>10,00,000</u>			
Issued Capital 80,000 shares of Rs. 10 each issued		<u>8,00,000</u>			
Subscribed Capital 60,000 share of Rs. 10 each		<u>6,00,000</u>			
Called up capital 60,000 share of Rs.10 each Rs. 8 per share called		<u>4,80,000</u>			
Paid-up capital called up Capital	4,80,000				
Less: Calls in Arrears @ Rs. 2 on 500 shares	1,000	<u>4,79,000</u>			
Calls in Advance 1,000 shares @ Rs. 2 paid in advance		<u>2,000</u>			

From the above example it can be observed that only the amount under the head of paid up capital is included in total. Other share capital heads are barred by drawing a horizontal line underneath each item.

**CHECK YOUR PROGRESS – 1**

i) What is the difference between Preference shares and Equity shares?

.....  
 .....  
 .....

ii) State the meaning of Authorized capital.

.....  
 .....  
 .....

**2.5 ACCOUNTING TREATMENT OF ISSUE OF SHARES**

It is learnt earlier that a public limited company, will issue shares to raise capital to acquire assets required to conduct the business. Hence the money received should be accounted



**Illustration – 2**

Bright limited was incorporated with a Share Capital of Rs. 10,00,000 comprising Equity Shares of Rs. 10 each. The company acquired the assets of Mr. Santhosh for Rs. 2,50,000 by allotting 25,000 Equity Shares as fully paid. The Directors also allotted 1,000 Equity Shares as fully paid to the promoters for their services. 50,000 Equity Shares were issued for cash, which were taken up by the public and they were fully paid.

Give the necessary journal entries for these issues. Also show the above particulars in the company's Balance Sheet.

**Solution****Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Sundry Assets A/c Dr. To Santhosh's A/c. (Being the purchase of assets from Mr. Snathosh as per agreement dated.....)		2,50,000	2,50,000
-	Bank Account Dr. To Equity Share Capital A/c (Being the issue of 50,000 equity shares for cash to the public)		5,00,000	5,00,000
-	Santhosh's Account Dr. To Equity Share Capital A/c. (Being the issue of 25,000 equity shares to vendors of assets)		2,50,000	2,50,000
-	Goodwill Account Dr. To Equity Share Capital A/c. (Being the issue of 1,000 equity shares to promoters for the services rendered by them as per director's Resolution No.....dated.....)		10,000	10,000

**Balance Sheet**

Liabilities	Rs.	Assets	Rs.
Share Capital: Authorised Capital: 1,00,000 Equity Share of Rs. 10 each	10,00,000	Sundry Assets Good will Cash at Bank	2,50,000 10,000 5,00,000
Issued, Subscribed and Called up Capital: 76,000 Equity Shares of Rs. 10 each fully paid (of the above 25,000 shares have been allotted to Vendors and 1,000 shares to Promoters for consideration other than cash)	7,60,000		
	<u>7,60,000</u>		<u>7,60,000</u>

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## CHECK YOUR PROGRESS – 2

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Write the journal entries for commencing the business with Rs. 30,000 assuming that it is (i) a sole trading organization, and (ii) show the entry when capital of Rs. 10,000 is contributed by Shankar, Vishnu and Nanda each to firm.

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## 2.8 ISSUE OF SHARES TO PUBLIC FOR CASH

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In the preceding unit, we have learnt that when a company offers its shares applicant submit the applicant for shares along with the 'application money' (the amount prescribed by the company to be paid along with the application) to be company's bankers appointed for this purpose. It has also been noted that the application money on each share should be at least 5 per cent of the nominal value of the share. The application money received thus must be deposited in a Scheduled Bank till the company gets the Certificate of commencement of Business or in the even of its inability to comply with the provisions of the Act within 120 days after the date of first issue of prospectus till it returns the money to the applications. No allotment can be made or any action can be taken on the applications till the time of the opening of the subscription lists, which may be either specified in the prospectus or the fifth day after the date of first issue of the prospectus.

After the subscription lists are opened, the applications are placed before the Board of Directors, who on scrutiny decide who among the applicants are to receive the letters of allotment or letters of regret. The amount payable on allotment is called 'Allotment Money'. The balance amount due on shares can be called in installments, viz., 'first call' 'second call' etc, and the last installment is called 'final call'. The money received on allotment, first call, etc., will be deposited in the Bank. Sometimes, a separate account is opened for the purpose. The applications received are numbered consecutively and entered in Share Application and Allotment Book. From this book allotment sheets are prepared for scrutiny and consideration by the Directors. For the money received on allotment the necessary entries are made in the Share Application & Allotment Book. When calls are made, 'call notice' is sent to the members informing them of the amount payable on call made. If a member fails to pay the call money, the Directors forfeit the shares held by such a member. Forfeiture of share will be explained in detail at a later stage. You are already aware that sometimes a member may pay the full amount of the share even before a call is made. Such an amount is treated as an advance received from the member and is called 'Calls in Advance'. The issue of shares to public for cash can be made by the company with any one of the following conditions,

- a) Issue of shares at par
- b) Issue of shares at premium
- c) Issue of shares at discount

Let us know what entries are to be made in the books of accounts under each circumstances.

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## 2.9 ISSUE OF SHARES AT PAR

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Generally a new company with moderate business potentials will issue shares to the public at the price on par with the nominal value or face value of share. For instance a company has an authorized capital of Rs. 4,00,000 divided into 40,000 Equity shares of Rs. 10 each. It means that the face value of the Share is Rs. 10/-. If the company offers the shares to the public for sale at the face value i.e., Rs. 10 it is said to be issued that par.

Before learning the journal entries to be passed for the transactions relating to the issue of shares, it is necessary to know the sequence of transactions involved. The following is the sequence of such transactions.

- i) The prospective shareholder sends his application to the company along with the application money. On receipt of this amount an entry is made in the books of the company debiting the bank account and crediting the Share Application Account.
- ii) The directors after scrutinizing the applications, allot the shares to the respective applicants.
- iii) After the scrutiny of applications, share application amount is transferred to share capital account.
- iv) On sending the letter of allotment an entry is made debiting the share allotment account and crediting the share capital account with allotment money.
- v) Within the stipulated period, Company receives the allotment money. Then an entry is made debiting the Bank account and crediting the Share Allotment account.
- vi) Similarly, whenever a call is made, an entry is made debiting the Share Call account and crediting the Share Capital account. After receiving the call money another entry is made debiting the Bank account and crediting the Share Call account.

It may be noted that the Share Application account, Share Allotment account and Share Call accounts are intermediary accounts and when the money due on these is received, these accounts get closed automatically and only the bank account shows debits and the Share Capital account shows credits with the amount of the Share capital received.

The accounting procedure is to record above transactions by journal entries. But the practical system of Accounting is that the entries connected with Bank (Cash) are made through the Cash Book and the remaining entries are made in Journal proper. Hence for a comprehensive understanding of the student the above transactions are shown in proforma entries.

#### Proforma Entries

Transaction	Entry
1. When Share Application money is received:	Bank Account                      Dr. To Share Application A/c
2. On Allotment of shares:	
a) For transferring Share Application money in respect of applications accepted	Share Application A/c              Dr. To Share Capital A/c
b) For Allotment money due on Allotment of Shares	Share Allotment A/c                Dr. To Share Capital A/c
3. On receipt of Allotment money	Bank A/c                              Dr. To Share Allotment A/c
4. On making calls:	
a) For Call money due on call	Share Call A/c                      Dr. To Share Capital A/c
b) On receipt of call money	Bank A/c                              Dr. To Share Calls A/c

There might be more than one call, in which case they would be called share first call, second call, etc.

**Note:** Cash book is journal and ledger. Hence, when cash book entries are asked cash book is to be prepared with bank transactions and journal entries relates bank transaction ar not be passed.

Now let us consider some illustrations relating to the process of recording the entries.

### Illustration – 3

On January 1, 1999 K Co. Ltd., makes an issue of 10,000 Equity Shares of Rs. 10/- each, payable as follows:

On application – Rs. 2/-; On allotment – Rs.2/-;  
On First Call – Rs. 3/-; On Second and Final Call Rs. 3/-;

Assuming that all the shares were issue and all the amounts are received, show the necessary entries, ledger accounts and opening Balance sheet of the company.

### Solution

Before making the journal entries, it is advisable to analyse the problem in the following way:

No. of shares issued & subscribed -- 10,000  
Application money received -- Rs. 2x10,000 = Rs. 20,000/-  
Allotment money received -- Rs. 2x10,000 = Rs. 20,000/-  
First Call money received -- Rs. 3x10,000 = Rs. 30,000/-  
Second & Final Call money received -- Rs. 3x10,000 = Rs. 30,000/-

The following Journal entries are to be made

Journal				
Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Share Application A/c <span style="float: right;">Dr.</span> To Share Capital A/c (Being the transfer of share application amount to share capital as per Board Resolution dated ..)		20,000	20,000
-	Share Allotment A/c <span style="float: right;">Dr.</span> To Share Capital A/c (Being amount due on allotment of shares as per Board Resolution dated ....)		20,000	20,000
-	Share First Call A/c <span style="float: right;">Dr.</span> To Share Capital A/c (Being amount due on making the first call as per Board Resolution dated ....)		30,000	30,000
-	Share Second & Final Call A/c <span style="float: right;">Dr.</span> To Share Capital A/c (Being amount due on making the second and final call as Board Resolution dated ....)		30,000	30,000

Posting of the above Journal entries

Dr.		Bank Account		Cr.	
Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Share Application A/c	20,000	-	By Balance c/d	1,00,000
-	To Share Allotment A/c	20,000			
-	To Share First Call A/c	30,000			
-	To Share Second and Final Call A/c	30,000			
		<u>1,00,000</u>			<u>1,00,000</u>
	To Balance b/d	1,00,000			

Dr.		Share Capital Account		Cr.	
Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Balance c/d	1,00,000	-	By Share Application A/c	20,000
			-	By Share Allotment A/c	20,000
			-	By Share First Call A/c	30,000
			-	By Share Second and Final-Call A/c	30,000
		<u>1,00,000</u>			<u>1,00,000</u>
				By Balance c/d	1,00,000

Dr.		Share Application Account		Cr.	
Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Share Capital A/c	20,000	-	By Bank A/c	20,000
		<u>20,000</u>			<u>20,000</u>

Dr.		Share Capital Account		Cr.	
Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Share Capital A/c	20,000	-	By Bank A/c	20,000
		<u>20,000</u>			<u>20,000</u>

Dr.		Share First Call Account		Cr.	
Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Share Capital A/c	30,000	-	By Bank A/c	30,000
		<u>30,000</u>			<u>30,000</u>

Dr.

**Share Second and Final Call Account**

Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Share Capital A/c	30,000	-	By Bank A/c	30,000
		<u>30,000</u>			<u>30,000</u>

The particulars relating to these transactions will appear in the Balance Sheet as follows:

**Balance Sheet**  
Of K Co. Ltd. As on ...

Liabilities	Rs.	Assets	Rs.
<b>Share Capital:</b>			
Authorised Capital ... Equity shares of Rs. 10/- each	xxx	Bank	1,00,000
Issued, subscribed and called up capital 10,000 equity shares of Rs. 10/- each fully paid	<u>1,00,000</u>		
	<u>1,00,000</u>		<u>1,00,000</u>

**CHECK YOUR PROGRESS – 3**

State the sequence of the transactions relating to the issue of shares at par.

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**2.10 OVER SUBSCRIPTION**

Sometimes, the public may apply for more than the number of shares issued for subscription. Then there is said to be over-subscription. If the members of the public apply for a larger number of shares than have been issued the Directors have to reject some applications. In such case the Directors may adopt any of the following methods.

- i) Rejecting the applications for excess number of shares;
- ii) Allotting the shares on a pro-rata basis on all the applications received;
- iii) Rejecting some applications completely and allotting to the remaining applications on a pro-rata basis;
- iv) Rejecting some applications; allotting the number of shares asked for by some applications and allotting the remaining shares to the remaining applications on a pro-rata basis.

Whatever the method, the directors may adopt for the rejection of excess applications, the following journal entry for the refund of excess applications amount is passed in the books.

Share Application A/c	Dr.
To Bank A/c	
(Being the refund of applications amount rejected as per the Board Resolution No....dated).	

For example, let us assume that a company issues only 10,000 shares but it receives applications for 15,000 shares. Then the Directors allot shares to applications for 10,000 shares and the remaining applications for 5,000 shares will be rejected (the first method, the company has to return the application money on applications for 5,000 shares which are rejected. Let us assume that the directors decide to allot shares on pro-rata basis to all the applicants. In such case no applications will be rejected and all the applicants get some allotment. Each applicant will get shares in the proportion of shares applied for and the number of shares issued (No. of shares issued/No. of shares applied for). For example, if the number of shares issued are 10,000 and the number of shares applied for are 20,000 each applicant gets allotment of one share for every two shares he has applied for (10,000/20,000 or in the ratio of 1:2). It may be noted that generally the excess application money received on extra shares applied for will be adjusted on allotment or in subsequent calls; if the company so decides, it may return the same immediately also.

Let us consider another case. If the directors decide to reject some applications and allot the remaining of them after rejecting a few applicants outright, the shares will be allotted to the remaining applications on a pro-rata basis. The following illustration will help us to understand this.

#### Illustration -- 4

X Ltd. Has issued 10,000 Equity Shares of Rs. 10/- each payable as follows:

On application Rs. 2/- per share: On allotment Rs. 3/- per share: and on First and Final Call Rs. 5/- per share.

Applications were received for 25,000 shares and the directors rejected applications for 5,000 shares and allotted the shares to the remaining applicants on a pro-rata basis. Show the necessary journal entries in the books of the company.

#### Solution

#### Working

No. of shares issued	10,000	
Application money received on 25,000 shares at Rs. 2/- per share		Rs. 50,000
Amount due on application money (Rs. 2x10,000)		Rs. 20,000
Excess application money received		<u>30,000</u>
Amount to be refunded on rejected applications (Rs. 2x5,000)		10,000
Surplus application money to be adjusted on allotment		<u>20,000</u>
Amount due on allotment – (Rs. 3x10,000)		30,000
Excess applications money to be adjusted		<u>20,000</u>
Amount received on allotment		<u>10,000</u>
First and Final call amount (Rs. 5x10,000)		<u>50,000</u>

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account <span style="float: right;">Dr.</span> To Share Application A/c (Being application money on 25,000 shares received)		50,000	50,000
-	Equity Share Application A/c <span style="float: right;">Dr.</span> To Equity Share Capital A/c (Being transfer to Share Capital Account as per Board Resolution dated ...)		20,000	20,000
-	Equity Share Application A/c <span style="float: right;">Dr.</span> To Bank Account (Being refund of application money on rejected applications)		10,000	10,000
-	Equity Share Application A/c <span style="float: right;">Dr.</span> To Equity Share Capital A/c (Being the amount due on allotment as per Board Resolution dated .....)		30,000	30,000
-	Equity Share Application A/c <span style="float: right;">Dr.</span> To Equity Share Allotment (Being the excess application money Adjusted on allotment)		20,000	20,000
-	Bank Account <span style="float: right;">Dr.</span> To Equity Share Allotment A/c (Being amount due on allotment received)		10,000	10,000
-	Equity Share First and Final Call A/c <span style="float: right;">Dr.</span> To Equity Share Capital A/c (Being amount due on making first and Final call as per Board Resolution dated ....)		50,000	50,000
-	Bank Account <span style="float: right;">Dr.</span> To Equity Share First and Final Call A/c (Being amount due on 1 <sup>st</sup> and final call received)		50,000	50,000

**Illustration – 5**

Beta Ltd., issued 10,000 Equity Shares of Rs. 10/- each, the terms of payment being:

On application Rs. 3/- per share; On allotment Rs. 3/- per share and on First and Final Call Rs. 4/- per share.

Application were received for 18,000 shares. Applications for 3,000 shares were rejected applications for 5,000 shares were allotted in full and the balance of applicants were allotted

the remaining shares on a pro-rata basis. Show the necessary journal entries in the books of the company assuming that all the moneys due were received.

**Solution**

**Working**

No. of Share issued	10,000
No. of Shares applied for	18,000
No. of Shares for which applications are rejected	3,000
No. of Shares applied for which full allotment is made	5,000
No. of Shares applied for which pro-rata allotment is made	10,000
Basis of allotment –	

One Share for every two shares applied for

$$\frac{\text{No. of shares remaining after full allotment}}{\text{No. of Shares applied for}} = \frac{5,000}{10,000} = \frac{1}{2}$$

Application money received (Rs. 3x18,000)	Rs. 54,000
Amount due on application (Rs. 3x10,000)	Rs. 30,000

Exercise application money received	Rs. 24,000
Amount to be refunded on rejected applications (Rs. 3x3,000)	9,000

Surplus application money to be adjusted	15,000
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Amount due on allotment (Rs. 3x10,000)	30,000
Surplus application money to be adjusted	15,000

Amount received on allotment	15,000
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First and Final Call Amount (Rs. 4x10,000)	40,000
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**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account Dr. To Share Application A/c (Being application money on 18,000 shares received)		54,000	54,000
-	Equity Share Application A/c Dr. To Equity Share Capital A/c (Being transfer to Share Capital Account as per Board Resolution dated.....)		30,000	30,000
-	Equity Share Application A/c Dr. To Bank Account (Being refund of application money on rejected applications)		9,000	9,000

Equity Share Application A/c To Equity Share Capital A/c (Being the amount due on allotment as per Board Resolution dated .....)	Dr.	30,000	30,000
Equity Share Application A/c Bank Account To Equity Share Allotment (Being adjustment of excess application money and the receipt of allotment money)	Dr. Dr.	15,000 15,000	30,000
Equity Share First and Final call Account To Equity Share Capital A/c (Being amount due on making first and final call as per Board Resolution dated)	Dr.	40,000	40,000
Bank Account To Equity Share First and Final Call A/c (Being the first and final call amount received)	Dr.	40,000	40,000

### CHECK YOUR PROGRESS – 4

State the decisions that the Board of Directors can take in case of over-subscription.

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### 2.11 UNDER SUBSCRIPTION

In certain cases, the number of shares applied for may be less than the number of shares issued. Then there is said to be under-subscription. In the event of under-subscription the number of shares allotted will be equal to the number of shares applied for. For example, if a company issues 10,000 shares and if the public applies only for 8,000 shares, the company will be allotting 8,000 shares only. It is not required to make any journal entry for under-subscription.

To prevent the possibility of under-subscription, an agreement is entered into by the company with underwriters who guarantee to subscribe to an agreed number of shares if the public does not subscribe for them. For undertaking this risk they are paid some commission which is called 'underwriting commission'. It should also be noted that the underwriting commission can be paid only if the Articles of Association authorizes such a payment and if the commission can be paid or agreed to be paid does not exceed 5 per cent of the price at which the shares are issued or the amount authorized by the Articles, whichever is less.

### 2.12 CALLS IN ARREARS

After making calls against the subscribed capital for payment of cash, the company may find, at times, that a few shareholders have not paid the amount such defaulters, no doubt will continue to be the shareholders but the unpaid amount is transferred to "Calls in Arrears" Account. For instance, the amount due on first call is Rs. 40,000 only an amount of Rs. 39,000 is received. The balance amount of Rs. 1,000 in the First call amount is

transferred to Calls in Arrears Account at end of the accounting year. In other words, on receipt of all money, the Bank Account is debited and the Share Call Account is credited. If all the call money is received the Share Call Account gets closed automatically. If some shareholders do not pay the call amount, there will be a debit balance in the Share Call Account. Such a balance of called up amount is called 'Unpaid Calls' or 'Calls-in-arrears'. The general practice is to transfer this balance to calls-in-arrears account at the end of the accounting year. The journal entry to be made for this purpose is:

Calls in Arrears A/c.                      Dr.  
    To Share Calls A/c.  
(Whichever is due)

As this is the amount called up by the Directors which the shareholders have failed to pay, the amount of calls in arrears is to be deducted from the called-up capital to arrive at the paid-up-capital. On calls in arrears the company can charge interest at 5 per cent per annum for the period for which the amount has remained in arrears, if there is a provision in the Articles of Association and if the Directors decide to collect the same.

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## 2.13 CALLS IN ADVANCE

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Sometimes, even though the company has not yet called up all the amount of the nominal value of the share, some shareholders may pay all the calls (including the calls not made). Such an amount received by the company is called "Calls in Advance". For instance a company has issued 10,000 shares of Rs. 100 each payable: on application Rs. 30/- on allotment Rs. 30/- and on first and final call Rs. 40. The company has received application money of Rs. 30/- each on all shares issued and allotted to all the shares applied for. The company has received allotment money on all shares and a shareholder holding 100 shares has paid the call money along with allotment money. Hence "Calls in Advance" amount in this case is Rs. 4,000 (Rs. 40x100 shares). This amount should be considered as Calls in Advance account and shown separately on the liabilities side of the Balance Sheet. The journal entry to be made for Calls in Advance is as under:

Bank Account                              Dr.  
    To Call in Advance Account  
(With the uncalled amount)

It may be noted that Calls in advance can be accepted by a company only when it is authorized by its Articles. If the company adopts Table A, then it has to pay interest on such Calls in Advance at 6 per cent per annum from the date of receipt up to the date when the calls become due.

Now let us work out an illustration with 'calls in arrears' and 'calls in advance'.

### Illustration – 6

On 1-1-2000 A-Ltd, issued 10,000 Equity Shares of Rs. 10/- each payable as follows:

On application Rs. 3/-; On allotment Rs. 3/- and On First and Final call – Rs. 4/-.

Applications were received for 12,000 shares. Applications for 2,000 shares were rejected. The Directors allotted the Shares, to the remaining applicants in full. Ramu, who was allotted 40 shares, paid the First and Final Calls also an allotment and Somu who was allotted 60 shares did not pay the allotment and first and final call amount. The remaining amounts were received in full. Show the necessary entries in the books of the company.

**Solution**

**Working**

No. of shares issued	-	10,000	
No. of shares applied for	-	12,000	
No. of shares whose applications were rejected	-	<u>2,000</u>	
Share application money received	-	Rs. 3x12,000 = Rs. 36,000	
Application money due on shares allotted	-	Rs. 3x10,000 = Rs. 30,000	
Application money to be refunded on account of rejected applications (Rs. 3x2,000)			6,000
Allotment money due			<u>30,000</u>
Amount received from Ramu on allotment –			
Allotment money on 40 shares	-	Rs. 3x40 = 120	
First & Final Call money paid in advance	-	Rs. 4x40 = 160 (calls in advance)	
		<u>Rs. 280</u>	
Amount received from other shareholders			
Rs. 30,000 - Rs. 300 [@ Rs. 3 on 100 shares = 40 of Ramu and 60 of Somu]		Rs. 29,700	
First and Final Call amount due – Rs. 4x10,000			Rs. 40,000
Amount already received from Ramu as			
Calls –in-advance		Rs. 160	
Amount not paid by Somu (Rs. 4x60)		<u>Rs. 240</u>	400
Amount received on account of first and final call			
Calls in arrears on account of shares allotted to Somu:			<u>39,600</u>
On account of allotment	=	Rs. 180	
On account of first and final call	=	Rs. 240	
		<u>Rs. 420</u>	

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account <span style="float: right;">Dr.</span> To Equity Share Application A/c (Being application money received on 12,000 shares)		36,000	36,000
-	Equity Share Application A/c <span style="float: right;">Dr.</span> To Bank Account A/c To Equity Share Capital A/c. (Being return of application money on rejected applications and transfer to Share Capital Account)		36,000	6,000 30,000

Equity Share Allotment A/c To Equity Share Capital A/c (Being the allotment money due as per Board Resolution dated ....)	Dr.	30,000	30,000
Bank Account Calls in Arrears Account To Equity Share Allotment A/c To Calls in Advanced A/c (Being the amount received on allotment including calls in advance from Ramu on 40 shares allotted to him)	Dr. Dr.	29,980 180	30,000 160
Equity Share First and Final Call A/c To Equity Share Capital A/c (Being the share first and final call amount due as per Board Resolution dated ....)	Dr.	40,000	40,000
Bank Account Calls in Advance Account Calls in Arrears Account To Equity Share First and Final Call A/c (Being the amount received of First and Final calls)	Dr. Dr. Dr.	39,600 160 240	40,000

### LEDGER

Bank Account					
Dr.			Cr.		
Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Equity Share Application A/c	36,000	-	By Equity Share Application A/c	6,000
-	To Equity Share Allotment A/c	29,980	-	By Balance c/d	99,580
-	To Equity Share First and Final Call A/c	39,600			
		<u>1,05,580</u>			<u>1,05,580</u>
	To Balance b/d	99,580			

Equity Share Application Account					
Dr.			Cr.		
Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Bank A/c	6,000	--	By Bank c/d	36,000
	To Equity Share Capital A/c	30,000			
		<u>36,000</u>			<u>36,000</u>

Dr. **Equity Share Allotment Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Equity Share Capital A/c	30,000	-	By Bank A/c	29,820
		<u>30,000</u>	-	By Calls in Arrears A/c	180
					<u>30,000</u>

Dr. **Equity Share First and Final Call Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Equity Share Capital A/c	40,000	-	By Bank A/c	39,600
		<u>40,000</u>	-	By Calls in Advance A/c	160
			-	By Calls in Arrears A/c	240
					<u>40,000</u>

Dr. **Equity Share Application Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Balance c/d	1,00,000	-	By Equity Share Application A/c	30,000
			-	By Equity Share Allotment A/c	30,000
			-	By Equity Share First and Final Call A/c	40,000
		<u>1,00,000</u>			<u>1,00,000</u>

Dr. **Calls in Advance Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Equity Shares Final Call A/c	160	-	By Bank A/c	160
		<u>160</u>			<u>160</u>

Dr. **Calls in Arrears Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
-	To Equity Share Allotment A/c	180	-	By Balance c/d	420
-	To Equity Share First and Final Call A/c	240			
		<u>420</u>			<u>420</u>

**Balance Sheet**

Liabilities	Rs.	Assets	Rs.
<b>Share Capital</b> Authorised, Issued & Subscribed Capital 10,000 Equity Shares of Rs. 10/- each	<u>1,00,000</u>	Bank A/c	99,580
<b>Called up Capital</b> 10,000 equity shares of Rs. 10/- each fully called up 1,00,000	1,00,000		
Less: Calls in arrears 420	<u>99,580</u>		
	<u>99,580</u>		<u>99,580</u>

**CHECK YOUR PROGRESS – 5**

Explain the following terms.

- Under subscription
- Calls in arrears
- Calls in advance

**When both Preference and Equity Shares are Issued**

A company may issue Preference Share Capital along with Equity Share Capital. In such a case we have to make separate entries for these two types of shares on application, allotment and calls. Let us consider the following illustration:

**Illustration – 7**

X Ltd., issued 5,000 Equity Shares of Rs. 10 each and 1,000 9% Preference Shares of Rs. 100 each, payable as follows:

	Equity Shares	9% Preference Shares
On application	Rs. 3	Rs. 25
On allotment	Rs. 3	Rs. 25
On 1 <sup>st</sup> and final call	Rs. 4	Rs. 50

All the shares were subscribed and the moneys due were received. Journalise the above mentioned transactions.

**Solution**

Working	Equity	9% Preference
No. of shares subscribed	5,000	1,000
Share application money received	15,000	25,000

Share allotment money	15,000	25,000
Share 1 <sup>st</sup> and final call money	20,000	50,000

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account <span style="float: right;">Dr.</span> To Equity Share Application A/c To 9% Pref. Share Application A/c (Being application money received on 5,000 Equity shares @ Rs. 3 and 1000 Pref. Shares @ Rs. 25 per share)		40,000	15,000 25,000
-	Equity Share Application A/c <span style="float: right;">Dr.</span> 9% Pref. Share Application A/c <span style="float: right;">Dr.</span> To Equity Share Capital A/c To 9% Pref. Share Capital A/c (Being the transfer of application money received on Equity shares and pref. Shares to their capital accounts respectively)		15,000 25,000	15,000 25,000
-	Equity Share Allotment A/c <span style="float: right;">Dr.</span> 9% Pref. Share Capital A/c <span style="float: right;">Dr.</span> To Equity Share Capital A/c To 9% Pref. Share Capital A/c (Being the allotment money due on 5,000 Equity shares at Rs. 3 per share and 1,000 Pref. @ Rs. 25/- per share)		15,000 25,000	15,000 25,000
-	Bank Account <span style="float: right;">Dr.</span> To Equity Share Allotment A/c To 9% Pref. Share Allotment A/c (Being the cash received on allotment of Equity shares and pref. Shares)		40,000	15,000 25,000
-	Equity Share First and Final Call A/c <span style="float: right;">Dr.</span> 9% Pref. Share Allotment A/c <span style="float: right;">Dr.</span> To Equity Share Capital A/c To 9% Pref. Share Capital A/c (Being first and final call amount due on 5000 Equity shares at Rs. 50 per share)		20,000 50,000	20,000 50,000
-	Bank Account <span style="float: right;">Dr.</span> To Equity Share First and Final Call A/c To 9% Pref. Share 1 <sup>st</sup> and Final Call A/c (Being the call amount received on 5,000 equity shares and 1000 pref. Shares)		70,000	20,000 50,000

Another point to be noted is that the set of entries which we have considered are all made in the journal. As stated earlier, the actual practice is that all cash transactions are to be passed

in the Cash Book and only non-cash transactions are to be passed in the journal. The following illustration will help us to understand procedure in this regard:

### Illustration – 8

The Sun Ltd., has an authorized capital of Rs. 25,00,000 comprising 10,000 8% Preference Shares of Rs. 100/- each and 1,50,000 Equity Shares of Rs. 10/- each. The company has made an issue of 10,000 Preference shares and 50,000 Equity Shares. The terms of payment are as follows:

	8% Preference Shares	Equity Shares
On application	Rs. 20	Rs. 3
On allotment	Rs. 30	Rs. 4
On 1 <sup>st</sup> and final call	Rs. 20	Rs. 3
On second call	Rs. 20	--

While all the Preference shares have been subscribed, only 40,000 Equity Shares have been subscribed. Except the First and Second calls on 100 Preference shares and call money on 500 Equity Shares, all the moneys were received.

Show the journal and Cash Book and prepare the Balance Sheet.

### Solution

	Working	
	8% Preference Shares	Equity Shares
No. of Shares issued	10,000	50,000
No. of Shares subscribed	10,000	40,000
Application money received	2,00,000 (Rs. 20x10,000)	1,20,000 (Rs. 3 x 40,000)
Allotment money due and received	3,00,000 (Rs. 30x10,000)	1,60,000 (Rs. 4x40,000)
1 <sup>st</sup> Call money due	3,00,000 (Rs. 30x10,000)	1,20,000 (Rs. 3x40,000)
1 <sup>st</sup> Call money received	2,97,000 (Rs. 30x9,900)	1,18,500 (Rs. 3x39,500)
2 <sup>nd</sup> Call money due	2,00,000 (Rs. 20x10,000)	--
2 <sup>nd</sup> Call money received	1,98,000 (Rs. 20x9,900)	--

**Cash Book (Bank Column only)**  
(Recording only Cash Transactions)

Dr.					Cr.
Date	Particulars	Rs.	Date	Particulars	Rs.
-	To 8% Pref. Share Application A/c	2,00,000	-	By Balance c/d	13,93,500
-	To Equity Share Application A/c	1,20,000			
-	To Preference Share Allotment A/c	3,00,000			
-	To Equity Share Allotment A/c	1,60,000			
-	To 8% Preference Share First Call A/c	2,97,000			
-	To Equity Share First Call A/c	1,18,500			
-	To 8% Pref. Share 2 <sup>nd</sup> and final call A/c	1,98,000			
		<u>13,93,500</u>			<u>13,93,500</u>

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	8% Pref. Share Application A/c      Dr. To Pref. Share Capital A/c (Being transfer of Pref. Application money to Pref. Share Capital A/c)		2,00,000	2,00,000
-	Equity Share Application A/c      Dr. To Equity Share Capital A/c (Being the transfer of Equity share application money to Equity share capital A/c)		1,20,000	1,20,000
-	8% Pref. Share Allotment A/c      Dr. To 8% Pref. Share Capital A/c (Being the allotment money due on 10,000 Pref. Shares)		3,00,000	3,00,000
-	Equity Share Allotment A/c      Dr. To Equity Share Capital A/c (Being allotment money due on 40,000 Equity shares)		1,60,000	1,60,000
-	8% Pref. Share First and Final Call A/c      Dr. To 8% Pref. Share Capital A/c (Being first and final call amount due on 10,000 Pref. Shares)		3,00,000	3,00,000
-	Equity Share First and Final Calls A/c      Dr. To Equity Share Capital A/c (Being the first and final call money due on 40,000 Equity Shares)		1,20,000	1,20,000

8% Pref. Share second call A/c To 8% Pref. Share Capital A/c (Being the amount due on 2 <sup>nd</sup> call on 10,000 8% Pref. Shares)	Dr.	2,00,000	2,00,000
Pref. Shares Calls in Arrears A/c To 8% Pref. Share 1 <sup>st</sup> Call A/c To 8% Pref. Share 2 <sup>nd</sup> and Final Call A/c (Being transfer of First call money at Rs. 30 and Second call money at Rs. 20 on 100 Preference shares to calls in arrears A/c)	Dr.	5,000	3,000 2,000
Equity Share Calls in Arrears A/c To Equity Share First and Final Call A/c (Being transfer of First call money at Rs. 500 Equity Shares to Calls in Arrears Amount)	Dr.	1,500	1,500

**Balance Sheet**  
of Sun Ltd., as on . . .

Liabilities	Rs.	Assets	Rs.
Authorized Capital: 10,000 8% Pref. Shares of Rs.100 each	10,00,000	Bank	13,93,500
1,50,000 Equity Shares of Rs.10/- each	15,00,000		
	<u>25,00,000</u>		
Issued, Subscribed and called up capital: 10,000 8% Pref. Shares of Rs. 100 each      10,00,000	9,95,000		
Less: Calls in arrears      5,000			
40,000 Equity Shares of Rs. 10 each      4,00,000	3,98,500		
Less: Capital in arrears      1,500	<u>13,93,500</u>		<u>13,93,500</u>

## 2.14 ISSUE OF SHARES AT PREMIUM

Some companies enjoy good reputation in the share market and people will be willing to buy shares of such companies even at a price higher than the nominal value of the shares. Such companies may issue shares at a price which is more than the face value. The excess amount collected over and above the face value is called 'Share Premium' and the issue is called 'Issue of Shares at a Premium'. There are no restrictions regarding the issue of shares as a premium. But the Companies Act lays down that the company should credit the amount of premium received to a separate 'Share Premium Account'. This amount will be shown as a separate item on the liabilities side of the Balance Sheet under the head, 'Reserves and Surplus'. If a company issues shares at a premium, even though the consideration is other than cash a sum equal to the amount of the premium must be transferred to the Share Premium Account.

Section 78 lays down that Share Premium Account can be utilized only for the following purposes:

- i) in paying up un-issued shares of the company to be issued to members of the company as fully paid bonus shares;
- ii) in writing off the preliminary expenses of the company;
- iii) in writing off the expenses of, or the commission paid or discount allowed on any of shares or debentures of the company; or
- iv) in providing for the premium payable on the redemption of Redeemable Preference shares or of any debentures of the company.

The share premium can be received either with the application money, allotment money or call money. Generally, the practice is to collect the share premium along with the allotment money. The following are the entries to be made when the shares are issued at a premium:

#### Proforma Journal Entries

- i) When share premium is received with applications:

Bank Account                      Dr.  
    To Share Application A/c  
(Including the premium amount)

- ii) When share premium is called along with allotment money or call money, any one of the following two sets of entries may be made:

- a) When premium is recorded along with the allotment money or call money:

*For allotment money/call money due:*

Share Allotment (or share call account) A/c              Dr.  
    To Share Capital Account  
    To Share Premium Account

*For the receipt of allotment money/ call money:*

Bank Account                      Dr.  
    To Share Allotment (or Share Call A/c) A/c

- b) When the premium is recorded only when it is actually received along with allotment money or call money:

*For the allotment money/call money due:*

Share Allotment (or Share Call A/c)                      Dr.  
    To Share Capital A/c

*For the receipt of allotment money/call money along with share premium:*

Bank Account                      Dr.  
    To Share Allotment (or Share Call A/c)  
    To Share Premium A/c

The following illustration will explain the entries relating to the transactions of the issue of shares at premium.

**Illustration – 9**

X Ltd., issued 1,00,000 equity shares of Rs. 10/- each at Rs. 12/- per share. The amount payable is Rs. 2/- on application; Rs. 3 on allotment; Rs. 3 on First call and Rs. 2 on Second and Final calls. Show the necessary journal entries up to the receipt of allotment money when (a) the premium is collected with Share Application money and (b) the premium is collected with Share Allotment money.

**Solution**

**Journal**

a) When premium is collected along with application money.

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account <span style="float: right;">Dr.</span> To Equity Share Application A/c. (Being the Equity Share application money received)		4,00,000	4,00,000
-	Equity Share Application A/c. <span style="float: right;">Dr.</span> To Equity Share Capital A/c. To Equity Share Premium A/c. (Being transfer of share application money to Share Capital and Share Premium account)		4,00,000	2,00,000 2,00,000
-	Equity Share Allotment A/c. <span style="float: right;">Dr.</span> To Equity Share Capital A/c. (Being the share allotment money due)		3,00,000	3,00,000
-	Bank Account <span style="float: right;">Dr.</span> To Equity Share Allotment A/c. (Being the share allotment received)		3,00,000	3,00,000

b) When premium amount is collected with allotment money. This may be recorded in any one of the following two methods.

- i) When premium is recorded along with allotment money due.
- ii) When premium is recorded when it is received along with allotment money.

The following entries will explain the difference between the above two methods.

i) When premium is recorded along with allotment money due.

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account Dr. To Equity Share Application A/c. (Being Share application money received)		2,00,000	2,00,000
-	Equity Share Application A/c. Dr. To Equity Share Capital A/c. (Being transfer of share application money to Share Capital account)		2,00,000	2,00,000
-	Equity Share Allotment A/c. Dr. To Equity Share Capital A/c. To Share Premium A/c. (Being the share allotment money due including premium)		5,00,000	3,00,000 2,00,000
-	Bank Account Dr. To Equity Share Allotment A/c. (Being share allotment money received)		5,00,000	5,00,000

ii) When premium is recorded when it is received along with allotment money:

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account Dr. To Equity Share Application A/c. (Being Share application money received)		2,00,000	2,00,000
-	Equity Share Application A/c. Dr. To Equity Share Capital A/c. (Being transfer of share application money to Share Capital account)		2,00,000	2,00,000
-	Equity Share Allotment A/c. Dr. To Equity Share Capital A/c. (Being the allotment money due)		3,00,000	3,00,000
-	Bank Account Dr. To Equity Share Capital A/c. To Share Premium A/c. (Being the allotment money received along with premium)		5,00,000	3,00,000 2,00,000

After posting the above entries into ledger accounts, Balance Sheet is prepared as under with the balances available in the accounts which are not closed.

### Balance Sheet

Liabilities	Rs.	Assets	Rs.
Share Capital: 1,00,000 Equity Shares of Rs. 10 each, Rs. 5 per share called up	5,00,000	Cash at Bank	7,00,000
Reserved and Surplus: Share Premium	<u>2,00,000</u> <u>7,00,000</u>		<u>7,00,000</u>

#### Illustration – 10

Beta Ltd., issued 50,000 Equity Shares of Rs. 10 each at a premium of Rs. 2 per share. The amount is payable as follows:

On application	- Rs. 2
On allotment	- Rs. 6 (including premium)
On First call	- Rs. 2
On Final call	- Rs. 2

Applications were received for 75,000 shares. Applications for 15,000 shares were rejected. The rest of the applications were allotted shares and the excess application money was retained and adjusted towards allotment money. Only the First call was made and all money due on allotment and First call were received except the First call amount on 1,000 shares allotted to Mr. X.

Give the journal entries and the Balance Sheet of the company relating to the above transactions.

#### Solution

#### Working

No. of Shares issued	50,000
No. of Shares applied for	75,000
Shares Application money received (Rs. 2 x 75,000)	1,50,000
Share Application money due (Rs. 2 x 50,000)	<u>1,00,000</u>
Excess application money received	50,000
Application money returned towards rejected applications (Rs. 2 x 15,000)	30,000
Application money to be adjusted towards allotment money	<u>20,000</u>
<b>Amount due on allotment:</b>	
Towards allotment money (Rs. 4 x 50,000)	2,00,000
Towards shares premium (Rs. 2 x 50,000)	<u>1,00,000</u>
	3,00,000
Excess application money adjusted	<u>20,000</u>
Amount received on allotment	<u>2,80,000</u>

Amount due on 1 <sup>st</sup> call (Rs. 2 x 50,000)	1,00,000
Calls in arrears (Rs. 2 x 1,000)	2,000
Call money received	<u>98,000</u>

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account Dr. To Equity Share Application A/c. (Being application money on 75,000 shares at Rs. 2 per share received)		1,50,000	1,50,000
-	Share Application A/c. Dr. To Equity Share Capital A/c. (Being transfer of Share application money is Share Capital Account)		1,00,000	1,00,000
-	Share Allotment A/c. Dr. To Equity Share Capital A/c. To Equity Share Premium A/c. (Being the amount due on allotment including premium @ Rs. 2 per share)		3,00,000	2,00,000 1,00,000
-	Equity Share Application A/c. Dr. To Equity Share Allotment A/c. To Bank A/c. (Being the return of application money on rejected application and adjustment of application money on 10,000 shares towards allotment)		50,000	20,000 30,000
-	Bank Account A/c. Dr. To Equity Share Allotment A/c. (Being the amount due on allotment received)		2,80,000	2,80,000
-	Equity Share First Call A/c. Dr. To Equity Share Capital A/c. (Being the share call amount due on making the 1 <sup>st</sup> call)		1,00,000	1,00,000
-	Bank Account Dr. To Equity Share First Call A/c. (Being the receipt of first call amount with the exception of amount on 1,000 shares allotted to Mr. X)		98,000	98,000
-	Equity Share Call Arrears A/c. Dr. To Equity Share First Call A/c. (Being the unpaid amount on 1,000 share of 1 <sup>st</sup> Call transferred to shares arrears account)		2,000	2,000

### Balance Sheet

Liabilities	Rs.	Assets	Rs.
Share Capital: 50,000 Equity Shares of Rs. 10 each, Rs. 8 per share paid 4,00,000 Less: Calls in arrears 2,000	3,98,000	Cash at Bank	4,98,000
Reserves and Surplus: Share Premium A/c.	1,00,000 <u>4,98,000</u>		<u>4,98,000</u>

### CHECK YOUR PROGRESS – 6

State the meaning of issue of shares at premium.

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### 2.15 ISSUE OF SHARES AT DISCOUNT

Sometimes a company may find that the demand for its shares is not encouraging. To induce the investors to buy its shares, the company may issue its shares at price which is below its nominal value. The difference between the nominal value and the price at which the shares are issued is called 'Discount' and such an issue is called 'Issue of Share at a Discount'. The loss on account of issue of shares at a discount is debited to 'Discount on Issue of Shares Account'. The balance in this account should appear in the Balance Sheet on the Assets side under the head, 'Miscellaneous Expenditure till it is written off.

A company issuing shares at a discount must fulfill the following conditions as laid down in Section 79 of the Companies Act:

- i) The Shares contemplated to be issued at a discount must be of a class of shares already issued.
- ii) Such an issue must be authorized by a resolution passed in General body meeting of the company.
- iii) Sanction for such an issue must be obtained from the Court.
- iv) The resolution authorizing such an issue must specify the maximum rate of discount, which should not exceed 10%, or a higher percentage which is permitted by the Central Government as a special case.
- v) At least one year should have elapsed, at the time of issue, from the date on which the company was entitled to commence the business.
- vi) The issue must be made within two months from the date on which the Court's sanction is obtained or within such an extended time as the Court may allow.

The discount on issue of shares can be recorded along with allotment or calls. The entries that may be passed are given below:

## Proforma Journal Entries

### a) When discount is recorded at the time of allotment or call money:

- i) For the Allotment money/call money due after adjusting discount on issue of shares:

Share Allotment/Share Call Account	Dr.
Discount on Issue of Shares Account	Dr.
To Share Capital Account	

- ii) On receipt of allotment/call money:

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

### b) When discount is recorded only when the allotment money/call money is received:

- i) For the allotment money/call money due without deducting discount:

Share Allotment/Share Call Account	Dr.
To Share Capital Account	

- ii) On receipt of allotment/call money after adjusting discount:

Bank Account	Dr.
Discount on issue of Shares Account	Dr.
To Share Allotment/Share Call Account	

Generally the set of entries as given in (a) above are made.

The following two illustrations will explain the process of recording the transactions relating to the 'Issue of Shares at a Discount'.

#### Illustration - 11

Desi Ltd., issued 10,000 shares of Rs. 10/- each at a discount of 10%. The terms of payment are:

On Application Rs. 2/- On allotment – Rs. 2 (after adjusting discount); Rs.3 on First Call and Rs. 2 Second and Final Call.

All the Call were made and all the amounts were received with the exception of Second and Final Calls amount on 500 shares held by Rao.

Pass the necessary journal entries to record the above.

**Solution**

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account <span style="float: right;">Dr.</span> To Equity Share Application A/c. (Being application money on 10,000 shares received)		20,000	20,000
-	Share Application A/c. <span style="float: right;">Dr.</span> To Share Capital A/c. (Being transfer of application money to Share Capital Account)		20,000	20,000
-	Share Allotment Account <span style="float: right;">Dr.</span> Discount on Issue of Shares A/c. <span style="float: right;">Dr.</span> To Share Capital Account (Being the allotment money due on 10,000 shares at Rs. 2/- per share, Rs.3-1 discount)		20,000 10,000	30,000
-	Bank Account <span style="float: right;">Dr.</span> To Share Allotment Account (Being the allotment money received)		20,000	20,000
-	Share First Call Account <span style="float: right;">Dr.</span> To Share Capital Account A/c. (Being the first call amount due)		30,000	30,000
-	Bank Account <span style="float: right;">Dr.</span> To Share First Call A/c. (Being the First Call amount received)		30,000	30,000
-	Share Second and Final Call A/c. <span style="float: right;">Dr.</span> To Share Capital Account (Being the Second and Final Call amount due)		20,000	20,000
-	Bank Account <span style="float: right;">Dr.</span> Call in Arrears Account <span style="float: right;">Dr.</span> To Share Second and Final Call A/c. (Being Second and Final Call money received on 9,500 shares)		19,000 1,000	20,000



Share Allotment A/c.	Dr.	67,500	
Discount on Issue of Shares A/c.	Dr.	22,500	
To Share Capital Account			90,000
(Being the share allotment money due on 22,500 shares @ Rs. 3 and discount @ Rs. 1 per share brought into A/c.)			
Bank Account	Dr.	67,500	
To Share Allotment A/c.			67,500
(Being the receipt of allotment money on 22,500 shares)			
Share First and Final Call A/c.	Dr.	90,000	
To Share Capital A/c.			90,000
(Being the First and Final Call amount due on 22,500 shares @ Rs. 4 per share)			
Bank Account	Dr.	88,000	
Call Arrears A/c.	Dr.	2,000	
To Share First and Final Call A/c.			90,000
(Being the first and final money received with the exception of call amount on 500 shares)			

### Balance Sheet

Liabilities	Rs.	Assets	Rs.
Share Capital: 22,500 Shares of Rs. 10 each,	2,25,000	Cash at Bank	2,00,500
Less: Call in arrears	2,000	Miscellaneous Expenditure: Discount on Issue of Shares	22,500
	<u>2,23,000</u>		<u>2,23,000</u>

### CHECK YOUR PROGRESS - 7

State the meaning of "Issue of Shares at a Discount".

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### 2.16 RIGHTS ISSUE

Section 81 of the Companies Act stipulates that whenever a public limited company proposes to increase its subscribed capital by allotment of further shares, after completion of two years from the date of incorporation or after completion of one year from the date of allotment of shares in that company, whichever is earlier, should offer those shares to the existing shareholders of Equity Shares in the proportion of paid up capital. Such an issue is called 'Right Issue'. Such shares are called 'Rights Shares' as they are offered as a matter of legal right.

Unless the articles provide otherwise, the existing Equity shareholders to whom the rights shares are offered must be given the right to renounce the whole or a part of the offer in favour of a third party. At least 15 days time must be given for the acceptance, rejection or renunciation of the offer. Afterwards, shares not taken up or not renounced by the Equity Shareholders can be disposed off by the Directors in such a manner as they consider most beneficial to the company.

The rights shares can be issued either at par or at a premium payable in one lump sum or by installments. Usually, they rank for dividend from the date on which the Final call is paid. Generally, the rights shares are issued at a premium, but at a price which is less than the price quoted for the shares of the company on the Stock Exchange. The accounting procedure for recording rights issue is similar to the procedure already discussed.

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## **2.17 SUMMING UP**

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Unlike private limited company, a public company collects its capital from the public by issuing invitation to subscribe to the share capital offered. Total capital of the company being divided into units of small denominations are known as shares. As per the companies Act, a public company issue equity shares and preference shares of a specific value to the public for the collection of capital. Further preference shares can also be redeemable, convertible and participating depending upon their nature. Information about the share capital is presented in the Balance Sheet in a classified manner as per the legally prescribed manner. These details are important in the interest of disclosure of information to the issue of accounting data.

A company can also issue shares to the vendors of the assets and promoters in satisfaction of the consideration due to them. When company issues shares to the general public for cash, it generally collects the share value from them in instalments, i.e., at the time of receiving applications for shares, allotment, and at subsequent intervals. The transactions relating to the issue of shares are recorded in the books of accounts by passing journal entries and by writing cash transactions in cash book (practical method). However, the company must comply with all the legal stipulations for issuing shares to public. When shares are issued for cash, it is also possible at times, that a few shareholders may fail to pay the instalments on time in which case, the due amount is transferred to "Calls in Arrears Account" at the end of the year. There might be a few shareholders who may pay the entire normal value even before the instalments are called for. In such case, "Calls in Advance Account" is prepared and shown in the Balance Sheet at the end of the financial year.

Depending upon the financial status and business image of the company, shares are also issued to the public at premium or at discount. For issuing shares at discount the company must comply with certain legal stipulations.

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## **2.18 CHECK YOUR PROGRESS: MODEL ANSWERS**

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1. i) Preference shares enjoy the preferential rights in respect of dividend at a fixed rate and repayment of capital in the event of liquidation whereas the rate of dividend on equity shares is decided by the Board depending upon the volume of disposable surplus and capital is refunded only after the preference shareholders are satisfied.
- ii) Authorised capital is the maximum amount of capital which the company is empowered to raise through public subscription. It is called Registered capital as it is registered and mentioned in Memorandum of Association.

2. i) Cash A/c.	Dr.	30,000	
To Capital A/c.			30,000
(Being the commencement of the business)			

ii) Bank A/c.	Dr.	30,000	
To Shankar's Capital A/c.			10,000
To Vishnu's Capital A/c.			10,000
To Nanda's Capital A/c.			10,000
(Being a partnership firm is started with a capital contributed by the partners)			

3. The following is the sequence of transactions relating to the issue of shares at par.

- i) Receipt of Application money
  - ii) Allotment after the Board scrutinizing the applications
  - iii) Transfer of application account to share capital account
  - iv) Sending the allotment letters and to show allotment money due
  - v) Receipt of Allotment money
  - vi) Calls to be made subsequently for which call money due entry and receipt of account entries are to be passed.
4. i) Rejecting the application for excess number of shares
  - ii) Allotting the shares on pro-rata basis
  - iii) Rejecting a few applications completely and allotting to the remaining applicants on pro-rata basis.
5. a) Receiving lesser number of applications for shares than the number of shares issued to the public for subscription.
  - b) The amount unpaid by the shareholders to the company on the calls made. Arrears of amount under any share call is "Calls in Arrears".
  - c) The amount received by the company from the shareholder even before the calls are made.
6. The excess price collected by the company on each share over and above the nominal value.
  7. Issue of shares by the company at a lower price than the nominal value.

## **2.19 MODEL EXAMINATION QUESTIONS**

**I. Answer the following questions in about 30 lines each.**

1. How the information about the issue of share capital is shown in Balance Sheet?
2. Explain the difference between preference shares, and equity shares.
3. State the proforma entries for the issue of shares to vendors, promoters for consideration other than cash.
4. Differentiate between issue of shares at premium and at discount.

**II. Answer the following questions in about 15 lines each.**

1. Why public companies issue shares to the public?
2. What is Issued Capital?
3. What is a Deferred share?

4. State the features of preference shares?
5. What do you mean by over subscription?
6. What is the meaning of calls in arrears?
7. What do you mean by Rights Issue?

### Problems

1. X Ltd., has been registered with an authorized capital of Rs. 2,00,000 divided into 20,000 Equity Shares of Rs. 10 each. The company has issued 10,000 equity shares at par, payable as under:

On application	Rs. 2;	On allotment	Rs. 2;
On first call	Rs. 3;	On second & final call	Rs. 3.

The public subscribed for all the shares and all moneys due were received. Show the necessary journal entries and ledger accounts. Also prepare the Balance Sheet of the Company after the issue.

(Ans: Balance Sheet Total Rs. 1,00,000)

2. A Ltd., has an authorized capital of Rs. 5,00,000 divided into 50,000 equity shares of Rs.10 each. The company issued all the shares which were subscribed in full.

On application	Rs. 3;	On allotment	Rs. 3;
On first call	Rs. 2;	On second & final call	Rs. 2.

All the calls were made and all the moneys due were received except the second and final call money on 250 shares allotted to Ravi.

Show the necessary journal entries and ledger accounts to record the transactions given above.

(Ans: Calls in arrears: Rs. 500)

3. Good Luck Ltd., has issued 10,000 equity shares of Rs. 10 each, the amount payable being:

On application	Rs. 3;	On allotment	Rs. 2;
On first call	Rs. 3;	On second & final call	Rs. 2.

Applications were received for 8,500 shares and moneys were duly allotted. All the calls were made and the moneys due were received with the exception of the first call money on 200 shares and the second and final call money on 250 shares.

Show the necessary journal entries to record the transactions given above:

(Ans: Calls in arrears: Rs. 1,100)

4. Y Ltd., was registered with an authorized capital of Rs. 10,00,000 divided into 1,00,000 Equity Shares of Rs. 10 each. The Company issued 50,000 shares payable as under:

On application	Rs. 2;	On allotment	Rs. 2;
On first call	Rs. 3;	On second & final call	Rs. 3.

Applications were received for 75,000 shares.

The allotment was made to all the applicants on pro-rata basis. All the calls were made and the moneys due was also received.

Show the journal entries in the books of the company.

(Ans: Application money adjusted on allotment: Rs. 50,000)

5. XYZ Ltd., issued 1,00,000 equity shares of Rs. 10 each, payable as follows:

On application	Rs. 2;	On allotment	Rs. 2.50;
On first call	Rs. 3;	On second & final call	Rs. 2.50.

Applications were received for 1,60,000 shares and allotment was made as follows:

To applicants of 80,000 shares – full  
 To applicants of 40,000 shares – 50%  
 To the remaining applicants – nil

Excess application money was adjusted against allotment money. One shareholder to whom 400 shares were allotted on 100% basis paid the total amount due from him on allotment. Both the calls were made and the amounts due were received.

Show the journal entries and ledger accounts in the books of the company.

(Ans: Excess application money adjusted on allotment – Rs. 40,000; calls in advance: Rs. 2,200)

6. A Ltd., was registered with an authorized capital of Rs. 10,00,000 comprising 50,000 equity shares of Rs. 10 each and 5,000 12% preference shares of Rs. 100 each and all the shares were offered to the public. The amounts payable being:

	Equity Shares	Preference Shares
On application	Rs. 2	Rs. 30/-
On allotment	Rs. 4/-	Rs. 30/-
On first call and final call	Rs. 4/-	Rs. 40/-

Applications were received for 60,000 equity shares and 4,000 Preference shares. Preference shares were allotted to all the applicants. Applicants for 5,000 equity shares were rejected and the remaining applicants were allotted on pro-rata basis.

All the money due was received except the call money on 1,000 equity shares and 100 Preference shares. Show the journal entries in the books of the company.

(Ans: Excess application money adjusted on allotment of equity shares Rs. 10,000; calls in arrears on Equity shares Rs. 4,000; on Preference shares Rs. 4,000; Balance Sheet Total Rs. 8,92,000)

7. Z Ltd., has an authorized capital of Rs. 5,00,000 divided into 50,000 equity shares of Rs.10 each. It has issued 20,000 equity shares payable as follows:

On application	Rs. 2;	On allotment	Rs. 2/-
On first call	Rs. 3;	On-second & final call	Rs. 3/-

Applications were received for 50,000 shares. The allotment was made as here under:

To the applicants 10,000 shares – full	
To the applicants for 10,000 shares (20%)	2,000
To the applicants for 20,000 shares (10%)	2,000
To the applicants for 10,000 shares (60%)	6,000

All the calls were made and all the moneys due were received except from one shareholder holding 300 shares allotted under 60% category who could not pay the final call.

Show the necessary journal entries to record the transactions given above:

(Ans: Application money adjusted towards allotment, etc.):

On 20% allotment	-- Rs. 4,000 on allotment and Rs. 4,000 on first call;
On 10% allotment	-- Rs. 4,000 on allotment Rs. 6,000 on first call; and Rs. 8,000 on second and final call;
On 60% allotment	-- Rs. 4,000 on allotment;
Calls in arrears	-- Rs. 1,200.

8. A Ltd., issued 25,000 equity shares of Rs. 10 each payable.

On application	Rs. 3/- On allotment Rs. 3/-
On first call	Rs. 2/- On second & final call Rs. 2/-

Applications were received for 45,000 shares. The directors made the allotment as here under:

On applications for 22,500 shares – full	
On applications for 10,000 (25%)	2,500
On applications for the balance of shares	nil

On shareholder to whom 1,000 shares were allotted on 100% basis the full amount on allotment. The company made the first call and all the moneys due were received except on 200 shares (allotment made on 100% basis)

Show the necessary journal entries.

(Ans: Calls in arrears Rs. 400;

Adjustment of share application money on, allotment made	
On 24% basis	-- Rs. 7,500 towards allotment Rs. 5,000 towards first call Rs. 5,000 towards second call.

Rs. 2,000 returned as it is in excess of total amount due on these shares.

Calls in advance	-- Rs. 2,000 on 1,000 shares and Rs. 5,000 on 2,500 shares)
------------------	--

9. Alpha Ltd., has an authorized capital of Rs. 60,00,000 divided into 6,00,000 equity shares of 10 each. It has issued 4,00,000 shares at a premium of Rs. 1/- and the amounts are payable as follows:

On application Rs. 3/-; on allotment Rs. 4/- (including premium); and on first and final call Rs. 4/-.

Applications were received for 7,20,000 shares and allotment was made as here under:

To applicants 3,00,000 shares – full  
To applicants of 50,000 shares – nil  
To the applicants of 3,70,000 shares – 1,00,000 shares.

Excess application money was adjusted against sums due. All the moneys were received. Show the journal entries and Balance Sheet in the books of the Company.

(Ans: Amount refunded to applicants of 3,70,000 shares  
Rs. 10,000 after adjusting towards allotment and final call amounts.  
Amount refunded to applicants of 50,000 shares Rs. 1,50,000  
Balance Sheet Total Rs. 44,00,000).

10. Beta Ltd., issued 6,000 shares of Rs. 10 each at a premium of Rs. 1/- per share, payable as here under:

On application Rs. 3/-; on allotment Rs. 4/- (including premium); on first call Rs. 3/-; and on second final call Rs. 2.

The company received application for 7,500 shares and allotment was made as here under:

To applicants for 300 share – nil  
To applicants for 1,200 shares – full  
To the applicants for 6,000 shares – pro-rata:

Show the necessary journal entries in the books of the company assuming that all calls were made and the moneys due were received.

(Ans: Share application money adjusted towards allotment money in respect of applicants for 6,000 shares – Rs. 3,600; Share premium amount: 12,000).

11. Delta Ltd., issued 5,000 shares of Rs. 100 each at a discount of 5% the amount payable is as under: Rs. 20 on application; Rs. 20 on allotment (including discount); Rs. 25 on first call and Rs. 30 on final call.

All the calls were made and amounts due were received with the exception of final call on 600 shares held by X.

Show the necessary journal entries and the Balance Sheet.

(Ans: Calls in arrears Rs. 15,000; Discount on issue of shares Rs. 25,000; Balance Sheet Total: Rs. 4,85,000)

12. Zebra Ltd., issued, 1,00,000 shares of Rs. 10 each payable as here under:

On application Rs. 3/-; On allotment Rs. 2/- (including discount); and on first and final call Rs. 4/-.

The company received application for 1,40,000 shares. After making pro-rata allotment on applications for 1,25,000 shares, the share application money on 15,000 shares were returned. The final call was made and all moneys due were received except allotment and first and final call money on 100 shares. Show the journal entries.

(Ans: Call in arrears on allotment		
Allotment money due (Rs. 2x100) =		Rs. 200
Less: Application money to be adjusted being excess application		
Money 25 shares x Rs. 3/-		<u>75</u>
Calls in arrears on first call =	Rs. 400	Rs. 275

## 2.20 RECOMMENDED BOOKS

1. M.C. Shukla and T.S. Grewal : **Advanced Accounts**,  
S. Chand & Company Ltd., New Delhi.
2. S.P. Jain and K.L. Narang : **Advanced Accountancy**,  
Kalyani Publishers, Ludhiana.
3. R.L. Gupa : **Advanced Accountancy, Vol-II**,  
S. & Sons, New Delhi.
4. A.N. Agarwala : **The Higher Science of Accountancy**,  
Kitab Mahal, Allahabad.
5. S.N. Maheshwari : **Advanced Accountancy, Vol-II**,  
Vani Educational Books, New Delhi.

## 2.21 GLOSSARY

- Allotment** : Allocation of shares/debentures to Applicants in response to their applications.
- Application Money** : The money to be remitted by an applicant along with his application for Shares/Debentures.
- Authorised Capital** : The total (maximum) amount of capital which the company is authorized to raise.
- Called up Capital** : The total allotment of capital which the shareholders are called upon to pay, till date.
- Calls in Advance** : The excess money paid by the shareholders in respect of the shares allotted to him over and above what is payable before he is called upon to pay.
- Calls in Arrears** : The amount though called up the Directors, the shareholders have failed to pay and thus in arrears.
- Call Money** : When the Directors inform the shareholders to pay a part of the share amount through a letter, it is said that a call has been made. The amount payable on such a call is called as call money.

- Dividend** : The amount paid to shareholders out of the profits of a year as return on the investment made by them.
- Equity Share** : The share on which dividend is paid only when profits are left after paying preference dividend. Capital is returned only after returning the preference share capital and the holder of such a share has voting rights.
- Issued Capital** : The part of the authorized which is offered to the public for subscription.
- Preference Shares** : Shares which enjoy a preferential right in respect of payment of a fixed rate of dividend and repayment of capital in the event of winding up of the company.
- Rights Issue** : The offer of shares to the existing shareholders of equity shares in the proportion of their paid up capital out of an issue subject to the conditions laid down in Sec. 81.
- Share Capital** : The total amount of capitals of a company.
- Share Premium** : Profit made by a company when the shares are issued at a higher price than the face value.
- Share Premium** : That portion of issued capital of a company which is applied for (subscribed) by the public.
- Vendors** : Persons who sell their business.

## **UNIT – 3 : FORFEITURE AND RE-ISSUE OF SHARES**

### **Contents**

- 3.0 Aims and Objectives
- 3.1 Introduction
- 3.2 Forfeiture of Shares
- 3.3 Re-issue of Forfeited Shares
- 3.4 Surrender of Shares
- 3.5 Redemption of Preference Share Capital
- 3.6 Summing Up
- 3.7 Check Your Progress : Model Answers
- 3.8 Model Examination Questions
- 3.9 Recommended Books
- 3.10 Glossary

### **3.0 AIMS AND OBJECTIVES**

This unit aims at discussing the accounting procedure relating to the forfeiture of shares and their re-issue.

After studying this unit, you should be able to:

- describe the accounting procedure relating to forfeiture of shares and their re-issue;
- explain the surrender of shares; and
- record the transactions relating to forfeiture and reissue of forfeited shares..

### **3.1 INTRODUCTION**

In the previous unit, you have learnt about the issue of shares and its accounting procedure. In this unit, you will learn about the accounting procedure relating to:

- i) forfeiture of shares in three different cases, i.e.,
  - a) forfeiture of shares which were issued at par,
  - b) forfeiture of shares which were issued at a premium, and
  - c) forfeiture of shares which were issued at a discount.
- ii) re-issue of forfeited shares in three different cases,
  - a) re-issue of forfeited shares which were issued at par,
  - b) re-issue of forfeited shares which were issued at premium, and
  - c) re-issue of forfeited shares which were issued at a discount.

Further you will learn about the accounting procedure relating to forfeiture of shares when there is over-subscription and pro-rata allotment is made.

### **3.2 FORFEITURE OF SHARES**

Forfeiture usually means the taking away of a thing or right from a person as a penalty for committing some mistake or default in complying with a certain condition laid down in an agreement. If a shareholder fails to pay any amount on the shares held by him, the shares allotted to him may be cancelled. Owing to non-payment of the amount outstanding, if a shareholder is deprived of the shares allotted to him, such an action by the company is referred to as 'Forfeiture of Shares'.

A company does not have a statutory right to forfeit for shares unless its Articles provide for such forfeiture for non-payment of calls or any other reason. Generally, shares are forfeited only for non-payment of outstanding moneys. Before forfeiting the shares of a defaulting shareholder proper notice has to be given directing him to pay the arrears and the interest accrued on that amount. The notice should also indicated that in the event of non-payment of the arrears on or before a stipulated date, the shares allotted to him will be forfeited.

On forfeiting the shares of a shareholder, he loses his right as a shareholder and the amount already paid by him on application, allotment etc. will be forfeited. While forfeiting the amount already paid by him, the company reserves the right to recover from him the balance due from him as on the date of forfeiture. However it is to be noted that the liability of the person whose shares are forfeited ceases when the company subsequently receives payment in full of all such money in respect of the shares on re-issue. Another point to be noted is that if the company is wound up more than one year after the forfeiture the member whose shares have been forfeited cannot be held liable for the amount unpaid on forfeited shares.

Forfeiture of shares means:

- a) Cancellation of the membership of the shareholder, i.e. cancellation of share capital called upon the shares forfeited.
- b) Forfeiture of whatever amount paid by the shareholder on account of the shares forfeited.

For bringing forfeiture of shares into effect in the books of account the following steps are needed:

- a) The credit given to Share Capital account is to be debited with the amount of share capital called up in respect of those shares.
- b) The debits in the allotment, call account etc. should be cancelled. For this, the respective accounts should be credited with the amounts due from shareholders.
- c) The amount already received from the shareholder is forfeited and transferred to "Shares Forfeited Account".

The shares forfeited account shows a credit balance and is to be shown on the liabilities side of the Balance Sheet as an addition to paid up capital. The balance in the shares forfeited account can be used to write off any capita loss (by way of re-issuing the forfeited shares at a discount) on re-issued of the respective forfeited shares and the balance remaining if any after re-issue is to be transferred to "Capital Reserve Account". The following are the proforma entries to be made when the shares are forfeited:

**Proforma Journal Entries:**

- a) When shares which are issued at par or shares which are issued at a premium and the premium is received are forfeited.
- Share Capital Account Dr.  
 (With called up amount)  
 To Forfeited Shares A/c.  
 (with amount received)  
 To Share Calls A/c or Calls in arrears A/c  
 (with amounts due on respective calls)
- 
- b) When shares are issued at a premium and such premium amount is also due and they are forfeited.
- Share Capital Account Dr.  
 (With called up amount)  
 (Share Premium Account Dr.  
 (With premium amount due)  
 To Shares Forfeited A/c  
 (With amount received)  
 To Shares Calls A/c. or  
 Calls in Arrears A/c.  
 (With amounts due on  
 respective calls)
- 
- c) When the shares are issued at a discount and they are forfeited.
- Share Capital Account Dr.  
 (With called up amount)  
 To Shares Forfeited A/c.  
 (with amount received)  
 To Share calls A/c. or calls in arrears A/c  
 (with amounts due on respective calls)  
 To Discount on Issue of Shares A/c.  
 (with amount of discount allowed)

**Forfeiture of Shares which were issued at par**

**Illustration – 1**

Gama Ltd., issued 10,000 shares of Rs. 10/- each payable as follows:

On application Rs. 2/- on allotment Rs. 2/- on first call Rs. 3/- and on second and final call Rs. 3/-.

The company made First call only. Rajiv was allocated 400 shares who paid only the application money. As he could not pay allotment and first call money, his shares were forfeited. Show the journal entry needed for recording the forfeiture of shares.

**Solution**

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
	Share Capital Account <span style="float: right;">Dr.</span> To Shares Forfeited A/c. To Shares Allotment A/c. To Shares First Call A/c. (Being forfeiture of 400 shares allotted to Rajiv who did not pay allotment and first call money.)		2,800	800 800 1,200

**Note:** Share Capital Account is debited with Rs. 2,800 as it has been credited earlier with the Application money of Rs. 800. Allotment money of Rs. 800 and First Call money of Rs. 1,200. The amount received on application has been credited to the Shares Forfeited Account. The calls in arrears on account of allotment and First Call are cancelled by crediting those accounts.

### Forfeiture of Shares which were issued at a premium

We have noted earlier that when a company issues shares at a premium the premium collected should be credited to the "Share Premium Account" and shown separately. According to Sec. 78, if the share premium is collected, it can not be cancelled even if the shares on which the premium is collected are forfeited at a later date. If the premium is due has not been collected and if such shares are forfeited the credit given to the share premium account at the time of issue should be cancelled by debiting the Share Premium Account.

### Illustration - 2

Q. Ltd., issued 10,000 shares of Rs. 10 each at a premium of Rs. 2 per share, payable as follows:

On application Rs. 2; On allotment Rs. 5 (including the premium); on First Call Rs. 3, and on Second and Final Call Rs. 2.

The company made the First Call. Basu who was allotted 200 shares failed to pay the allotment and first call money. Joshi who was allotted 300 shares failed to pay the first call. The shares of Basu and Joshi were forfeited. Show the necessary journal entries for forfeiting the said shares.

### Solution

#### Journal

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
	Share Capital Account Dr.		1,600	
	Share Premium Account Dr.		400	
	To Shares Forfeited A/c.			400
	To Shares Allotment A/c.			1,000
	To Shares First Call A/c.			600
	(Being forfeiture of 200 shares allotted to Basu as he failed to pay the first call money.)			
	Share Capital Account Dr.		2,400	
	To Shares Forfeited A/c.			1,500
	To Shares First Calls A/c.			900
	(Being forfeiture of 300 shares allotted to Joshi as he failed to pay the first call money)			

**Note:** It may be noted that we have cancelled the Shares Premium Account in respect of the shares allotted to Basu, as the share premium has not been collected.

In the case of shares allotted to Joshi we have not cancelled the Shares Premium Account as the premium has already been collected.

### Forfeiture of Shares which were issued at a Discount

It is to be noted that when shares issued at a discount are forfeited, the discount allowed on such shares should be cancelled. This is necessary because the discount is to be allowed only on the shares purchased by the shareholders and not on the shares cancelled.

#### Illustration – 3

Rakesh was allotted 50 shares of Rs. 10 each of A Ltd., at a discount of 10%. He paid Rs.2 per share as application money but failed to pay the allotment money of Rs. 3 per share. Consequently his shares were cancelled. Show the journal entry required for forfeiture of the said shares.

#### Solution

#### Journal

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
	Share Capital Account Dr. To Shares Forfeited A/c. To Shares Allotment A/c. To Discount on issue of shares A/c. (Being forfeiture of 50 shares allotted to Rakesh as he failed to pay the allotment money Rs. 3 per share)		300	100 150 50

**Note:** It is to be assumed that the allotment money payable is inclusive of discount, and the discount on Issue of Shares Account has already been debited.

#### CHECK YOUR PROGRESS – 1

i) Write the Journal entry for the forfeiture of shares which were issued at a premium resuming such premium amount if also due.

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.....  
.....  
.....

ii) Whether the "Discount on Issue of Shares Account" is debited or credited when the shares are issued at a discount and they are forfeited?

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### 3.3 RE-ISSUE OF FORFEITED SHARES

The forfeited shares can be re-issued by a company to some other persons at the discretion of the Board of Directors. Such shares can be re-issued at any price by the company, i.e. even at a discount. When the forfeited shares are re-issued at a discount, the discount allowed should not exceed the amount already received from the defaulting shareholder,

which is forfeited and credited to the Shares Forfeited Account. The loss on account of re-issue of forfeited shares is to be debited to the Shares Forfeited Account. If there is surplus in the Shares Forfeited Account after adjusting the discount on re-issue of forfeited shares, such a balance is to be transferred to the Capital Reserve Account as it is a Capital profit.

The following entries are to be made when the forfeited shares are re-issued:

i) For re-issue of forfeited shares:

Bank Account	Dr.	
(with the amount actually received)		
Shares Forfeited A/c.	Dr.	
(with the amount of discount allowed)		
To Share Capital A/c.		
(with the amount called up)		

ii) For transferring the surplus in the Shares Forfeited Account to Capital Reserve:

Shares Forfeited A/c.	Dr.
To Capital Reserve	

The following illustration will help us to understand the method of dealing with the re-issue of forfeited shares:

**When the shares issued at par are forfeited and re-issued**

**Illustration -4**

P. Ltd., issued 400 shares of Rs. 10/- each to Kapil who paid Rs. 3/- per share on application but failed to pay Rs. 3/- on allotment and Rs. 4/- on first and final call. These shares were forfeited and re-issued to Sandeep at Rs. 8/- per share fully paid.

Show the necessary journal entries for the said transaction.

**Solution**

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
	Share Capital Account Dr. To Shares Forfeited A/c. To Shares Allotment A/c. To Shares First & Final Call A/c. (Being forfeiture of 400 shares held by Kapil)		4,000	1,200 1,200 1,600
	Bank A/c. Dr. Shares Forfeited A/c. Dr. To Shares Capital A/c. (Being re-issue of forfeited shares to Sandeep at Rs. 8/- per share)		3,200 800	4,000
	Shares Forfeited A/c. Dr. To Capital Reserve A/c (Being balance shares in Forfeited A/c transferred to Capital Reserve A/c share)		400	400

### Illustration – 5

Zenity Ltd., issued 500 shares of Rs. 10 each to Sanjay and called Rs. 8 per share. He paid Rs. 5 per share as application and allotment money and failed to pay the first call. The Shares were forfeited and the Directors Re-issued 400 shares to Ram at Rs. 6 per share fully paid up.

Show the necessary journal entries to record the said transactions.

### Solution

#### Journal

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Share Capital Account* To Shares Forfeited A/c. To Shares First Call A/c. (Being forfeiture of 500 shares held by Sanjay)	Dr.	4,000	2,500 1,500
-	Bank A/c. Shares Forfeited A/c. To Shares Capital Account ** (Being re-issue of 400 shares to Ram as fully paid)	Dr. Dr.	2,400 1,600	4,000
-	Shares Forfeited A/c. To Capital Reserve A/c @ (Being balance in shares Forfeited A/c transferred to Capital Reserve A/c)	Dr.	400	400

### Note

- \* Share Capital Account has been debited with Rs. 4,000/- only as Rs. 8/- per share is called (500 x Rs.8)
- \*\* As 400 shares have been re-issued as fully paid, i.e., at Rs. 10/- per share. Share Capital account has been credited with Rs. 4,000 (400 x Rs. 10)
- @ Amount forfeited on 100 shares (Rs. 5 x 100) = 500/-  
 Amount to be used on 400 shares re-issued (400 x Rs. 5/-) = Rs. 2,000/-  
 Amount actually used on re-issue Rs. 1,600/-  
 Amount transferred to Capital Reserve Rs. 400/-

Balance of Rs. 500/- in Shares Forfeited Account in respect of 100 shares to be re-issued will appear in the Shares Forfeited account.

### Re-issue of Forfeited Shares which were issued at a premium

If the shares originally issued at a premium are forfeited, it is not compulsory for the company to re-issue them at a premium even though the premium is not received at the time of forfeiture. But if the company wants to re-issue the forfeited shares at a higher price, then

the Share Premium Account is credited and Shares Forfeited Account is debited with the amount of premium. If some balance still remains in the Shares Forfeited Account, it has to be transferred to Capital Reserve Account

### Illustration - 6

Gajanan Ltd., issued 100 shares of Rs. 10 each at 10 per cent premium to Satish (Rs. 9 per share called up). He did not pay Rs. 3 (including premium) on allotment and Rs. 2 on the First Call. These shares were duly forfeited. Out of these, 60 shares were re-issued to Dinesh as fully paid up at Rs. 8 per share; 20 shares were issued to Vijay at Rs. 12 per share as fully paid up and 20 shares were issued to Sunil at Rs. 5 per share as fully paid up.

Show the necessary journal entries to record the above transactions.

### Solution

### Journal

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Share Capital Account <span style="float: right;">Dr.</span> Share Premium Account <span style="float: right;">Dr.</span> To Shares Forfeited A/c. To Share Allotment A/c. To Share First Call A/c. (Being forfeiture of shares issued to Satish)		900 100	500 300 200
-	Bank A/c. <span style="float: right;">Dr.</span> Shares Forfeited A/c.* <span style="float: right;">Dr.</span> To Share Capital A/c (Being re-issue of 60 shares to Dinesh)		480 120	600
-	Shares Forfeited A/c. <span style="float: right;">Dr.</span> To Capital Reserve A/c (Being transfer of shares forfeited amount in respect of 60 shares issued to Dinesh) (300 - 120 = 180)		180	180
-	Bank Account <span style="float: right;">Dr.</span> To Share Capital Account To Share Premium Account (Being re-issue of 20 shares to Vijay at a premium of Rs. 2 per share)		240	200 40
-	Shares Forfeited A/c. <span style="float: right;">Dr.</span> To Capital Reserve A/c. (Being the transfer per shares forfeited amount in respect of 20 shares re-issued to Vijay)		100	100
-	Bank Account <span style="float: right;">Dr.</span> Shares Forfeited A/c. <span style="float: right;">Dr.</span> To Share Capital A/c. (Being re-issue of 20 shares to Sunil)		100 100	200

## Note

- \* Shares forfeited Account has been debited with Rs. 120 only on the assumption that the shares have been re-issued without collecting any premium. If it is assumed that the shares have been re-issued at a premium Re. 1 per share, the following entries are to be made.

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank Account Shares Forfeited To Share Capital A/c. To Share Premium A/c. (Being re-issue of 60 shares to Dinesh at a Premium of Rs. 1/- per share)	Dr. Dr.	480 180	600 60
-	Shares Forfeited A/c. To Capital Reserve A/c. (Being transfer of shares forfeited amount in respect of 60 shares re-issue to Dinesh)	Dr.	120	120

## Note

In respect of 20 shares re-issue to Sunil, the shares forfeited amount has been completely exhausted and hence no transfer entry has been made.

### Re-issue of forfeited shares which were issued at a discount

If the shares issued at a discount are re-issued after forfeiture, the person who gets the re-allotment of shares is given the benefit of the discount allowed earlier in addition to the benefit that is normally given on re-issue. Therefore, the Discount on Issue of Shares Account is debited once again with the amount which was cancelled earlier in respect of the shares which are being re-issued. The following journal entry has to be passed on re-issue of such shares.

Bank A/c. Dr.  
Discount on Issue of shares A/c. Dr.  
Shares Forfeited A/c. Dr.  
    To Share capital A/c.  
(Being allotment of shares forfeited  
    to Mr. .... at discount)

### Illustration - 7

Bright Ltd., issued 100 shares of Rs. 10 each at a discount of 10% to Gopal and Rs. 6 per share called up out of which he paid only Rs. 2/- per share on application and allotment and failed to pay the call amount. The shares were forfeited. They were re-issued to Radha at Rs. 7 per shares as fully paid up.

Show the necessary journal entries to record the above mentioned transaction.

## Journal

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Share Capital Account <span style="float: right;">Dr.</span> To Shares Forfeited A/c. To Share Call A/c. To Discount on Issue of Shares A/c. (Being forfeiture of shares issued to Gopal)		600	200 300 100
-	Bank Account <span style="float: right;">Dr.</span> Discount on Issue of Shares A/c. <span style="float: right;">Dr.</span> Shares Forfeited A/c. <span style="float: right;">Dr.</span> To Share Capital Account (Being re-issue of shares to Radha)		700 100 200	1,000

### CHECK YOUR PROGRESS – 2

Pass the journal entry on re-issue of forfeited shares which were issued at a discount.

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### **Forfeiture of shares when there is over-subscription and pro-rata allotment is made**

We have noted that sometimes there may be over-subscription to the issue. In such a case the company may reject some applications, and make full allotment on some other applications. If a problem is given relating to forfeiture of shares when there is over-subscription, we must be careful in calculating the amount forfeited. In such cases, we have to find out the amount sent by the applicant for the number of shares applied for by him. To arrive at the correct amount to be foresighted, we have to note the following points.

- i) Ascertain the number of shares applied for by the share holder;
- ii) Ascertain the total amount sent by him as application money (Application money X No. of shares applied);
- iii) Ascertain the application money due on the actual number of shares allotted (Application money X No. of shares allotted);
- iv) Deduct the amount arrived at in step (iii) from the total application money received arrived at in step (ii). The balance is the amount received in advance which is to be adjusted towards allotment money.
- v) Ascertain the amount due on allotment (Allotment money X No. of shares applied). From the Allotment money due deduct the amount received in advance on account of application money (Amount arrived at in step (iv)). The balance is the amount in arrears allotment. For canceling this balance. Share allotment account is to be credited with this amount for forfeiture.

The following illustration will help us to understand these steps:

### Illustration - 8

X Limited issued a prospectus inviting application for 10,000 shares of Rs. 10 each at a premium of Rs. 2 per share. The amount payable on application is Rs. 2 on allotment Rs. 5 (including premium); on first call Rs. 3 and on second and final call Rs. 2.

Applications were received for 15,000 shares and pro-rata allotment was made on application for 12,000 shares. Excess amount received on account of application money was adjusted towards amount due on allotment.

Raghavan, who was allotted 200 shares could not pay allotment money and first call money. His shares were forfeited after first call.

Madhavan, who was allotted 300 shares did not pay the two calls and his shares also were forfeited after the second call.

Out of these forfeited shares, Kumaran was allotted 400 shares originally held by Raghavan and 300 shares held by Madhavan at Rs. 9/- per share. Show journal entries, Cash Book and Balance Sheet.

### Solution

#### Working Notes

No. of Shares for which applications were received:	15,000
No. of shares allotted:	10,000
Application money received:	Rs. 2 x 15,000 = Rs. 30,000
Application money transferred to	
Share Capital Account	Rs. 2 x 10,000 = Rs. 20,000
Application money returned on	
rejected applications	Rs. 2 x 3,000 = Rs. <u>6,000</u>
Application money to be adjusted on	
Allotment: (Rs. 30,000 - Rs. 26,000)	= Rs. 4,000
Amount received from Raghavan as application money:	
No. of shares applied for and allotment is made:	12,000
No. of shares allotted to applicants for the said shares	10,000
No. of shares allotted to Raghavan	200
No. of shares applied for by Raghavan (200 x 12,000/10,000)	240
Application money received from Raghavan (Rs. 2 x 240)	480
Application money on the shares allotted (Rs. 2 x 200)	<u>400</u>
Application money to be adjusted on allotment	<u>80</u>
Allotment money due: (Rs. 5 x 10,000)	50,000
Less: Application money adjusted	<u>4,000</u>
	Rs. 46,000

Less: Amount due from Raghavan (Rs. 5 x 200 = Rs. 1,000 – Rs. 80)	Rs. 920
Amount actually received on allotment...	Rs. 45,080
Amount due on first call: (Rs. 3 x 10,000)	Rs. 30,000
Less: Due from Raghavan (Rs. 3 x 300) = Rs. 600	
Due from Madhavan (Rs. 3 x 300) = Rs. 900	1,500
Amount received on first call	<u>28,500</u>
Amount due on second call (Rs. 2 x 9,800)	Rs. 19,600
Less: Due from Madhavan (Rs. 2 x 300)	Rs. 600
Amount received on second call ....	<u>Rs. 19,000</u>

#### Cash Book

Date	Particulars	Amount	Date	Particulars	Amount
		Rs.			Rs.
-	To Share Applications A/c.	30,000	-	By Share Application A/c.	6,000
-	To Share Allotment A/c.	45,080	-	By Balance c/d	1,20,180
-	To Share First Call A/c.	28,500			
-	To Share 2 <sup>nd</sup> Call A/c.	19,000			
-	To Share Capital A/c.	3,600			
		<u>1,26,180</u>			<u>1,26,180</u>

**Note:** Amount received on account of re-issue of forfeited shares.

#### Journal

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Share Application A/c. Dr. To Share Capital A/c. (Being transfer of application money on shares allotted)		20,000	20,000
-	Share Allotted A/c. Dr. To Share Capital A/c. To Share Premium A/c. (Being the amount due on allotment)		50,000	30,000 20,000
-	Share Application A/c. Dr. To Share Allotment A/c. (Being the amount on application transferred to Share Capital)		4,000	4,000

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Share First Call A/c. Dr. To Share Capital A/c. (Being the amount due on first call)		30,000	30,000
-	Share Capital Account Dr. Share Premium A/c. Dr. To Shares Forfeited A/c. To Share Allotment A/c. To Share First Call A/c. (Being forfeiture of 200 shares allotted to Raghavan)		1,600 400	480 920 600
-	Share Second & Final Call A/c. Dr. To Share Capital A/c. (Being second call amount due)		19,600	19,600
-	Share Capital A/c. Dr. To Shares Forfeited A/c. To Share First Call A/c. To Share Second Final Call A/c. (Being forfeiture of 200 shares allotted to Madhavan)		3,000	1,500 900 600
-	Shares Forfeited A/c. Dr. To Share Capital A/c. (Being the discount allowed on 400 shares re-issued to Kumaran)		400	400
-	Shares Forfeited A/c. Dr. To Capital Reserve A/c. (Being profit on re-issue of 400 shares to Kumaran transferred to Capital Reserve Account)		1,080	1,080

#### Balance Sheet

Liabilities	Rs.	Assets	Rs.
Share Capital: 9,900 shares of Rs. 10 each fully paid	99,000	Cash at Bank	1,20,180
Share Premium A/c.	19,600		
Shares Forfeited A/c. *	500		
Capital Reserve	1,080		
	<u>1,20,180</u>		<u>1,20,180</u>

#### Note

- \* The balance is kept in Shares Forfeited Account, as there are 100 shares yet to be issued @ Rs. 5 per share.

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### **3.4 SURRENDER OF SHARES**

If a shareholder finds it difficult to pay the call money due from him, he may return the shares to the company voluntarily requesting for cancellation. Such return of shares by the shareholder is called "Surrender of Shares". There is no provision regarding "Surrender of shares" in the Companies Act. However the Articles sometimes gives power to the directors to accept a "Surrender of Shares".

The "Surrender of Shares" by a member to the company is valid, where the articles give the power to accept the surrender to the Directors. The surrender is accepted in the case of partly paid shares to save the company from going through the formalities of forfeiture. Surrender of partly paid shares can be accepted only where forfeiture is justified.

From the accounting point of view, there is no difference between Surrender of Shares and forfeiture of shares. The same set of entries made in respect of forfeiture are made even in the case of surrender of shares.

### **3.5 REDEMPTION OF PREFERENCE SHARE CAPITAL**

A company limited by shares may issue redeemable preference shares. After commencement of the companies (Amendment) Act, 1988 no company shall issue any preference share which is redeemable after the expiry of a period of 10 years from the date of issue.

Legal provisions in this context are:

1. Share can be redeemed only if they are fully paid.
2. Sources to redeem such shares.
  - a) Divisible profits (profits available for distribution as dividend e.g. General Reserve, Reserve fund, Dividend equalization fund, Insurance fund, profit and loss a/c. balances.
  - b) Proceeds of fresh issue of shares (Equity or Preference shares)
  - c) When preference shares are to be redeemed from divisible profits, the nominal amount should be transferred from divisible profits to capital Redemption Reserve a/c. The capital Redemption Reserve is created by way of a book entry showing transfer of profits to capital redemption reserve. This shows the amount of divisible profits utilized for the proposed redemption.

#### **Accounting Entries**

The proforma entries are to be noted in this regard.

<b>Transaction</b>	<b>Entry</b>
1. On issue fresh capital for redemption.	Bank A/c. Dr. Discount on issue (if any) Dr. To Share Capital A/c. To Share Premium A/c. (if any)
2. On utilization dividend profits	Relevant Reserve A/c. Dr. Profit/Loss A/c. Dr. To Capital Redemption Reserve A/c.

3. On redemption due	Preference Share Capital A/c. Dr. Premium on Redemption of Pref. Shares Dr. To Preference Shareholder A/c.
4. On payment	Preference Shareholder A/c. To Bank A/c.
5. Utilisation of share premium or reserves for premium payable on redemption	Share Premium A/c. Dr. Reserves A/c. Dr. To Premium on Redemption of Pre. Shares A/c.

### Illustration – 9

Anupam Ltd. Had 20,000 12% redeemable preference shares of Rs. 100 each redeemable at 10% Premium. To Redeem the preferences shares, the company has decided the following:

- To sell investments of Rs. 10,00,000 which realize 90%.
- To issue 1,50,000 shares of Rs. 10 each at a premium of Rs. 2.
- To utilize the following : General Reserve Rs. 3,75,000 and Profit Rs. 1,25,000.
- The premium collected to be utilized for premium on redemption.

Your are required pass journal entries.

### Solution

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank A/c. Dr. Profit/Loss A/c. Dr. To Investment A/c.		9,00,000 1,00,000	10,00,000
-	Bank A/c. Dr. To Equity Capital A/c. To Share Premium A/c.		18,00,000	15,00,000 3,00,000
-	General Reserve A/c. Dr. Profit/Loss A/c. Dr. To Capital Redemption Reserve A/c.		3,75,000 1,25,000	5,00,000
-	Redemption Preference Share Capital A/c. Dr. Premium on Redemption of Pre. Share A/c. Dr. To Preference Shareholder A/c.		20,00,000 2,00,000	22,00,000
-	Preference Shareholder A/c. Dr. To Bank A/c.		22,00,000	22,00,000
-	Share Premium A/c. Dr. To Premium on Redemption of Pre share		2,00,000	2,00,000

**Illustration – 10**

The following is the Balance Sheet of Anurag Ltd.

		(Rs. '000)	
Liabilities	Rs.	Assets	Rs.
10,000 equity shares @ Rs. 10	1,000	Good will	120
6,000 preference shares @ 100 each	600	Fixed Assets	1,112
Capital Reserve	200	Investments	464
General Reserve	240	Current Assets	584
P/L A/c.	240		
	2,280		2,280

The preference shares are to be redeemed at 10% premium. The company sold investments at Profit of Rs. 36,000 and issued 2000 5% preference shares at Rs. 100 each.

Show journal entries and prepare new Balance Sheet.

**Solution**

**Journal Entries**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Bank A/c. <span style="float: right;">Dr.</span> To Investments A/c. To Profit /Loss A/c.		5,00,000	4,64,000 36,000
-	Bank A/c. <span style="float: right;">Dr.</span> To 15% Preference Share Capital A/c.		2,00,000	2,00,000
-	Capital Reserve A/c. <span style="float: right;">Dr.</span> General Reserve A/c. <span style="float: right;">Dr.</span> To Capital Redemption Reserve A/c.		2,00,000 2,00,000	4,00,000
-	Preference Share Capital A/c. <span style="float: right;">Dr.</span> Premium Payable on Redemption of Pref. Shares A/c. <span style="float: right;">Dr.</span> To Pre. Shareholder A/c.		6,00,000 60,000	6,60,000
-	Pre. Shareholder A/c. <span style="float: right;">Dr.</span> To Bank A/c.		6,60,000	6,60,000
-	Profit/Loss A/c. <span style="float: right;">Dr.</span> To Premium Payable A/c.		60,000	60,000

Balance Sheet		(Rs. '000)	
Liabilities	Rs.	Assets	Rs.
Equity Capital (10,000 shares @ Rs. 100)	1,000	Good will	120
Preference Capital (2000 shares @ Rs. 100)	200	Fixed Assets	1,112
Capital Redemption Reserve	400	Current Assets	624*
General Reserve	40		
P/L A/c.	216		
	<u>1,856</u>		<u>1,856</u>

\*  $584 + 500 + 200 - 660 = 624$

### 3.6 SUMMING UP

The forfeiture of shares, re-issue of forfeited shares have been discussed in this unit. In case the members fail to pay the call money, the Directors after giving due notice can cancel the shares of defaulting shareholders. This cancellation of shares is called forfeiture of shares. Such forfeited shares are generally re-issued at a discount.

If the shareholders find it difficult to pay the call money due, they may return the shares to the company, which is called 'surrender of shares'.

### 3.7 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) Share Capital A/c. Dr.  
     To Share Premium A/c.  
     To Share Forfeited A/c.  
     To Share Call a/c. or Calls in Arrears A/c.
- ii) Discount on issue of Share Account is credited.
2. Bank A/c. Dr.  
     Discount on Issue of Shares A/c. Dr.  
     Shares Forfeited A/c. Dr.  
     To Share Capital A/c.

### 3.8 MODEL EXAMINATION QUESTIONS

#### I. Answer the following questions in about 30 lines each.

1. What is forfeiture of shares? Explain the accounting procedure for forfeiture of shares.
2. Explain the accounting procedure for re-issue of forfeited shares.

#### II. Answer the following questions in about 15 lines each.

1. What do you understand by 'forfeiture of shares'?
2. What do you mean by 're-issue' of forfeited shares?
3. What is surrender of shares?

## Problems

1. S Ltd. Issued 2,00,000 equity shares of Rs. 10 each at a premium of Re. 1/- per share, payable as follows: Rs. 2.50 on application; Rs. 4.50 on allotment (including premium); Rs. 2.50 on first call and Rs. 2.50 on final call.

Applications were received for 3,00,000 shares. Pro-rata allotment was made to applicants for 2,40,000 shares and the balance of applications were rejected. Excess applications money was adjusted against allotment money due.

X, to whom 400 shares were allotted, could not pay the amount due on allotment. On his failure to pay the first call the shares held by him were forfeited.

Y, to whom 600 shares were allotted, could not pay the two calls. His shares were forfeited after the final call was made.

Show the necessary journal entries.

(Ans: Amount received on allotment: Rs. 7,98,400; Shares forfeited account balance (Cr.): 4,200).

2. B. Ltd., issued 50,000 shares of Rs. 10 each payable as hereunder: On application Rs. 2/- on allotment Rs. 3/- and on first and final call Rs. 5/-. All the shares were subscribed for and allotment was made. All the moneys due were received with the exception of the money due on 1,000 shares held by Raju who could not pay allotment and call moneys. His shares were forfeited, and subsequently re-issued at Rs. 9 per share fully paid.

Show the journal entries recording the above mentioned transactions including forfeiture and re-issue. Show the Balance Sheet immediately after forfeiture and also after re-issue of the forfeited shares.

(Ans: Cash at Bank Rs. 5,01,000; Shares Forfeited Account : Rs. 2,000; Amount transferred to Capital Reserve Account – Rs. 1,000).

3. P Ltd., issued 50,000 shares of Rs. 10 each payable as Rs. 4 on application (including Rs. 2 as premium): Rs. 2 on allotment: Rs. 3 on first call and Rs. 3 on second and final call.

All the shares were subscribed and all the calls were made. All the amounts due were received with the exception of the 1<sup>st</sup> call money on 60 shares and the second call money on 120 shares. The above mentioned shares were forfeited and reissued at Rs. 8 per share fully paid. Show the cash book necessary journal entries and balance sheet after reissue of feited shares.

(Note: It is to be noted that 120 shares on which the Second call is in arrears include 60 shares on which first call is in arrears.)

(Ans: Share Premium – Rs. 1,00,000; Amount transferred to Capital Reserve – Rs.4,200; Balance Sheet Total Rs. 6,04,200).

4. Lucky Ltd., issued 1,00,000 equity shares of Rs. 10 each at a premium of Re. 1 per share. The amount was payable as here under:

Rs. 2 on application; Rs. 4 on allotment (including premium)  
Rs. 2 on the first call; Rs. 2 on final call.

Applications were received for 1,30,000 shares. While applications for 20,000 shares were rejected, allotment was made on pro-rata basis on the remaining applications. Both the calls were made and all the moneys due were received except the final call money on 3,000 shares. Later these were forfeited. Out of these 2,000 shares were re-issued as fully paid at Rs. 8 per share. Show the journal entries required and the Balance Sheet.

(Ans. Excess application money adjusted:

On allotment – Rs. 20,000

Shares forfeited amount on 3,000 shares is Rs. 24,000

On re-issue of 2,000 shares Rs. 4,000 is utilized and Rs. 12,000/- is transferred to Capital Reserve.

Rs. 8,000 on account of 1,000 shares still to be re-issued will be shown in the Shares Forfeited Account.

Balance Sheet Total : Rs. 11,10,000).

5. Q Ltd., issued 10,000 equity shares of Rs. 10 each at a premium of Rs. 2 per share payable as follows:

On application – Rs. 5 (including premium)

On allotment – Rs. 4 and on call Rs. 3.

All the money & due were received with the exception of allotment money on 400 shares and call money on 1,000 shares (including 400 shares on which allotment was not received).

The above mentioned 1,000 shares were forfeited and 800 of these shares (including 400 shares on which allotment money was due) are re-issued at Rs. 7 per share as fully paid.

Show the journal entries and the Balance Sheet after re-issue of forfeited shares.

(Ans: Balance in Shares Forfeited Account – 1,400;  
Amount transferred to Capital Reserve – Rs. 800).

6. R Ltd., issued 10,000 shares of Rs. 100 each at a discount of 5%. The amounts payable were as here under.

Rs. 25 on application (including discount).

Rs. 34 on allotment and Rs. 36 on call.

Applications were received for 9,000 shares and allotment was made to all the applicants in full. All moneys due were received except the first and final call money on 200 shares. These shares were forfeited. Out of them 100 shares were re-issued at Rs. 90 per share as fully paid.

Show the Cash Book, Journal entries for non-cash transactions and Balance Sheet after re-issue.

(Ans: Shares forfeited account balance – Rs. 5,900/-;  
Amount transferred to Capital Reserve – 5,400;  
Discount on Issue of shares – Rs. 44,500).

7. Give Journal entries to recorded the following transactions:

- a) A company forfeited 2,000 shares of Rs. 10 each, Rs. 7 per share called up, on which Rs. 4 per share was paid and the call amount of Rs. 3 per share was in arrears. Out of these shares, 1,200 shares were re-issued at Rs. 5 per share crediting as Rs. 7 per share paid up.
- b) X-Ltd., forfeited 250 shares of Rs. 10 each (issued at a premium of 10 per cent) for non payment of Rs. 3 on first call and Rs. 2 on final call. Out of these shares 100 shares have been re-issued at a discount of 10%.
- c) P Ltd., forfeited 400 shares of Rs. 10 each issued at a discount of 10% on which Rs. 2,400 had been paid. These shares were re-issued to B for Rs.3,000.
- d) A company forfeited 50 shares of Rs. 10 each issued at a premium of 10 percent, Rs. 8 per share (including premium) called up, for non-payment of Rs. 4 per share as allotment money and Rs. 2 per share as first call money. These shares were subsequently issued for Rs. 450 as fully paid.

8. Q Ltd., issued 40,000 shares of Rs. 10 each payable as here under.

On application – Rs. 2; On allotment – Rs. 3 (including discount of Rs. 1); and on first and final call Rs. 4.

Applications were received for 36,000 shares and all these shares were allotted. All moneys due were received except the first and final call on 400 shares, which were duly forfeited. Out of these 200 shares were re-issued at Rs. 7 per share as fully paid. Show the journal entries and the cash book in the books of the company. Also show how the particulars relating to the above mentioned transactions appear in the Balance Sheet of the Company.

(Ans: Amount transferred to Capital Reserve Rs. 600; Balance in Shares Forfeited Account Rs. 1,000; Balance Sheet Total Rs. 3,59,600)

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### 3.9 RECOMMENDED BOOKS

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1. R.L. Gupta and M. Radhaswamy : **Advanced Accountancy, Volume --II,** Sultan Chand & Sons, 23, Daryaganj, New Delhi.
2. S.N. Maheswari : **Advanced Accountacy, Volume – II,** Vani Educational Books, New Delhi.
3. S.P. Jain and K.L. Narang : **Advanced Accountancy,** Kalyani Publishers, Ludhiana.
4. M.C. Shukla and T.S Grewal : **Advanced Accountancy,** S. Chand & Sons, New Delhi.

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### **3.10 GLOSSARY**

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**Forfeiture of Shares**

: Cancellation of shares held by a shareholder who has failed to pay the calls made on the shares held by him.

**Surrender of Shares**

: The return of shares voluntarily by the shareholders to the company requesting for their cancellation.

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## **UNIT - 4: ISSUE AND REDEMPTION OF DEBENTURES**

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### **Contents**

- 4.0 Aims and objectives
- 4.1 Introduction
- 4.2 Meaning of Debenture
  - 4.2.1 Differences between a Shareholder and a Debentureholder
- 4.3 Types of Debentures
- 4.4 Recording the issue of Debentures
- 4.5 Treatment of Discount on issue of Debentures
- 4.6 Interest on Debentures
- 4.7 Issue of Debentures as Collateral Security
- 4.8 Recording the Redemption of Debentures
- 4.9 Summing Up
- 4.10 Check Your Progress: Model Answers
- 4.11 Model Examination Questions
- 4.12 Recommended Books
- 4.13 Glossary

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### **4.0 AIMS AND OBJECTIVES**

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This unit aims at discussing the meaning of Debenture, different types of Debentures issued by a company and the accounting procedure involved in recording the transactions relating to the issue and redemption of debentures.

Having studied and worked through this unit, you should be able to :

- explain the meaning of Debentures;
- describe the different types of Debentures; and
- explain the accounting procedure relating to the issue and redemption of debentures.

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### **4.1 INTRODUCTION**

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In the previous two units you have learnt about the issue of shares(including rights issue), forfeiture of shares and re-issue of forfeited shares. In this unit you will learn about the issue and redemption of Debenture.

The funds needed by a company can either be raised in the form of share capital from its members or through short-term and long term loans from outsiders. A company usually borrows Short-term loans from banks or depositors and long term loans through the issue of debentures. The Debentures have got a significant place in the financial plan of a company.

A company issues debentures for its initial needs of acquiring fixed assets, and also for its expansion and development schemes.

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## **4.2 MEANING OF DEBENTURE**

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A debenture is a written acknowledgment of a debt given under the seal of a company. The debentures carry a fixed rate of interest and are usually secured by a charge on the company's assets. These can be repaid within a specified period or after a specified date. Some debentures will not be repaid during the life time of the company.

### **4.2.1 DIFFERENCES BETWEEN A SHAREHOLDER AND A DEBENTURE HOLDER**

1. While a shareholder is an owner of the company, the debentureholder is a creditor of the company.
2. The shareholder is paid dividend out of the profits for the company, while the debenture holder is paid interest whether the company makes profits or not.
3. While the shareholder has voting rights, the debentureholder does not have such rights.
4. Except in the case of redeemable Preference Shares, a shareholder will not get repayment of his capital during the life time of the company. Generally, a debentureholder gets back his amount after a specified period.
5. In the case winding up of the company, the debentureholders get back the amount due to them on a priority basis to the shareholder; whereas a shareholder will get back the amount only after repayment of all the amounts due to creditors.

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## **4.3 TYPES OF DEBENTURES**

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Classification of debentures can be done on the basis of the following characteristics:

- i) Negotiability
- ii) Priority
- iii) Permanence
- iv) Security
- v) Convertibility

### **i) Classification based on Negotiability**

Under this classification, debentures are called Registered Debentures and Bearer Debentures.

## **Registered Debentures**

These are made out in the name of particular person, who is registered as debentureholder. These can be transferred only after executing a regular transfer deed. Therefore, they are not freely negotiable. The interest on such debentures is payable either to the order of the registered debenture holder or the bearer of the interest coupons attached to the debentures.

## **Bearer Debentures**

These are unregistered debentures and can be transferred by mere delivery. Interest coupons are attached to these debentures and interest is payable to the bearer of these coupons. These debentures have free negotiability. They can be converted into registered debentures at the option of the holder.

### **ii) Classification based on Priority**

Based on priority, debentures are classified as first debentures and second debentures.

Those documents which are repayable first in preference to other series are called First Debentures. The debentures which are issued next to First Debentures in priority are called Second Debentures. These are the debentures which are repayable only after the First Debentures are redeemed.

### **iii) Classification based on Permanence**

Under this categorization, debentures are classified as Redeemable Debentures and Irredeemable Debentures.

#### **Redeemable Debentures**

The debentures which are to be repaid during the life time of a company are called Redeemable Debentures. These debentures may be redeemable (a) either on a specified date or within a specified period, (b) after the expiry of a stipulated period, and (c) on the occurrence of a contingency, which is rather remote.

#### **Irredeemable Debentures**

Those debentures which are not to be repaid during the life time of a company are called Irredeemable Debentures. They get redeemed only on liquidation of the company. However, such debentures are very not common.

### **iv) Classification based on Security**

Based on security, debentures are classified as (a) Simple or Naked Debentures (b) Mortgage debentures.

#### **Simple or Naked Debentures**

The debentures which do not carry not security to its holder in regard to payment of interest or repayment of the principal amount are called Simple or Naked Debentures. They are also

called Unsecured Debentures. It may be noted that such debentures are not so common as the others.

### **Mortgage Debentures**

Those debentures which have security of the company's property (movable or immovable) are called Mortgage Debentures. They are also called Secured Debentures. The security can be fixed, called as fixed charge or such security may be general in its nature, in which case it is called a floating charge.

A fixed charge represents a mortgage on certain specified and definite assets. The company cannot deal with such assets without the consent of the debenture holders (mortgagees).

A Floating charge is a mortgage on a particular type of company's assets or even the undertaking as a whole which are subject to changes in the ordinary course of business.

### **v) Classification based on Convertibility**

Sometimes the debentures carry an option to their holders for conversion into shares at a future date. Such debentures are called Convertible Debentures. These debentures may be fully convertible or partly convertible. Those debentures which do not carry the convertibility clause are called Non-Convertible Debentures.

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### **CHECK YOUR PROGRESS – 1**

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What do you mean by Convertible Debentures?

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### **4.4 RECORDING THE ISSUE OF DEBENTURES**

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From the accounting point of view, the issue of debentures can be considered on the basis of (i) consideration, (ii) price and (iii) redemption.

i) Issue of Debentures from the point of view of consideration:

From this point of view, debentures can be issued (a) for cash, (b) for consideration other than cash and (c) as collateral security.

ii) Issue of Debentures from the point of view of price:

From this point of view debentures may be issued (a) at par (b) at a discount, and (c) at premium.

iii) Issue of Debentures from the view point of Redemption:

From this point of view, the conditions of redemption will be taken into account. The Debentures are generally issued with specific conditions of redemption. It is to be noted that the conditions of issue as also redemption should be laid down in advance. The conditions of issue and of redemption can be classified as following:

<b>Condition of Issue</b>	<b>Condition of Redemption</b>
a) Issued at par	Redeemable at par
b) Issued at discount	Redeemable at par
c) Issued at premium	Redeemable at par
d) Issued at par	Redeemable at premium
e) Issued at discount	Redeemable at premium

Now we know the different terms of issue and let us consider the accounting entries to be made in each of the above mentioned cases.

**i) Entries for issue of debentures from the view point of consideration**

**a) When the debentures are issued for cash**

When debentures are issued for cash, they are issued like shares, by issuing a prospectus inviting the public to subscribe to its debentures. In such a case the amount of the debenture may be paid in one installment on application or in two or more installments. When the total amount of debentures is paid on application, the following journal entry is made:

Bank Account  
    To Debentures Account

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However, when the debentures amount is paid in installments, the same set of entries, as passed in the case of issue of shares, are to be passed here:

The following illustration will help us to understand the entries to be made for recording the Issue of debentures and the amount, if received in installments.

**Illustration – 1**

Beta Ltd., issued 10,000 debentures of Rs.100 each, the amount is payable as follows: Rs.25 on application, Rs.35 on allotment and the balance on first and final call. Assuming that all the money was received by the company, show the journal entries required for recording the above issue.

**Solution**

**Journal**

Date	Particulars	LF	Dr. Rs.	Cr. Rs.
--	Bank Account Dr. To Debenture Application A/c. (Being the receipt of application money on 10,000 debentures)		2,50,000	2,50,000
--	Debenture Application Dr. To Debentures Account A/c. (Being transfer of application money to Debentures Account)		2,50,000	2,50,000
--	Debenture Allotment A/c. Dr. To Debentures Account (Being the amount due on debenture allotment)		3,50,000	3,50,000
--	Bank Account Dr. To Debenture Allotment A/c. (Being the receipt of Debenture allotment money)		3,50,000	3,50,000
--	Debenture First & Final Call A/c. Dr. To Debentures Account (Being the Debenture call money due)		4,00,000	4,00,000
--	Bank Account Dr. To Debenture First & Final Call A/c. (Being the receipt of Debenture call money)		4,00,000	4,00,000

**b) Entries for Issue of Debentures for Consideration other than cash**

A company may purchase certain assets from the vendor and instead of paying cash it may issue Debentures as purchase consideration. Such an issue is called "issue for consideration other than cash". The following entries are to be made in this regard:

**a) For purchase of Assets**

Sundry Assets Account Dr.  
    To Vendors Account

**b) For issue of debentures as purchase consideration**

Vendors Account Dr.  
    To Debentures Account

### Illustration - 2

A company purchased assets worth Rs.6,00,000 and took over liabilities amounting to Rs.1,00,000 and the company issued Rs.5,00,000 debentures as purchase consideration. Give journal entries in the books of the company.

#### Solution

Journal				
Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Sundry Assets Account Dr. To Sundry Liabilities A/c. To Vendors Account (Being the assets and liabilities of vendors taken over)		6,00,000	1,00,000 5,00,000
-	Vendors Account Dr. To Debentures Account (Being the issue of Debentures Vendors)		5,00,000	5,00,000

#### ii) Entries for Issue of Debentures from the point of view of price

##### a) When debentures are issued at par

If the amount collected on the debentures is equal to the nominal value (face value) of the debentures, such an issue is called "Issue of Debentures at par". Suppose 1,000 Debentures of Rs.100 each are issued for Rs.1,00,000 the following journal entry is to be passed:

Bank Account	Dr.	1,00,000	
To Debentures Account			1,00,000
(Being issue of 1,000 debentures of Rs. 100 each at par)			

##### b) When debentures are issued at a discount

If the amount collected on the debentures is less than the nominal value, such an issue is called "Issue of Debentures at a Discount". For example 1,000 debentures of Rs.100/- each are issued for Rs.90,000 i.e. at a discount of Rs.10,000 or 10%. The following entry is to be passed:

Bank Account	Dr.	90,000	
Discount on Issue of Debentures A/c	Dr.	10,000	
To Debentures Account			1,00,000
(Being issue of 1,000 debentures of Rs.100 each at a discount of 10%)			

**c) When Debentures are issued at a premium**

If the amount collected on the debentures is more than the nominal value, such an issue is called "Issue of Debentures at a Premium. For example 1,000 debentures of Rs.100 each are issued for Rs.10,000 i.e., at a premium of Rs.10,000 or 10%. The following entry is to be passed:

Bank Account	Dr.	1,10,000	
To Debentures Account			1,00,000
To Premium on Issue of Debentures A/c			10,000
(Being issue of 1,000 debentures at a premium of 10%)			

**iii) Entries for Issue of Debentures from the point of view of Redemption**

We have already noted that the terms of issue include redemption also. Let us now consider the entries to be made, when the terms of redemption also get reflected in the accounting treatment.

**a) When debentures are issued at par and redeemable at par**

In this case the amount collected on debentures is equal to the nominal value and the amount to be paid at the time of redemption will also be equal to the nominal value of the debentures. If 1,000 debentures of Rs.100/- each are issued at par and redeemable at par, the following entry is to be made:

Bank Account	Dr.	1,00,000	
To Debentures Account			1,00,000
(Being issue of Debentures at par which are redeemable at par)			

**b) When debentures are issued at a discount and redeemable at par**

In this type of issue, the amount collected on the debentures is less than the nominal value and at the time of redemption the amount payable will be equal to the nominal value of debentures. If 1,000 debentures of Rs.100 each are issued for Rs.95,000 (at 5% Discount) and redeemable at par, the journal entry to be made is as follows:

Bank Account	Dr.	95,000	
Discount on Issue of Debentures A/c	Dr.	5,000	
To Debentures Account			1,00,000
(Being issue of Debentures at 5% discount and redeemable at par)			

**c) When debentures are issued at a premium and redeemable at par**

In this case the amount collected on the debentures is more than the nominal value and the amount payable on redemption is equal to the nominal value. IF 1,000 debentures of Rs.100 each are issued for Rs.1,05,000 (at 5% premium) and redeemable at par, the entry to be made is as follows:

Bank Account	Dr	1,05,000	
To Debentures Account			1,00,000
To Premium on Issue of Debentures A/c			5,000
(Being issue of debentures at 5% premium and redeemable at par)			

**d) When debentures are issued at par and redeemable at premium**

In this type of issue, the amount collected is equal to the nominal value but at the time of redemption the amount payable will be more than the nominal value. If 1,000 debentures of Rs.100 each are issued at par and are redeemable at Rs.1,05,000 (at a premium of 5%), the entry to be made is as follows:

Bank Account	Dr	1,00,000	
Loss on Issue of Debentures A/c	Dr	5,000	
To Debentures Account			1,00,000
To Premium on Redemption of Debentures A/c			5,000
(Being issue of debentures at par and redeemable at a premium of 5%)			

As the company promises to pay more at the time of redemption than what it has received, there occurs a loss equal to that amount which is debited to "Loss on Issue of Debentures Account." This amount is written off gradually during the life of debentures. The balance in that account is shown on the Assets side of the Balance Sheet under the head "Miscellaneous Expenditure".

Premium on Redemption of Debentures is a liability to the company and it is a personal account as the amount of premium is to be paid to the Debenture-holders. The amount is shown on the liabilities side of the Balance Sheet till it is paid at the time of redemption of debentures. At the time of redemption of debentures the amount is transferred to Debenture-holders Account and the account is closed. On paying the amount to Debenture-holders, their account is closed.

**e) When debentures are issued at a discount and redeemable at a premium**

In this case the amount collected is less than the nominal value and the amount payable on redemption will be more than the nominal value of debentures. If 1,000 debentures of Rs.100/- each are issued for Rs.95,000 (at 5% discount) and redeemable by paying Rs.1,05,000 (at a premium of 5%) the entry to be made is as follows:

Bank Account	Dr	95,000	
Loss on Issue of Debentures A/c	Dr	10,000	
To Debentures Account			1,00,000
To Premium on Redemption of Debentures A/c			5,000
(Being the issue of Debentures at a discount of 5% and redeemable at 5% premium)			

It may be noted that the loss on issue of debentures is equal to the amount of discount allowed and the premium payable on redemption. As in the previous case, this amount is shown on the Assets side of the Balance Sheet under head, "Miscellaneous Expenditure",

which is gradually written off during the life of the debentures. The treatment of premium on Redemption of Debentures is similar to that followed in the previous case.

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### **CHECK YOUR PROGRESS – 2**

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What journal entry will be passed, when debentures are issued at a premium and redeemable at par.

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### **4.5 TREATMENT OF DISCOUNT ON ISSUE OF DEBENTURES**

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It is desirable to write off the discount on issue of debentures during the life time of the debentures as the company derives the benefit out of the funds raised through the issue of debentures during that period only. The Directors may decide to write off the discount, depending upon the mode of redemption of debentures.

If the debentures are redeemed after a particular period, the discount is spread over the life of the debentures equally. For example, if debentures are issued for 10 years and if they are to be redeemed after the expiry of 10 years, the total discount is divided by 10 and the resultant amount is transferred to the Profit and Loss Account every year. If the total amount of discount on issue of debentures is Rs.10,000 and if the debentures are to be redeemed after 10 years, every year an amount of Rs.1,000 is transferred to the Profit and Loss Account.

Sometimes, if the Articles, so provide, the debentures are redeemed every year by installments. To decide which debentures are to be included in the first installment, lots are drawn. This method is called 'Redemption by drawing lots. Under this method, to make the burden of discount proportionate to the benefit received by the company out of funds raised through the debentures, the Profit and Loss Account is charged with the amount of discount which is in proportion to debentures debt outstanding during the year. Let us consider the above mentioned methods with the help of the following illustration:

#### **Illustration – 3**

X Ltd., issued Rs.10,00,000 debentures on January 1, 1985 at a discount of 5% repayable after 5 years. The company's financial year ends on the 31<sup>st</sup> of December. Show the amount to be charged to the Profit and Loss Account for 5 years.

#### **Solution**

##### **First Method**

When debentures are redeemed after the expiry of five years and when the amount of discount is written off equally, each year, the amount to be charged to the profit and loss account is arrived as follows:

The total amount of discount on Rs.1,00,000 is Rs.50,000. As the benefit from the funds is derived by the company equally during the 5 years, the amount to be written off each year would be Rs.10,000 i.e. Rs.50,000/5.

### Second Method

When debentures are redeemed every year by drawing lots, the amount of discount to be written off is arrived at as follows:

Year	Amount used	No.of years used	Amount to be written off
1	Rs.10,00,000	5	$5/15 \times 50,000 = 16,667$
2	Rs. 8,00,000	4	$4/15 \times 50,000 = 13,333$
3	Rs. 6,00,000	3	$3/15 \times 50,000 = 10,000$
4	Rs. 4,00,000	2	$2/15 \times 50,000 = 6,667$
5	Rs. 2,00,000	1	$1/15 \times 50,000 = 3,333$
			<u>50,000</u>

## 4.6 INTEREST ON DEBENTURES

Interest on debentures is payable by the company which raise the funds by it through debentures. It is a contractual obligation to the company and it has to pay the interest irrespective of the fact whether it earns profits or not. Generally, interest on debentures is paid once in six months.

A company paying interest on debentures is required by Law to deduct Income Tax at the prescribed rate from the interest amount before it is paid to the debenture-holders. The deducted amounts should be remitted to the Income Tax Department on behalf of the Debenture-holders.

The rate of interest payable on the debentures is prefixed to them. If the rate of interest is 15% per annum the debentures will be termed 15% Debentures. The amount of interest payable on debentures is calculated on the nominal value of the debentures. It may be noted that whether debentures are issued at par, at a discount or at a premium, the interest should always be calculated on the nominal value only.

## 4.7 ISSUE OF DEBENTURES AS COLLATERAL SECURITY

When a company raises loans from Banks or other creditors, it may give some assets as principal security to the creditors. In addition, the company may also issue debentures as a secondary or subsidiary security. Such an issue of debentures is called 'Issue of Debentures as Collateral Security'. The secondary security will be realised only when the principal security fails to provide the amount of loan. Issue of debentures as collateral security can be dealt with in the following ways.

(a) One method is not to make any entry in the books. A note is appended indicating that the loan is secured by the issue of debentures below the loan item on the Liabilities side of

the Balance Sheet. For example a company issued 10,000 debentures of Rs.100/- each. In addition, it has also issued debentures of Rs.15,000 to its Bankers as security for a loan extended by them amounting to Rs.10,000.

The information relating to the above mentioned debentures will be shown in the Balance Sheet as follows:

<b>Balance Sheet</b>			
Liabilities	Rs.	Assets	Rs.
10,000 Debentures of Rs.100 each	10,00,000		
Loan from Bankers (Collaterally secured by the issue of Rs.15,000 debentures)	10,000		

b) In the alternative method, the issue of debentures is recorded in the books. For the issue, the following entry is passed.

Debenture Suspense Account	Dr
To Debentures Account	

Debentures Suspense Account appears on the Assets side of the Balance Sheet and Debentures Account appears on the Liabilities side as usual.

#### Illustration – 4

Show the journal entries required in the following cases:

- a) X Ltd., issued Rs.10,00,000 9% debentures at par and redeemable at par.
- b) X Ltd., issued Rs.10,00,000 9% debentures at a discount of 10% and redeemable at par;
- c) X Ltd., issued Rs.10,00,000 9% debentures at a premium of 5% and redeemable at par.
- d) X Ltd., issued Rs.10,00,000 9% debentures at par and redeemable at a premium of 10%.
- e) X Ltd., issued Rs.10,00,000 9% debentures at a discount of 5% and redeemable at a premium of 5%

**Solution**

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
(a)	Bank Account Dr. To 9% Debentures A/c. (Being issue of Debentures at par which are redeemable at par)		10,00,000	10,00,000
(b)	Bank Account Dr. Discount on Issue of Debentures A/c. Dr. To 9% Debentures A/c. (Being issue of Debentures at a discount of 10% and redeemable at par)		9,00,000 1,00,000	10,00,000
(c)	Bank Account Dr. To 9% Debentures A/c. To Premium on Debentures (Being issue of Debentures at 5% premium and redeemable at par)		10,50,000	10,00,000 50,000
(d)	Bank Account Dr. Loss on Issue of Debentures A/c. Dr. To 9% Debentures A/c. To Premium on Redemption of Debentures A/c. (Being issue of debentures at par and re-deemable at 10% premium)		10,00,000 1,00,000	10,00,000 1,00,000
(e)	Bank Account Dr. Loss on Issue of Debentures A/c. Dr. To 9% Debentures A/c. To Premium on Redemption of Debentures A/c. (Being issue of Debentures at 5% discount and redeemable at 5% premium)		9,50,000 1,00,000	10,00,000 50,000

**4.8 RECORDING THE REDMPTION OF DEBENTURES**

As debentures represent the loan amount raised by the company, they have to be repaid. When the amount due on debentures is repaid and when the liability is thus discharged, it is called redemption of debentures.

We have already noted that the terms of redemption will be fixed at the time of issue. Based on the terms of issue and redemption, the amount to be paid on redemption will be known. Debentures can be redeemed at par, at a premium or at a discount. Generally, debentures are redeemed at par or at a premium. When the company purchases its own debentures in the

open market at a price which is lower than the par value resulting in a profit, it will amount to redeeming at a discount. Before dealing with different methods of redeeming the debentures, let us first consider the entries that are to be made when the debentures are redeemed in one lump sum.

**i) When debentures are redeemed at par**

a) for the amount payable on debentures:

Debentures Account	Dr
To Debenture-holders A/c	

b) When the amount is paid:

Debenture-holders Account	Dr
To Bank Account	

**Note:** It may be noted that we find only one entry in the text books, which is as follows:

Debentures Account	Dr
To Bank Account	

**ii) When debentures are redeemed at a premium**

a) for the amount payable on debentures:

Debentures Account	Dr
Premium on Redemption of Debentures Account	Dr
To Debenture-holders A/c	

b) When the amount is paid:

Debenture-holders Account	Dr
To Bank Account	

**Note:** It may be noted that premium on Redemption of Debentures Account is credited at the time of issue. Now it is debited and gets closed automatically.

**iii) When the debentures are redeemed at a discount**

a) for the amount payable on debentures

Debentures Account	Dr
To Debenture-holders A/c	
To Profit on Redemption of Debentures A/c	

b) When the amount is paid:

Debenture-holders Account	Dr
To Bank Account	

While redeeming the debentures, the company has to take into account the following two aspects:

- i) The timing of redemption;
- ii) The sources from which redemption is to be made.

### **Timing of Redemption**

Usually, debentures are redeemed after the fixed term is completed. The company may also stipulate at the time of issue itself that they will be redeemed in installments at the end of each year by giving notice to the debentureholders. The debentures to be redeemed at the end of each year are decided by drawing lots. Therefore, such a redemption is called 'Redemption of debentures by lots'.

If the company finds that it is profitable to buy its own debentures in the open market, it buys them. Then the debentures are redeemed automatically without giving any notice to the debentureholders.

### **Sources of Redemption**

A company can redeem its debentures through the following sources:

- i) out of profits;
- ii) out of capital;
- iii) out of provision made for redemption;
- iv) by conversion of old debentures into new debentures or shares.

#### **i) Redemption of debentures out of profits**

When debentures are redeemed out of profits, an amount equal to the amount to be utilised for repaying the debenture-holders is transferred from the Profit and loss Account to a new account, 'Debentures Redemption Reserve Account' opened for this purpose. The following entries are made for this purpose;

- i) for transfer of profits to the Reserve Account:

Profit & Loss (Appropriation) A/c	Dr
To Debenture Redemption Reserve A/c	
  
- ii) for redemption of debentures:
  - a) for the amount payable:

Debentures Account	Dr
To Debenture holders Account	
  
  - b) when the amount is paid:

Debenture-holders Account	Dr
To Bank Account	

The Debenture Redemption Reserve account will be shown on the liabilities side of the Balance Sheet. With each redemption, the balance in this account goes on increasing. When

If the debentures are redeemed, the balance in this account is transferred to 'Capital redemption Reserve'; which is not a free reserve.

With each transfer from the Profit and Loss (Appropriation) Account to Debenture redemption Reserve, the balance of profit gets reduced and consequently the amount available for distribution as dividend also gets reduced. As the debentures are redeemed out of profits during the year, this is called 'Redemption out of Profits'.

### ii) Redemption of Debentures out of Capital

In this case, no transfer is made from the Profit and Loss (Appropriation) Account to Capital redemption Reserve, and hence the amount available for distribution as dividend is not affected. As the redemption is made out of funds not earned during the normal course of business it is called Redemption out of Capital. The following entries are to be made:

- i) for the amount payable:
- |                          |    |
|--------------------------|----|
| Debentures Account       | Dr |
| To Debenture-holders A/c |    |
- ii) When the amount is paid:
- |                   |    |
|-------------------|----|
| Debenture-holders | Dr |
| To Bank Account   |    |

### Illustration - 5

A Ltd., issued 10,000 15% Debentures of Rs.100 each at par redeemable at a premium of 10% after 10 years. After completion of the terms, all the debentures were redeemed by giving due notice to debenture-holders. The company did not maintain any sinking Fund or transfer any amount from the Profit and Loss (Appropriation) Account to the Debenture Redemption Reserve.

Show the Journal entries made at the time of issue and redemption of debentures in the books of the company.

#### Journal

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
Beginning of first year	Bank A/c. <span style="float: right;">Dr.</span>		10,00,000	
	Loss on Issue of Debentures A/c. <span style="float: right;">Dr.</span> To Debentures A/c. To Premium on issue of Debentures A/c. (Being issue of 10,000 Debentures at par redeemable at 10% premium)		1,00,000	10,00,000 1,00,000
End of 10 <sup>th</sup> year	for redemption of debentures: 15% Debentures Account <span style="float: right;">Dr.</span>		10,00,000	
	Premium on Redemption of Deb. A/c. <span style="float: right;">Dr.</span> To Debenture-holders A/c. (Being the amount due for redeeming the debentures)		1,00,000	11,00,000

Debenture-holders A/c. To Bank Account (Being the amount paid on redemption of 15% debentures at a premium of 10%)	Dr.	11,00,000	11,00,000
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- Notes:**
1. Loss on Issue of Debentures Account must have been written off over 10 year period in a manner found proper by their Directors.
  2. Premium on Redemption of Debentures Account appears in the Balance Sheet on the liabilities side of the Balance Sheet for all the 10 years. After redemption it is closed automatically.

### iii) Redemption of debentures out of provision

In this method a part of profits is set aside for redeeming the debentures every year. Such an amount can either be utilised in the business itself or invested outside by creating a Sinking Fund. If the amount set aside is utilised in the business, the company may find it difficult to mobilise the amount required to redeem the debentures when they are due for repayment. Therefore, it is desirable that the amount set aside is invested outside the business in readily marketable securities, which can be disposed off to realise the amount required for redemption of debentures. This method is called 'Sinking Fund Method'. An alternative to investing the amount in outside securities is to take an Insurance Policy, which is called 'Insurance Policy method'. Let us now consider these two methods of redemption of debentures.

#### Sinking Fund Method

This method is similar to the Depreciation Fund Method which is already discussed under the topic, 'Depreciation and Reserves'. The difference between the two methods is that Depreciation Fund is utilised for replacing an asset, whereas Debentures Redemption Fund is utilised for redeeming a liability.

As already shown, a certain amount is to be set aside for creating a Sinking Fund / Debenture Redemption Fund. The amount to be set aside is ascertained by consulting the Sinking Fund Tables. The Sinking Fund Tables provide information regarding the amount to be invested every year to get Re-1 at the end of a given period at the expected rate of interest. The figure indicated in the Sinking Fund Tables is to be multiplied with the amount required for redeeming the debentures and the resultant product is the amount to be set aside every year towards Debentures Redemption Fund. This amount is used for buying securities in the market. The investment in securities yields interest. The interest so realised is added to the annual provision and the total amount is again invested in securities. The process of investing annual provision along with interest received on investments already made continues till the last year. In the last year when the debentures are due for redemption the investments are sold in the market and the amount realised is used for redeeming the debentures without affecting the working capital of the business.

The following are the entries to be made under this method:

Transaction	Journal entry
<b>At the end of first year</b>	
a) For transfer of the amount to Sinking Fund	Profit and Loss Appropriation A/c      Dr To Sinking Fund /Debentures Redemption Fund A/c
b) For investing the amount in outside securities:	Sinking Fund Investments A/c      Dr To Bank Account
<b>At the end of Second and subsequent years:</b>	
a) For receipt of interest on investments on last year's balance	Bank Account      Dr To Interest on Sinking Fund Investments A/c
b) For transfer of interest for Sinking fund	Interest on Sinking Fund Investments A/c      Dr To Sinking Fund A/c
c) For making annual provision to Sinking Fund	Profit and Loss Appropriation A/c      Dr To Sinking Fund A/c/ Debenture Redemption Fund A/c.
d) For investing annual installments along with interest received	Sinking Fund Investments A/c      Dr To Bank Account
<b>At the end of last year or at the time of redemption</b>	
a) For receipt of interest on investments	Bank Account      Dr To Interest on Sinking Fund Investment A/c
b) For transfer of interest to Sinking Fund	Interest on sinking Fund Investments A/c      Dr To Sinking Fund A/c.
c) For making annual provision to Sinking Fund	Profit and Loss Appropriation A/c      Dr To Sinking Fund Account/ Debenture Redemption Fund A/c.
d) For sale of investments	Bank Account      Dr To Sinking Fund Investments A/c
e) For profit on sale of Investments	Sinking Fund Investments A/c      Dr To Sinking Fund Account/ Debenture Redemption Fund A/c.

Note: For loss on sale of investments the entry given above will be reversed.

f) For redeeming the Debentures:	i) Debentures A/c To Debenture-holders A/c	Dr
	ii) Debenture-holders A/c To Bank Account	Dr
g) For transfer of balance in Sinking fund account to capital redemption reserve	Sinking Fund A/c / Debenture Redemption Fund A/c. To Capital Redemption Reserve A/c	Dr

**Note:** At the end of the last year the annual installment along with interest is not invested but the investments are sold.

### Illustration – 6

On January 1, 1985 X-Ltd., issued 12% debentures for Rs.10,00,000 redeemable at par at the end of 5 years. A Sinking Fund has been established for the purpose of redeeming the debentures.

Reference to Sinking Fund Tables shows that Rs.0.180975 invested at the end of each year, at 5% interest will yield Re.1 at the end of the 5 years.

Give the journal entries and show the necessary ledger accounts based on the following assumptions:

- i) investments are purchased in multiples of hundred
- ii) investments yield an interest of 5% which is received annually and the same is reinvested immediately.
- iii) the investments are realised at a loss of Rs.4,000

### Solution

For getting Re.1 after 5 years the amount to be set aside is Re.0.180975;

For getting Rs.10,00,000 the amount to be set aside every year is :  $0.180975 \times 10,00,000 =$  Rs. 1,80,975.

### Journal

Date	Particulars	L.F	Dr. Rs.	Cr. Rs.
1995 Jan.1	Bank Account Dr. To 12% Debentures A/c. (Being issue of Rs. 10,00,000 12% debentures)		10,00,000	10,00,000
Dec.31	Profit and Loss Appropriation Account Dr. To Sinking Fund a/c. (Being the provision made for redemption of debentures)		1,80,975	1,80,975
Dec.31	Sinking Fund Investments A/c. Dr. To Bank Account (Being the purchase of securities)		1,81,000	1,81,000

1996 Dec.31	Bank Account To Interest on Sinking Fund Investments A/c. (Being interest on investments for the year received)	Dr.	9,050	9,050
Dec.31	Interest on Sinking Fund Investments A/c. To Sinking Fund A/c. (Being transfer of interest to Sinking Fund)	Dr.	9,050	9,050
1996 Dec.31	Profit and Loss Appropriation Account To Sinking Fund A/c. (Being the annual provision made for debenture redemption)	Dr.	1,80,975	1,80,975
Dec.31	Sinking Fund Investments A/c. To Bank A/c. (Being purchase of investments – Rs. 1,80,975 + interest received Rs. 9,050 rounded off to nearest 100)	Dr.	1,90,000	1,90,000
1997 Dec.31	Bank Account To Interest on Sinking Fund Investment A/c. (Being interest on investments (on Rs. 3,71,000 i.e., Rs. 1,81,000 + 1,90,000) at 5% received)	Dr.	18,550	18,550
Dec.31	Interest on Sinking Fund Investments A/c. To Sinking Fund A/c. (Being transfer of interest on investments to Sinking Fund)	Dr.	18,550	18,550
Dec.31	Profit and Loss Appropriation Account To Sinking Fund Account (Being the annual provision made for debenture redemption)	Dr.	1,80,975	1,80,975
Dec.31	Sinking Fund Investments A/c. To Bank Account. (Being purchase of investments Rs. 1,80,975 + interest received Rs. 18,550)	Dr.	1,99,500	1,99,500
1998 Dec.31	Bank Account To Interest on Sinking Fund Investment A/c. (Being interest on investments on Rs. 1,81,000 + 1,90,000 + 1,99,500 at 5% received)	Dr.	28,525	28,525
Dec.31	Interest on Sinking Fund Investments A/c. To Sinking Fund A/c. (Being transfer of interest to Sinking Fund)	Dr.	28,525	28,525

Dec.31	Profit and Loss Appropriation Account To Sinking Fund A/c. (Being the annual provision made for debenture redemption)	Dr.	1,80,975	1,80,975
Dec.31	Sinking Fund Investments A/c. To Bank Account. (Being purchase of investments Rs. 1,80,975 + interest Rs. 28,525)	Dr.	2,09,500	2,09,500
1999 Dec.31	Bank Account To Interest on Sinking Fund Investment A/c. (Being interest on investments on Rs. 1,81,000 + 1,90,000 + 1,99,500 + 2,09,500 at 5% received)	Dr.	39,000	39,000
Dec.31	Interest on Sinking Fund Investments A/c. To Sinking Fund A/c. (Being transfer of interest to Sinking Fund)	Dr.	39,000	39,000
Dec.31	Profit and Loss Appropriation Account To Sinking Fund A/c. (Being the annual provision made for debenture redemption)	Dr.	1,80,975	1,80,975
1999 Dec.31	Bank Account To Sinking Fund Investment A/c. (Being the amount realised on sale of Sinking Fund Investments – Rs. 7,80,000 – Rs. 4,000)	Dr.	7,76,000	7,76,000
Dec.31	Sinking Fund A/c. To Sinking Fund Investments Account (Being loss on sale of investments transferred to Sinking Fund)	Dr.	4,000	4,000
Dec.31	12% Debentures Account To Debenture-holders a/c. (Being transfer of amount due on debentures to debenture-holders A/c.)	Dr.	10,00,000	10,00,000
Dec.31	Debentures-holders A/c. To Bank Account (Being redemption of Debentures)	Dr.	10,00,000	10,00,000
Dec.31	Sinking Fund Account To Capital Redemption Reserve Fund A/c. (Being transfer of Sinking Fund to Capital Redemption Reserve)	Dr.	9,96,000	9,96,000

Ledger					
12% Debenture A/c			Cr.		
Dr.					
Date	Particulars	Rs.	Date	Particulars	Rs.
1995			1995		
Dec.31	To Balance c/d	10,00,000	Jan. 1	By Bank A/c.	10,00,000
1996			1996		
Dec.31	To Balance c/d	10,00,000	Jan. 1	By Balance b/d	10,00,000
1997			1997		
Dec.31	To Balance c/d	10,00,000	Jan. 1	By Balance b/d	10,00,000
1998			1998		
Dec.31	To Balance c/d	10,00,000	Jan. 1	By Balance b/d	10,00,000
1999			1999		
Dec.31	To Debenture holders A/c	10,00,000	Jan. 1	By Balance b/d	10,00,000

Sinking Fund Account					
Dr.			Cr.		
Date	Particulars	Rs.	Date	Particulars	Rs.
1995			1995		
Dec.31	To Balance c/d	1,80,975	Dec.31	By Profit and Loss Appropriation A/c.	1,80,975
1996			1996		
Dec.31	To Balance c/d	3,71,000	Jan. 1	By Balance b/d	1,80,975
			Dec.31	By Interest on & Sinking Fund Investments A/c.	9,050
				By Profit and Loss Appropriation A/c.	1,80,975
		3,71,000			3,71,000
1997			1997		
Dec.31	To Balance c/d	5,70,525	Jan. 1	By Balance b/d	3,71,000
			Dec.31	By Interest on sinking fund investments A/c.	18,550
				By Profit and Loss Appropriation A/c.	1,80,975
		5,70,525			5,70,525
1998			1998		
Dec.31	To Balance c/d	7,80,025	Jan. 1	By Balance b/d	5,70,525
			Dec.31	By Interest on & sinking fund investment A/c.	28,525
				By Profit and Loss Appropriation A/c.	1,80,975
		7,80,025			7,80,025
1999			1999		
Dec.31	To Sinking Fund Investments A/c.	4,000	Jan. 1	By Balance b/d	7,80,025
			Dec.31	By Interest on & sinking fund investments A/c.	39,000
	To Capital Redemption Reserve Fund A/c.	9,96,000		By Profit and Loss Appropriation A/c.	1,80,975
		10,00,000			10,00,000

Dr.			Sinking Fund Investments A/c			Cr.		
Date	Particulars	Rs.	Date	Particulars	Rs.			
1995 Dec.31	To Bank A/c	<u>1,81,000</u>	1995 Dec.31	By Balance c/d	<u>1,81,000</u>			
1996 Jan.1	To Balance b/d	1,81,000	1996 Dec.31	By Balance c/d	3,71,000			
	To Bank A/c	1,90,000						
		<u>3,71,000</u>			<u>3,71,000</u>			
1997 Jan.1	To Balance b/d	3,71,000	1997 Dec.31	By Balance c/d	5,70,500			
	To Bank A/c	1,99,000						
		<u>5,70,500</u>			<u>5,70,500</u>			
1998 Jan.1	To Balance b/d	5,70,500	1998 Dec.31	By Balance c/d	7,80,000			
	To Bank A/c	2,09,000						
		<u>7,80,000</u>			<u>7,80,000</u>			
1999 Dec.31	To Balance b/d	7,80,000	1999 Jan.1	By Bank A/c.	7,76,000			
		<u>7,80,000</u>		By Sinking Fund A/c.	4,000			
					<u>7,80,000</u>			

**Illustration - 7**

Swaraj Ltd., had issued 12% debentures for Rs.5,00,000, which were redeemable at 5% premium on December 31, 1990. The following balances appeared in the Ledger on that date:

Debenture Redemption Fund Account	5,25,000
Debenture Redemption Fund Investments (in 9% Central Govt. Loan of the face value of Rs.4,62,000)	4,52,000
Bank Account	2,50,000
Premium on Redemption of Debentures A/c	25,000

The investments realised Rs.4,57,000 and the debentures were redeemed. Show the necessary ledger accounts for the redemption of debentures.

**Solution**

Dr.		Debenture Redemption Fund Account				Cr.
Date	Particulars	Rs.	Date	Particulars	Rs.	
2000 Dec.31	To Capital Redemption Reserve A/c. (transfer)	5,30,000	2000 Dec.31	By Balance b/d	5,25,000	
			"	By Debenture Redemption Fund Investment A/c.	5,000	
		<u>5,30,000</u>			<u>5,30,000</u>	

Dr.		Debenture Redemption Fund Investments Account				Cr.
Date	Particulars	Rs.	Date	Particulars	Rs.	
2000 Dec.31	To Balance b/d (face value Rs.4,62,000)	4,52,000	2000 Dec.31	By Bank	4,57,000	
"	To Debenture Redemption Fund A/c (transfer of profit)	5,000				
		<u>4,57,000</u>			<u>4,57,000</u>	

Dr.		12% Debentures Account				Cr.
Date	Particulars	Rs.	Date	Particulars	Rs.	
2000 Dec.31	To Debenture holders A/c	5,00,000	2000 Dec.31	By Balance b/d	5,00,000	
		<u>5,00,000</u>			<u>5,00,000</u>	

Dr.		Premium on Redemption of Debentures A/c				Cr.
Date	Particulars	Rs.	Date	Particulars	Rs.	
2000 Dec.31	To Sundry Debenture holders A/c	25,000	2000 Dec.31	By Balance b/d	25,000	
		<u>25,000</u>			<u>25,000</u>	

Dr.		Debenture-holders Account		Cr.	
Date	Particulars	Rs.	Date	Particulars	Rs.
2000 Dec.31	To Bank A/c	5,25,000	2000 Dec.31	By 12% Debentures A/c	5,00,000
			"	By Premium on Redemption of Debentures A/c	25,000
		<u>5,25,000</u>			<u>5,25,000</u>

### Insurance Policy Method

As already mentioned, in this method, the amount set aside as the annual instalment of Debenture Redemption Fund is used for taking out an Insurance Policy instead of investing it in outside securities. A fixed amount of premium is paid at the beginning of every year to the Insurance company and in turn the Insurance company agrees to pay the amount required for redemption of debentures at the end of the stipulated period. The total premiums paid will be less than the policy amount (as interest is earned) while the policy amount paid will be equal to the amount payable for redeeming the debentures. The difference between the policy amount and the total premium amount will be the interest on the premium amounts paid. While providing the required funds for redeeming the debentures, this method covers the risk involved in buying and selling the securities.

The following journal entries are to be passed under this method:

#### First year

##### At the beginning of the year

- a) For the payment of premium:

Debenture Redemption Fund Insurance Policy A/c	Dr
To Bank A/c	

- b) At the end of the year for making annual provision for debenture redemption:

Profit and Loss (Appropriation) A/c	
To Debenture Redemption Fund A/c	

- c) For interest on Premium amounts:

Debenture Redemption Fund Insurance policy A/c	Dr
To Debenture redemption Fund A/c	

The entries given above will be repeated during the subsequent years including the last year. In addition to the entries, the following additional entries are to be made in the last year.

- a) For the receipt of policy amount:

Bank A/c Dr.  
 To Debenture Redemption Fund Insurance Policy A/c

- b) For transfer of balance in the Debenture Redemption Fund A/c:

Debenture Redemption Fund A/c Dr.  
 To Capital Reserve A/c

For redeeming the debentures, the usual entries for redemption which have been shown earlier will be passed.

### Illustration - 8

X Ltd., Issued 10,00,000, 12% debentures on 1<sup>st</sup> January, 1996. The company took a 4-year Debenture Redemption Fund Insurance Policy for their redemption. The annual premium is Rs.2,30,000. The policy amount earns an interest of 6% every year. Show the necessary entries to record the above mentioned transaction for 4 years, assuming that the debentures have been redeemed on the expiry of the term.

### Solution

Journal				
Date	Particulars	L.F	Dr. Rs.	Cr. Rs.
1996 Jan. 1	Bank A/c. <span style="float: right;">Dr.</span> To 12% Debentures (Being the issue of 12% debentures)		10,00,000	10,00,000
Jan. 1	Debenture Redemption Fund Insurance Policy A/c. <span style="float: right;">Dr.</span> To Bank A/c. (Being payment of Insurance Premium)		2,30,000	2,30,000
1996 Dec.31	Profit and Loss (Appropriation) A/c. <span style="float: right;">Dr.</span> To Debenture Redemption Fund A/c. (Being the annual provision for redemption of debenture)		2,30,000	2,30,000
Dec.31	Debenture Redemption Fund Insurance Policy A/c. <span style="float: right;">Dr.</span> To Debenture Redemption Fund A/c. (Being interest on premium amount i.e., $2,30,000 \times 5/100$ )		13,800	13,800
1997 Jan. 1	Debenture Redemption Fund Insurance Policy A/c. <span style="float: right;">Dr.</span> To Bank A/c. (Being payment of Insurance Premium)		2,30,000	2,30,000

Dec.31	Profit and Loss (Appropriation) A/c. To Debenture Redemption Fund A/c. (Being the annual provision for redemption of debentures)	Dr.	2,30,000	2,30,000
Dec.31	Debenture Redemption Fund Insurance Policy A/c. To Debenture Redemption Fund A/c. (Being interest on Premium amounts i.e., on (2,30,000 + 13,800 + 2,30,000 = 4,73,800))	Dr.	28,428	28,428
1998 Jan. 1	Debenture Redemption Fund Insurance Policy A/c. To Bank A/c. (Being payment of Insurance Premium)	Dr.	2,30,000	2,30,000
Dec.31	Profit and Loss (Appropriation) A/c. To Debenture Redemption Fund A/c. (Being the annual provision for redemption of Debentures)	Dr.	2,30,000	2,30,000
Dec.31	Debenture Redemption Fund Insurance Policy A/c. To Debenture Redemption Fund A/c. (Being interest on premium amounts i.e., Rs. 4,73,800 + 28,428 + 2,30,000 = 7,32,228)	Dr.	43,934	43,934
1999 Jan. 1	Debenture Redemption Fund Insurance Policy A/c. To Bank A/c. (Being payment of Insurance Premium)	Dr.	2,30,000	2,30,000
Dec.31	Profit and Loss (Appropriation) A/c. To Debenture Redemption Fund A/c. (Being annual provision for redemption of debentures)	Dr.	2,30,000	2,30,000
Dec.31	Debenture Redemption Fund Insurance Policy A/c. To Debenture Redemption Fund A/c. (Being interest on premium amount i.e., Rs. 7,32,224 + Rs. 43,934 + 2,30,000 = 10,66,532)	Dr.	60,370	60,370
Dec.31	Bank A/c. To Debenture Redemption Fund A/c. (Being the receipt of policy Amount)	Dr.	10,66,532	10,66,532

2000 Dec.31	12% Debentures A/c. To Debenture-holders A/c. (Being transfer of Debentures amount to Debenture-holders)	Dr.	10,00,000	10,00,000
Dec.31	Debenture-holder's A/c. To Bank A/c. (Being redemption of debentures)	Dr.	10,00,000	10,00,000
Dec.31	Debenture Redemption Fund A/c. To Capital Reserve (Being transfer of debenture redemption fund)	Dr.	10,66,532	10,66,532

### Redemption of Debentures by Conversion

Under this method, the existing debentures are redeemed by converting them into new debentures or shares. If the debenture-holders find that conversion into new debentures or shares is beneficial to them they will accept the conversion. An option for conversion of old debentures into shares gives the debentures-holders a distinct privilege. Since having enjoyed the position of secured creditors during the early stages of the company (now that the company is financially sound ) they are given the right to become the owners of the company. The new shares or debentures can be issued at par, at a premium or at a discount. The following entry is to be made.

Old Debentures Account	Dr.
To New Shares of Debentures Account (Being issue of (new) shares/debentures in satisfaction of the price of old debentures)	

### Illustration – 9

On January 1, 1999 X Ltd., issued Rs. 5,00,000 15% debentures of Rs.100 each at par repayable at a premium of 5%, with an option for the holder to convert their holdings into 15% Preference Shares of Rs.100 each at a premium of Rs.20 per share.

On June 30, 1999 a debenture-holding 120 debentures gave notice for exercising his option.

Show the necessary journal entries for the conversion of the debentures into 15% Preference shares.

**Solution**

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
1998 Jan.1	Bank Account <span style="float:right">Dr.</span> Loss on Issue of Debentures Account <span style="float:right">Dr.</span> To 15% Debentures A/c To Premium on Redemption of Debentures A/c (Being issue of 5,000 debentures of Rs. 100 each at par redeemable at a premium of 5%)		5,00,000 25,000	5,00,000 25,000
1999 Jun. 30	15% Debenture Account <span style="float:right">Dr.</span> Premium on Redemption of Debentures A/c Dr. To 15% Preference Share Capital A/c To Share Premium A/c (Being issue of 15% preference shares at 20% premium for conversion of 100 debentures of Rs. 100 each redeemable at 5% premium)		10,000 500	8,500 2,000

**Purchase of Own Debentures**

We have already noted that sometimes a company may buy its own debentures in the open market when it finds it advantageous. It may purchase its own debentures for the following purposes:

- i) for cancellation;
- ii) for re-sale;
- iii) for investment.

Whatever be the object of buying its own debentures, the company withdraws or takes back the debentures, which can be at par, at a premium or at a discount.

By purchasing its own debentures the company assumes the role of general investor and the debentures purchased are treated as if they were normal investments, and they are shown on the assets side of the Balance Sheet till they are cancelled or sold again. The following entries are made on purchase of own debentures.

**i) When debentures are purchased at par.**

Own Debentures Account Dr  
 To Bank Account

**ii) When debentures are purchased at a discount  
 (the discount is capital profit)**

Own Debentures Account Dr  
 To-Bank A/c  
 To Profit on Purchase of Debentures A/c

**iii) When debentures are purchased at a premium**  
(Premium paid is capital loss)

Own Debentures Account	Dr
Loss on Purchase of Debentures Account	Dr
To Bank Account	

**iv) When the debentures purchased are cancelled**

Debentures Account	Dr
To Own Debentures Account	

**Illustration – 10**

On the 31<sup>st</sup> of December, 1999, the Balance Sheet of Ashok Ltd., showed the following balances:

15% Debentures	Rs.5,00,000
Debenture Redemption Fund	Rs.2,50,000
 Debenture Redemption Fund Investments:	
Own Debentures (Purchased at Rs. 98)	Rs. 50,000
Debentures Redemption Fund Investments (9% Stock (face value Rs.2,20,000))	Rs.2,00,000

On the above mentioned date all the debentures were redeemed by realising 9% stock at par and utilising Rs.1,00,000 out of the current year's profits. Give the journal entries required for these transactions.

**Solution**

**Working**

**Profit on sale of Debenture Fund Investments:**

On 9% Stock (Rs.2,20,000 – Rs.2,00,000)	=	Rs.20,000
On own Debentures (Rs.50,000 – 49,000)	=	<u>Rs. 1,000</u>
		<u><u>Rs.21,000</u></u>

**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
1999 Dec.31	Bank Account Dr. To Debenture Redemption Fund Investments A/c To Debenture Redemption Fund A/c (Being sale of investments for redeeming debentures)		2,20,000	2,00,000 20,000
Dec. 31	15% Debentures A/c Dr. To Debenture holders A/c (Being the amount due to debenture holders redemption)		4,50,000	4,50,000
Dec. 31	Debenture holders A/c Dr. To Bank A/c (Being the payment of amount due to debentures holders)		4,50,000	4,50,000
Dec. 31	15% Debentures A/c Dr. To own Debenture A/c To Debenture Redemption Fund A/c (Being cancellation of own debenture and transfer of profit thereon to Debenture Redemption fund)		50,000	49,000 1,000
Dec. 31	Debenture Redemption Fund A/c Dr. To Capital Redemption Reserve (Being transfer of Debentures Redemption fund account balance)		2,71,000	2,71,000
Dec.31	Profit and Loss Appropriation Account Dr. To Capital Redemption Reserve* (Being transfer of profit to General Reserve towards the amount used for redeeming the Debentures)		1,00,000	1,00,000

\* Instead of transferring the amount to Debenture Redemption Fund Account first and then transferring the same to Capital Redemption Reserve Account, only one entry is made directly transferring to Capital Redemption Reserve Account.

**Note:** Out of Rs.5,00,000 debentures redeemed, a sum of Rs.2,50,000 was utilised from Debentures Redemption Fund and a sum of Rs.1,00,000 from the current year's profits. The balance of Rs.1,50,000 debentures are supposed to have been redeemed out of capital.

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### CHECK YOUR PROGRESS – 3

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Pass required journal entries in the following cases:

i) 'Z' Ltd.; issued 9,00,000 15% debentures at a discount of 10% and redeemable at par.

.....  
.....  
.....

ii) 'Z' Ltd., issued 9,00,000 15% debentures at a discount of 10% and redeemable at a premium of 10%.

.....  
.....  
.....

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### 4.9 SUMMING UP

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The Capital needed by a company can be raised through issue of shares or through long-term loans. The loan capital is raised through Debentures. A Debenture is a written acknowledgement of a debt given under the seal of the company.

Based on the characteristics, Debentures can be classified into different categories. Based on negotiability, they are classified as Registered and Bearer Debentures. On the basis of priority, they are classified as First and Second debentures. On the basis of permanence they are classified as Redeemable and Irredeemable Debentures. Based on security available, they are called Simple or Naked debentures and Mortgage debentures.

Debentures can be issued for cash and also for consideration other than cash. They can be issued as collateral security also. Just as in the case of shares, debentures can be issued at par, at a discount or at a premium.

While redeeming debentures, the timing of redemption and the sources from which the redemption is to be made are two important points to be considered by a company.

Debentures can be redeemed after completion of the fixed term or in instalments at the end of each year by taking lots.

Debentures can be redeemed through any of the following sources: (a) out of profits; (b) out of capital; (c) out of provision made for redemption and (d) by conversion of old debentures into new debentures or shares.

If the redemption is out of profits, an amount equal to the amount paid to the debenture-holders is to be transferred to the Debenture Redemption Reserve Account. If the redemption is out of provision made for that purpose, it can be either by establishing a sinking fund or by taking out an Insurance policy.

Sometimes, if it is found to be profitable the company may buy its own debentures in the open market either for cancellation or for re-sale.

#### 4.10 CHECK YOUR PROGRESS : MODEL ANSWERS

1. Sometimes the debenture-holders are given the option to convert the debentures fully or partly into equity shares after a specified time. Such debentures are called convertible debentures.

2.	Bank A/c	Dr		
	To Debentures Account			
	To Premium on Issue of Debenture A/c			
3. i)	Bank A/c	Dr	8,10,000	
	Discount on Issue of Debentures A/c	Dr	90,000	
	To 15% Debentures Account			9,00,000
ii)	Bank A/c	Dr	8,10,000	
	Loss on issue of Debentures A/c	Dr	1,80,000	
	To Debentures A/c			9,00,000
	To Premium on Redemption of Debentures A/c			90,000

#### 4.11 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the different types of debentures
2. Explain the accounting procedure for the issue of debentures.
3. Explain the different methods used for redeeming debentures
4. Explain the entries required under the Debentures Redemption Fund method of redeeming debentures

II. Answer the following questions in about 15 lines each.

1. Explain the meaning of Debentures
2. Distinguish between bearer debentures and registered debentures
3. What is the difference between redeemable debentures and irredeemable debentures
4. Distinguish between simple or naked debentures and mortgage debentures.
5. Distinguish between convertible debentures and non-convertible debentures
6. Write a short note on:
  - a) Premium on redemption of debentures
  - b) Discount on issue of debentures.
7. What do you understand by issue of debentures as collateral security?
8. What is meant by own debentures

9. Write a short note on redemption of Debentures
10. Distinguish between fixed charge and floating charge..
11. Write a short note on:
  - a). First debentures
  - b) Second debentures
12. Write a brief note on interest on debentures
13. Write a brief note on Sinking Fund Investments
14. Explain the treatment of discount on issue of debentures
15. Explain the accounting procedure for recording the issue of debentures as collateral security.

### Problems

1. Pass the necessary journal entries for the following issues of debentures:
  - a) A company issued 25,000 15% Debentures of Rs.100 each at par:
  - b) A company issued 25,000 15% Debentures of Rs.100 each at a premium of 5%
  - c) A company issued 25,000 15% Debentures of Rs.100 each at a discount of 5%.
2. Journalise the following transactions:
  - a) A company issued 1,00,000 12% Debentures of Rs.100 each at par and redeemable at par:
  - b) A company issued 1,00,000 12% Debentures of Rs.100 each at a discount of 5% and redeemable at par;
  - c) A company issued 1,00,000 12% Debentures of Rs.100 each at a premium of 5% and redeemable at par;
  - d) A company issued 1,00,000 12% Debentures of Rs.100 each at par and redeemable at 5% premium;
  - e) A company issued 1,00,000 12% Debentures of Rs.100 each at a discount of 5% and redeemable at a premium of 5%.
3. A company issued 10,000 15% debentures of Rs.100 each payable thus: Rs/20 on application; Rs.20 on allotment and the balance on call. All the debentures were subscribed for and duly allotted. All the moneys due were received. Give journal entries, ledger accounts and the Balance Sheet.
4. X Ltd., purchased from Unlucky Ltd., assets worth Rs.5,50,000. It issued 5% Debentures of Rs.100 each at a premium of 10%. Give journal entries in the books of X Ltd.
5. Y Ltd., issued 12% Debentures of Rs.12,00,000 redeemable after 3 years at 10% premium. The amount set aside for redemption of debentures is invested in 5% Government securities. Sinking Fund Tables show that Re.0.31720856 at 5% compound interest yields Re.1 in three years. Give journal entries and open ledger accounts for three years.

6. A company issued 15% Debentures of Rs.9,00,000 redeemable through the establishing of a Debenture Redemption Fund by investing Rs.60,000 every year in 5% Government securities. The interest received on the investments at the end of every year should be re-invested in the same securities. Show the Debentures Redemption Fund Account and Debenture Redemption Fund Investments Account for the first four years.
7. The following are the balances as shown in the books of XYZ Ltd., on the 31<sup>st</sup> of December, 1998.

15% Debentures	Rs.4,00,000
Debenture Redemption Fund	Rs.3,40,000
Debenture Redemption Fund Investments	Rs.3,60,000

The amount set aside annually was Rs.45,600. On the above mentioned date the investments were sold at Rs.95 and the debentures were redeemed. The Bank balance, after receiving interest on Debenture Redemption Fund Investments, was Rs.86,600.

Give ledger accounts showing the redemption of debentures.

8. Good luck Ltd., issued Rs.1,00,000 debentures in Jan.1 1986. The Company has taken a 5 year Debentures Redemption Fund Insurance policy for their redemption the annual premium being Rs.18,500. Interest accrues on the policy at 4% per annum. Show the necessary entries in the books of the company.

(Ans: Amount transferred to Capital reserve A/c. – 1,04,210)

#### 4.12 RECOMMENDED BOOKS

- |                                    |   |
|------------------------------------|---|
| 1. R.L. Gupta and<br>M. Radhaswamy | : <b>Advanced Accountancy, Volume - II</b><br>Sultan Chand & Sons 23, Daryaganj, New Delhi. |
| 2. S.N. Maheswari                  | : <b>Advanced Accountancy, Volume – II,</b><br>Vani Educational Books, New Delhi.           |
| 3. S.P.Jain and<br>K.L. Narang     | : <b>Advanced Accountancy,</b><br>Kalyani Publishers, Ludhiana.                             |
| 4. M.C. Shukla and<br>TS Grewal    | : <b>Advanced Accountancy,</b><br>S. Chand & Sons, New Delhi.                               |

#### 4.13 GLOSSARY

- Debenture** : A written acknowledgement of a debt issued under the seal of a company.

**BLOCK – II**  
**COMPANY FINAL ACCOUNTS**

**Unit – 5 : Company Accounts – I**

**Unit – 6 : Company Accounts – II**

**Unit – 7 : Profits Prior to Incorporation**

**Unit – 8 : Bonus Shares**

BRAOU

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## UNITS - 5 : COMPANY FINAL ACCOUNTS - I

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### Contents

- 5.0 Aims and Objectives
- 5.1 Introduction
- 5.2 Provisions relating to Company Final Accounts
- 5.3 Provisions relating to Profit and Loss Account
- 5.4 Provisions relating to Balance Sheet
- 5.5 Summing Up
- 5.6 Check Your Progress: Model Answers
- 5.7 Model Examination Questions
- 5.8 Recommended Books
- 5.9 Glossary

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### 5.0 AIMS AND OBJECTIVES

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The aim of this unit to discuss the legal provisions for preparing the final accounts of companies.

After studying this unit, you should be able to:

- explain the provisions relating to company final accounts;
- describe the provisions relating to profit and loss account; and
- state the provisions pertaining to Balance Sheet.

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### 5.1 INTRODUCTION

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In the previous 4 units you will have learnt about the procedure of issue of shares, forfeiture of shares, re-issue of forfeited shares, issue and redemption of debentures and their accounting treatment. This unit and subsequent unit are meant for discussing the preparation of company final accounts.

The term, 'Final Accounts', is popularly used to refer to (a) Profit and Loss Account, and (b) **Balance Sheet**. It may be pointed out that Profit and Loss Account of a company is prepared on the same basis as in the case of a sole proprietorship or a partnership firm. As far as the Balance Sheet of a company is concerned a format is prescribed. While it is considered desirable for a Sole Trade/Firm to prepare the final accounts, it is compulsory for a company to prepare the final accounts. In this unit we will discuss the legal provisions pertaining to preparation of a company final accounts.

## **5.2 PROVISIONS RELATING TO COMPANY FINAL ACCOUNTS**

Companies have statutory obligation to prepare final accounts as required by section 210 of the Companies Act. The requirements of this selection are quoted below:

1. At every annual general meeting of a company in pursuance of section 166, the board of directors of the company shall lay before the company.
  - (a) balance sheet as at the end of the period specified in sub-section (3) and
  - (b) profit and Loss Account for that period
2. In the case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting instead of profit and Loss Account and all references to 'Profit and Loss Account', 'Profit' and 'Loss' in this section and elsewhere in this Act shall be construed in relation to such a company as references respectively to the income and expenditure account, "the excess of income over expenditure and the excess of expenditure over income".
3. The Profit and Loss Account shall relate –
  - a) In the case of the first annual general meeting of the company to the period beginning with the incorporation of the company and ending with a day which shall not precede the day of the meeting by more than nine months; and
  - b) In the case of any subsequent annual general meeting of the company, to the period beginning with the day immediately after the period for which the account was last submitted and ending with a day which shall not precede the day of the meeting by more than six months or in cases where an extension of time has been granted for holding the meeting under the second provision to Sub-Section (1) of Section 166, by more than six months and the extension so granted.
4. The period to which the account aforesaid relates is referred to in this Act as a 'financial year' and it may be less or more than a calendar year, but it shall not exceed fifteen months.

Provided that it may extend to eighteen months where special permission has been granted in that behalf by the Registrar.

5. If any person, being a director of a company, fails to take all reasonable steps to comply with the provision of this section, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or fine which may extend to one thousand rupees or both.

Provided that for any proceedings against a person in respect of an offence under this section, it shall be defence to prove that a competent and reliable person was charged with the duty of seeing that the provisions of this section were complied with and that he was in a position to discharge that duty.

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed willfully.

6. If any person, not being a director of the company, having been charged by the Board of Directors with the duty of seeing that the provisions of this section are complied with, defaults in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees or both.

Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed willfully.

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### **5.3 PROVISIONS RELATING TO PROFIT AND LOSS ACCOUNT**

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Sub-section (2) of section 211 of the Companies Act, 1956 requires that 'Every Profit and Loss Account of a company shall give a true and fair view of the profit or loss of the company for the financial year and comply with the requirements of Part II of Schedule VI in so far as they are applicable thereto.

Provided that nothing contained in this sub-section shall apply to any insurance or banking company, or any company engaged in the generation or supply of electricity or to any other class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company.

It is also given in sub-section (3) of Section 211 that the Central Government may by notification in the Official Gazette, exempt any class of companies from compliance with any of the requirements in Schedule VI if, in its opinion, it is necessary to grant exemption in the public interest. Any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

No form for Profit and Loss Account has been prescribed in the companies Act as it has been prescribed for Balance Sheet, but 'Requirements as to Profit and Loss Account are given in Part II of Schedule VI. The requirements relating to Profit and Loss Account are as follows:

#### **Schedule VI. Part II**

##### **Requirements as to Profit and Loss Account**

1. The Provisions of this part shall apply to the income and expenditure account referred to in Sub-section 210 of the Act, in like manner as they apply to a Profit and Loss Account but subject to the modification of reference as specified in that Sub-section.
2. The profit and Loss Account (a) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account and (b) shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or a transaction of an exceptional nature.
3. The Profit and Loss Account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads and in particular, shall disclose the following information respect of the period covered by the account.

- i) a) The turnover, that is the aggregate amount for which sales are effected by the company, giving the amount of sales in respect each class of goods dealt with by the company and indicating the quantities of such sales for each class separately.
- b) Commission paid to selling agents within the meaning of Section 294 of the Act.
- c) Commission paid to other selling agents.
- d) Brokerage and discount on sales, other than the usual trade discount.

ii) a) In the case of manufacturing companies:-

1. The value of the raw material consumed, giving items-wise break-up and indicating the quantities thereof. In this break-up as far as possible all important basic raw materials shall be shown as separate items. The intermediate or components procured from other manufactures may, if their list is too large to be included in the break-up be grouped under suitable headings without mentioning the quantities, provided all those items, which in value individually account for 10% or more of the total value of the raw material consumed, shall be shown as separate and distinct items with quantities thereof in the break-up.
2. The opening and closing stocks of goods produced, giving the break-up in respect of each class of goods and including the quantities thereof.
  - b) In the case of trading companies, the purchases made the break-up in respect of closing stocks, giving the break-up in respect of each class of goods traded in by the company and indicating the quantities thereof.
  - c) In the case of companies rendering or supplying services, the gross income derived from the services rendered or supplied.
  - d) In the case of company which fall under more than one of the categories mentioned in (a), (b), (c), above, it shall be sufficient compliance with the requirements therein if the total accounts are shown in respect of the opening and closing stocks, and if purchases sales and consumption of raw material with value and quantitative break-up and the gross income from services rendered is shown.
  - e) In the case of other companies, the gross income derived under different Heads.

**NOTE: 1.** The quantities of raw materials, purchase, stocks and the turnover, shall be expressed in the denominations in which they are normally purchased or sold in the market.

**NOTE: 2.** For the purpose of items (ii) (a), (ii) (b), and (d) the items for which the company is holding separate industrial licenses shall be treated as separate class of goods, but where a company has more than one industrial license for production of the same items at different places or for expansion of the licensed capacity, the item covered by all such licenses shall be treated as one class. In the case of the trading companies, the imported items shall be classified in accordance with the classification adopted by the Chief controller of the imports and exports in granting the import licenses.

**NOTE: 3.** In giving the break-up of purchases stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break-up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10% or more of the total value of the purchases, stock, or turnover,

as the case may be, are shown as separate and distinct items with quantities thereof in the break-up.

- iii) In the case of all concerns having work-in-progress the amounts for which such works have been completed at the commencement and at the end of the accounting period.
- iv) The amount provided for depreciation, renewals or diminution in the value of fixed assets.

If such provision is not made means of a depreciation charge, the method adopted in making such provision should be shown.

If no provision is made for the depreciation the fact that no provision has made shall be stated and the quantum of arrears of depreciation computed in accordance with Section 205(2) of the Act shall be disclosed by way of a note.

- v) The amount of interest on the company's debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any paid or payable to the managing director and the manager, if any,
- vi) The amount of charge for Indian Income-Tax and other Indian taxation on profits, including, where practicable, with Indian Income tax any taxation imposed elsewhere to the extend of the relief, if any, from Indian Income-Tax and distinguishing, where practicable between income tax and other taxation.
- vii) The amounts reserved for:
  - a) repayment of share capital and
  - b) repayment of loans.
- viii) a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve but not including provisions made to meet any specific liability, contingency or commitment know to exit or the date as on which the Balance Sheet is made up.  
b) The Aggregate, if material, of the amounts withdrawn from such reserves.
- ix) a) The aggregate, if material, of the amounts set aside to provision made for meeting specific liabilities, contingencies or commitments.  
b) The aggregate, if material, of the amount withdrawn from such provisions as no longer required.
- x) Expenditure incurred on each of the following items, separately for each item:
  - a) Consumption of Stores and spare parts
  - b) Power and fuel
  - c) Rent
  - d) Repairs to buildings
  - e) Repairs to machinery
  - f) i) Salaries wages and bonus

- ii) Contribution to provident and other Funds
- iii) Workmen and staff welfare expense to the extent not adjusted from any previous provision or reserve.

**NOTE 1 :** Information in respect of this item should also be given in the Balance Sheet under the relevant provision or reserve account.

**NOTE 2 :** In respect of sub-items (1 & 2), the Profit and Loss Account shall also contain, by way of note, the break-up of the expenditure incurred on employees who (i) if employed throughout the financial year were in receipt of remuneration for that year which in the aggregate was not less than Rs. 12,00,000 or (ii) if employed for a part of the financial year, were in receipt of remuneration for any part of that year at a rate which in the aggregate was not less than Rs. 1,00,000/- per month. The said note shall also indicate the number of employees falling in each of the above mentioned two categories. Remuneration for this purpose has the same meaning as the in the explanation to section 198 and shall further include honoraria. The monetary value of the perquisites shall be calculated in accordance with the provisions of the Income Tax Act, 1961 (4 of 1961) and the rule made there under.

- g) Insurance
- h) Rates and taxes, excluding taxes on income.
  - i) Miscellaneous expenses, provided that any item under which the expenses exceed 1% of the total revenue of the company or Rs. 5,000/- whichever is higher, shall be shown as a separate and distinct item against an appropriate account head in the profit and Loss Account and shall not be combined with any other item to be shown under 'Miscellaneous Expenses'.
- xi) a) The amount of income from investments distinguishing between trade investments and other investments.
  - b) Other income by way of interest, specifying the nature of the income.
  - c) The amount of income-tax deducted in the gross income is stated under-sub-paragraphs (a) and (b) above.
- xii) a) Profits or losses on investments showing distinctly the extent of the profits or losses carried or incurred on account of membership of a partnership of a partnership firm, to the extent not adjusted from any previous provision or reserve.

**NOTE:** Information in respect of this item should also be given in the Balance Sheet under the relevant provision or reserve account.

- b) Profits or loss in respect of transactions of a kind not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount.
- c) Miscellaneous income.
- xiii) a) Dividends from subsidiary companies.
  - a) Provision for losses of subsidiary companies.

- xiv) The aggregate amount of the dividends paid and proposed, and stating whether such amounts are subject to deduction of income-tax or not.
  - xv) Amount, if material, by which any items shown in the Profit and Loss account are affected by any change in the basis of accounting.
4. The profit and loss account shall also contain or give by way or a note detailed information, showing separately the following payments provided or made during the financial year to the Directors (including Managing Directors) or manager, if any, by the company, the subsidiaries of the company or any other person:
- i) Managerial remuneration under section 198 of the Act paid or payable during the financial year to the Directors (including Management Directors) or managers, if any;
  - ii) Others allowances and commission (including guarantee commission) details to be given;
  - iii) Any other perquisites or benefits in cash or in kind (Stating approximately their money value, where practicable);
  - iv) Pensions, etc:
    - a) Pensions
    - b) Gratuities
    - c) Payments from provident funds, in excess of own subscriptions and interest thereon
    - d) Compensation for loss of office
    - e) Consideration in connection with retirement from office.

4A. The Profit and Loss Account shall contain or give by way of a note a statement showing the computation of net profits in accordance with section 349 of the Act with the relevant details of the calculation of the commissions payable by way of percentage of such profits to the Directors (including Managing Director) or managers, if any.

4B. The profit and Loss Account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, whether as fees expenses or otherwise for services rendered –

- 1. as auditor; and
- 2. as adviser in any other capacity in respect of
  - a) taxation matters;
  - b) company law matters;
  - c) management services.
- 3. other amounts paid in any other manner:

The Institute of Chartered Accountants of India has stated in its statement 'Styled Payment' to Auditors for other service' that the remuneration to the auditor for other services should be classified as follows:

- 1) for tax representation;
- 2) for company law matters;

necessary for the purpose, the excess shall be treated for the purpose of this schedule as a reserve and not as a provision.

8. For the purposes afore said, the expression, 'quoted investment', means an investment in respect of which there has been granted a quotation or permission to deal on a recognised Stock Exchange and the expression, 'unquoted investment', shall be construed accordingly.

Thus, it may be seen that the Companies Act has not prescribed any standard form for the preparation of the Profit and Loss Account because no standard form can meet the requirements of different types of business. However, according to the companies Act every Profit and Loss Account of a company should be so prepared as to give a true and fair view of the profit or loss of the company for the financial year and comply with the requirements of part II of Scheduled VI, as applicable to it.

It may be noted that the Profit and Loss Account:

- i) should clearly disclose the result of company's working during the period covered by it;
- ii) should disclose every material feature regarding its working results including receipts and payments in respect of non-recurring transactions or transactions of an exceptional nature;
- iii) should disclose any material effect of a change on the basis of accounting, viz., any change in the method of providing for depreciation or any change in the method of valuation of stock etc.

#### Profit and Loss Appropriation Account

A company has to prepare the Profit and Loss Appropriation Account in addition to the Profit and Loss Account. The Profit and Loss Appropriation Account shows the appropriations of profit and is popularly known as 'below the line'. In the case of a company, it is not necessary to show the Trading Account, P & L Account and P & L Appropriation Account separately. Only P & L Account may be prepared which may cover items appearing in Trading Account, P & L Account into three separate accounts, viz. Trading Account, P&L Account and P&L Appropriation Account. It may be noted that the splitting of the P & L Account and P & L Appropriation Account is not forbidden by the Companies Act. However, it is desirable to split it into three sections so that the gross profit, new profit and surplus carried to the Balance Sheet may be ascertained. The Profit and Loss Appropriation Account is prepared as follows:

#### PROFIT AND LOSS APPROPRIATION ACCOUNT

To Transfer to Reserves	By Last year's balance b/f
To Income tax for Previous year not provided for	By Net profit for the year
To Interim dividend	By Amount withdrawn from Gen. Reserve/other reserve
To Proposed dividend	By Provision
To Surplus (balancing figure carried to Balance Sheet)	(like Income Tax provision not required)

In the case of a company, income tax on profits is treated as an expense and not an appropriation of profit, and so it is debited to P&L Account.

The profit or loss disclosed by the P&L Account of a sole proprietor/firm is transferred to Capital/Current account(s), but the surplus left in P&L Appropriation Account is not transferred to the Share Capital Account. It is kept in a separate account. It is so because called up capital cannot be more than the amount called on shares.

At this juncture, it is necessary to know the provisions relating to Dividends. Dividends cannot be declared except out of profits, i.e., excess of income over expenditure. Ordinarily, capital profits (profits arising from revaluation, etc.,) are not available for distribution because such profits are not trading profits. The principles of divisible profits are governed by section 205 of the Companies Act.

### **Transfer to Reserves**

Section 205 of Companies Act makes it compulsory to transfer certain percentage of profits to reserves, before declaring dividends which may be notified Central Government. As per Central Governments rules, the transfer to reserves is to be made as follows:

- a) 2.5% if the proposed dividend is 10% to 12.5%
- b) 5% if the proposed dividend is 12.5% to 15%
- c) 12.5% if the proposed dividend is 15% to 20%
- d) 10% if the proposed dividend exceeds 20%.

Journal entry for this purpose is:

Profit and Loss appropriate a/c.	Dr.
To General Reserve a/c.	

### **Declaration of Dividend out of Reserves**

Prior to the 1<sup>st</sup> February, 1975, dividends could be declared out of reserves or past profits as laid down in Section 205. The newly introduced Section 205(A) provides that if a company wants to use reserves or past profits for paying a dividend, it will have to comply with certain rules framed by the Government.

### **Payment of Dividend**

Section 205 lays down that if any dividend is not claimed for a period of years, the balance in the Special Bank Account (Opened for this purpose) must be transferred to the General Revenue Account of the Central Government. After such a transfer the claim for the unpaid dividend can be lodged with the Central Government. Unclaimed dividends thus cannot be forfeited by the Companies.

INTERIM DIVIDEND is declared between two annual general meetings by the Board of Directors. The FINAL DIVIDEND is declared at the annual general meeting of the shareholders and is declared only on the recommendation of the directors. The final dividend proposed by the Directors is provided in the final accounts of the company and is paid only after it has been passed at the annual general meeting.

**CAPITAL PROFITS** are not earned during the normal course of the business and arise in the following special circumstances :

- a) Profit on sale of fixed assets
- b) Profit on purchase of business
- c) Profit prior to incorporation
- d) Premium received on issue of Shares/Debentures
- e) Balance in Forfeited Shares Account
- f) Profit made in the redemption of debentures.

Ordinarily, capital profits are not available for distribution of dividend. Such profits are utilized for writing off capital losses and fictitious assets. They can be distributed as dividend only if :

- a) the Articles of the company permit;
- b) they are realized in cash;
- c) surplus remains after revaluation of all assets;
- d) capital losses have been written off.

It may be noted that premium on issue of shares and profit on forfeited shares cannot be distributed as dividend under the Companies Act.

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### **CHECK YOUR PROGRESS -1**

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i) Give three items that are to be debited to Profit and Loss Appropriation Account.

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.....  
.....

ii) Give three examples of Capital Profit.

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## **5.4 PROVISIONS RELATING TO BALANCE SHEET**

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Section 210 of the Companies Act requires that at every annual general meeting of the shareholders, the Board of Directors of the company shall lay before the company a Balance Sheet at the end of each trading period. According to Section 211(1), the Balance Sheet of a company shall be prepared in the given in Part I of the Schedule VI of the Companies Act, 1956 or as near there to as circumstances admit or in such other form as may be approved by the Central Government. The objective of prescribing the form for the Balance Sheet is to make sure that the Balance Sheet exhibits a true and fair view of the company's state of affairs. There should be no room for window dressing, showing a better position than what actually is, and secret reserves, showing a worse picture than what actually is.

If the information required to be given under any of the items in the prescribed form cannot be conveniently shown in the Balance Sheet itself, it should be shown in a separate

schedules(s) attached to the Balance Sheet. The form of the Balance Sheet as given in Part I of Schedule VI of the Companies Act is given below:

Schedule VI (Section 211)

Part I – Form of Balance Sheet

Balance Sheet of ----- as on -----

Figures for the previous year Rs.	Liabilities	Figures for the current year Rs	Figures for the previous year Rs.	Assets	Figures for the current year Rs
1	2	3	4	5	6
	<p><b>Share Capital:</b>            Authorised _____ Shares of _____ each            Issued _____ Shares of Rs. _____ each            Subscribed _____ Shares of Rs. _____ each _____ Shares of Rs. _____ per share called up.  <b>Less:</b> Calls unpaid                i) by directors                ii) by others  <b>Add:</b> Forfeited Shares of the above shares _____ shares are allotted as fully paid up pursuant to a contract without payments being received in cash of the above _____ shares are allotted as fully paid up by way of bonus shares.  <b>Reserves and Surplus</b>            Capital Reserve            Capital Redemption Reserve            Share Premium Account            Other Reserve  <b>Less:</b> Debit Balance in Profit and Loss Account, if any.</p>			<p><b>Fixed Assets:</b>            Goodwill            Land            Buildings            Leaseholds            Railway sidings            Plant and Machinery            Furniture &amp; Fittings            Development of Property            Patents, trade marks and designs            Livestock            Vehicles, etc.  <b>Investments</b>            Showing nature of investment and mode of valuation, e.g., cost or market value:            a) Investments in Government or Trust securities.            b) Investments in shares, debentures or bonds            Immovable Properties  <b>Current Assets, Loans and Advances</b>  <b>A) Current Assets</b>            Interest accrued on Investments</p>	

Surplus, i.e., balance in Profit and Loss Account after providing for proposed allocations, namely, Dividend, Bonus, etc.

Proposed additions to Reserves, Sinking Funds

**Secured Loans**

Debentures

Loans & Advances from Banks

Loans & Advances from Subsidiaries

Other Loans & Advances

**Unsecured Loans**

Fixed Deposits

Loans & Advances from subsidiaries

Short term loans and advances:

- a) from Banks
- b) from others

**Current Liabilities and Provisions**

**A) Current Liabilities**

Acceptances

Sundry Creditors

Advance payments and unexpired discounts

Unclaimed dividends

Other Liabilities (if any)

Interest accrued but not due on loans

**B) Provisions**

Provision of Taxation

Proposed Dividends

For contingencies

For Provident Fund Scheme

Stores & Spareparts  
Loose Tools  
Stock-in-Trade  
Work-in-Progress

**Sundry Debtors**

a) Debts

outstanding for a period exceeding six months

b) Other debts

Less: Provision

Cash balance in hand

Bank Balances:

a) With Scheduled Banks

b) With others

**B) Loans & Advances**

Advances and Loans to Subsidiaries

Advances and Loans to Partnership firms in which the company or any of its subsidiaries is a partner

Bills of Exchange

Advances recoverable in cash or in kind or for value to be received, e.g., Rates, Taxes, Insurance, etc.  
Balance with Customs, Port Trust, etc. (where payable on demand)

**Miscellaneous**

**Expenditure**

(To the extent not written off or adjusted)

Preliminary Expenses

<p>For Insurance; Pension and similar staff benefit schemes Other provisions</p> <p><b>Contingent Liabilities</b> (A foot note to the balance sheet is added to show separately and these are not included in the total)</p> <p>Claims against the company not acknowledged as debts Uncalled liability on shares partly paid Arrears of fixed cumulative dividends Estimated amount of contracts remaining to be executed on capital account and not provided for Other moneys for which the company is contingently liable.</p>		<p>Expenses including commission or brokerage on underwriting or subscription of shares or debentures Discount allowed on the issue of Shares or debentures Interest paid out of capital during construction (also stating the rate of interest)</p> <p>Development expenditure not adjusted Other items (specifying nature)</p> <p><b>Profit and Loss Account</b> (Show here the debit balance of Profit and Loss Account carried forward, after deduction of the uncommitted reserves, if any.)</p>
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**Vertical form of Balance Sheet**

Name of the company -----

Balance Sheet as at -----

Particulars	Schedule No.	Figures at the end of current year	Figures at the end of previous year
<b>I. Sources of Funds</b>			
1. Share holders funds			
a) Capital		---	---
b) Reserves and surplus		---	---
2. Loan funds			
a) Secured loans		---	---
b) Unsecured loans		---	---
 Total		 ----- =====	 ----- =====

<b>II. Application of Funds</b>			
1. Fixed assets			
a) Gross block		---	---
b) Less depreciation		---	---
c) Net block		-----	-----
d) Capital work in progress		---	---
2. Investments		---	---
3. Current assets, loans and advances			
a) Inventories		---	---
b) Sundry debts		---	---
c) Cash and bank balance		---	---
d) Other current assets		---	---
e) Loans and advances		---	---
Less current liabilities and provisions			
a) Liabilities		---	---
b) Provisions		---	---
Net Current Assets		-----	-----
4. a) Misc. Expenses		---	---
b) Profit/Loss a/c.		---	---
		-----	-----

The following additional information is also to be given in the Balance Sheet in respect of Assets and Liabilities:

#### Share Capital

If bonus shares are issued, the sources from which they are issued, i.e., whether out of profits or reserves or from share premium, etc., should be indicated.

If Redeemable Preferences Shares are issued, the terms of their redemption or conversion are to be mentioned.

#### Reserves and Surplus

In respect of reserve, additions and deductions made since the last Balance Sheet should be disclosed.

The Share Premium Account should disclose full details of the manner in which it is utilized as per legal requirements.

The debit balance in the Profit and Loss Account should be shown as deduction from free and uncommitted reserves only. No such deduction should be made from Capital Reserves.

The term, 'Fund' should be used only when a Reserve is represented by investments clearly earmarked against it.

#### Secured Loans

In the case of each secured loan, the nature of security given by the company should be indicated.

Secured loans from Directors, the Managing Director and/or the manager, should be shown separately.

Interest accrued and due on secured loans should be shown as an addition to the loan. Interest accrued but not due should be shown under current liabilities.

With regard to debentures, the terms of their redemption or conversion should be indicated.

If debentures are deposited as security for a loan, it should be separately.

### **Unsecured Loans**

Unsecured loans from Directors, Manager, and others, should be shown separately. Interest accrued and due on unsecured loans must be shown as an addition to the respective loans. Interest accrued but not due should be shown under current liabilities.

### **Fixed Assets**

In the case of each fixed assets, details regarding the original cost, additions and deductions made during the year, and the total depreciation provided up to the date of the Balance Sheet must be indicated.

On account of capital reduction scheme or revaluation of assets, if the value of any fixed assets is written down, the amount so written down should be indicated in the Balance Sheet for a period of five years from the date of reduction.

In the case of increase in value of any asset also the aforesaid procedure should be adopted.

If there is any capital expenditure, which could not be allocated to different fixed assets on the date of the Balance Sheet, it should be shown as Work-in-Progress.

### **Investments**

Generally, investments are shown at cost in the Balance Sheet. If their market value has gone down, it is preferable to create a reserve against them. The market value of quoted investments (which are quoted on any Stock Exchange) should be indicated in the Balance Sheet.

### **Current Assets**

Only sums due in respect of goods sold or services rendered should be included under Sundry Debtors, Loans and Advances should not be included under Sundry Debtors.

Debts which are outstanding for more than six months should be shown separately.

Provision for doubtful debts should be equal to the amount of debts considered doubtful and deducted from 'Sundry Debtors' amount.

### **Miscellaneous Expenditure**

The amount of expenditure to the extent not written off should be shown under this head.

Development expenditure in the case of new industrial concerns which could not be apportioned to different fixed assets should be shown under this Head till it is properly allocated to various fixed assets. Deferred Revenue Expenditure like advertising should also be shown under this Head.

### **Profit and Loss Account**

This is the balance forward from the Profit and Loss Appropriation Account.

In showing the Profit and Loss Account balance, the following points may be kept in mind.

- i) When the Profit and Loss Account shows a surplus after the usual appropriations, it should be shown under the Head, 'Reserves and Surplus', on the liabilities side;
- ii) If the Profit and Loss Account shows a debit balance and if there are revenues reserves in excess of such a balance, it should be deducted from the revenue reserves on the liabilities side of the Balance Sheet;
- iii) If the Profit and Loss Account shows a debit balance and if it is in excess of all revenue reserves, the balance after deducting such reserves, if any, should be shown on the assets side.

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### **CHECK YOUR PROGRESS -2**

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Give any two examples of preliminary expenses shown under the heading "Miscellaneous Expenditure".

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### **5.5 SUMMING UP**

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The final accounts (i.e., Profit & Loss Account and Balance Sheet) disclose the result and the financial position. Usually, a 12 month period is taken for the preparation of the final accounts.

Like other types of concerns, Companies also have to prepare the final accounts but according to the provisions of the Companies Act. Every Profits & Loans Account and Balance Sheet must disclose a true and fair view of the profit or loss and the financial state of the affairs of the Company. While the Balance Sheet is to be prepared in the form prescribed (or as near thereto as circumstances permit) in Part I of Schedule VI. There is no specific form for the preparation of Profit & Loss Account. The P&L Account must comply with the requirements of Part II of the Schedule VI.

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### **5.6 CHECK YOUR PROGRESS : MODEL ANSWERS**

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1. i) a) Income Tax Provision  
b) Transfer to Reserves  
c) Proposed Dividend
- ii) a) Profit on Sale of fixed assets  
b) Profit on purchase of business  
c) Profit prior to incorporation.

2. a) Discount allowed on issue of shares or debentures.
- b) Commission or brokerage on underwriting or subscription of shares or debentures.

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## 5.7 MODEL EXAMINATION QUESTIONS

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### I. Answer the following questions in about 30 lines each.

1. Explain the legal provisions relating to Final Accounts.
2. Discuss briefly the legal provisions pertaining to Profit and Loss Account.
3. Explain in brief the provisions relating to Balance Sheet.
4. Give the proforma of a company Balance Sheet.
5. Explain briefly the broad items of the Balance Sheet of a company.

### II. Answer the following questions in about 15 lines each.

1. Write a short note on Profit and Loss Appropriation Account.
2. Give any three examples of preliminary expenses.
3. Distinguish between interim dividend and final dividend.
4. How are the contingent liabilities are shown in the company Balance Sheet?
5. Under what circumstances the capital profits Are available for distribution of dividend?
6. Explain the items to be shown under the heading "Current Assets" in a company balance Sheet?
7. Give any five examples of capital profits.

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## 5.8 RECOMMENDED BOOKS

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1. R.L.Gupta and M.Radha Swamy : **Advanced Accountancy, Volume-II**  
Sultan Chand & Sons, 23, Daryaganj, New Delhi.
2. S.N.Maheshwari : **Advanced Accountancy, Volume-II**  
Vani Educational Books, New Delhi.
3. S.P.Jain and K.L.Narang : **Advanced Accountancy,**  
Kalyani Publishers, Ludhiana.
4. M.C.Shukla and T.S.Grewal : **Advanced Accountancy,**  
S. Chand & Sons, New Delhi.

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## 5.9 GLOSSARY

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- Capital Loss** : Unusual and exceptional loss which is not incurred in the usual course of business.
- Capital Profits** : Extraordinary and unusual profits which are not made in the usual course of running a business.
- Capital Reserve** : Reserve built up out of capital profits.

- Dividend** : The amount paid to share-holders out of the profits of an accounting year as a return on the investment made by them.
- Final Dividend** : The dividend declared by the Board of Directors after the final accounts are prepared for an accounting year, in addition to an interim dividend.
- General Reserve** : Reserve built up out of revenue Profits for meeting any unforeseen contingency in the future.
- Interim Dividend** : A dividend paid by the directors at any time during the accounting year, i.e., between two usual regular dividends. The interim dividend is usually paid for six months.
- Preliminary Expenses** : These are the expenses incurred in connection with the formation of the company.
- Profit and Loss Appropriation Account** : The account prepared by a company in addition to Trading, and Profit and Loss Account, showing appropriations out of Profits.

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## **UNIT - 6 : COMPANY FINAL ACCOUNTS - II**

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### **Contents**

- 6.0 Aims and Objectives
- 6.1 Introduction
- 6.2 Preparation of Profit and Loss Account
- 6.3 Certain Items appearing in Profit and Loss Account
- 6.4 Preparation of Balance Sheet
- 6.5 Certain Items of Balance Sheet
- 6.6 Summing Up
- 6.7 Check Your Progress : Model Answers
- 6.8 Model Examination Questions
- 6.9 Recommended Books

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### **6.0 AIMS AND OBJECTIVES**

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This Unit aims at explaining the typical items of expenses incomes, assets and liabilities that normally appear in the final accounts of companies. Further, its purpose is to give a drill in the preparation of company final accounts.

After studying this unit, you should be able to :

- know how to prepare Profit and Loss Account and Balance Sheet of Company;
- get familiarity with the nature of expenses, gains, assets and liabilities that are typical to the company final accounts; and
- solve the problems on final accounts of companies.

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### **6.1 INTRODUCTION**

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In the preceding Unit we have explained the legal provisions for preparing Final Accounts of Companies. Companies have legal obligation to prepare Profit & Loss Account and Balance Sheet within a stipulated time. Hence, it is essential to learn the process of construction of company P&L Account, P&L Appropriation Account, and Balance Sheet. As in other organizations, the basis for the preparation of Final Statements of company is the Trial Balance drawn with the help of balances extracted from the ledger. In the following paragraphs the items that come in the Final Accounts are explained.

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### **6.2 PREPARATION OF PROFIT AND LOSS ACCOUNT**

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The General principles governing the preparation of P&L Account are the same, whether it is a firm or a company. However, in case of companies it is not necessary to show Trading Account as a separate section. In other words, the Profit and Loss Account of a company consists of three parts in an integrated manner. It consists of Trading Account to show gross profit, Profit and Loss Account to determine net profit, and Profit and Loss Appropriation account to give an idea about the manner in which profits are disposed. The Trading and Profit & Loss Accounts' items are known as items "above the line" and the Appropriation

Account' items are known as items "below the line". Thus all the three sections put together are called the Profit and Loss Account. In this connection let us now discuss certain typical items that appear in P&L Account of a company.

### **6.3 CERTAIN ITEMS APPEARING IN P&L ACCOUNT**

In fact, many of the items of expenses and incomes that appear in P&L Account have been discussed in the preceding unit in detail. The following items are typical to the company P&L Account. As such a brief explanation is offered for comprehensive understanding of company Profit and Loss Account.

#### **1. Discount and Expenses on issues of Shares/Debentures**

This item appears in the debit column of the Trial Balance. If there are instructions at the end of the Trial Balance, the portion to be written off is debited to P&L Account, and such amount is deducted from the item in the Balance Sheet on the assets side. If there are no instructions as to this expenditure, nothing should be written off.

#### **2. Preliminary Expenses**

This item also appears in the Trial Balance in the debit column. The treatment suggested for item 1 above should be followed.

#### **3. Interest paid on borrowing for construction/acquisition of assets**

This appears in the debit column of the Trial Balance and is required to be capitalized by adding to the cost of the asset. However till it is apportioned, the interest on money borrowed for different assets is to be shown under the Head, "Miscellaneous Expenditure", on the assets side of the Balance Sheet.

#### **4. Dividends/Interest received**

This represents the income of the company on the investments made in the shares of other companies or bonds and appears in the credit column of the Trial Balance. This is to be shown on the credit side of P&L Account being income. However, if the tax deducted at source is also indicated, the amount of tax is added to the net income (which is known as grossing up) and the resulting total amount is shown on the credit of the P&L Account. The tax deducted is shown on the assets side of the Balance Sheet under the Head, "Loans and Advances".

#### **5. Interest on Debentures**

This is an expenditure item and shown in the debit side of P&L Account. Sometimes, the entire debenture interest relating to the period may not be paid and such information may be given in the adjustments. To the extent interest is outstanding the amount is shown as a liability on the 'liabilities' side of the Balance Sheet. The P&L Account should be debited with the total interest relating to the period (i.e., paid and outstanding).

#### **6. Provisions for Taxation**

If this item is given in the 'Trial Balance', it represents saving in the provision made for the previous year. This should be credited back to the P&L (Appropriation) Account.

If this item is given in the adjustments, it is debited to the P&L Account and shown under the Head, 'Provision', on the liabilities side of the Balance Sheet.

### 7. Provision for Tax and 'Income Tax Paid'

Sometimes, both may be given in the Trail Balance, in which case the tax paid is to be compared with provision. If the provision is more than the tax paid, the surplus is to be credited to the P&L Appropriation Account. On the other hand, if the tax paid is more than the provision the excess amount should be debited to the P&L Appropriation Account. It should not be debited to the P&L Account as the tax assessed is related to the profits of previous year.

### 8. Income tax paid

If such an item is given in the Trail Balance, (without any provision for taxation) it is to be construed that the amount is the advance tax paid for the current year. Since it is a prepaid expense, it appears under the item 'Loans and Advances'. On the assets side of the Balance Sheet.

### 9. Managerial Remuneration

The following relevant points are to be noted :

#### I. When companies have adequate profits

- |   |                   |
|---|-------------------|
| i) Overall limit (excluding fees for attending meetings ) | 11% of net profit |
| ii) If there is one managerial person                     | 5% of net profit  |
| iii) If there are more managerial persons                 | 10% of net profit |
| iv) Remuneration of part time director:                   |                   |
| a) If there is no whole-time director                     | 3% of net profit  |
| b) If there is whole-time director                        | 1% of net profit  |

#### II. When companies have no adequate profits

In this case the managerial remuneration is based on the effective capital of the company. Effective capital is the total of paid up capital, share premium, reserves (excluding revaluation reserves), long term loans and deposits payable after one year as reduced by non trading investments, accumulated losses and preliminary expenses. The monthly remuneration is calculated as follows:

Where Effective Capitals is	Remuneration
i) Less than Rs. 1 crore -----	Rs. 40,000
ii) Rs. 1 crore to Rs. 5 crores-----	Rs. 57,000
iii) Rs. 5 crores to Rs. 15 crores-----	Rs. 72,000
iv) More than Rs. 15 crores -----	Rs. 87,500

The profit on which remuneration is to be calculated without deducting: a) income tax payable, b) compensation payment and c) loss of capital nature and should not include capital profit. The depreciation is to be charged as per provisions of Companies Act.

## 10. Depreciation

Under the Companies Act depreciation is to be provided on the assets as under :

- i) According to rates in Income Tax Act which are applicable to written down value of the assets;
- ii) According to the Straight Line Method; and
- iii) As may be approved by the Central Government, if no rate is approved for the asset under the Income Tax Act.

However, it is not compulsory for a company to make provision for depreciation on fixed assets, but it cannot declare any dividend unless depreciations been charged.

## 11. Profit prior to incorporation

Sometimes it may happen that a running business is purchased from a particular date and the company may come into existence at a later date. The profit made before the legal existence of the company is known as 'profit prior to incorporation', and is regarded as of the capital nature.

## 12. Loss prior to incorporation

If loss is incurred during the period preceding incorporation, it should be merged with Goodwill (debited to the Goodwill Account). It can also be written off against Capital Profits, if any (share premiums, profit on forfeited shares, etc.).

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### CHECK YOUR PROGRESS -1

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i) What is the source of information for the preparation of P&L Account?

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.....

ii) Explain the accounting treatment of preliminary expenses.

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.....  
.....

iii) What is meant by profit before incorporation?

.....  
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.....  
.....

After knowing the nature of typical items that appear in the P&L Account, it is to be remembered that P&L Appropriation Account is prepared. The purpose of the Appropriation Account has been explained earlier. The balance of profit in the P&L Appropriation Account is shown as liability in the Balance Sheet under the head "Reserves and Surplus". Hence let us know the process of preparation of a company's Balance Sheet.

## **6.4 PREPARATION OF BALANCE SHEET**

As stated earlier, the Balance Sheet of a company is to be prepared in the form given in part-I schedule VI of the Companies Act, 1956. The format has been given in Unit:5. The general principles governing the preparation of Balance Sheet are the same but presented in a prescribed proforma. The sources of information for the preparation of Balance Sheet are Trial Balance, and adjustments that are normally given along with the Trial Balance. We shall now discuss certain items that are typical to the company's Balance Sheet.

## **6.5 CERTAIN ITEMS OF BALANCE SHEET**

In the preceding unit, we have learnt about the details of the items like share capitals, reserves and surpluses, secured loans, unsecured loans, fixed assets, investments, current assets, etc. All these items are shown in a classified manner in the Balance Sheet. We shall now discuss about a few typical items that would appear in a Company's Balance Sheet.

### **1. Share Premium**

This item appears in the Trial Balance with a credit balance. This is to be shown on the liabilities side of the Balance Sheet under the second Major Head, 'RESERVES AND SURPLUS'.

### **2. Forfeited Shares**

This item also appears in the trial balance with a credit balance. It is to be added to the paid up capital on the liabilities side of the balance sheet under the Head, 'SHARE CAPITAL'.

### **3. Calls in Arrears**

This item appears with a debit balance in the Trial Balance, representing the amount not paid by the share holders on the calls made. Hence, this amount is deducted from the called up share capital on the liabilities of the Balance Sheet.

### **4. Calls in Advance**

This is the amount paid by the Shareholders in advance of calls being made. Since it is an amount received in advance, the account shows a credit balance and is shown separately from the called up capital on the liabilities side of the Balance Sheet.

### **5. Debentures**

Companies raise funds through the issue of debentures. Unless otherwise stated, they are to be treated as secured and shown under the third Major Head on the liabilities side of the Balance Sheet.

### **6. Fixed Deposits**

Companies can accept fixed deposits from the public. This item shows a credit balance. Since it is a liability, it is shown under 'UNSECURED LOANS' on the liabilities side.

## 7. Unclaimed Dividends

Dividends are declared on the paid up Share Capital out of profits of the company. The amount of unencashed dividend warrants is shown as unclaimed dividends. This item shows a credit balance and is shown under current liabilities.

## 8. Proposed Dividends

Directors propose dividends for the approval of the General Body. They become payable only when approved by the General Body. The amount required for the proposed dividends is appropriated and shown as 'Provision for Proposed Dividends' under 'Provisions' on the liabilities side of the Balance Sheet.

## 9. Debenture Redemption Fund

This item represents the amount of profit appropriated for redeeming the liability on Debentures after the expiry of the term. It shows a credit balance and is to be shown under the head 'RESERVES AND SURPLUS' on the Liabilities side of the Balance Sheet.

## 10. Debenture Redemption Fund Investments

This item represents the amount invested in outside securities (corresponding to the amount available in the Debenture Redemption Fund) and shows a debit balance. The amount is to be shown under the head 'INVESTMENTS' on the Assets side of the Balance Sheet.

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### CHECK YOUR PROGRESS -2

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State the meaning of the following items:

i) Debenture interest, ii) Debenture Redemption Fund

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.....

.....

The following illustrations will explain the process of preparation of Profit & Loss Account and Balance Sheet in respect of companies.

### Illustration -1

Mahavir Manufacturing Co. Ltd., was registered with a nominal capital of Rs. 25,00,000 divided into shares of Rs. 10 each. On 31<sup>st</sup> of March 2000, the following were the ledger balances of the company.

	Rs.		Rs.
Plant & Machinery	9,00,000	Freight	42,750
Stock (1.4.1999)	2,87,500	Goodwill	1,90,250
Fixtures	18,000	Wages	2,02,000
Sundry Debtors	3,47,500	Cash in Hand	15,875
Buildings	6,00,000	Cash at Bank	85,750

Purchases	3,62,500	Directors fees	10,350
Interim Dividend paid	28,750	Bad Debts	9,275
General Expenses	30,250	Salaries	48,250
Debenture Interest	22,250	6% Debentures	7,50,000
Bills payable	45,000	Sales	10,87,500
General Reserve	66,250	4% Govt. Bonds	1,50,000
P&L Account (Cr.)	86,250	Provision for Doubtful Debt	10,000
Share Capital Fully Called Up	12,50,000	Sundry Creditors	1,05,000
Calls in Arrears	38,750	Preliminary Expenses	10,000

The stock on the 31 of March, 2000 was estimated at Rs. 2,02,500. The following adjustments have to be made:

- Depreciation on Plant & Machinery at 10%, on Fixtures @ 5%.
- Rs. 25,000 of wages were utilized in adding rooms to the premises.
- Final dividend @ 5 % is to be provided.
- Preliminary expenses are to be written off by 25%.
- A provision of Rs. 8,215/- on Sundry Debtors is to be provided.
- Rs. 20,000 is to be transferred to reserve.
- A provision for income tax to the extent of Rs. 65,500 is to be made.

You are required to prepare the Profit & Loss Account, P & L Appropriation Account and Balance Sheet as on the 31<sup>st</sup> March 2000.

### Solution

#### Mahavir Manufacturing Co. Ltd.

#### Profit & Loss Account

Dr.		for the year ending on the 31 <sup>st</sup> of March, 2000		Cr.	
		Rs.			Rs.
To Stock (1-4-1999)		1,87,500	By Sales		10,87,500
To Purchases		3,62,500	By Closing Stock		2,02,500
To Wages	2,02,000				
Less: Charged to Building a/c	25,000	1,77,000			
To Freight		42,750			
To Gross Profit c/d.		4,20,250			
		<u>12,90,000</u>			<u>12,90,000</u>
To General Expenses		30,250	By Gross Profit b/d.		4,20,250
To Salaries		48,250	By Interest		6,000
To Debenture interest	22,250				
Add: Outstanding	27,750	45,000			
To Directors fees		10,350			

To Preliminary Expenses		2,500	
To Depreciation:			
P & M @ 10%	90,000		
Fixtures @ 5%	<u>900</u>	90,900	
To Bad Debts	9,275		
Add: Prov. for dividend	<u>8,125</u>		
	17,400		
Less: Existing Provision	<u>10,000</u>	7,400	
To Provision for Tax		65,500	
To Net Profit c/d.		1,26,100	
		<u>4,26,250</u>	<u>4,26,250</u>

Dr.		Profit & Loss Appropriation Account		Cr.	
	Rs.				Rs.
To General Reserve	20,000	By Balance b/d.			86,250
To Interim Dividend	28,750	By Net Profit for Current year			1,26,100
To Final Dividend	60,562				
To Balance c/d	1,03,038				
	<u>2,12,350</u>				<u>2,12,350</u>

**Mahavir Manufacturing Company Limited**  
**Balance Sheet**

As on the 1<sup>st</sup> of March, 2000

Liabilities	Rs.	Assets	Rs.
<b>1. Share Capital</b>		<b>1. Fixed Assets</b>	
Authorised:		Goodwill	1,90,250
2,50,000 shares of Rs.10 each	<u>25,00,000</u>	Buildings	6,00,000
		Add: Addition	<u>25,000</u>
			6,25,000
<b>Issued, Subscribed Called Up &amp; Paid Up</b>		P & M	9,00,000
1,25,000 shares of Rs. 10 each fully called up 12,50,000		Less: Depn.	<u>90,000</u>
Less: Calls in arrears <u>38,750</u>	12,11,250		8,10,000
		Fixtures	18,000
		Less: Depn.	<u>900</u>
			17,100
<b>2. Reserve and Surplus</b>		<b>2. Investments</b>	
General Reserve	66,250	4% Govt. bonds	1,50,000
Add: Addition	<u>20,000</u>		
	86,250	<b>3. Current Assets, Loans and Advances</b>	
P & L Account	1,03,038		

<b>3. Secured Loans</b>		<b>A. Current Assets</b>	
6% Debentures	7,50,000	Interest on bonds	6,000
<b>4. Unsecured Loans</b>	--	Stock in Trade	2,02,500
<b>5. Current Liabilities &amp; Provisions</b>		Sundry Debtors	3,47,500
<b>A. Current Liabilities</b>		Less: Prov. for D.D.	8,125
Bills Payable	45,000		3,39,375
Sundry Creditors	1,05,000	Cash in Hand	15,875
Debenture Interest	22,750	Cash at Bank	85,750
<b>B. Provisions</b>		<b>B. Loans &amp; Advances</b>	--
Provision for I.T.	65,500	<b>4. Miscellaneous expenditure</b>	
Final Dividend proposed	60,562	Preliminary Expenses	10,000
		Less: Written off	2,500
<b>6. Contingent Liabilities</b>			7,500
	<u>24,49,350</u>		<u>24,49,350</u>

### Illustration - 2

The following Trial Balance has been drawn up from the books of Super Sales Agencies Ltd., as on the 31<sup>st</sup> of March, 2000.

	Dr. Rs.	Cr. Rs.
Authorised & Issued Capital (Equity Shares of Rs.10/- each)	--	5,00,000
Properties at cost:		
Lease hold	1,40,000	--
Other Property	6,60,000	--
Motor Car	21,500	--
Provision for Depreciation (1-4-99):		
Leasehold Property	--	24,500
Other Properties	--	50,000
Motor Car	--	6,500
Administration & Selling Expenses	1,80,000	--
Opening Stock	2,20,000	--
Purchases less returns	12,87,500	--
Sales less returns	--	21,45,000
Mg. Directors remuneration	50,000	--
Rent Received	--	36,025
Investment at cost	2,28,575	--
Investment income (after deduction 22.575% IT)	--	3,375
7% Debentures	--	1,50,000
Debenture Interest	10,500	--
Bank Interest	5,845	--
Bank Over Draft	--	7,500

Debtors & Creditors	3,00,000	1,50,000
Interim Dividend	50,000	--
P & L A/c. 1-4-99	--	57,520
Miscellaneous Receipts	--	3,500
General Reserve 1-4-99	--	96,500
Share Suspense	--	3,000
Unclaimed Dividend	--	2,300
Cash in Hand	25,000	--
Cash at Bank	56,800	--
	<u>32,35,720</u>	<u>32,35,720</u>

The following additional information is available:

1. Closing Stock was Rs. 87,000.
2. Directors have recommended the following appropriations:
  - a) Final Dividend @ Rs.4 per share including the interim dividend declared on 23-12-99.
  - b) Transfer to General Reserve Rs. 10,000.
3. Depreciation to be provided as follows:
  - Motor Car 20% p.a. on W.D.V.
  - Properties other than leasehold 3% on W.D.V.
  - Leasehold property-purchased on 1-4-92 at Rs. 1,40,000 for 40 years.
4. Managing Directors are entitled to a remuneration of 10% of the net profit subject to a minimum of Rs. 50,000;
5. Provision for Taxation to be made at 5.5%.

You are required to prepare P & L Account for the year ending on the 31<sup>st</sup> of March, 2000 and Balance Sheet as on that date after making such assumptions as may be necessary.

### Solution

#### Profit and Loss Account of Super Sales Agencies Ltd.

Dr.	For the year ending on the 31 <sup>st</sup> of March, 2000		Cr.
	Rs.		Rs.
To Opening Stock	2,20,000	By Sales	21,45,000
To Purchases	12,87,500	By Closing Stock	87,000
To Gross Profit c/d.	7,24,500		
	<u>22,32,000</u>		<u>22,32,000</u>
To Ad. & Selling Exp.	1,80,000	By Gross Profit b/d.	7,24,500
To Debenture interest	10,500	By Rent received	36,025

To Bank interest	5,845	By Income from investments	4,359
To Depreciation		<u>3,375</u>	
Motor Car (20%) 3,000		<u>77,425</u>	
Leasehold $\left[ \frac{1,40,000}{40} \right]$ 3,500		By Miscellaneous Receipts	3,500
* Other prop. (3%) <u>18,300</u>	24,800		
Managing Director Remuneration **	54,724		
Provision for Taxation***	2,70,883		
To Net Profit c/d.	2,21,632		
	<u>7,68,384</u>		<u>7,68,384</u>
To Interim Dividend	50,000	By Balance b/f.	57,520
To Proposed Dividend	1,50,000	By Net Profit b/d.	2,21,632
To Transfer to General Reserve	10,000		
To Balance c/f.	69,152		
	<u>2,79,152</u>		<u>2,79,152</u>

#### Working Notes

\* Depreciation on other properties:

Cost of other properties	6,60,000
Depreciation up to 1-4-99	<u>50,000</u>
Bank Value 1-4-99	7,10,000
Depreciation at 3% on 6,10,000 =	Rs. 18,300

\*\* Managing Director's remuneration:

Net Profit per P & L A/c.	2,21,632
Add. Provision for taxation	2,70,883
M.D. Remuneration	54,724
(M.D. Remuneration @ 10% of Rs. 5,47,239 = 54,724)	
	<u>5,47,239</u>

\*\*\* Provision for Taxation:

Net profit as per P & L A/c.	2,21,632
Add. Provision for taxation	<u>2,70,883</u>
Profit prior to calculation of tax provision	<u>4,92,515</u>
(Provision for taxation at 55% of 4,92,515 = 2,70,883)	

**Super Sales Agencies Limited**

**Balance Sheet**

As on the 31<sup>st</sup> of March, 2000

	Rs.		Rs.
<b>1. Share Capital</b>		<b>1. Fixed Assets</b>	
Authorised Issued, Subscribed, Called Up & Paid up:		Property at cost, 6,60,000	
		Less: Depn. (to date) 68,300	5,91,700
50,000 Equity Shares of @ Rs. 10 each	5,00,000	Leasehold Property 1,40,000	
Shares Suspense A/c.	3,000	Less: Depn. (to date) 28,000	1,12,000
<b>2. Reserves and Surplus</b>		Motor car 21,500	
General Reserve 96,500		Less: Depn. (to date) 9,500	12,000
Add: Additions 10,000	1,06,500		
P & L Account	69,152		
<b>3. Secured Loans</b>		<b>2. Investments</b>	
7% Debentures	1,50,000	Investments at cost	2,28,575
<b>4. Unsecured Loans</b>		<b>3. Current Assets, Loans and Advances</b>	
Bank OD	7,500	<b>A. Current Assets</b>	
<b>5. Current Liabilities and Provisions</b>		Stock in Trade	87,000
<b>A. Current Liabilities</b>		Sundry Debtors	3,00,000
Sundry Creditors	1,50,000	Cash at Bank	56,800
Managing Director's Remuneration 54,724		Cash in hand	25,000
Less: Paid 50,000	4,724	<b>B. Loans &amp; Advances</b>	
Unclaimed Dividends	2,300	Income tax deducted at source (Gross Income) 4,359	
<b>B. Provisions</b>		Less: Net Income 3,375	984
Provision for taxation	2,70,883		
Proposed Dividends	1,50,000		
	<u>14,14,059</u>		<u>14,14,059</u>

**Illustration - 3**

From the following Trial Balance of Superior Flour Mills Co., Ltd., prepare the Profit & Loss Account for the year 1999 and Balance Sheet as on that date.

	Dr. Rs.	Dr. Rs.
Subscribed Capital	--	26,00,000
Calls in Arrears	1,000	--

Building-cost	8,00,000	--
Machinery-cost	50,00,000	--
Depn. on Buildings (1-1-99)	--	2,50,000
Depn. on Machinery (1-1-99)	--	7,00,000
General Reserve	--	2,00,000
Reserve for equalization of dividend	--	2,50,000
Loan from Andhra Bank (Secured by stock wheat flour etc.)	--	5,00,000
Creditors for wheat	--	95,000
Unclaimed dividends	--	1,200
Wheat (purchases) Account	54,15,000	--
Coal (purchases) Account	3,00,000	--
Flour Account (Sales)	--	67,60,000
Fixed Deposits	--	11,20,000
Cash at Bank	86,595	--
Advance to Employees	25,000	--
Stores (purchases)	3,55,000	--
Wages	3,90,000	--
Interest earned	--	4,020
Share transfer fees	--	750
Sundry Debtors	66,000	--
P&L Account	--	90,225
Salaries	67,000	--
Rent & Rates	34,500	--
Income Tax Paid	16,000	--
General Charges	44,000	--
Audit Fees	3,000	--
Salaries & Wages outstanding	--	31,900
	<u>1,26,03,095</u>	<u>1,26,03,095</u>

You are required to make the following adjustments as stipulated by the Directors:

1. Depreciation on Buildings: Rs. 40,000; On Machinery : Rs. 2,00,000
2. Set aside Rs. 1,50,000 towards General Reserve and Rs. 1,00,000 towards Reserve for Equalisations of the Dividend.
3. The Directors resolved to give a gross dividend of 20% on the paid up value of the shares.
4. Provide Rs. 1,49,075 for M.D's remuneration.
5. Provide interest on Bank Loan for 6 moths @ 7% p.a.

6. On 31-12-99 the following stocks were held:  
Wheat at Cost – Rs. 10,00,000; Coal at Cost – Rs. 15,000;  
Flour – Rs. 2,40,000; Stores at Cost – Rs. 95,000.
7. Provide for taxation: Rs. 2,00,000
8. Interest earned but not received : Rs. 1,990.

**Solution**

**Superior Flour Mill Co., Ltd.**  
**Profit and Loss Account for the year ending on the 31<sup>st</sup> of Dec. 1999**

	Rs.		Rs.
To Wheat	54,15,000	By Flour Sales	67,60,000
To Coal	3,00,000	By Closing Stock:	
To Stores Purchase 3,55,000		Wheat 10,00,000	
Less: Closing stock 95,000	2,60,000	Coal 15,000	
To Wages	3,90,000	Flour 2,40,000	12,55,000
To Gross Profit c/d.	16,50,000		
	80,15,000		80,15,000
To Salaries	67,000	By Gross Profit b/d	16,50,000
To Rent & Rates	34,500	By Interest 4,020	
To General Charges	44,000	Add: Accrued 1,980	6,000
To Audit Fees	3,000	By Share Transfer fees	750
To Interest on Bank			
Loan @ 7% for 6			
months on 5,00,000	17,500		
To M.D. Remuneration	1,49,075		
To Depreciation:			
Buildings 40,000			
Machinery 2,00,000	2,40,000		
To Provision for taxes 2,00,000			
Add: Tax paid 16,000	2,16,000		
To Net Profit c/d.	8,85,675		
	16,56,750		16,56,750
To General Reserve	1,50,000	By Balance b/f.	90,225
To Res. for Equalisation		By Net Profit b/d.	8,85,675
of Dividends	1,00,000		
To Proposed Div. 20% of			
Rs. 25,99,000	5,19,800		
To Balance c/f.	2,06,100		
	9,75,900		9,75,900

**Superior Floor Mill Co., Ltd.**

**Balance Sheet**

As on December 31, 1999

Liabilities	Rs.	Assets	Rs.
<b>1. Share Capital</b>		<b>1. Fixed Assets</b>	
Authorised Issued, Subscribed		Buildings at cost 8,00,000	
Called Up 26,00,000		Less: Depn. (to date) <u>2,90,000</u>	5,10,000
Less: Calls in arrears <u>1,000</u>	25,99,000	Machinery at cost 50,00,000	
		Less: Depn. (to date) <u>9,00,000</u>	41,00,000
<b>2. Reserve and Surplus</b>		<b>2. Investments</b>	---
General Reserve 2,00,000			
Add: Appropriations <u>1,50,000</u>	3,50,000	<b>3. Current Assets, Loans and Advances</b>	
Reserve for equalization		<b>A. Current Assets</b>	
of dividend 2,50,000		Stock in trade:	
Add: Transfer from		Wheat at cost 10,00,000	
P.L.Appr. A/c <u>1,00,000</u>	3,50,000	Coal at cost 15,000	
P & L A/c.	2,06,100	Flour 2,40,000	
		Stores at cost <u>95,000</u>	13,50,000
<b>3. Secured Loans</b>		Sundry debtors 66,000	
Loan from Andhra Bank	5,00,000	Interest earned 1,980	
(secured by wheat stocks, etc.)		Cash at Bank 86,595	
<b>4. Unsecured Loans</b>		<b>B. Loans &amp; Advances</b>	
Fixed Deposits 11,20,000	11,20,000	Advances to employees 25,000	
<b>5. Current Liabilities &amp; Provisions</b>			
<b>A. Current Liabilities</b>			
Sundry Creditors 95,000	95,000		
M.D's Remuneration 1,49,075	1,49,075		
Salaries & Wages outstanding 31,900	31,900		
Unclaimed Dividends 1,200	1,200		
Interest outstanding on Bank Loan 17,500	17,500		
<b>B. Provisions</b>			
Proposed Dividends 5,19,800	5,19,800		
Provision for taxation 2,00,000	2,00,000		
	<u>61,39,575</u>		<u>61,39,575</u>

The preparation of the Profit and Loss Appropriation Account is explained in detailed through the following illustration:

**Illustration - 4**

Prakash Tubes Ltd., had an amount of Rs. 10,25,000 in the P & L Account as on 1-1-1999. During the year ending on the 31<sup>st</sup> of Dec. 1999, the company earned a profit of Rs.20,90,000. The Board of Directors proposed the following:

- a. Transfer of Rs. 6,25,000 to General Reserve;
- b. Transfer of Rs. 5,00,000 to Dividend Equalisation Reserve;
- c. Payment of dividend at 11% on Rs. 25,00,000 cumulative preference shares and at 10% on Rs. 30,00,000 equity shares;
- d. Transfer Rs. 5,00,000 to Debenture Redemption Fund.

Prepare the Profit and Loss Appropriation Account.

### Solution

#### Profit and Loss Appropriation Account for the year ending on the 31<sup>st</sup> of December, 1999

	Rs.		Rs.
To General Reserve	6,25,000	By Balance b/f.	10,25,000
To Dividend Equalisation Reserve A/c.	5,00,000	By P&L A/c. (Net profit for 1999)	20,90,000
To Proposed Pref. Share Dividend A/c.	2,75,000		
To Proposed Equity Dividend A/c.	3,00,000		
To Debentures Redemption Fund A/c.	5,00,000		
To Surplus	9,15,000		
	31,15,000		31,15,000

### INCOME TAX

Every company has to pay income tax on its profits. Profits can be known only after the end of the accounting period and the actual assessment of the tax completed thereafter. However, as per the Income Tax Act, 1961, Companies have to pay the tax while they are earning profits (during the accounting period itself) and the amount so paid is known as 'ADVANCE TAX'.

While preparing the P&L Account for the accounting period, the liability towards tax (for that accounting period) is estimated and the necessary provision is made.

At the time of the actual assessment of tax, the balances in Provision for Income Tax Account, Advance Tax Account are transferred to the Income Tax Account. If the actual tax as assessed is more than the provision, the difference is debited to the P&L Appropriation Account (it is not debited to the P&L Account as the amount relates to the profits of the previous accounting period).

On the other hand, if the provision made is more than the actual assessment of tax. The difference is credited to the P&L Appropriation Account.

The Point is made clear through the following illustration:

**Illustration – 5**

Mahavir Alluminum Ltd. made a provision of Rs. 25,00,000 towards income tax for the year ending on the 31<sup>st</sup> of March 1999. However, advance tax paid and tax deducted at source on Company's income amounted to 23,00,000 and Rs. 20,000 respectively, for the said accounting year. On August 1, 1999 I.T.O. determined the tax liability for the year ending on the 31<sup>st</sup> of March 1999 at Rs. 28,40,000. For the year 1999-2000 an amount of Rs. 30,00,000 has been paid as advance tax. Show the ledger accounts necessary assuming that the provision required for 1999-2000 is Rs. 35,00,000.

**Solution**

**Advance Income Tax A/c.**

		Rs.			Rs.
1999 Apr. 1	To Balance b/f	23,00,000	1999 Agu.1	By Income Tax A/c.	23,00,000
?	To Bank A/c.	30,00,000	2000 Mar. 31	By Balance c/d.	30,00,000
		<u>53,00,000</u>			<u>53,00,000</u>
2000 Apr. 1	To Balance b/d.	30,00,000			

**Provision for Income Tax A/c.**

		Rs.			Rs.
1999 Aug. 1	To Income Tax A/c.	25,00,000	1999 Apr. 1	By Balance b/f.	25,00,000
2000 Mar.31	To Balance c/d	35,00,000	2000 Mar. 31	By P&L Appr. A/c.	35,00,000
		<u>60,00,000</u>			<u>60,00,000</u>
			2000 Apr. 1	By Balance b/d.	35,00,000

**Income Tax Deducted at Source A/c.**

		Rs.			Rs.
1999 Apr. 1	To Balance c/d.	20,000	1999 Agu.1	By Income Tax A/c.	20,000

**Income Tax Account**

		Rs.			Rs.
1999 Aug. 1	To Advance I.T. A/c.	23,00,000	1999 Aug. 1	By Provision for I.T. A/c.	25,00,000
"	To Income Tax deducted at source Account	20,000	2000 Mar. 31	By P&L Appr. A/c.	3,40,000
"	To Bank	5,20,000			
		<u>28,40,000</u>			<u>28,40,000</u>

### CHECK YOUR PROGRESS - 3

Explain the accounting treatment of Income Tax in respect of companies.

#### Illustration - 6

Rampur Engineering Co. Ltd., has an Authorised Capital of Rs. 40,00,000 consisting of 40,000 equity shares of Rs. 100 each of which 20,000 equity shares were issued to be the public. However, only 10,000 equity shares were subscribed and the amount has been fully called up. The following balances were extracted from the company ledgers.

	Rs.	Rs.
Share Capital	---	10,00,000
6% Debentures of Rs. 100 each	---	5,00,000
Sales and Purchases	12,00,000	15,39,000
Returns	35,000	25,000
P&L Account Jan. 1, 1999	---	44,000
Sundry Creditors	---	1,53,000
Reserve	---	75,000
Bank Overdraft	---	55,900
Interim Dividend Paid	17,500	---
Repairs to Machinery	2,800	---
Repairs to Buildings	1,500	---
Salaries	7,500	---
Income Tax	14,000	---
Insurance	9,500	---
Rent	15,000	---
Wages	1,16,000	---
Carriages	18,500	---
Legal charges	5,000	---
Advertising	12,700	---
Stock Jan. 1, 1999	2,38,000	---
Cash in hand	2,500	---
Sundry Debtors	1,04,000	---
Goodwill	80,000	---
Bills receivable	68,000	---
Motor Vehicles	15,000	---
5% Tax free Govt. loan (face value Rs. 50,000)	49,400	---
Calls in Arrears	12,500	---
Preliminary Expenses	24,500	---
Furniture & Fittings	18,000	---
Office Equipments	47,000	---
Plant & Machinery	8,28,000	---
Land & Buildings	4,50,000	---
	<u>33,91,900</u>	<u>33,91,900</u>

The following additional information is provided:

- Stock on hand on the 31<sup>st</sup> of Dec. 99, at cost was Rs. 2,71,000. However, the market value on that date amounted to Rs. 2,95,000.
- Provision is to be made for doubtful debts at 5%.
- Depreciation is to be provided on written down values as follows:  
Plant and machinery at 15%, Furniture and Fittings at 10%  
Motor vehicles at 20%, Buildings at 5%
- The directors have recommended final dividend of Rs. 35,000.
- Salaries included Rs. 2,500 paid to auditors as Audit fees.
- Calls in arrears include Rs. 1,000 due from the directors.

Prepare the Profit and Loss Account for the year ending on the 31<sup>st</sup> of Dec. 1999 and a Balance Sheet on the date.

**Solution**

**Rampur Engineering Company Ltd.**

**Profit and Loss Account**

for the year ending on the 31<sup>st</sup> Dec. 1999

Dr.

Cr.

		Rs.			Rs.
To Opening Stock		2,38,000	By Sales	15,39,000	
To Purchases	12,00,000		Less: Returns	<u>35,000</u>	15,04,000
Less: Returns	<u>25,000</u>	11,75,000			
To Wages		1,16,000	By Closing Stock		2,71,000
To Carriage		18,500			
To Gross Profit c/d.		<u>2,27,500</u>			
		<u>17,75,000</u>			<u>17,75,000</u>
To Salaries	7,500		By Gross Profit b/d		2,27,500
Less: Audit fees	<u>2,500</u>	5,000	By Interest on Govt. Securities		2,500
To Rent		15,000	By Net Loss		10,700
To Insurance		9,500			
To Advertising		12,700			
To Legal Charges		5,000			
To Audit Fees		2,500			
To Repairs:					
Building	1,500				
Machinery	<u>2,800</u>	4,300			
To Depreciation:					
Building	22,500				
P&M	1,24,200				
F&F	1,800				
Motor Vehicles	<u>3,000</u>	1,51,500			

To Prov. for Doubtful Debts	5,200	
To Debenture Interest	30,000	
	<u>2,40,700</u>	<u>2,40,700</u>

**Profit and Loss Appropriation Account**

Dr.		for the year ending on the 31 <sup>st</sup> of Dec. 1999	Cr.
	Rs.		Rs.
To Net Loss	10,700	By Balance (1-1-99) b/f.	44,000
To Interim dividend	17,500	By General Reserve	
To Proposed final dividend	35,000	(Amount transferred from)	19,200
	<u>63,200</u>		<u>63,200</u>

**Rampur Engineering Company Ltd.**

**Balance Sheet**

Dr.		as on December 31, 1999	Cr.
Liabilities	Rs.	Assets	Rs.
<b>SHARE CAPITAL</b>		<b>FIXED ASSETS</b>	
<b>Authorised</b>		Goodwill	80,000
40,000 shares of Rs.100 each	40,00,000	Land & Buildings 4,50,000	
		Less: Depn. 22,500	4,27,500
<b>Issued</b>		Plant & Machinery 8,28,000	
20,000 shares of Rs.100 each	20,00,000	Less: Depn. 1,24,200	7,03,800
<b>Subscribed</b>		Office Equipment	47,000
10,000 shares of Rs.100 each	10,00,000	Furniture & Fittings 18,000	
<b>Called up &amp; Paid up</b>		Less: Depn. 1,800	16,200
10,000 Equity Shares of		Motor Vehicles 15,000	
Rs.100 each fully		Less Depn. 3,000	12,000
called up: 10,00,000		<b>INVESTMENTS</b>	
Less: Calls in arrears		5% Tax-free Govt. Loan	49,400
(including Rs.1,000			
due from Director) 12,500	9,87,500	<b>CURRENT ASSETS</b>	
<b>RESERVES &amp; SURPLUS</b>		<b>LOANS &amp; ADVANCES</b>	
General Reserve 75,000		<b>A. Current Assets</b>	
Less: Appropriation 19,200	55,800	Interest on Investments	2,500
<b>SECURED LOANS</b>		Stock in trade	2,71,000
6% Debentures of Rs.100 each	5,00,000	Sundry Debtors 1,04,000	
Interest on Debentures		Less: Prov. for DD 5,200	98,800
Outstanding	30,000	Cash in hand	2,500
<b>UNSECURED LOANS</b>		<b>B. Loan &amp; Advances</b>	
Bank Overdraft	55,900	Bills Receivable	68,000

CURRENT LIABILITIES & PROVISIONS		Tax paid in advance	14,000
A. Current Liabilities		MESCELLANEOUS EXPENSES NOT WRITTEN OFF	
Sundry Creditors	1,53,000	Preliminary Exp.	24,500
B. Proposed Dividends			
Proposed Dividends	35,000		
	<u>18,17,200</u>		<u>18,17,200</u>

#### Illustration – 7

From the following Trial Balance and additional information given, prepare the Profit and Loss Account of Krest Engineering Co. Ltd., for the year ending on the 31<sup>st</sup> of June, 2000 and a Balance Sheet as on that date:

#### Trial Balance as on 30<sup>th</sup> June, 2000

	Rs.		Rs.
Interest	1,000	General Reserve	15,000
Debenture Interest	2,000	8% Debentures	50,000
Director's fees	1,000	Share Capital	1,00,000
Rent, Rates & Insurance	1,400	Bank Overdraft at IOB	750
Advance Income Tax	4,000	Sundry Creditors	8,000
Cash at SBH	12,000	Profit & Loss A/c	4,250
Preliminary Expenses	2,000	Gross Profit	52,000
Cash on Hand	1,000	Debenture Redemption Reserve	20,000
Sundry Debtors	35,000	Share Premium	5,000
Investment at cost	3,000		
Printing & Stationery	600		
Salaries and Wages	4,000		
Stock on 30 <sup>th</sup> June, 1999	64,000		
Plant & Machinery	50,000		
(Original Cost Rs.75,000)			
Land & Buildings	70,000		
(Original Cost Rs.1,00,000)			
	<u>2,55,000</u>		<u>2,55,000</u>

#### Additional Information

1. Of the Sundry Debtors, debtors worth Rs.5,000 are less than six months old, and of the remaining a debt for Rs. 1,000 is doubtful.
2. The Share Capital consists of 20,000 Equity Shares of Rs. 10 each, of which 12,500 shares are issued and those of Rs. 8/- per share are called up.
3. Audit Fees Rs. 1,250 are to be paid and Rs. 12,000 are to be provided towards income tax.
4. Insurance is prepaid to the extent of Rs. 400/-.
5. Land and Buildings are to be depreciated at 5% on the straight line basis, and Furniture, P&M are to be depreciated at 10% in their written down values.

6. Rs. 5,000 are to be transferred to Debenture Redemption Reserve.
7. 8% dividend on the paid up capital is to be provided.
8. Half of Preliminary expenses are to be written off.

**Solution**

<b>Krest Engineering Company Ltd.</b>		<b>Profit and Loss Account</b>	
Dr.		Cr.	
for the year ending on the 30 <sup>th</sup> of June, 2000			
	Rs.		Rs.
To Salaries and Wages	4,000	By Gross Profit	52,000
To Printing & Stationary	600		
To Interest	1,000		
To Debenture Interest	2,000		
To Directors' fees	1,000		
To Audit Fees	1,000		
To Rent, Rates & Insurance	1,400		
Less: Prepaid Ins.	400		
To Preliminary Expenses	1,000		
To Depreciation on:			
L&B 5% on 1,00,000	5,000		
F&F 10% on 4,000	400		
P&M 10% on 50,000	5,000		
To Prov. for Doubtful Debts	1,000		
To Prov. for Income Tax	12,000		
To Net Profit c/d.	16,750		
	52,000		52,000
To Debenture Redemption Reserve	5,000	By Balance b/f.	4,250
To Proposed Dividend	8,000	By Net Profit b/d.	16,750
To Balance c/d.	8,000		
	21,000		21,000

**Krest Engineering Company Ltd.**  
**Balance Sheet**  
as on the 30<sup>th</sup> June, 2000

Liabilities	Rs.	Assets	Rs.
SHARE CAPITAL		FIXED ASSETS	
<b>Authorised</b>		Land & Buildings	
20,000 Equity shares of		(at cost)	1,00,000
Rs. 10 each	2,00,000	Less: Depn. (to date)	35,000
	2,00,000		65,000

<b>Issued &amp; Subscribed</b> 12,500 Equity shares of Rs. 10 each	1,25,000	Furniture & Fix.(at cost) 7,500 Less: Dpen. (to date) 3,900	3,600
<b>Called up &amp; Paid up</b> 12,500 Equity Shares of Rs. 10 each 8/- per share Called up an paid up	1,00,000	Plant & Machinery (at cost) 75,000 Less: Dpen. (to date) 30,000	45,000
<b>RESERVES &amp; SURPLUS</b> Share Premium 5,000 General Reserve 15,000 Debenture Redemption Reserve 25,000 P & L Account 8,000		<b>INVESTMENTS</b> Investments (at cost) 3,000	3,000
<b>SECURED LOANS</b> 8% Debentures 50,000		<b>CURRENT ASSETS</b> <b>LOANS &amp; ADVANCES</b> <b>A. Current Assets</b> Stock in trade 64,000 Sundry Debtors More than 6 months old 30,000 Other debts 5,000 35,000 Less: Prov. for DD 1,000	34,000
<b>UNSECURED LOANS</b> ---		Cash in hand 1,000 Cash at Bank (SBH) 12,000	
<b>CURRENT LIABILITIES &amp; PROVISIONS</b> <b>A. Current Liabilities</b> Sundry Creditors 8,000 Bank overdraft at IOB 750 Audit fees Outstanding 1,250		<b>B. Loans &amp; Advances</b> Adv. Income Tax 4,000 Prepaid Insurance 400	
<b>B. Provisions</b> Prov. for income tax 12,000 Proposed Dividend 8,000		<b>MESCELLANEOUS EXPENDITURE</b> Preliminary Exp. 2,000 Less: Written off 1,000	1,000
	<u>2,33,000</u>		<u>2,33,000</u>

### Illustration - 8

The Authorised Capital of Binny Traders Ltd., is Rs. 6,00,000 divided into 60,000 equity shares of Rs. 10 each. The following balances are extracted from the company's books on the 31<sup>st</sup> of March, 2000.

	Rs.	Rs.
Cash in hand and at Bank	25,000	--
Directors fees	6,800	--
Stock on 31 <sup>st</sup> March 2000	70,000	--
Rent and taxes paid in advances		6,290
Office Salaries	16,000	--
Motor lorries 1 <sup>st</sup> April, 1999	37,500	--
Motor lorries purchased during the year	4,500	--
Factory premises	2,00,000	--
Plant and Machinery	1,99,580	--
Sundry Debtors	60,880	--
Bad Debts written off	1,430	--

Rent rates and taxes	13,200	--
Advertising	10,750	--
Dividend paid (interim)	21,750	--
Discount on issue of shares	7,500	--
Calls in arrears	63,000	--
Profit & Loss A/c.	--	7,120
Gross profit for the year	--	1,06,820
Capital Redemption Reserve	--	30,500
Provision for doubtful debts	--	3,500
Sundry Creditors	--	40,820
Transfer fees	--	450
Accrued wages	--	6,020
Staff Benefit Fund	--	8,900
Miscellaneous receipts	--	50
Share capital, Rs. 9 Called up	--	5,40,000
	<u>7,44,180</u>	<u>7,44,180</u>

You are required to prepare the Profit & Loss Account for the period ended the 31<sup>st</sup> of March, 2000 and a Balance Sheet as on date, after taking into account the following:

- The Factory premises, and plant and machinery are to be depreciated by 2% and 10% respectively.
- Provision for doubtful debts, should be maintained at Rs. 5,000.
- Half of the Discount on issue of shares is to be written off.
- Transfer Rs. 10,000 to General Reserve.

#### Solution

<b>Profit and Loss Account</b>			
for the year ending on the 31 <sup>st</sup> of March, 2000			
Dr.			Cr.
	Rs.		Rs.
To Office Salaries	16,000	By Gross Profit b/f.	1,06,820
To Rent, Rates & Taxes	13,200	By Transfer fees	450
To Advertising	10,750	By Miscellaneous receipts	50
To Director's fees	6,800		
To Bad debts	1,430		
Add: Provision to be maintained	<u>5,000</u>		
	6,430		
Less: Existing Provision	<u>3,500</u>		
	2,930		
To Depreciation on:			
Factory Premises @ 2%	4,000		
Plant and Mach at 10%	<u>19,958</u>		
	23,958		
To Discount on issue of shares	3,750		

To Net Profit c/d	29,932		
	<u>1,07,320</u>		<u>1,07,320</u>
To Dividend paid	21,750	By Balance b/f.	7,120
To General Reserve	10,000	By Net Profit b/d.	29,932
To Balance c/d	5,302		
	<u>37,052</u>		<u>37,052</u>

**Binny Traders Ltd.**  
**Balance Sheets**  
as on the 31<sup>st</sup> March, 2000

Liabilities	Rs.	Assets	Rs.
<b>SHARE CAPITAL</b>		<b>FIXED ASSETS</b>	
<b>Authorised</b>		Factory Premises 2,00,000	
60,000 Equity shares of Rs. 10 each	<u>6,00,000</u>	Less: Depn. 4,000	1,96,000
<b>Issued &amp; Subscribed</b>		Plant & Machinery 1,99,580	
60,000 Equity shares of Rs. 10 each	<u>6,00,000</u>	Less: Depn. 19,958	1,79,622
<b>Called up &amp; Paid up</b>		Motor Lorries as on 1-4-1999 37,500	
60,000 Equity Shares of Rs. 10 each 9/- per share called up 5,40,000		Add: Additions 4,500	42,000
Less: Calls in arrears 63,000	4,77,000	<b>CURRENT ASSETS, LOANS &amp; ADVANCES</b>	
<b>RESERVES &amp; SURPLUS</b>		Stock 70,000	70,000
Capital Redemption Reserve 30,500		Sundry Debtors 60,880	
General Reserve 10,000		Less: Prov. for D.D 5,000	55,880
P&L Account 5,302		Cash in hand & at Bank 25,000	25,000
<b>SECURED LOANS</b>	--	Rent, taxes paid in advances 6,290	6,290
<b>UNSECURED LOANS:</b>	--	<b>MESCELLANEOUS EXPENDITURE</b>	
<b>CURRENT LIABILITIES &amp; PROVISIONS</b>		Discount on issue of shares 7,500	
<b>A. Current Liabilities</b>		Less: Written off 3,750	3,750
Sundry Creditors 40,820	40,820		
Accrued wages 6,020	6,020		
Staff Benefit Fund 8,900	8,900		
	<u>5,78,542</u>		<u>5,78,542</u>

**Illustration – 9**

The following ledger balances are extracted from Anush Ltd., as on 31-3-2000.

	Rs. (000)		Rs. (000)
Equity capital	480	Provision for Depreciation	252
Investments	228	Current liabilities	394
Loans and advances	12	Current assets	586
Provision for tax	180	Fixed assets	1092
Discount of debentures	24	Reserves	396
Unsecured loans	60	Secured loans	180

There is a contingent liability in respect of a claim of Rs. 1,00,000 against the company not acknowledged as debt.

Prepare Balance Sheet in horizontal and vertical forms.

### Solution

#### a) Balance Sheet in horizontal form

<b>Anush Ltd.</b>			
Balance Sheet as on the 31-3-2000			
Liabilities	Rs.(000)	Assets	Rs.(000)
SHARE CAPITAL		FIXED ASSETS	
Equity Capital	480	Original cost	1,092
		Less: Depn.	<u>252</u>
RESERVES & SURPLUS	396		840
		Investments	228
SECURED LOANS	180	CURRENT ASSETS &	
UNSECURED LOANS	60	ADVANCES	
CURRENT LIABILITIES		a) Current Assets	586
& PROVISIONS		b) Loans and Advances	12
A. Current Liabilities	394	MESCELLANEOUS	
B. Provision for tax	180	EXPENDITURE	
		Discount on Debentures	24
	<u>1,690</u>		<u>1,690</u>

Note: There is a contingent liability to the extent of Rs. 1,00,000.

#### b) Balance Sheet in Vertical form

<b>Anush Ltd.</b>		
Balance Sheet as at 31-3-2000		
Particulars	Schedule No.	Rs. (000)
<b>I. Source of Funds</b>		
1. Share holders' funds:		
a) Capital		480
b) Reserves & Surplus		<u>396</u>
		<u>876</u>

2. Loan funds:		
a) Secured loans		180
b) Unsecured loans		<u>60</u>
		<u>240</u>
		<u>1116</u>
<b>II. Application of Funds</b>		
1. Fixed Assets:		
a) Gross block		1092
b) Less depreciation		<u>252</u>
c) Net block		840
d) Work in progress		<u>--</u>
		<u>840</u>
2. Investment		<u>228</u>
3. Current Assets & Advances:		
Other Current assets		586
Loans and advances		<u>12</u>
Less: Current Liabilities and Provisions		596
a) Liabilities	384	
b) Provisions	<u>180</u>	<u>564</u>
c) Net current Assets		<u>24</u>
4. Miscellaneous Expenses:		
Discount on debentures		<u>24</u>
Total		<u>1116</u>

**Note:** Contingent liability to the extent of Rs. 1,00,000.

## **6.6 SUMMING UP**

The Final Accounts of companies consist of Profit and Loss Account and Balance Sheet. Profit and Loss Account is an integrated Account consisting of Trading Account, Profit and Loss Account and P&L Appropriation Account. The sources of information for the preparation of these Final Accounts are Trial Balance and adjustments made at the end of the financial period. The principles governing the preparation of P&L A/c and Balance Sheet of company are same as those in other forms of organisations. But P&L A/c and Balance Sheet are to be prepared as per the form prescribed by the Companies Act.

## **6.7 CHECK YOUR PROGRESS : MODEL ANSWERS**

- I. i) Trial Balance which consists of the balances drawn from the ledger accounts.
- ii) As per the instructions given in the adjustments, a portion of preliminary expenses is to be written off. The written off amount is debited to P&L Account and credited (deducted) to preliminary expenses. The balance of Preliminary expenses will appear as assets in the Balance Sheet.
- iii) When a running business is purchased by a company before its incorporation the profits made prior to the acquisition is called profits prior to incorporation. It is to be capitalized.

2. i) Debenture interest is payable to debentureholders by the company. Hence it is an expenditure. Debenture interest appears on debit side of P&L Account and the outstanding portion of Debenture interest, if any, will appear as liability.
- ii) Debentures Redemption Fund represents the amount of profit appropriated for redeeming the Debenture on the expiry of the term.
- 3) Companies pay advance tax on their income as per the law. While preparing P&L Account a provision for tax is created and debited to P&L Account. At the time of actual assessment provision and advance tax account balances are transferred to Income Tax Account.

## **6.8 MODEL EXAMINATION QUESTIONS**

### **I. Answer the following questions in about 30 lines each.**

1. State the purpose of Profit and Loss Appropriation Account.
2. What do you mean by "above the line" and "below the line" in P&L Account?
3. State the meaning of preliminary expenses and cost of issue of shares. What is the accounting treatment in respect of these items?
4. What do you mean by Contingent Liabilities? How are they shown in the Company Balance Sheet?
5. Discuss the special items that will appear in the P&L Account of a company as compared to that of a Trader.

### **II. Answer the following questions in about 15 lines each.**

1. Explain the meaning of debenture.
2. What is meant by fixed charge?
3. What is interest on debenture?
4. What do you mean by Managerial Remuneration?
5. Explain the terms :
  - a) Income Tax paid by company.
  - b) Profits prior to incorporation.
6. State the accounting treatment of profits prior to incorporation.
7. What are "divisible profits"?

### **Problems**

1. From the following balances extracted from the Sundar Finance Ltd., and the adjoining information, prepare its Profit & Loss Account for the year ending on the 30<sup>th</sup> of September, 1999 and a Balance Sheet as on the date:

	Rs.
Financial & Service Charges received	18,08,106
Rentals received	11,30,550
Interest received	76,498
Other Incomes	28,939
Administration Expenses	5,52,328
Interest paid	10,86,599
Depreciation	2,32,304

Preliminary expenses written off	20,874
P&L A/c. 1-10-98	951
Short Provision for dividend of previous year	78
2,00,000 shares of Rs. 10 each	20,00,000
General Reserve	86,000
Investment Allowance Reserve	8,000
Secured Loans	31,40,533
Unsecured Loans	80,07,281
Net Block	35,29,249
Investments	3,86,136
Current Assets:	
Sundry Debtors	1,21,74,380
• Cash & Bank Balances	22,45,947
Loans & Advances	3,64,223
Sundry Creditors	40,10,267
Unclaimed Dividends	3,02,494
Bills Payable	67,369
Preliminary Expenses	74,870

You are required to:

- a) provide Rs. 1,83,459 for the proposed dividends,
- b) transfer Rs. 4,00,000 to the General Reserve,
- c) transfer Rs. 5,69,000 to Investment Allowance Reserve.

(Ans: Balance of profit carried to Balance Sheet: Rs. 402, Balance Sheet Total Rs. 1,87,74,805).

2. Graphite Vicarb Ltd., has an Authorised Capital of Rs. 5,00,000 divided into 35,000 equity shares of Rs. 10 each and 15,000 6% cumulative preference shares of Rs. 100 each. The following are the balance in the books as on the 31<sup>st</sup> of December 1999.

	Rs.	Rs.
Land and Buildings at cost	1,60,000	
Plant and machinery at cost	1,02,000	
Furniture and Fixtures at cost	30,000	
Accumulated Depreciation:		
Plant & Machinery		15,900
Furniture and Fittings		3,200
Equity Share Capital		2,00,000
Preference Share Capital		25,000
Profit & Loss A/c. 31-12-99		23,000
5% Debentures		30,000
General Reserve		5,000
Creditors		33,600
Investments	6,000	
Stock 31-12-99	8,700	
Debtors	3,900	
Cash at Bank	25,100	
	<u>3,35,700</u>	<u>3,35,700</u>

The directors have resolved to:

- a) pay dividends on preference shares;
- b) propose 8% dividend on Equity Share Capital;
- c) transfer Rs. 5,000 to General Reserve.

Prepare the Profit & Loss Appropriation Account and Balance Sheet as per the Company's Act.

(Ans: Balance in P&L Appropriation A/c: Rs. 500; Balance Sheet total: Rs. 3,16,600)

3. The Authorised Capital of Modern Synthetics Ltd., consists of 12,00,000 equity shares of Rs. 10 each. The following balances were extracted from the company's account books as on the 30<sup>th</sup> of June 2000.

	Rs.
General Reserve	50,000
Provisions for Bad debts	7,000
Calls in arrears	15,000
Premises	2,00,000
Plant & Machinery	10,60,000
Interim dividend	75,000
Audit fees	1,450
Stock on 1-7-99	1,40,000
Furniture & Fixtures	14,400
Sundry Debtors	1,74,000
Goodwill	50,000
Cash at Bank	85,800
Cash in hand	3,500
Purchases less returns	3,72,000
Wages	1,29,730
Freight	13,000
Carriage	13,230
General Expenses	33,670
Preliminary expenses	10,000
Salaries	29,000
Directors' fee	10,000
Bad debts	4,220
Debenture Interest paid	18,000
Capital fully paid	8,00,000
6% Debentures	6,00,000
P&L Account 1-7-99	29,000
Bills Payable	40,000
Sundry Creditors	96,000
Sales	8,30,000

Plant and Machinery is to be depreciated by Rs. 66,000. One tenth of Preliminary Expenses have to be written off. Interest on Debentures for the half year ending on the 30<sup>th</sup> of June, 2000 is not yet paid. Provision for doubtful debts is to be maintained at 5% on Sundry Debtors. The closing stock amounted to Rs. 1,90,000. Prepare the Final Accounts.

(Ans: Profit Rs. 1,23,000, Balance Sheet Total: 17,12,000)

4. Jolly Plastic Industries Ltd., was incorporated with 2,00,000 shares of Rs. 10 each on 1-7-98. 1,50,000 shares were issued to the public and except for 30,000 shares, all others were subscribed. The following is the trial balance as on 30<sup>th</sup> June, 2000.

	Rs.	Rs.
Closing Stock	3,00,000	
Salaries	1,05,000	
Printing & Stationery	3,000	
Postage	4,500	
Motor Car maintenance	13,500	
Calls in arrears (on 1,200 shares)	3,600	
Share Capital		12,00,000
Debtors & Creditors	4,35,000	90,000
Gross Profit		6,00,000
Fixed Assets at cost:		
Furniture	1,80,000	
Motor Car	63,000	
Premises	6,00,000	
Investments	45,000	
Dividend		4,500
Audit fees	2,250	
Directors' fees	3,600	
P&L A/c. 1-7-99		78,000
Cash at Bank	2,70,000	
Cash in hand	7,050	
Provision for Depreciation 1-7-99		
Furniture		30,000
Motor Car		18,000
Premises		15,000
	<u>20,35,500</u>	<u>20,35,500</u>

You are required to prepare P&L Account and Balance Sheet after taking into consideration the following:

- a) provide depreciation on written down values: furniture at 10%, Motor Car at 20%, and premises at 2 ½ %.
- b) Market value of the Investments on the 30<sup>th</sup> June, 2000, Rs. 32,000.
- c) Provision for taxation required to be made is Rs. 1,58,000.
- d) The shares on which calls are unpaid are to be forfeited.
- e) Directors proposed a dividend of 15%.

(Ans: Profit: 1,58,325; Balance Sheet total: Rs. 17,85,425)

5. M/s. Novelty Manufactures Ltd., was formed with an Authorised Capital of Rs.30,00,000 consisting of equity shares of Rs. 10 each. The closing stock on the 30<sup>th</sup> of Sept. 2000 amounted to Rs. 2,74,000. The following Balances have been taken from the company's account books:

	Rs.		Rs.
Sundry Debtors	5,00,000	Interest on Govt. Bonds	6,000
Wages & Salaries	1,91,826	Sales	19,67,000

Purchases	14,94,000	P&L A/c. Balance	19,200
Bad debts	6,800	Depreciation Provision	4,04,800
Directors' fees	5,800	Unclaimed dividends	3,400
Interest on Debentures	12,000	Sinking Fund	5,00,000
Insurance	6,000	General Reserve	95,200
Cash at Bank	35,500	Returns (Purchase)	7,000
4% Govt. Bonds	2,00,000	Bills payable	18,600
Motive power	38,000	Fully called capital	25,00,000
Buildings	7,01,200	Interest on Sinking Fund	
General Expenses	14,834	Investments	16,000
Rent, Rates, Taxes	18,500	Sundry Creditors	4,00,050
Discount on Debentures	10,000	Misc. receipts	800
Sinking Fund Investments	5,00,000	4% Debentures	6,00,000
Goodwill	1,00,000	Prov. for bad debts	20,000
Loose tools	8,450	Stock 1-10-99	2,60,000
Returns	9,400	Machinery	19,85,400
Bank Charges	2,900	Leasehold land	3,00,800
Depn: Machinery	1,10,000	Preliminary Expenses	16,640
Buildings	30,000		

Provision for bad debts is to be maintained at 5% on Sundry Debtors. Rent Rs. 2,600 is outstanding. Insurance paid is for the year ending on the 31<sup>st</sup> of Dec. 2000. The whole of preliminary expenses are to be written off. Provision of Rs. 20,000 towards Sinking Fund (for redemption of Debentures) is to be made.

Prepare the Profit & Loss Account, P&L Appropriation Account and Balance Sheet.

(Ans: Net profit: 22,000; P&L Appropriation A/c. Balance: Rs. 21,200; Balance Sheet Total: Rs. 41,89,050)

6. Prepare the Profit & Loss Account for the year ending on the 30<sup>th</sup> of Sept. 2000 and Balance sheet as on that date from the following Balance extracted from the books:

	Rs.		Rs.
Debenture interest	7,500	Equity Share capital	4,00,000
Sundry Debtors	1,00,200	Sundry Creditors	1,75,700
Property at cost	7,00,000	6% Pref. Share Capital	4,00,000
Furniture	70,000	5% Debentures	3,00,000
Advance tax paid	30,000	Interest received	8,500
Motor Vans at cost	3,00,000	P&L Account	57,700
Investments	1,00,000	Bank O.D.	3,00,000
Purchases	9,81,000	Sales	13,40,000
Packing	18,000	Opening Stock	2,90,400
Delivery charges	88,800	Salaries	1,04,000
Interest on O.D.	15,600	Rent	30,000
		Freight	21,400
		Final Dividend (98-99)	24,000
		Pref. Share Dividend (99-2000)	12,000
		Discount on issue of shares	4,000
		Preliminary expenses	2,000
		Bills Receivable	83,000

You are required to take into account the following:

1. Salaries include Rs. 4,000 spent on making furniture.
2. Bad debts amounting to Rs. 1,500 to be written off.
3. Furniture (including new) to be depreciated at 20%.
4. Closing stock: 2,85,000.
5. Rs. 2,000 are to be written off out of discount on issue of debentures.
6. Provision for taxation is to be made for Rs. 16,000.
7. Motor Vans have to be written off over 15 years.
8. 5% dividend is proposed by Directors on the Equity Capital.

(Ans: Net Profit: Rs. 35,000 Balance of P&L Appropriation A/c. Rs. 8,700. Total of Balance Sheet Rs. 16,39,900.)

7. The following balances have been taken from the account books of Kanoria Chemical Ltd., as on the 31<sup>st</sup> of March, 2000.

	Rs.		Rs.
Debenture interest	1,250	Sales	41,35,000
Purchases	38,20,000	Discount received	4,350
Wages	1,42,500	Salaries	33,500
Income Tax	13,500	Electricity	4,250
Director's fees	17,000	Repairs	6,250
Trade Expenses	15,000	Rates and Insurance	10,000
Advertising	65,000	Packing materials	8,250
P&L Account 1-4-99	1,50,350	Share Capital	10,00,000
5% Debentures	50,000	Premises	7,00,000
Furniture	50,000	Stock 1-4-99	6,10,000
Sales Ledger Balances	18,500	Cash on hand	700
Bought Ledger Balances	72,500	Capital Reserve	75,000
Accumulated Depn. on furniture	7,500	Bank O.D.	21,000

Prepare the Profit and Loss Account and the Balance Sheet after taking into account the following:

- a. Closing stock was Rs. 7,93,350.
- b. Furniture to be depreciated at 10% on the straight line basis.
- c. Rs. 1,750 for doubtful debts to be provided.
- d. Rs. 5,000 to be transferred to Capital Reserve.
- e. Repairs outstanding Rs. 23,540.
- f. Insurance prepaid: 3,300.
- g. Stock of packing materials at the end of the year amounted to Rs. 1,000.
- h. Provision for income tax: Rs. 77,500, and for dividend at 6%.

(Ans: P&L Appropriation Account Balance : 1,66,810; Balance Sheet Total: Rs. 15,52,600.)

8. The following balances have been extracted from the books of Krishna Ceramics Ltd., as on the 31<sup>st</sup> March, 2000. The Authorised Capital of the Company consists of 1,00,000 shares of Rs. 10 each of which Rs. 8 per share are called up.

	Rs.		Rs.
Share Capital	8,00,000	P&L A/c. (Dr.)	25,600
Stock 1-4-99	1,23,000	Light & Heat	25,600
Insurance	5,000	Carriage	16,500
Interest	3,000	Cash at Bank	1,27,365
Prov. for Doubtful debts	13,600	Sundry Debtors	3,26,200
Sundry Creditors	1,63,400	Wages	72,400
Sales	19,25,200	Purchases	15,64,300
Plant and Machinery	2,56,400	Salaries	45,400
Discount received	5,665	Advertisement	76,600
Office Furniture	1,44,200	Factory Power	43,800
Rent, Rates	52,500		

The following additional information is provided:

- i) Stock on the 31<sup>st</sup> of March, 2000 amounted to Rs. 2,56,130.
- ii) Provision for wages amounting to Rs. 12,100 and for rent amounting to Rs. 12,000 to be made.
- iii) Further bad debts amounted to Rs. 15,700.
- iv) Provision for doubtful debts should be at 5%.
- v) A machine costing Rs. 26,800 has been debited to Purchase A/c.
- vi) Included in Sundry Creditors is Rs. 50,000 borrowed from the Bank of India on 1-12-99 at 9% on hypothecation of stocks.
- vii) Prepaid insurance was Rs. 1,000.
- viii) Depreciation on machinery was Rs. 41,250 and on Furniture Rs. 13,068/-.
- ix) The directors proposed a maiden dividend of 4%.

(Ans: Net Profit for the year Rs. 30,802. Balance Sheet total : Rs. 10,52,552.)

9. The following balances are taken from the books a company whose capital is Rs. 50,00,000 of shares @ Rs. 10 each.

	Rs.		Rs.
Opening stock	6,65,000	Distribution frieght	30,000
Discount	30,000	Calls in arrears	10,000
Carriage	57,500	Debenture Interest (1/2 year)	10,000
Boilers	3,75,000	Shares	10,000
Rates and taxes	55,000	Railway sidings	1,00,000
Bank	4,000	Loan to Director	6,000
Cash	8,000	Bad debts	25,500
Interest on loan	91,000	Equity capital	20,00,000
Preli. Expenses	10,000	4% Debentures	5,00,000
Furniture	1,50,000	Bank O.D.	7,57,000
Purchases	17,32,500	Bills payable	1,00,000
Wages	8,05,000	Creditors	1,40,500
Consumables	63,000	Sales	36,17,000
Land	12,50,000	Rent received	30,000
Machinery	7,50,000	Transfer fees	6,500
Engg. Tools	1,50,000	Profit/Loss A/c (Cr.)	67,000

Goodwill	2,75,000
Debtors	2,66,000
Bills receivable	1,34,500
Advertising	5,000
Dealers Aids	10,000
Repairs	16,500
Commission	57,500
Transit insurance	10,000
Trade expenses	56,000

#### Additional Information

- Directors recommended 10% dividend.
- Stock at close is Rs. 7,08,000. But Marketing Manager estimated its value as Rs. 8,50,000.
- Rs. 25,000 for wages and Rs. 25,000 for trade expenses are outstanding.
- Depreciation to be charged: machinery 5%, Engg. Tools 20%, Boilers 10%, Furniture 10%.
- Rs. 21,500 are bad debts, provide 2% for doubtful debts.
- Write off 50% of Personal expenses, Transfer Rs. 50,000 to Redemption Reserve.
- Bills receivable for Rs. 6,500 are discounted.
- Provide Rs. 2,40,000 for tax. Prepare P&L Account and Balance Sheet in horizontal and vertical form.

(Ans: N.P. Rs. 1,90,610. Balance sheet total : Horizontal Rs. 40,45,110, vertical Rs. 33,05,610.)

10. The following are the ledger balances from Apurupa Limited.

	Rs.		Rs.
Opening stock	1,32,000	Fixed assets:	
Purchases	1,84,000	Opening Balance	12,60,000
Stores Consumed	10,000	Addition	67,000
Manufacturing Exp.	1,65,000	Investments	26,000
Salaries & Wages	1,50,000	Share Capital	2,80,000
Freight	57,000	Share Premium	20,000
Sales	7,76,000	General Reserve	80,000
Items used in works	90,400	Development Reserve	1,20,000
Dividends (Cr.)	1,000	Repairs Reserve	40,000
Profit on Blocks	30,000	Secured loan	2,30,000
Sundry Expenses	3,000	Unsecured loans	50,000
Profit/Loss A/c.	20,000	Debtors	1,02,400
Provision for depreciation	5,60,000	Interest on Capital during	
Transfer to repairs reserve	52,000	construction	15,000
Interest on Loan	22,500	Deposits (Dr.)	40,000
Depreciation	51,500	Bank	1,40,000
Interim dividend	28,000	Cash	2,000
Provision for Tax	75,000	Managing Directors	
Out standing exps.	5,000	remuneration	6,000
		Creditors	1,70,000

### Further information

- i) Closing stock valued at Rs. 1,47,000.
- ii) Managing Directors (MD) is eligible for 5% Remuneration on profit.
- iii) Profit on block sold as per Companies Act Rs. 20,000.
- iv) Depreciation alone under I.T. Rules Rs. 65,000.
- v) Profit/Loss at Balance has been arrived at after debiting provision for Tax Rs. 75,000 and Development rebate Rs. 15,000.
- vi) Details of repairs Reserve are:

Opening balance	38,000
Add. Transfer	<u>52,000</u>
	90,000
Less. Exp.	<u>50,000</u>
Balance	<u>40,000</u>

- vii) Final Dividend declared is 20%.
- viii) Share Capital Consists of shares @ Rs. 10 each.

Prepare final accounts. Show M.D. Remuneration calculation.

(Ans: N.P Rs. 1,65,573, Balance Sheet Rs. 12,39,682)

<b>Hint:</b> M.D. Remuneration		Rs.
N.P. before M.D. remuneration		1,73,682
Add. Exp. not allowed		
Depreciation	51,500	
Repairs	<u>52,000</u>	<u>1,03,500</u>
		2,77,182
Less: Allowable exp: depreciation	65,000	
Repairs	<u>50,000</u>	<u>1,15,000</u>
		<u>1,62,182</u>

M.D. Remuneration  $1,62,182 \times 5/100 = 8,109$ .

11. Sunrise Limited has a Nominal Capital of Rs. 5,00,000 of Shares @ Rs. 100 each. The following are balances at the close of financial year. Prepare final accounts after taking additional information into account.

	Rs. (000)		Rs. (000)
Buildings	290	Advance Tax	60
Machinery	100	Loose Tools	23
Sales	520	Deb. Interest	28
Salaries o/s	2	Investments	120
Provision for doubtful debts	3	Interest accrues	2
Share Capital	200	Bad Debts	6
Closing Stock	90	Depreciation	20
Purchase (Adj.)	210	Rent	26
Salaries	60	General reserve	40
Directors Fees	10	Profit/ Loss a/c.	25

Bank	30	Creditors	92
Debtors	125	Provision for depreciate Building	50
Expenses	18	Machinery	55
Unclaimed Dividend	5	14% Debentures	200
Interest on investment	12		

#### Additional information

- i. Closing stock is more than opening stock by Rs. 30,000.
- ii. Reserve for doubtful debts @ 4%.
- iii. Make provision for Income Tax @ 30%.
- iv. Depreciation includes Rs. 8,000 on buildings and Rs. 12,000 on machinery.
- v. 25% dividend declared.

(Ans: N.P. Rs. 1,06,400, B/S. Rs. 7,30,000)

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### 6.9 RECOMMENDED BOOKS

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1. S.N. maheshwari : **An Introduction to Accountancy,**  
Vani Educational Books, New Delhi.
2. M.C. Shukla & T.S. Grewal : **Advanced Accounts,**  
S. Chand & Company, New Delhi.
3. S.P. Jain & K.L. Narang : **Advanced Accountancy,**  
Kalyani Publishers, Ludhiana.
4. A.N. Agarwala : **The Higher Science of Accountancy,**  
Kitab Mahal, Allahabad.

## **UNIT-7 : PROFITS PRIOR TO INCORPORATION**

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### **Contents**

- 7.0 Aims and Objectives
- 7.1 Introduction
- 7.2 Meaning of Profits Prior to Incorporation
- 7.3 Ascertainment of Profit or Loss
- 7.4 Summing Up
- 7.5 Check Your Progress : Model Answers
- 7.6 Model Examination Questions
- 7.7 Recommended Books
- 7.8 Glossary

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### **7.0 AIMS AND OBJECTIVES**

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This unit aims at discussing profits prior to incorporation and the method of ascertaining such profits.

Having studied and worked through this unit, you should be able to :

- explain the meaning of profits prior to incorporation;
- describe the accounting procedure of ascertainment of profit or loss; and
- solve the problems relating to profits prior to incorporation.

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### **7.1 INTRODUCTION**

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In the previous unit you have learnt about preparation of company final accounts, ascertaining of net profit, which is to be distributed to shareholders after making required appropriations. In this unit, you will learn about profits prior to incorporation and the accounting procedure pertaining to ascertainment of profit or loss prior to incorporation.

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### **7.2 MEANING OF PROFITS PRIOR TO INCORPORATION**

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A company comes into existence only when it is incorporated. While a Private Limited Company can commence its business as soon as it is incorporated, a Public Limited Company can commence its business operations only after getting a certificate to commence business. Profits prior to incorporation means profits made by a company before it is incorporated, rather before it has come into existence. How can a company earn profits before it is incorporated? Sometimes a proposed company may enter into an agreement with the vendors of an already existing business to take over such business from a date prior to its incorporation. For example, a company incorporated on the 1<sup>st</sup> of May, 1999 may have purchased a running business from the 1<sup>st</sup> of January, 1999 and if, according to the agreement, the company is entitled to the profits of such a running business from 1<sup>st</sup> January, 1999 to the 30<sup>th</sup> of April, 1999 (pre – incorporation period) such profits are known as 'profits prior to incorporation'. When a running business is purchased from the vendors,

it is generally taken over from the date on which the accounting year of the vendor starts, so that the assets and liabilities can be taken over on the basis of the figures given in the Balance Sheet which is prepared on the basis of the previous day's position.

Profits prior to incorporation are not earned by the company in the normal course of its business. Since the purchase price payable by the company to the vendors is likely to include the amount of estimated profits for the pre-incorporation period, they are to be treated as capital profits and are to be transferred to capital reserve account. These profits cannot be made available to the shareholders as dividends. Just as there can be profits prior to incorporation there can be losses prior to incorporation also. Such a loss is a capital loss and is debited to the Goodwill account.

It is to be noted that the date of incorporation is to be taken into consideration but not the date of commencement of business for the purpose of calculating profit or loss prior to incorporation. In a public company, some people argue, profits prior to incorporation mean profits upto the date on which the company is entitled to commence the business. But profits prior to incorporation, strictly speaking will mean only profits upto the date of incorporation whether it is a Public or a Private company. Moreover, when a company is incorporated, as and its is legally speaking entitled to enter into contracts and earn profits.

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### **CHECK YOUR PROGRESS – 1**

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i) What do you understand by profits prior to incorporation?

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ii) Indicate the correct answer from the following alternatives.  
Profit prior to incorporation means:

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- a) profit upto the date on which the company is entitled to commence the business.
- b) profit upto the date of incorporation
- c) profit before the company has come into existence

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### **7.3 ASCERTAINMENT OF PROFIT OR LOSS**

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Profit or loss prior to incorporation can be accurately ascertained by preparing the Profit and Loss Account as on the date of incorporation. For this purpose, stock-taking and balancing of accounts have to be done, which will involve a lot of inconvenience. To avoid this inconvenience, the profits for the entire year are apportioned between pre-incorporation and post-incorporation periods on the basis of time and turnover ratios. The method usually followed in apportioning the profits involves the following steps:

- 1) Trading Account is prepared for the whole period, i.e., the period between the date of purchase and the date of final accounts to ascertain the gross profit. Date of incorporation will not affect the ascertainment of gross profit.

- 2) Time ratio and sales ratio are calculated. Time ratio is calculated taking into account the time between the date on which the business is taken over and the date of incorporation and the period between the date of incorporation and the date on which the final accounts are prepared. For example, a running business was taken over by a company from the 1<sup>st</sup> January, 1989, the certificate of incorporation was received on the 1<sup>st</sup> of May, 1989 and the final accounts were being prepared on 31<sup>st</sup> of December 1989. In such a case the time ratio of pre and post incorporation periods are four months (from the 1<sup>st</sup> of January to the 30<sup>th</sup> of April, 1989), and eight months (from the 1<sup>st</sup> of May to the 31<sup>st</sup> of the December, 1989 and so the ratio is 1:2. The sales ratio is similarly calculated taking into account the sales during pre-incorporation period and the sales during post incorporation period. If the sales between the 1<sup>st</sup> of January, 1989 and the 30<sup>th</sup> of April, 1989 are Rs. 2,00,000 and the sales between the 1<sup>st</sup> of May, 1989 to the 31<sup>st</sup> December, 1989 are Rs. 6,00,000 the ratio is 1:3.
- 3) The gross profit is then divided on the basis of turnover or sales ratio in between pre-incorporation and post-incorporation periods.
- 4) The Profit and Loss Account is prepared separately for pre-incorporation and post-incorporation periods dividing the various expenses in between the two periods. Those expenses which are incurred on the basis of time like salaries, rent, insurance, depreciation, audit fees, etc., are allocated in the ratio of time and those expenses which are connected with sales like commission, advertising, bad debts, discounts, etc., are allocated in the ratio of sales.

However, the following points should be remembered:

- i) Expenses such as the director's fees, interest on debentures, preliminary expenses, and remuneration to managerial personnel should be charged entirely to post-incorporation period as these expenses are incurred by the company after incorporation.
- ii) Expenses such as partner's salaries, interest on capitals, etc, should be charged to pre-incorporation period.
- iii) If there are any expenses, which are of seasonal nature, they are charged to the period in which they are incurred.

The total expenses thus allocated in between the two periods are deducted from the respective gross profits and the profit or loss prior to incorporation is ascertained. The following entry is made to bring such profit or loss into account :

- a) For profit :
 

Profit and loss Account	Dr
To Profits prior to incorporation Account	
- b) For loss :
 

Goodwill Account/Suspense Account	Dr
To profit and loss Account	

#### Illustration -1

A.P.Traders Limited was incorporated on the 1<sup>st</sup> May, 1999 to take over the business of M/s A and B from the 1<sup>st</sup> of January, 1999. The company received the certificate to commence

business on the 1<sup>st</sup> of July, 1999. From the following particulars relating to the year ending on the 31<sup>st</sup> of December, 1999, you are required to find out the profit prior to incorporation:

- i) Sales for the year 1999 Rs. 6,00,000; Sales up to the 1<sup>st</sup> of May, 1999 amounted to Rs. 2,50,000 and sales up to the 1<sup>st</sup> of July, 1999 Rs. 3,00,000.
- ii) The Gross profit ascertained by preparing Trading account was Rs.1,80,000
- iii) The other expenses relating to the business for the year were:

Salaries -----	15,000
Director's fees -----	4,800
Stationery and printing -----	3,600
Rent -----	9,000
Interest on debentures -----	5,000
Bad debts -----	1,500
Audit fees -----	1,500
Commission on sales -----	6,000
Discount on sales -----	3,600
Depreciation -----	24,000
General expenses -----	4,800
Advertising -----	18,000

- iv) Interest to M/s A and B on the purchase price up to the 1<sup>st</sup> of May, 1999 was Rs.3,000
- v) Rs.600 of bad debates relate to the debt before incorporation.

#### Solution

#### Statement showing profit before and after incorporation

Particulars	Basis of allocation	Pre-incorporation		Post-incorporation	
		Dr.	Cr.	Dr.	Cr.
Gross Profit	Sales	-	75,000	-	1,05,000
Salaries	Time	5,000	-	10,000	-
Director's fees	-	-	-	4,800	-
Stationery & Printing	Time	1,200	-	2,400	-
Rent	Time	3,000	-	6,000	-
Interest on debentures	-	-	-	5,000	-
Bad debts	-	600	-	900	-
Audit fees	Time	500	-	1,000	-
Commission on sales	Sales	2,500	-	3,500	-
Discount of sales	Sales	1,500	-	2,100	-
Depreciation	Time	8,000	-	16,000	-
General expenses	Time	1,600	-	3,200	-
Advertising	Sales	7,500	-	10,500	-
Interest to vendors upto the 1 <sup>st</sup> of May, 1999	-	3,000	-	-	-
PROFIT	-	<u>40,600</u>	-	<u>39,600</u>	-
		<u>75,000</u>	<u>75,000</u>	<u>1,05,000</u>	<u>1,05,000</u>

The profit prior to incorporation amounting of Rs. 40,600 is to be transferred to capital reserve account which will be distinctly shown under the head, "Reserves and Surplus" on liabilities side in the balance sheet.

### Working Notes

i) **calculation of sales ratio**

Total sales for the year 1999	Rs.6,00,000
Sales up to the 1 <sup>st</sup> of May, 1999 (Date of incorporation)	Rs.2,50,000

The ratio will be 2,50,000 : 3,50,000 or 5:7

ii) **Calculation of time ratio**

Period between the beginning of the year to the 1<sup>st</sup> of May, 1999 is 4 months

Period between the 1<sup>st</sup> May, 1999 to the end of the year is 8 months

The ratio is 4:8 or 1:2

### Illustration - 2

Apex Ltd., was incorporated on the 1<sup>st</sup> of October, 1999 take over an existing business from the 1<sup>st</sup> of July, 1999. The purchase price agreed upon was Rs.3,60,000 to be satisfied by the issue of the 12% mortgage debentures to the extent of Rs.3,00,000 and the balance of Rs.60,000 in cash. The assets taken over by the company were Rs.3,40,000 and Good will amounting to Rs. 20,000. Interest at 9% was payable on the purchase price from the 1<sup>st</sup> of July, 1999 to the date of settlement and the purchase price was duly paid on the 1<sup>st</sup> of November, 1999. On the same date company issued to the public 40,000 equity shares of Rs.10 each which were subscribed and paid for in full.

The profit and Loss Account of the business for the year ending on the 30<sup>th</sup> of June, 1990 was as follows :

To Salaries and Administrative expenses	1,00,000	By Gross profit	5,00,000
To Selling and Distribution expenses	50,000		
To Depreciation	10,000		
To Debenture interest	24,000		
To Director's fees	6,000		
To Preliminary expenses	10,000		
To Interest on purchase price	10,800		
To Goodwill written off	20,000		
To proposal dividend on equity shares @ 10%	40,000		
To Balance of profit	2,29,000		
	<u>5,00,000</u>		<u>5,00,000</u>

Sales for the months of July 1999 to Sept. 1999 amounted to Rs.5,00,000 and from October,1999 to June 2000, to Rs.15,00,000. Prepare a statement apportioning the profits between pre-incorporation and post incorporation periods.

**Statement apportioning the profits between pre and post incorporation periods**

Particulars	Ratio	Pre-incorporation		Post-incorporation	
		Dr.	Cr.	Dr.	Cr.
Gross profit apportioned on the basis of sales	1:3	-	1,25,000	-	3,75,000
<b>EXPENSES BASED ON TIME</b>					
Salaries and Administrative expenses	1,00,000				
Depreciation	10,000				
	1,10,000	1:3	27,500	-	82,500
<b>EXPENSES BASED ON TIME</b>					
Selling and Distribution expenses	50,000	1:3	12,500	-	37,500
Interest on purchase price	10,800	3:1	8,100	-	2,700
<b>EXPENSES APPLICABLE TO COMPANY</b>					
Debenture interest	24,000				
Director's fees	6,000				
Preliminary expenses	10,000				
Goodwill written off	20,000				
Proposed dividends	40,000				
	1,00,000			1,00,000	-
<b>PROFIT</b>			76,900	1,52,300	-
			1,25,000	1,25,000	3,75,000
				3,75,000	3,75,000

Therefore, the profit prior to incorporation amount to Rs.76,900

**Working Notes**

**1) Sales ratio**

Sales from July 1999 to Sept 1999 ... Rs. 5,00,000  
 Sales from Oct.1999 to June,2000 ... Rs.15,00,000

∴ The ratio will be 1:3

**2) Time ratio**

Pre-incorporation period –July 1999 to Sept.1999 = 3 months  
 Post-incorporation period- Oct,1999 to June,2000 = 9 months

∴ The ratio will be 1:3

## PROFITS PRIOR TO INCORPRATION

### Illustration - 3

Cookme Ltd. was incorporated on 1<sup>st</sup> March, 2001 to acquire a spice powder merchant's business as from 1<sup>st</sup> January, 2001. The purchase consideration was agreed at Rs. 6,000/- to be satisfied by the issue of:

3000 Equity Shares of Rs. 1 each, fully paid and Rs. 3000 6% Debentures.

The following Trading and Profit & Loss Account for the year ended 31<sup>st</sup> December, 2001 is presented to you:

	Rs.		Rs.
Purchases (after adjusting stocks)	7740	Sales	15000
Gross Profit	7260		
	15000		15000
Management Salaries	3000	Gross Profit	7260
Office expenses	250		
Selling expenses	820		
Carriage outwards	170		
Rent and Rates	200		
Debenture Interest	135		
Dividend	300		
Director's fees	200		
Preliminary expenses	287		
Interest on Purchase consideration	90		
Balance	1808		
	7260		7260

You obtain the following additional information:

- i. Sales made by the Company amounted to Rs.13,000/-
- ii. The Shares and Debentures were issued to the Vendor on 1<sup>st</sup> April, 2001.
- iii. Interest at 6% per annum was paid on the purchase consideration from 1<sup>st</sup> January, 2001 to the date Payment.

You are required to prepare a statement in a columnar form apportioning the balance Profit and Loss account for the year ended 31<sup>st</sup> December, 2001 between the periods before and after incorporation.

## Solution

Statement showing Profits earned prior to and after incorporation

Particulars	Basics	Total	Pre-incorporation	Post-incorporation
			1-1-2001 to 28-2-2001	1-3-2001 to 31-12-2001
		Rs.	Rs.	Rs.
Gross profit	Sales 2:13	7260	968	6292
Less: Expenses & Losses				
Management Salaries	Time 1:5	3000	500	2500
Office Expenses	Time 1:5	250	42	208
Selling Expenses	Sales 2:13	820	109	711
Carriage Outwards	Sales 2:13	170	23	147
Rent and Rates	Time 1:5	200	33	167
Debenture Interest	Actual	135	-	135
Director's Fees	Actual	200	-	200
Interest on Purchase Consideration	Time 2:1	90	60	30
		4865	767	4098
Net Profit		2395	201	2194
Less: Appropriation:				
Preliminary Expenses		287	201	86
Dividend		300	-	300
		587	201	386
Balance Profit		1808	-	1808

### Working Notes

- Interest on Purchase Consideration:  
Pre-incorporation: 2 months (January & February)  
Post-incorporation: 1 month (March)
- Though preliminary expenses relate to the post-incorporation period yet it is permitted by law to write off the same against pre-incorporation profit. Accordingly, the pre-incorporation profit has been applied first and post incorporation profit has been applied only to the extent not covered by pre-incorporation profit.

**Illustration - 4**

Sweetex Ltd. was incorporated as Private Limited Company on 1<sup>st</sup> August, 2001 to take over a business as a going concern as from 1<sup>st</sup> February, 2001. The purchase price of the business for such acquisition was fixed on the basis of the Balance Sheet of the firm as at 31<sup>st</sup> January, 2001 but this agreement provided that the vendors would get 80% of the Profits earned prior to 1<sup>st</sup> August, 2001 as compensation. Company's accounts were made upto 31<sup>st</sup> January each year and the summarised Trading and Profit & Loss Account for the year ended 31<sup>st</sup> of January, 2002 disclosed the following results:

	Rs.		Rs.
To Materials Consumed	186000	By Net Sales	260000
To Manufacturing Wages	48500	By Stock	
To Miscellaneous Expenses of Manufacture	18600	Finished goods	49000
To Carriage Inward	6300	Incomplete goods	6000
To Gross Profit C/d	55600		
	<u>315000</u>		<u>315000</u>
To Salaries & Establishment Charges	18300	By Gross Profit b/d	55600
To Office Expenses	2750	By Bad debts recovered	500
To Directors Fees	1800		
To Bad debts	2300		
To Debenture Interest	1250		
To Commission & Discounts	7800		
To Carriage Outwards	1600		
To Depreciation	10300		
To Net Profit for the year	10000		
	<u>56100</u>		<u>56100</u>

Further information available was that:

- Sales from 1-2-2001 to 31-7-2001 amounted to Rs. 116000
- Bad debts amounting to Rs. 1100 were written off prior to 1<sup>st</sup> August, 2001 and
- Recovery of Bad debts was in respect of debts written off during 1998.

Prepare a statement showing profits earned prior to and after incorporation. State also the amount of profit prior to 1<sup>st</sup> August, 2001 thus payable to the vendors.

**Solution**

Statement showing profits earned prior and after incorporation

Particulars	Basics	Total	Pre-incorporation	Post-incorporation
			1-2-2001 to 31-7-2001	1-8-2001 to 31-1-2002
Gross Profit	Sales 116:144	Rs. 55600	Rs. 24806	Rs. 30794
Add: Bad Debts recovered	Actual	<u>500</u> 56100	<u>500</u> 25306	<u>-</u> 30794
Less: Expenses & Losses:				
Salaries & Establishment Charges	Time 1:1	18300	9150	9150
Office expenses	Time 1:1	2750	1375	1375
Directors Fees	Actual	1800	-	1800
Bad debts	Actual	2300	1100	1200
Debenture Interest	Actual	1250	-	1250
Commission & Discounts	Sales 116:144	7800	3480	4320
Carriage Outwards	Sales 116:144	1600	714	886
Depreciation	Time 1:1	<u>10300</u> 46100	<u>5150</u> 20969	<u>5150</u> 25131
Net Profit		10000	4337	5663
Less: Compensation to Vendors:		3470	3470	-
80% of Rs.4337				
Balance Profit		6530	867	5663

**Illustration - 5**

New Ventures Ltd., was incorporated on 1<sup>st</sup> January, 2002 with an authorized Capital consisting of 5000 equity shares of Rs. 10 each to take over the running business of Rundown Brothers as from 1<sup>st</sup> October, 2001:

The following is the summarized Profit & Loss account for the year ended 30<sup>th</sup> September, 2002:

Sales.	Rs.	Rs.
1 <sup>st</sup> October, 2001 to 31 <sup>st</sup> December 2001	6000	
1 <sup>st</sup> January, 2002 to 30 <sup>th</sup> September 2002	19000	25000
Cost of Sales for the year	16000	
Administrative Expenses	1768	
Selling commission	875	
Goodwill Written Off	200	
Interest paid to Vendors	373	
(Loan repaid on 1 <sup>st</sup> February, 2002)		
Distribution Expenses (60 percent variable)	1250	
Preliminary Expenses written off	330	
Debenture Interest	320	
Depreciation	444	
Director's Fees	100	21660
Net Profit		3340

The company deals in one type of product. The unit cost of sales was reduced by 10 percent in the post-incorporation period as compared to the pre-incorporation period in the year.

You are required to prepare a statement apportioning the net profit amount between pre-incorporation and post-incorporation periods showing the basis of apportionments.

### Solution

Statement showing profits earned prior to and after incorporation

Particulars	Basics	Total	Pre-	Post-incorporation
			incorporation	1-1-2002 to
		Rs.	1-10-2001 to	30-9-2002
			31-12-2001	
		Rs.	Rs.	Rs.
Sales	Actual	25000	6000	19000
Less: Expenses & Losses:				
Cost of Sales	60:171	16000	4156	11844
Administrative Expenses	Time 3:9	1768	442	1326
Selling Commission	Sales 6:19	875	210	665
Interest paid to Vendors	Time 3:1	373	280	93
Distribution Expenses:				
Fixed (40%)	Time 3:9	500	125	375
Variable(60%)	Sales 6:19	750	180	570
Debenture Interest	Actual	320	-	320
Depreciation	Time 3:9	444	111	333
Directors Fees	Actual	100	-	100
		<u>21130</u>	<u>5504</u>	<u>15626</u>
Net Profit		3870	496	3374
Less: Appropriations:				
Goodwill Written Off		200	-	-

Preliminary Expenses	330	-	-
	530	496	34
Balance Profit	3340	-	3340

### Working Notes

Cost of Sales:

Ratio of cost per unit between pre-incorporation and post-incorporation periods: 10:9

Ratio of number of units sold between pre-incorporation and post-incorporation periods: 6:19

Hence the ratio of allocation will be  $10 \times 6 : 9 \times 19$  or  $60 : 171$

Interest paid to vendors:

Pre-Incorporation : 3 months (October to December)

Post-incorporation : 1 month (January)

In writing of good will and preliminary expenses pre-incorporation profit has been applied first. The portion not covered by pre-incorporation profit has been written off against post-incorporation profit.

### CHECK YOUR PROGRESS - 2

i) Prepare time ratio from the following particulars:

A running business was taken over by a company from 1<sup>st</sup> of July, 2000, the certificate of incorporation was received on the 1<sup>st</sup> of November, 2000 and the final accounts were being prepared on the 30<sup>th</sup> June, 2001.

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ii) Calculate the sales ratio from the following particulars:

'Z' limited was incorporated on 1<sup>st</sup> of May, 2000 to take over the business of 'Y' Limited from 1<sup>st</sup> January, 2000. The company received the certificate of commencement of business on the 1<sup>st</sup> of June, 2000. Sales for the year 2000 Rs.10,00,000; Sales up to 1<sup>st</sup> of May, 2000 amounted to Rs.4,00,000; and sales upto the 1<sup>st</sup> of June, 2000 amounted Rs.5,00,000.

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### 7.4 SUMMING UP

Profits prior to incorporation mean profits made by a company before it is incorporated. These profits are not earned by the company in the normal course of its business and as such they are to be treated as capital profits. Profits prior to incorporation are not available to the shareholders in the shape of dividends.

For the purpose of calculating profit or loss prior to incorporation, the date of incorporation of the company is taken into account but not the date on which the company is entitled to commence the business. To ascertain the profits prior to incorporation, the profits for the entire year are apportioned between pre-incorporation and post-incorporation.

Time Ratio and Turnover Ratio are taken as the basis for apportioning profits in between the two periods.

## **7.5 CHECK YOUR PROGRESS : MODEL ANSWERS**

1.
  - i) Profits made by a company before it is incorporated rather before it has come into existence are known as profits prior to incorporation.
  - ii) Profits upto the date of incorporation.
2.
  - i) Time ratio = 1:2
  - ii) Sales ratio = 5:2

## **7.6 MODEL EXAMINATION QUESTIONS**

**I. Answer the following questions in about 30 lines each.**

1. How do you ascertain the profit or loss prior to incorporation? Explain with example.

**II. Answer the following questions in about 15 lines each.**

1. What are profits prior to incorporation?
2. Can there be loss prior to incorporation? Explain with examples.

### **Problems**

1. XYZ Limited was incorporated on the 1<sup>st</sup> of May, 1999 and it was entitled to commence business on the 1<sup>st</sup> of June, 1999. The company has acquired a running business from the 1<sup>st</sup> of January, 1999. The Profit and Loss Account of the business for the year 1999 was as follows:

To Salaries	40,000	By Gross profit	2,00,000
To Carriage	15,000		
To Advertising	20,000		
To General Expenses	10,000		
To Interest on Debentures	6,000		
To Director's Fees	4,000		
To Audit Fees	5,000		
To Depreciation on fixed assets	20,000		
To Interest paid to vendors (up to 30 <sup>th</sup> June)	10,000		
To Net profit for the year	70,000		
	2,00,000		2,00,000

Sales upto the 1<sup>st</sup> of May, 1999 were Rs.2,00,000. and after the 1<sup>st</sup> of May, 1999 Rs.8,00,000. You are required to ascertain the profit prior to incorporation.

(Ans: Profit prior to incorporation : Rs.1,333)

2. Ajantha Ltd., was incorporated on the 1<sup>st</sup> of July, 1999 to take over the business of A & Co. as a going concern with effect from 1<sup>st</sup> of April, 1999. The following is the profit and loss account for the year ending on the 31<sup>st</sup> of the March, 2000 of Ajantha Ltd.

To Opening Stock	2,40,000	By Sales (upto 30-6-99 Rs.2,00,00)	6,00,000
To Purchases	3,50,000	By Closing Stock	1,40,000
To Balance C/d	1,50,000		
	<u>7,40,000</u>		<u>7,40,000</u>
To Administrative Expenses	36,000	By Balance c/d	1,50,000
To Director's Fees	6,000		
To Selling Expenses	72,000		
To Audit Fees	2,000		
To Preliminary expenses	6,000		
To Net profit	28,000		
	<u>1,50,000</u>		<u>1,50,000</u>

You are required to prepare a statement showing the profit earned prior to and after incorporation.

(Ans: Profit prior to incorporation: Rs.16,500)

## 7.7 RECOMMENDED BOOKS

1. R.L. Gupta and M. Radhaswamy : **Advanced Accountancy, Volume-II**  
Sultan Chand & Sons, 23, Daryaganj, New Delhi.
2. S.N. Maheswari : **Advanced Accountancy, Volume-II**  
Vani Educational Books, New Delhi.
3. S.P. Jain and K.L. Narang : **Advanced Accountancy,**  
Kalyani Publishers, Ludhiana.
4. MC. Shukla and T.S. Grewal : **Advanced Accountancy,**  
S. Chand & Sons, New Delhi.

## **7.8 GLOSSARY**

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- Loss prior to Incorporation** : Loss suffered by a company before it is incorporated
- Profits prior to incorporation** : Profits made by a company before it is incorporated

**C. Mallikarjuna Rao**

BRAOU

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## **UNIT - 8 : BONUS SHARES**

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### **Contents**

- 8.0 Aims and objectives
- 8.1 Introduction
- 8.2 Meaning of Bonus Shares
- 8.3 Objects of Issuing Bonus Shares
- 8.4 Sources of Bonus Shares
- 8.5 Provisions of the Companies Act, 1956
- 8.6 Accounting Treatment
- 8.7 Summing up
- 8.8 Check Your Progress : Model Answers
- 8.9 Model Examination Questions
- 8.10 Recommended Books
- 8.11 Glossary

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### **8.0 AIMS AND OBJECTIVES**

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This unit aims at discussing the issue of bonus shares by a company, the conditions to be fulfilled before the issue of such shares and the accounting treatment pertaining to issue of bonus shares.

Having studied and worked through this unit, you should be able to:

- explain the objects of issuing bonus shares;
- state the sources of bonus shares;
- explain the provisions of the Company Act, 1956;
- describe the accounting treatment pertaining to issue of bonus shares; and
- solve the problems on issue of bonus shares.

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### **8.1 INTRODUCTION**

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You have already learnt the meaning of divisible profits, that is, profits to be distributed to shareholders as dividends and profits prior to incorporation in the previous three units. In this unit you will learn about the objects of issue of bonus shares and accounting treatment pertaining to issue of such bonus shares. Further you will learn about the various sources for issue of bonus shares.

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### **8.2 MEANING OF BONUS SHARES**

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Bonus shares are those shares which are issued without any payment to the share holders. They are issued out of reserves, both capital and revenue. The Process of issuing bonus shares is also known as capitalization of reserves.

When a company built up large reserves, it may desire to distribute such reserves among the shareholders as bonus. Such bonus may be either cash bonus or capital bonus. Cash bonus can be given only when the company has sufficient cash to pay the bonus and when distribution of cash bonus does not affect the working capital of the company. Capital bonus is given when the company wants to distribute among the share holders the accumulated reserves and when it is not in a position to pay the bonus in cash. Then the bonus declared is either used in making partly paid shares fully paid or in issuing free fully paid shares of the company. Such free fully paid shares issued by the company are known as 'bonus shares'. In the process the reserves utilized by the company in issuing bonus shares become part of the company's subscribed capital. Such bonus shares can be issued only with the permission of the Controller of Capital Issues.

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### **8.3 OBJECTS OF ISSUING BONUS SHARES**

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The objects of issuing bonus shares are:

- i. to conserve the cash resources of the company;
- ii. to present a proper figure of share capital with which profits can be compared; and
- iii. to offer capital gain to the share holders.

A company can justify the issue of bonus shares in the following circumstances:

- i. when the company has accumulated large reserves ;
- ii. when the company has expended such reserves in revenue producing assets and when it is not in a position to give cash bonus; and
- iii. when there is a wide gap between the 'share capital' and 'fixed assets', i.e., when the company is under capitalized.

Otherwise the issuing of bonus shares cannot be justified by a company. A company should not resort to the issuing of bonus shares merely because sufficient cash is not available for paying cash dividend, because the issuing of bonus shares not only increases the dividend bearing capital of the company. Moreover if in future the rate of dividend is not maintained it may lead to discontentment among the share holders and fall in the market value of the shares which will not be conducive to the flow of capital into it.

The bonus shares issued by a company may be either Equity shares or Preference shares, but it is only the equity share-holders which do not carry a fixed rate of dividend that are issued as bonus shares.

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#### **CHECK YOUR PROGRESS – 1**

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I. What is the purpose of issuing bonus shares?

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## **8.4 SOURCES OF BONUS SHARES**

The various sources for issue of bonus shares are:

- i) Share Premium,
- ii) Capital Redemption Reserve,
- iii) General Reserve,
- iv) Profit and Loss Account Credit Balance,
- v) Capital profits such as profit prior to incorporation, profit on purchase of business, profit on sale of fixed assets, etc., and
- vi) Any other reserves accumulated out of profits

Sections 78 and 80 of the Companies Act, 1956, state that the Share Premium account and Capital Redemption Reserve account or other reserves may be utilized by a company in paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares. It follows, therefore, that only revenue reserves should be used by a company for making partly paid shares fully paid.

A Company which wants to issue bonus shares must fulfill certain conditions before the shares are issued. The provisions of the Companies Act, 1956, regarding the issue of bonus shares are worth noting in this connection.

### **CHECK YOUR PROGRESS - 2**

- I. What are the sources of bonus shares?

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.....

.....

.....

## **8.5 PROVISIONS OF THE COMPANIES ACT, 1956**

- i) The Articles of Association of the Company must permit the issue of bonus shares;
- ii) There should be a sufficient number of unissued shares to enable the company to issue bonus shares. If there is no unissued capital, the necessary resolution altering the memorandum of association and articles of association should be passed by company for increasing the authorized capital.
- iii) The share holders at their general meeting must approve the Board's resolution regarding the issue of bonus shares.

Per the issue of bonus shares the guidelines issued by SEBI have to be followed:

Besides the above mentioned provisions, the following points must also be kept in view by the company before it resorts issuing bonus shares. Some of important guidelines are as follows:



**Illustration - 1**

The Balance Sheet of 'A' limited company on the 31<sup>st</sup> of the Dec., 1999 was as under:

Liabilities	Rs.	Assets	Rs.
<b>Share Capital:</b>			
1,00,000 shares of Rs. 10 each	10,00,000	Fixed Assets	15,00,000
		Current Assets	5,00,000
Rs. 7.50 per share paid up	7,50,000		
General Reserve	4,00,000		
Share Premium	2,00,000		
Profit and Loss A/c	2,50,000		
Sundry Creditors	4,00,000		
	<u>20,00,000</u>		<u>20,00,000</u>

The Company decided to make partly paid shares fully paid out of Profit and Loss Account. The company also decided to issue one fully paid bonus share for every two shares held and for this purpose the share premium was to be fully paid. Give journal entries for the issue of bonus shares and prepare the Balance Sheet of the company.

**Solution**

**Books of 'A' Limited Company  
Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
1999 Dec. 31	Profit and Loss Account Dr. To Bonus to Shareholders A/c (Being bonus declared to make partly paid shares fully paid)		2,50,000	2,50,000
Dec. 31	Share Final Call Account Dr. To Share Capital Account (Being final call amount due at the rate of Rs. 2.50 per share on 1 lakh shares to be met out of bonus)		2,50,000	2,50,000
Dec. 31	Bonus to Share-holders A/c Dr. To Share Final Call Account (Being final call Adjusted out of bonus)		2,50,000	2,50,000
Dec. 31	Share Premium Account Dr. General Reserve Account Dr. To Bonus to Share holders A/c (Being bonus declared to issue 50,000 shares as fully paid in the ratio of share for every 2 shares held)		2,00,000 3,00,000	5,00,000

Dec. 31	Bonus to Share holders A/c To Share capital Account (Being bonus declared converted into capital)	Dr.	5,00,000	5,00,000
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**Balance Sheet**  
as on the 31<sup>st</sup> of December, 1999

Liabilities	Rs.	Assets	Rs.
<b>Share Capital:</b>		<b>Fixed Assets</b>	15,00,000
1,50,000 shares of Rs. 10 each Fully paid (of the above shares 50,000 shares are issued as bonus shares)	15,00,000	<b>Current Assets</b>	5,00,000
General Reserve	1,00,000		
Sundry Creditors	4,00,000		
	<u>20,00,000</u>		<u>20,00,000</u>

**Illustration – 2**

'A' Limited Company having a subscribed capital of Rs.2,00,000 in fully paid shares of Rs.10 each. quoted in the market at Rs.20, declares bonus out of General Reserve at 60% of the original capital for issuing bonus shares at a premium of Rs.5 per share. Give the necessary Journal entries in the books of the company.

**Solution**

**Books of 'A' Limited Company**  
**Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
Dec.31	General Reserve Account Dr. To Bonus to Shareholders A/c (Being bonus at 60% of the capital declared out of General Reserve)		1,20,000	1,20,000
	Bonus to Shareholders A/c - Dr. To Share Capital Account To Share Premium Account (Being Bonus satisfied by the issue of 8,000 shares of Rs.10 each as fully paid at a premium of Rs.5 per share)		1,20,000	80,000 40,000

**Illustration – 3**

The paid up share capital of 'B' Limited Company was Rs.10,00,000 divided into equity shares of Rs.10 each. The company decided to distribute Rs.2,50,000 as bonus to

shareholders out of General Reserve. In satisfaction of the bonus, one bonus share was issued for every 5 shares held. Give necessary Journal entries to record the bonus issue in the books of the company;

**Books of 'B' Limited Company  
Journal**

Date	Particulars	L.F	Dr. Rs.	Cr. Rs.
Dec.31	General Reserve Account <span style="float: right;">Dr.</span> To Bonus to Shareholders A/c (Being bonus declared out of General Reserve)		2,50,000	2,50,000
	Bonus to Shareholders A/c <span style="float: right;">Dr.</span> To Share Capital Account To Share Premium Account (Being Bonus satisfied by the issue of 2,000 bonus shares of Rs.100 each, at a premium of Rs.25 per share, in the ratio of 1 bonus share for every five share held)		2,50,000	2,00,000 50,000

**Note**

The existing paid up share of the capital of the company consists of 10,000 equity shares of Rs.100 each. If one bonus share is issued for every five shares held, the company can issue only 2,000 shares of Rs.100 each which works out of Rs.2,00,000. But as the company has decided to give Rs.2,50,000 as bonus, the balance of Rs.50,000 is regarded as premium at the rate of Rs.25 per share.

**Illustration-4**

Ajanta Trading Co. Ltd., has authorized capital of Rs.800000 divided into:

- 10,000 6% Preference share of Rs.10 each;
- 20,000 7% Preference share of Rs. 10 each; and
- 50,000 equity shares of Rs. 10 each.

On January 1,2001, the whole of the two classes of Preference shares and 15,000 of the equity shares stood in the books as fully paid. The share Premium account as on that date showed a balance of Rs. 20,000. The balance of Profit was Rs. 32,000. On July 1,2001, it was decided to redeem the whole of 6% Preference shares at a Premium of Rs. 1 per share and for this specific purpose, the company issued for cash 8000 equity shares of Rs. 10 each at a Premium of Rs. 2 per share, payable full on allotment. All the above shares were taken up. The cost of issue of shares amounted to Rs. 3000. On October1, the company issued to existing share holders one bonus share of Rs. 10 fully paid each five held. It is the intention of the directors that minimum reduction should be made in revenue reserve account, which stood at Rs. 1,25,000. Give necessary Journal entries.

**Solution**

**Journal Entries**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
2001 July 1	6% redeemable preference share capital Premium on redemption of preference Shares account To Preference Shareholders Account (Amount due on redemption)	Dr.  Dr.	1,00,000  10,000	  1,10,000
July 1	Bank Account To Equity Share Application Account (The application money received on the issue of shares including premium)	Dr.	96,000	96,000
July 1	Equity Share Application Account To Equity Share Capital Account To Share Premium Account (Transfer of application money to share capital and share premium accounts respectively)	Dr.	96,000	80,000 16,000
July 1	Cost of Issue Account To Bank Account (Expenditure incurred on the issue of shares)	Dr.	3,000	3,000
July 1	Preference Shareholders Account To Bank Account (Amount paid on redemption)	Dr.	1,10,000	1,10,000
July 1	Share Premium Account To Premium on the Redemption of Preference Shares Account To Cost of Issue Account (The utilization of premium money for writing of premium on redemption and preliminary expenses)	Dr.	13,000	10,000 3,000
July 1	Profit and Loss Appropriation Account To Capital Redemption Reserve Account (Amount transferred to capital redemption reserve to the extent of nominal amount paid out of profits)	Dr.	20,000	20,000
Oct. 1	Share Premium Account Capital Redemption Reserve Account General Reserve Account To Bonus Issue Account (The sum required for bonus issue taken)	Dr. Dr. Dr.	23,000 20,000 3,000	46,000

	from different reserves accounts utilizing the minimum general reserve account)			
Oct. 1	Bonus Issue Account To Equity Share Capital Account (Issue of bonus shares)	Dr.	46,000	46,000

### Working Notes

1. Only the nominal value of shares issued should be considered for determining the amount to be transferred to capital redemption reserve account. Premium received on issue of shares is therefore not to be considered. This is supported by Section 78 of the Companies Act 1956, which does not specify redemption of preference shares as one of the purposes for which share premium account can be used.
2. Bonus shares can be issued only to the equity shareholders because reserves and surplus belong to them only. The words existing shareholders in the illustration only means the equity shares issued on 1. Oct, 2001 too. It does not include existing preference shares under any circumstances.

## 8.7 SUMMING UP

Bonus shares are the shares issued by the company without payment being made by the shareholders.

Cash bonus is given only when the company has sufficient cash to pay the bonus. Capital bonus is given when the company is not in a position to give cash bonus. Bonus declared by a company is applied either in making partly paid shares fully paid or in issuing fully paid shares free.

The Objects of issuing bonus shares are to conserve the cash resources, to present a proper figure of share capital and to offer capital gain to shareholders.

The sources for issuing bonus shares are free reserves, share premium, profit and loss credit balance, capital profits, etc.

Provisions of the Companies Act, 1956 must be fulfilled before a company resorts to the issuing of bonus shares.

## 8.8 CHECK YOUR PROGRESS : MODEL ANSWERS

1. The purpose of issue of bonus shares is to conserve or capitalize cash resources of a company.
2. The sources for issuing bonus shares are free reserves, share premium, profit and loss account credit balance, capital profits and other reserves, etc.

## 8.9 MODEL EXAMINATION QUESTIONS

### I. Answer the following question in about 30 lines.

1. Discuss the accounting treatment pertaining to issue of bonus shares. Explain with an example.

### II. Answer the following questions in about 15 lines each.

1. What are bonus shares? Discuss the objects of issuing such shares?
2. What are the sources available to a company for the issue of bonus shares?
3. What conditions must be fulfilled by a company before it can think of issuing bonus shares?

### Problems

1. A limited company with an issued capital of Rs.5,00,000 in equity shares of Rs.10 each decided to issue fully paid bonus shares of Rs.10 each at the rate of 1 share for every 5 held. Some of the ledger balances were: Share Premium Account Rs.50,000; Capital Redemption Reserve Account Rs.25,000; and Profit and Loss Account credit balance Rs.1,00,000. You are required to give journal entries carrying out the decision by using the minimum amount from the undistributed profits.
2. A Limited company has resolved to utilise Rs.2,50,000 out of its General Reserve in declaration of bonus to the share-holders. The bonus is to be applied to the extent of Rs.1,00,000 in payment of Final Call of Rs.20 per share on 5,000 equity shares of Rs.100 each. The balance of Rs.1,50,000 was to be applied in the issue of 1,500 fully paid equity shares of Rs.100 each to the existing shareholders. Give the necessary Journal entries to give effect to the above mentioned resolution in the books of the company.
3. The Balance Sheet of X Ltd as on the 31<sup>st</sup> of December, 1999 was as under:

Liabilities	Rs.	Assets	Rs.
10,000 equity shares of Rs.5 each Rs.3.75 per share paid	37,500	Machinery	45,000
Share Premium	5,000	Buildings	20,000
General Reserve	25,000	Furniture	10,000
Profit and Loss account	20,000	Investments	20,000
Creditors	12,500	Cash and Bank balances	5,000
	<u>1,00,000</u>		<u>1,00,000</u>

The company resolved to make the shares fully paid out of the Profit and Loss Account and then issue one fully paid bonus share for every 2 shares held. For this purpose the Share Premium account was to be fully used and the General Reserve. Give journal entries and prepare the Balance Sheet after the issue of bonus shares.

(Ans: Balance Sheet total : Rs.1,00,000)

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## 8.10 RECOMMENDED BOOKS

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1. R.L.Gupta  
M.Radhaswamy : **Advanced Accountancy,**  
Himalaya Publishing House, Delhi.
2. S.N. Maheswari : **Advanced Accountancy,**  
Volume-II (Vani Educatinal Books, New Delhi.
3. S.P.Jain and  
K.L.Narang : **Advanced Accountancy,**  
Kalyani Publishers, Ludhiana.
4. M.C. Shukla and  
T.S. Grewal : **Advanced Accountancy,**  
S. Chand & Sons, New Delhi.

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## 8.11 GLOSSARY

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- Bonus Shares** : Shares issued by the company without payment being made by shareholders.
- Capital Shares** : Bonus distributed among shareholders in the shape of shares.
- Cash Bonus** : Bonus declared and paid in cash.

**C. Mallikarjuna Rao**

BRAOU

**BLOCK – III**  
**AMALGAMATION, ABSORPTION AND**  
**RECONSTRUCTION**

**Unit – 9 : Amalgamation, Absorption and  
Reconstruction – An Introduction**

**Unit – 10 : Amalgamation**

**Unit – 11 : Absorption**

**Unit – 12 : Reconstruction**

BRAOU

# **UNIT - 9 : AMALGAMATION, ABSORPTION AND RECONSTRUCTION - AN INTRODUCTION**

## **Contents**

- 9.0 Aims and Objectives
- 9.1 Introduction
- 9.2 Merger and its Objectives
- 9.3 Amalgamation
- 9.4 Absorption
- 9.5 Holding Company
- 9.6 Reconstruction
- 9.7 Similarities and differences between Amalgamation, Absorption and Reconstruction
- 9.8 Accounting Standard - 14
- 9.9 Purchase Consideration: Meaning and Need
- 9.10 Explanation of Terms
- 9.11 Methods of Calculating Purchase Consideration
- 9.12 Entries in the Books of Vendor Company
- 9.13 Entries in the books of Purchasing Company
- 9.14 Summing Up
- 9.15 Check Your Progress : Model Answers
- 9.16 Model Examination Questions
- 9.17 Recommended Books
- 9.18 Glossary

## **9.0 AIMS AND OBJECTIVES**

The aim of this unit is to acquaint the student with the concepts and accounting aspects of mergers and reconstruction. The accounting fundamentals of mergers such as calculation of purchase consideration and closure of books of Vendor Company are also explained.

After studying this unit, you should be able to:

- explain the concepts of amalgamation, absorption and reconstruction;
- differentiate between merger and holding company;
- describe the Accounting Standard – 14;
- calculate purchase consideration; and
- record the entries in the books of both the vendor company and purchasing company.

## **9.1 INTRODUCTION**

A substantial portion of modern industrial production is done by large manufacturing units, especially of company form of organizations. After indulging in cut-throat competition

among themselves they tend to combine. Business concerns combine with each other to achieve economies of scale or to control prices or market or to avoid competition among themselves. Small firms may combine for reducing risks of business. Combinations take place in many forms. Combination presupposes the liquidation of one or two companies so as to merge with each other. This liquidation involves certain financial transactions which require to be recorded in the books of accounts. Hence there is a need to learn the process of recording these transactions in the books of companies involved in combination.

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## 9.2 MERGER AND ITS OBJECTIVES

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It is noted that combination of two or three companies can take place in several ways. Literary meaning of merger is the act of joining together for commercial advantage. Combination can be achieved either by means of holding company or through mergers. Merger may take the form of "amalgamation" or "absorption".

The important objectives of mergers, especially amalgamations, absorptions are:

- i) to eliminate or minimise competition,
- ii) to pool resources, whether financial or technical, facilitating research and development and best utilization of staff,
- iii) to effect general economies in (a) production (b) use of capital, (c) selling (d) distribution and (e) general overheads, through centralization and closing down of unprofitable and redundant sections.
- iv) to create a more powerful and economic unit,
- v) to control markets, supplies of materials, and
- vi) to effect purchases on a large scale at generally lower prices and on most advantageous terms.

Since merger may take the form of amalgamation or absorption, let us know their meaning and the process.

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## 9.3 AMALGAMATION

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When two or more companies carrying on similar business go into liquidation and a new company is formed to take over their business, it is called amalgamation. For example Sun Light Ltd., and Moon Light Ltd., are carrying on similar business. To avoid cut-throat competition and to have economies of scale, if a company Bright Ltd., is formed to take over the business Sun Light Ltd., and Moon Light Ltd., it is known as amalgamation. The companies which went into liquidation i.e., Sun Light Ltd., and Moon Light Ltd., are called amalgamated companies and the company which is formed to take over the business of amalgamated companies i.e., Bright Ltd., is called 'amalgamating' company.

The share capital in the liquidated or amalgamated companies, need not be returned to the share-holders. Generally, fully paid shares of the newly created, i.e., the amalgamating company will be given to the shareholders of the amalgamated companies for the shares held by them in the old companies.

## **Types of Amalgamation**

The Companies Act, 1956 has not specifically defined the term 'amalgamation'. However, from several legal decisions, the definition of amalgamation may be inferred. The Institute of Chartered Accountants of India (ICAI) has introduced Accounting Standard – 14 (AS-14) on Accounting for Amalgamations. The Standard recognizes two types of amalgamation (i) Amalgamation in the nature of merger, and (ii) Amalgamation in the nature of purchase.

### **I. Amalgamation in the Nature of Merger**

This is an amalgamation which satisfies all the following conditions:

- i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiary or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
- iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- v) 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.

### **II. Amalgamation in the Nature of Purchase**

If any one or more of the above conditions are not satisfied in an amalgamation, such amalgamation is called amalgamation in the nature of purchase.

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## **9.4 ABSORPTION**

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When an existing company takes over the business of one or more existing companies, it is called absorption. The companies whose business is taken over are liquidated. For example, Good Luck Ltd., (a strong company) and Bad Luck Ltd., (a weak company) are carrying on similar business. To avoid competition among them and to enhance profits by effecting economy in management, Good Luck Ltd., takes over Bad Luck Ltd. This process is called absorption. In this case only one company, i.e. the Bad Luck Ltd. (the weak company) goes into liquidation, and the strong company, Good Luck Ltd., continues to exist with its old legal entity. The company which went into liquidation is called absorbed company, and the company which takes over its business is called the 'absorbing company'.

Along with the assets, the creditors and the other liabilities of the absorbed company may be taken over by the absorbing company or they may be settled by payment. The shareholders in the wound up company may be given shares or debentures in the absorbing company or they may be paid in cash or a combination of some or all of these things.

Generally, amalgamation or absorption takes place voluntarily as decided by the shareholders of the respective companies. But, if the Central Government feels that in the national interest, amalgamation of two or more particular company is advisable, then it may order the amalgamation of such companies under Section 396 of the Companies Act, 1956. The rights and responsibilities of the new company created under such compulsory amalgamation, may also be specified in that order.

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## **9.5 HOLDING COMPANY**

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A holding company is one which is able to nominate the majority of the directors of some other company. Such other company is known as subsidiary company. In this case no new company is created. Not only that, none of the existing companies which are coming together need be liquidated. In other words all the companies which are coming together in the holding company form, maintain their existence. Under this form, if a company purchases majority (more than 50%) of the equity share (i.e. major part of the paid up equity share capital) of some other company, the company purchasing the shares is called a holding company. For examples, Food Exports Ltd., missing is called the holding company, and Sea Foods Ltd., is called the subsidiary company. But both of them continue to exist and carry on business.

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## **9.6 RECONSTRUCTION**

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It is entirely of a different nature. The purpose of reconstruction is not to bring about combination, but merely to reorganise a company which is, generally over capitalised or which has suffered heavy losses which are to be written off. Reconstruction is of two types. Viz., (a) Internal Reconstruction and (b) External Reconstruction.

Where a company, due to various reasons such as inadequacy of working capital or uneconomically high cost of production or bad business conditions, incurs continuous losses, part of the share capital may also be actually lost. However, the balance sheet continues to show the original share capital. This fact can be seen from a close look at the Balance Sheet (Asset side). Such a company will have huge fictitious assets like Profit and Loss Account representing accumulated losses, preliminary expenses, discount of issue of shares and debentures, patent rights, etc., which should have been written off over a period of years normally, but could not be written off as the company had no profits for several years against which these fictitious assets can be written off. Further, the asset side might show a huge amount under the intangible asset namely, goodwill. There can be no value for goodwill when the company has been continuously incurring losses. Like-wise, proper depreciation may not have been written off from the fixed assets. All these amounts like the fictitious assets, goodwill and inadequate depreciation represent nothing but loss. But, the company has not written off these amounts as that would show the loss at a very high figure which the management may not want to display even though that is the correct position. Thus, the share capital shown in the balance sheet is not represented by assets. If the same circumstances continue for a considerable length of time, there is no option except to wind up the company. However, if the company has turned the corner and is expected to earn

sufficient profits in future, the company may be reorganised or reconstructed so that it can start again on a clear slate wiping of the losses and showing the assets at their real worth. The accumulated losses will have to be borne mainly by the shareholders. Sometime the debentureholders and creditors may also have to make sacrifices when they see that if they don't agree to do so, the alternative is only liquidation in which event they may get nothing at all. Of course, must hold out bright prospect or otherwise their sacrifice is meaningless. The total accumulated losses will thus be borne by equity shareholders, preference shareholders, debenture-holders and other creditors in mutually agreed proportions set out in a scheme of reconstruction. The share capital and the claims of creditors will be reduced to the extent of accumulated real losses. As the shareholder's capital stands reduced, the company may utilize the opportunity to provide itself with working capital by collecting the remaining amount on the shares so reduced. For example, each existing equity share of Rs.10 fully paid is reduced to Rs.4 per share paid up under a scheme of reconstruction, the company can collect again on each share @Rs.6/-(Rs.10-4). Not only can the company collect more working capital by this method, but it can project a better image by declaring a higher rate of dividend when the profits are earned in future.

When the capital of the company is reduced either with or without sacrifices made by outsiders (i.e., creditors, etc.) under a scheme of reorganisation without liquidation of the company, it is known as Internal Reconstruction or Capital Reduction. While it is true that in most cases companies formulate schemes of internal reconstruction as a result of accumulated losses and lost capital, it is also possible that a company may reduce its capital by refunding surplus capital when it cannot usefully employ those funds due to decline in business or closing down certain departments. Thus the internal construction may take place even though the capital of the company is in tact and nothing is lost. Internal reconstruction is also known as reorganization.

External reconstruction takes place when a new company is floated to take over the business of an existing weak company which is then wound up. In other words, an existing company starts with a fresh lease of life under a new name. Here one liquidation and one formation take place.

The objects of reconstruction are :

- i) to compromise with creditors including debenture-holders;
- ii) to compromise with shareholders by alteration of various rights between each class, usually involving the writing down of the amount of share capital;
- iii) to raise further capital from shareholders ( by treating fully paid-up shares as partly paid-up shares) ;
- iv) to alter the name of the company (external reconstruction); and
- v) to alter the Memorandum of Association.

It is important to note that whether the reconstruction has become absolutely necessary or is it merely advisable. A necessary reconstruction almost invariably involves the alteration of rights, or the imposition of some sacrifice – temporary or permanent – on both shareholders and creditors. Generally, reconstruction means external reconstruction only.

## **9.7 SIMILARITIES AND DIFFERENCES BETWEEN AMALGAMATION, ABSORPTION AND RECONSTRUCTION**

Section 494 of the Companies Act, 1956 facilitates amalgamation, absorption and reconstruction, with the sanction of a special resolution of the company concerned. The liquidator can accept shares, policies or other like interests in the transferee company for the distribution among the members of the transferor company. This means a company going into liquidation can be purchased by some other company and the purchase price may be discharged fully or partly by issuing shares or debentures in the Purchasing Company.

The distinction between amalgamation, absorption and reconstruction may be illustrated by reference to two imaginary companies say A and B.

1. If an amalgamation takes place between A and B, then the two companies A and B go into liquidation and a new company, say, AB, is formed to take over the business of A and B.
2. If an absorption takes place between A and B, then there will be one liquidation say, B, and no new company is formed. That means A takes over or absorbs B. This is nothing but amalgamation by the method of purchase as per AS-14.
3. If A takes over B as its subsidiary, then both A and B continue to exist as holding and subsidiary companies respectively and there is no liquidation of any company.
4. Reconstruction:
  - i) if internal reconstruction takes place, there is neither liquidation of any company, nor formation of any new company. Only capital reorganisation takes place.
  - ii) if there is external reconstruction there will be only one liquidation say that of A, and a new company say C, is formed with the specific objective of taking over the business of A.

Therefore,

- |   |                                   |
|---|-----------------------------------|
| a) Two or more liquidations and a formation                               | ... means Amalgamation            |
| b) One or more liquidations and no formations                             | ... means Absorption              |
| c) No liquidation, but only acquisition of controlling interest           | ... means Holding company         |
| d) No liquidation and no formation, but only alternation of share capital | ... means internal reconstruction |
| e) One liquidation and a formation  | ... means external Reconstruction |

In case of amalgamation, absorption or (external) reconstruction, liquidation of one or more companies 'must' take place, and in all the above cases the business must be purchased by some other company, whether the other company is a newly created one for this purpose or an old (existing) one. Therefore, in amalgamation, absorption, and external reconstruction, the accounting procedure/ problem is common, which is as follows:

- a) The purchase consideration has to be calculated.

- b) In all the three cases accounting entries are to be passed in the books of vendor (liquidated) company or companies to close down the books of accounts.
- c) In all three cases, accounting entries are to be passed in the books of the purchasing company, new or old, to record the transactions relating to the acquisition of business.

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### **CHECK YOUR PROGRESS - 1**

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i) State the objectives of merger

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.....

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ii) Differentiate between reorganisation and reconstruction

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### **9.8 ACCOUNTING STANDARD - 14**

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This statement deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This standard does not deal with acquisitions whereby one company acquires the whole or part of the shares or assets of another company for consideration. In case of acquisition the acquired company is not dissolved and its separate entity continues to exist.

#### **Types of Amalgamation**

Amalgamation may be classified into two categories:

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

An amalgamation should be considered to be an **amalgamation in the nature of merger** when all the following conditions are satisfied:

- i. All the assets and liabilities of the transferor company become the assets and liabilities of the transferee company.
- ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company become the equity shareholders of the transferee company.
- iii. The business of the transferor company is intended to be carried on by the transferee company after amalgamation.
- iv. The purchase consideration is discharged by the transferee company by the allotment of equity shares to the shareholders of transferor company. **However, cash may be paid only in respect of fraction shares.**

- v. No adjustment is made in respect of the book values of the assets and liabilities of transferor company when they are incorporated in the financial statement of the transferee company except to ensure uniformity of accounting policies.

If such amalgamation does not satisfy any one or more conditions stated above, it is referred to Amalgamation in the nature of purchase :

### **Methods of Accounting**

**The Pooling of Interest Method:** This method of accounting is followed for amalgamation in the nature of merger.

**The Purchase Method:** This method is followed for amalgamation in the nature of purchase.

#### **I. Pooling of Interest Method**

- i) While preparing the transferee company's financial statements, the assets, liabilities, reserves of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of amalgamation.
- ii) The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to the General Reserve, if any.

#### **II. Purchase Method**

Under this method, the transferee company incorporates the assets and liabilities by adopting any of the following values.

- i) Existing carrying amounts (i.e., book values) as disclosed in Balance Sheet.
- ii) Allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair value on the date of amalgamation. The purchase consideration of amalgamation may consist of securities, cash or other assets. The reserves (whether capital or revenue) of the transferor company, other than 'statutory reserves' should not be included in the financial statements of the transferee company. If the purchase consideration is more than the net value of assets then it is goodwill. If the amount of the consideration is lower than the value of net assets then difference should be treated as Capital Reserve. Debentures issued for satisfying the existing debentureholders is not to be regarded as part of purchase consideration.

#### **Disclosure**

For all amalgamations, the following disclosures should be made in the first financial statements.

- i) Names and general nature of business of the amalgamating companies.
- ii) Effective date of amalgamation for accounting purposes.
- iii) The method of accounting used to reflect the amalgamation.

- iv) Particulars of the scheme sanctioned under a statute.

Let us now go further to know the meaning and methods of determining purchase consideration which is an important ingredient of amalgamation, absorption and external reconstruction.

## **9.9 PURCHASE CONSIDERATION: MEANING AND NEED**

Determination of purchase of consideration is the first and the most important step in problems relating to amalgamation, absorption and reconstruction of companies. The purchase consideration is determined as per agreement. Purchase consideration is the amount which is paid by the purchasing company for acquiring business of the vendor company.

In other words it is the price agreed between the purchaser and seller at which the subject matter is going to be exchanged. For instance, ABC Co. Ltd. offers to purchase the XYZ Co. Ltd., at a price of Rs.10 lakhs payable partly in cash and partly in shares. If XYZ Co. Ltd. agrees to the price, then Rs. 10 lakhs is called purchase consideration. Before proceeding to calculate purchase consideration and pass accounting entries, a clear understanding of the following terms is essential.

## **9.10 EXPLANATION OF TERMS**

- i) **Trade Liabilities:** The term trade liabilities stands for those liabilities which are incurred on account of goods of the business such as trade creditors and Bills payable.
- ii) **Liabilities:** The term liabilities is however a broad term which includes trade and non-trade liabilities. The non-trade liabilities, i.e., the other liabilities are, bank over-draft, debentures, salary and other expenses outstanding, provision for taxation, workmen savings bank account, workmen provident fund account, workmen gratuity fund account and pension fund account, etc.
- iii) **All assets:** The term all assets includes cash and bank balances also.
- iv) **Business:** The term business stands for all assets minus all liabilities which means the taking over of all assets and liabilities.
- v) **Assets and Liabilities taken over:** The term "assets" here means all assets except cash bank balances and liabilities means trade liabilities only.

In the above discussion it is very important to note that the terms all assets and assets do not include accumulated losses and terms trade liabilities and liabilities do not include accumulated profits. Hence there is a need to understand the treatment of the accumulated losses, profits and other funds.

**Accumulated Losses:** Accumulated losses and fictitious assets and expenses not written off such as (a) debit balance of profit and loss account (b) preliminary expenses, (c) discount on issue of shares and debentures (d) commission on issue of shares and debentures etc. are transferred to equity shareholders account (not to realisation account).

**Accumulated profits:** Undistributed profits like credit balance of profit and loss account, reserve fund, general reserve, sinking fund, share premium, capital reserve, etc., are not transferred to realisation account but they are transferred to equity shareholders account.

**Accident fund and Workmen's compensation fund:** These funds are created to meet any liability on these accounts at some future time. On liquidation of the company, if there is no further possibility of any liability arising on these accounts, the entire amount will be treated as accumulated profit and hence transferred to equity shareholder's account.

**Provisions:** The balance sheet of any company often shows provisions like (a) provision for depreciation (b) provision for investment (c) provision for doubtful debts (either as a deduction from the asset or separately on the liabilities side). Whatever may be the mode of presentation in the balance sheet, on liquidation, if the purchasing company takes over a particular asset the provisions pertaining to that asset will also be taken over, and is to be transferred to realization account along with the asset. The provision on these assets which are not taken over by the purchasing company should not be transferred to realization account. They are to be transferred to equity shareholders account only.

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## 9.11 METHODS OF CALCULATING PURCHASE CONSIDERATION

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Purchase consideration may be calculated in the following ways:

### 1. A Lumpsum Payment Method

When the purchasing company agrees to pay a lumpsum amount to the vendor company, it is called a lumpsum payment of purchase consideration. For example, if, "Big Ltd.," purchases the business of "Small Ltd.," and agrees to pay Rs.3,00,000 in all, it is an example of lumpsum payment.

### 2. Net Payment Method

Under this method purchase consideration is calculated by adding the various payments in the form of shares, debentures, cash, etc., made by the purchasing company. It may be noted that payments are made for what is taken over. Net assets taken over may be agreed to be paid partly in equity shares, preference shares, debentures or cash. No amount of liabilities is deducted even if these are assumed by the purchasing company.

It is usual practice that the purchasing company issues its own shares as a part of purchase consideration. For the purpose of calculating purchase consideration, these shares are always taken at an agreed value which may be the paid up value, or market value or any other value.

Debentures taken over by the purchasing company will have to be replaced by debentures of the purchasing company. Hence, corresponding Debentures will be issued to the liquidator of vendor company. When debentures are not taken over, if the company goes into liquidation, provision must be made for their payment. This payment may be made out of cash received or out of new debentures issued to the liquidator. In this case Debenture - holders account may be treated exactly as shareholders account. If, however Debentures are satisfied by the purchasing company directly, Debentures will be treated exactly as other creditors taken over.

Expenses of liquidation may be borne by the selling company or by the purchasing company. When borne by the purchasing company, the amount may be taken as a part of purchase consideration. But when the amount is not handed over to the liquidator, it may be completely left out from purchase consideration and the accounts of the vendor company.

### Summary

Thus, the discussion can be summarized as under:

- Add all payments whatever may be the form, i.e. shares, debentures, cash etc.,
- Add all payments whatever may be the purpose i.e., for shareholders, debenture-holders, creditors, liquidation expenses, etc.,
- Leave out all the payments made by the purchasing company to some other party on behalf of the vendor company, and
- Do not deduct liabilities taken over by the purchasing company.

It may be noted that as far as possible only this method should be applied for calculating the purchase consideration. However, this method cannot be used when some form of the payment is missing.

For example, if it is given that, 10,000 shares of Rs. 10 each are issued at Rs. 15/- 1,000 9% Debentures of Rs. 100 each are issued at Rs.90, and the balance is paid in cash. In this case net payment method cannot be used.

### Illustration-1

A Ltd., agreed acquire the business of B Ltd., as on December 31, 2000 on which date the Balance Sheet of B Ltd., was as follows:

Liabilities	Rs.	Assets	Rs.
<b>Share Capital</b>		Goodwill	50,000
30,000 shares of Rs.10 each fully paid	3,00,000	Land & Buildings	1,50,000
General Reserve	85,000	Plant & Machinery	1,70,000
Profit & Loss A/c	55,000	Stock	84,000
7% Debentures	50,000	Debtors	28,000
Creditors	10,000	Cash	18,000
	<u>5,00,000</u>		<u>5,00,000</u>

The consideration to be paid by A Ltd. was :

- a cash payment of Rs.2.50 for every share in B Ltd.
- the issue of 3 shares in A Ltd., of Rs.10 each at an agreed value of Rs.12.50 per share for every 2 shares held in B Ltd.
- the issue of such an amount of fully paid 6% Debentures in A Ltd., at 96% as is sufficient to discharge the 7% Debentures in B Ltd., at a premium of 20%. The expenses of liquidation of Rs.2,500 were paid to the liquidator of B Ltd., by A Ltd. Calculate purchase consideration.

**Solution**

Calculation of purchase consideration:

Particulars	Amount Rs.	Form
i) 30,000 shares x 2.50	75,000	cash
ii) $3/2 \times 30,000$ shares x Rs. 12.50	5,62,500	shares
b. Debenture holders - Rs.50,000 x 120/100	60,000	6% debentures
	2,500	cash
c. Liquidation Expenses	7,00,000	
<b>Purchase consideration</b>		

**Illustration - 2**The following is the Balance Sheet of Y Ltd., as on 30<sup>th</sup> June, 2000.

Liabilities	Rs.	Assets	Rs.
<b>Equity Share capital</b>		Goodwill	20,000
15,000 equity shares of Rs.10 each	1,50,000	Plant & Machinery	1,50,000
10,000 6% cumulative Preference shares of Rs.10 each	1,00,000	Current Assets	2,08,900
5% Debentures of Rs.100 each	50,000	Miscellaneous	49,100
Bank O.D	20,000		
Sundry Creditors	91,500		
Employee Provident Fund	14,000		
Interest Accrued on debentures	2,500		
<b>Contingent Liability</b>			
Arrears of preference dividend Rs.12,000			
	4,28,000		4,28,000

X Ltd., agreed to take over Y Ltd., from 1<sup>st</sup> July, 2000 on the following terms:

- X Ltd., is to take over all tangible assets except cash.
- It is to pay debenture holders at a premium of 10% by issue of its 6% cumulative preference shares of Rs.10 each in X Ltd.
- It is to issue one equity share of Rs.10 each and make a payment of Rs.4 in cash in exchange of every two equity shares in Y Ltd.
- Sundry creditors will receive 90% of the sums due to them in fully paid equity shares of Rs.10 each in X Ltd., in full satisfaction of their claims.
- Preference shareholders will be issued 5% Debentures in X Ltd.

Calculate purchase consideration.

## Solution

### Calculation of purchase consideration

Particulars	Amount Rs.	Form
a) Debentureholders:		
5% Debentures	50,000	
Add: Premium of 10%	<u>5,000</u>	
	55,000	6% cumulative pref. shares.
b) Equity shareholders:		
5,000 Equity shares x $\frac{1}{2}$ = 7,500 x Rs.10 = 75,000	75,000	Equity shares
7,500 x Rs.4	30,000	Cash
c) Preference shareholders:	1,00,000	5% debentures
d) Sundry creditors		
91,500 x 90/100	82,350	Equity Shares
Purchase consideration	<u>3,42,350</u>	

### 3. Net Assets or Networth Method

Sometimes it is seen that the full details of purchase price may not be given and thus it is not possible to add the payments given to arrive at the full amount of purchase price. Under these circumstances the purchase consideration is arrived at by "adding the agreed value of only those assets which have been taken over by the purchasing company and deducting therefrom the agreed value of those liabilities which have been taken over by the purchasing company". The method is called as net assets method and is adopted only when the net payment method cannot be adopted. If the purchase consideration is in fractional value of shares, such amount is to be settled in the form cash.

#### Illustration - 3

Alpha Ltd., and Beta Ltd., decided to amalgamate and a new company Alpha Beta Ltd., is formed to take over both the businesses. The following are Balance Sheets of the two Companies.

Liabilities			Assets		
	Alpha Ltd. Rs.	Beta Ltd. Rs.		Alpha Ltd. Rs.	Beta Ltd. Rs.
Equity Share Capital of Rs.10 each fully paid	25,00,000	15,00,000	Goodwill	5,00,000	4,00,000
General Reserve	10,00,000	7,50,000	Land & Buildings	12,50,000	9,50,000
P&L Account	1,50,000	2,50,000	Plant & Mach.	10,00,000	12,75,000
Workmen compensation fund	1,00,000	-	Investments	-	2,62,500
Dividend equalization fund	-	5,00,000	Stock	10,00,000	7,50,000
Bank O D	-	2,50,000	Debtors	5,00,000	2,50,000
Bills payable	2,50,000	1,50,000	Bill Receivable	-	1,00,000
Sundry Creditors	5,00,000	6,00,000	Cash at Bank	2,50,000	-
			Cash	-	12,500
	<u>45,00,000</u>	<u>40,00,000</u>		<u>45,00,000</u>	<u>40,00,000</u>

Calculate the purchase consideration to be received by Alpha Ltd. and Beta Ltd.

### Solution

#### Calculation of Purchase Consideration

	Alpha Ltd. Rs.	Beta Ltd. Rs.
Goodwill	5,00,000	4,00,000
Land and Buildings	12,50,000	9,50,000
Plant & Machinery	10,00,000	12,75,000
Investments	---	2,62,500
Stock	10,00,000	7,50,000
Debtors	5,00,000	2,50,000
Bills Receivable	---	1,00,000
Cash at Bank	2,50,000	---
Cash	---	12,500
	<u>45,00,000</u>	<u>40,00,000</u>
Less: Liabilities		
Bank overdraft	---	2,50,000
Bills Receivable	2,50,000	1,50,000
Sundry Creditors	<u>5,00,000</u>	<u>6,00,000</u>
Purchase Consideration	<u>37,50,000</u>	<u>30,00,000</u>

#### 4. Share Exchange Method

In some cases the transferee company issues its own shares to the shareholders of the transferor company on the basis of intrinsic or market value of the shares concerned.

### Example

Ram Ltd., whose share are considered as worth Rs. 50 each (Face value Rs. 20 each) takes over the business of Shyam Ltd. (1,00,000 shares of Rs. 10 each) whose shares are considered as worth Rs. 15 each. The total amount payable to Shyam Ltd. is Rs. 15,00,000 (i.e. 1,00,000 x 15). If the shares in Ram Ltd are to be issued as purchase consideration, then the number of shares to be issued will be Rs. 15,00,000/50 = 30,000.

### Illustration - 4

Let us consider the Balance Sheet of X Ltd. As on 31<sup>st</sup> March, 2002.

Liabilities	Rs.	Assets	Rs.
<b>Share capital</b>		Land & Buildings	50,00,000
Equity shares of Rs.10 each	75,00,000	Plant & Machinery	45,00,000
14% Pref. shares of Rs. 100 each	25,00,000	Furniture	10,50,000
General Reserve	12,50,000	Investments	5,00,000
12% Debentures	40,00,000	Stocks	23,00,000
Creditors & current liabilities	20,00,000	Debtors	24,00,000
		Cash & Bank balance	15,00,000
	<u>1,72,50,000</u>		<u>1,72,50,000</u>

### Other Information

- i) Y Ltd. Takes over X Ltd. On 10<sup>th</sup> April, 2002.
- ii) Debentureholders of X Ltd. are discharged by Y Ltd. at 10% premium by issuing 15% own debentures of Y Ltd.
- iii) 14% preference shareholders of X Ltd. are discharged at a premium of 20 by issuing necessary number of 15% Preference Shares of Y Ltd. (Face value Rs. 100 each)
- iv) Intrinsic value per share of X Ltd. is Rs. 20 and that of Y Ltd. Rs. 30. 'Y' Ltd. will issue equity shares to satisfy the equityshareholders of X Ltd. on the basis of intrinsic value. However, the entry should be made at par value only. The nominal value of each equity share of Y Ltd. is Rs. 10.

Calculate the purchase consideration.

### Solution

Calculation of Purchase Consideration:

	Rs.	Form
For Preference Shareholders of X Ltd.	30,00,000	30,000, 15% Pref. Shares in Y Ltd.
For Equity Shareholders of Y Ltd: 2/3 x 7,50,000 x Rs.10	50,00,000	5,00,000 Equity Shares of Y Ltd. of Rs. 10 each.
	<u>80,00,000</u>	

**Note:** Consideration for debenture-holders should not be included above. Such debentures will taken over by Y Ltd. and then discharged.

**Illustration - 5**

'S' Ltd. is absorbed by 'P' Ltd. The balance sheet of S Ltd is as under:

**Balance Sheet**

Liabilities	Rs.	Assets	Rs.
<b>Share capital</b>		<b>Sundry Assets</b>	<b>13,00,000</b>
2000 – 7% Pref. shares of Rs. 100 each (fully paid)	2,00,000		
5000 equity shares of Rs. 100 each (fully paid)	5,00,000		
Reserves	3,00,000		
6% Debentures	2,00,000		
Trade Creditors	1,00,000		
	<u>13,00,000</u>		<u>13,00,000</u>

P Limited has agreed:

- i) to issue 9% Pref. shares of Rs. 100 each in the ratio of 3 shares of 'P' Ltd. for 4 Pref. shares in 'S' Ltd;
- ii) to issue to the debentureholders in 'S' Ltd. 8% Mortgage Debentures at Rs. 96 in lieu of 6% Debentures in 'S' Ltd. which are to be redeemed at a premium of 20%;
- iii) to pay Rs. 20 per share in cash and to issue six equity shares of Rs. 100 each (market value Rs. 125), in live of every 5 shares held in S Ltd.
- iv) to assume the liability to trade creditors.
- v) Calculate the purchase consideration.

**Solution**

The purchase consideration will be:

	Amount (Rs.)	Form
Pref. Shareholders : $2,000 \times \frac{3}{4} \times 100 =$	1,50,000	9% Pref. Shares
Equity Shareholders: $5,000 \times 20 =$	1,00,000	Cash
$5,000 \times \frac{6}{5} \times 125 =$	<u>7,50,000</u>	Equity Shares
	<u>10,00,000</u>	

**Note**

Suppose, the total number of fractions arising on exchange aggregate to 20 shares (equivalent to equity shares in 'P' Ltd) each will have to be paid @ Rs. 125 per share; the remaining amount will be settled by the issue of equity shares. Alternatively, fraction

certificates are issued; these are converted into shares on presentation. The holder of the fraction certificates must buy more such certificates or sell those held by him.

### Illustration – 6

Y Ltd. decides to absorb X Ltd. The Balance Sheet of X Ltd. is as follows:

Liabilities	Rs.	Assets	Rs.
3,000 Equity shares of Rs. 100 each (fully paid)	3,00,000	Sundry Net Assets	2,90,000
Preference Shares	60,000	P & L A/c.	70,000
	<u>3,60,000</u>		<u>3,60,000</u>

Y Ltd. agrees to take over the net assets of X Ltd. An equity share in X Ltd. for the purpose of absorption, is valued @ Rs. 70. Y Ltd. agrees to pay Rs. 60,000 in cash for payment to preference shareholders and the balance in the form of its equity shares valued at Rs. 120 each.

### Solution

Value of 3000 shares @ Rs. 70 = Rs. 2,10,000

The purchase consideration will be:

$$\begin{aligned} \text{Net Assets} &= \text{Rs. } 2,10,000 + \text{liability towards preference shareholders.} \\ &= \text{Rs. } 2,10,000 + \text{Rs. } 60,000 = \text{Rs. } 2,70,000. \end{aligned}$$

### Note

Rs. 60,000 out of the above will be in cash and Rs. 2,10,000 in the form of shares in X Ltd. issued at Rs. 120 per share; the number of shares that will be issued:

$$2,10,000/120 = 1,750 \text{ shares.}$$

Suppose, in the above example Y Ltd. already holds in X Ltd. 1000 equity shares. The purchase consideration will be:

### Amount required to pay to outside shareholders

	Rs.
2,000 shares @ Rs. 70 (in the form of shares)	1,40,000
Amount required to be paid in cash	<u>60,000</u>
	<u>2,00,000</u>

The total number of shares to be issued =  $1,40,000/120 = 1,166 \frac{2}{3}$  shares.

### Notes

1. Cash will be paid for  $\frac{2}{3}$  share Rs. 80.
2. At the time of passing entries for the purchase of business, the account representing the investment must be credited to make it nil.



- ii) All those liabilities which the purchasing company agrees to pay out are to be transferred to Realisation Account.
- iii) All those liabilities which are not taken over by the purchasing company are not to be transferred to Realisation Account.

### 3. For Purchase Consideration Receivable

Purchasing Company's Account                      Dr.  
     To Realisation Account

### 4. For Liquidation expenses

The expenses incurred on liquidation are called liquidation expenses. These expenses may either be borne by the vendor company or by the purchasing company.

- a) When liquidation expenses are borne by the vendor company.

Realisation Account                      Dr.  
     To Bank Account

- b) When liquidation expenses are borne by the purchasing company.

- 1) When purchasing company pays realisation expenses and this amount is included in purchase consideration, the entry is:

Realisation Account                      Dr.  
     To Bank Account

- 2) When purchasing company bears the expenses but the amount is not surrendered to the liquidator, the accounting treatment may be in any of the following two methods:

- i) No entry is made in the vendor company's books.
- ii) The item is treated as reimbursable and the following entries are to be made.

a) Purchasing Company Account                      Dr.  
     To Bank Account  
     (Being the liquidation Expenses paid  
     and due from the purchasing company)

b) Bank Account                      Dr.  
     To Purchasing Company Account  
     (Being the reimbursement of liquidation expenses  
     by the purchasing company)

### 5. For Loss or Gain on Assets or liabilities not taken over

- a) The purchasing company may not take over all the tangible assets and all the liabilities. Those assets which have not been taken over are to be sold in the open market and similarly those liabilities which are not taken over are to be paid by the Vendor Company. In the process of sale of these assets and making payments to these liabilities,

there is a possibility of loss or gain on these transactions. This loss or gain is transferred to Realisation Account. The entries are:

- (i) If there is any profit on sale of these assets -

Bank Account	Dr.
To Assets A/c	
To Realisation A/c	

(Being the amount received on sale of assets not taken over by the purchasing company and the profit on sale of assets transferred to realisation a/c)

- (ii) If there is loss on sale of these assets, the entry is:

Bank Account	Dr.
Realisation Account	Dr.
To Assets Account	

- b) On making payment towards the liabilities not taken over by the purchasing company.

- (i) If excess amount over the book value of liabilities is paid

Liabilities Account	Dr.
Realisation Account	Dr.
To Bank Account	

(Being the payment made towards liabilities not taken over and loss on this payment transferred to realisation account.)

- (ii) If there is any gain on above transaction, the entry is:

Liabilities Account	Dr.
To Bank Account	
To Realisation Account	

Instead of closing the assets and liabilities not taken over by the purchasing company separately, alternatively these assets and liabilities can also be dealt through Realisation Account.

**6. For Premium or Discount to Debentureholders and Preference shareholders, if any, agreed to in the scheme**

As per the scheme of amalgamation, or absorption or external reconstruction, the preference shareholders and debentureholders may have to suffer loss by way of discount on amount due to them or to receive premium on redemption or in satisfaction of their claims. Unless this loss or gain on account of settling the amounts due to preference shareholders, and debenture holders, is ascertained and transferred to Realisation Account, the total loss or gain on liquidation of the vendor company cannot be ascertained. Therefore such premium or discount must first be adjusted before transferring the balance in the Realisation Account to equity shareholders account. The entries for this purpose are:

i) Realisation Account Dr.  
To Preference Shareholders/Debentureholders A/c.  
(Being the loss due to premium on redemption or in  
satisfying the claim on liquidation is transferred  
to Realisation Account)

ii) Preference Shareholders/Debentureholders A/c. Dr.  
To Realisation Account  
(Being the gain due to the discount on redemption or  
in satisfying the claims on liquidation is transferred  
to realisation account)

**7. For closing the realization account**

a) If there is loss on realisation account:

Equity Shareholders Account Dr.  
To Realisation Account.

b) If there is a gain on Realisation Account:

Realisation Account Dr.  
To Equity Shareholders Account

**8. For receiving purchase consideration**

Cash Account Dr.  
Shares in Purchasing Company A/c. Dr.  
Debentures in Purchasing Company A/c Dr.  
To Purchasing Company Account

**9. For transferring Debentures**

Debentures Account Dr.  
To Debentureholders Account

**10. For paying Debentureholders**

Debentureholders Account Dr.  
To Bank, Debentures in Purchasing Company

**11. For transferring preference share capital**

Preference Share Capital Account Dr.  
To Preference Shareholders Account

**12. For paying the Preference shareholders**

Preference Shareholders Account Dr.  
To Bank Shares in Purchasing Company.



intended to be continued by the transferee company. Only minimum changes are made in aggregating the individual financial statements of the amalgamating companies. The features of this method are as follows:

1. In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of amalgamation. The balance of P&L A/c of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve.
2. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and amount of share capital of the transferor company should be adjusted in reserves.
3. If at the time of amalgamation, the transferor company and the transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted.

## II. Purchase Method

This method is used in accounting for amalgamation in the nature of purchase. The following are the features of the Purchase Method:

1. The assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or alternatively the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.
2. The reserves (whether capital or revenue arising on revaluation) of the transferor company, other than statutory reserves, should not be included in the financial statements of the transferee company.
3. Any excess of the amount of the consideration over the value of net assets of the transferor company acquired by the transferee company should be regarded as Goodwill. If the amount of the consideration is than the value of the net assets acquired, the difference should be treated as Capital Reserve.
4. Normally, in an amalgamation in the nature of purchase, the identity of the reserves of the transferor company is not preserved. However, in order to get the advantage of some statutory provisions of it may be necessary to retain the identity of statutory reserves of the transferor company in the books of transferee company. To record the statutory reserves of the transferor company in the books of transferee company, the following entry may be passed:

Amalgamation Adjustment A/c.	Dr.	XXX	
To Statutory Reserves (individually)			XXX
(with the amount of statutory reserves of transferor company)			

**Note:** Amalgamation Adjustment A/c. should be disclosed as a part of "Misc. Expenditure" in the Balance Sheet.

Accounting entries in the books of purchasing company may be passed in two ways:

**FIRST METHOD:** Under this method a minimum of three entries are passed. A new account "Business Purchase Account" is opened and purchase of business is recorded through this account. The journal entries are:

**1. For the purchase of business**

Business Purchase Account Dr.  
    To Liquidator of the vendor company  
(Being the purchase consideration payable to  
the liquidator on purchase of the business)

**2. For recording the purchase of individual assets and liabilities**

Various Assets (excluding goodwill)  
(taken over at revised values, if any) a/c. Dr.  
    To Various Liabilities  
(taken at revised values, if any)  
    To Business Purchase Account  
(with purchase consideration)

It may be noted that:

- i) If credit is more than debit, the difference is debited to Goodwill Account.
- ii) If debit is more than credit, the difference is credited to Capital Reserve Account.

**3. For making Payment to the liquidator of vendor company**

Liquidator of Vendor Company A/c. Dr.  
Discount on Issue of Shares (if any) A/c. Dr.  
    To Equity Share Capital Account  
    To Preference Share Capital A/c.  
    To Share Premium A/c. (if any)  
    To Debentures Account  
    To Bank Account  
(Being the purchase consideration paid to  
the liquidator of vendor company)

**SECOND METHOD:** Under this method only two entries are passed:

**1. For recording the assets and liabilities taken over**

Individual Assets Account Dr.  
(taken over at revised values,  
if any and excluding goodwill)  
    To Individual Liabilities A/c.  
(taken over at revised values, if any)  
    To Liquidator of Vendor Company A/c.  
(with purchase consideration)

**Note:** As already explained in the first method, the difference is debited to Goodwill or credited to the Capital Reserve, as the case may be.

**2. For making payment of purchase consideration**

Liquidator of Vendor Company A/c.	Dr.
Discount on Issue of Shares (if any) Account	Dr.
To Equity Share Capital A/c.	
To Share Premium A/c. (if any)	
To Preference Share Capital A/c.	
To Debentures Account.	
To Bank Account.	

In addition to either of the above sets of entries, the following entries may be required in the books of purchasing company towards liquidation expenses borne by it.

**1. If liquidation expenses are paid by the purchasing company directly**

Goodwill (Capital Reserve) Account	Dr.
(as the case may be)	
To Bank Account	

**2. If liquidation expenses are paid to the liquidator of the vendor company and included in purchase consideration**

As the amount paid is already included in purchase consideration, the amount paid towards this expenditure will be automatically debited to Goodwill Account or Capital Reserve Account as the case may be, in such a case no separate entry need be made in the books of purchasing company.

**3. If the vendor company pays the liquidation expenses and subsequently the purchasing company reimburses them to vendor company**

The entries are:

- |   |     |
|---|-----|
| i) Goodwill (Capital Reserve) Account                         | Dr. |
| To Vendor Company Account.                                    |     |
| (Being the reimbursable expenses paid by the vendor company)  |     |
| ii) Vendor Company Account                                    | Dr. |
| To Bank Account   |     |
| (Being the liquidation expenses reimbursed to vendor company) |     |

**Illustration - 7**

1. Amrit Ltd. is absorbed by Bhavan's Ltd. Given below are the balance sheet of the two companies as on 31<sup>st</sup> March, 2002.

Liabilities	Amrit Ltd. (Rs.)	Bhavan's Ltd. (Rs.)	Assets	Amrit Ltd. (Rs.)	Bhavan's Ltd. (Rs.)
9,000 Equity shares of Rs.135 each fully paid	12,15,000	--	S. Assets	16,85,000	43,60,000
40,000 Equity shares of Rs.75 each fully paid.	--	30,00,000	Cash at Bank	15,000	40,000
General Reserve	4,25,000	13,00,000			
Profit & Loss A/c.	--	35,000			
S. Creditors	60,000	65,000			
	<u>17,00,000</u>	<u>44,00,000</u>		<u>17,00,000</u>	<u>44,00,000</u>

The holders of every three shares in Amrit Ltd was to receive five shares in Bhavan's Ltd. Pass the necessary journal entries in the books of both the companies and the Balance Sheet of Bhavan's Ltd. after absorption. The amalgamation is in the nature of merger.

### Solution

#### Calculation of Purchase Consideration

For 3 shares in Amrit Ltd. – 5 shares in Bhavan's Ltd.  
 Fro 9,000 shares in Amrit Ltd. - ?  
 = 15,000 shares of Rs. 75 each = Rs. 11,25,000.

#### Journal Entries in the Books of Amrit Ltd.

#### Journal

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
	Realisation A/c. Dr. To Sundry Assets To Cash at Bank (Being the transfer of assets to Realisation A/c.)		17,00,000	16,85,000 15,000
	S. Creditors A/c. Dr. To Realisation A/c. (Being the transfer of liabilities to Realisation A/c.)		60,000	60,000
	Bhavan's Ltd. A/c. Dr. To Realisation A/c. (Being the purchase consideration agreed upon)		11,25,000	11,25,000
	Equity Shares in Bhavan's Ltd. A/c. Dr. To Bhavan's Ltd. (Being the purchase consideration received)		11,25,000	11,25,000

Equity Share Capital A/c.	Dr.	12,15,000	
General Reserve A/c.	Dr.	4,25,000	
To Equity Shareholders A/c.			16,40,000
(Being share capital and General Reserve transferred to shareholders A/c.)			
Equity Shareholders A/c.	Dr.	5,15,000	
To Realisation A/c.			5,15,000
(Being the loss on realization transferred to Equity Shareholders A/c.)			
Equity Shareholders A/c.	Dr.	11,25,000	
To Equity Shares in Bhavan's Ltd.			11,25,000
(Being the distribution of shares received from Bhavan's Ltd. among the shareholders)			

Journal Entries in the Books of Bhavan's Ltd.

Journal				
Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
	Business purchase A/c. Dr. To Liquidator of Amrit Ltd. (Being the purchase consideration agreed upon)		11,25,000	11,25,000
	S. Assets A/c. Dr. Cash at bank A/c. Dr. To S. Creditors A/c. To Business Purchase A/c. To General Reserve (Balancing figure) (Being the assets and liabilities of Amrit Ltd. taken over)		16,85,000 15,000	60,000 11,25,000 5,15,000
	Liquidation of Amrit Ltd. Dr. To Equity Share Capital (Being the payment of purchase consideration)		11,25,000	11,25,000

Balance Sheet of Bhavan's Ltd. as at 31<sup>st</sup> March, 2002

Liabilities	Rs.	Assets	Rs.
5,000 Equity shares of Rs.75 each, fully paid (of these 15,000 shares are issued for consideration other than cash)	41,25,000	Sundry Assets	60,45,000
General Reserve	18,15,000	Cash at Bank	55,000
Profit & Loss A/c.	35,000		
S. Creditors	1,25,000		
	<u>61,00,000</u>		<u>61,00,000</u>

**Illustration - 8**

The balance sheets of A Ltd. and B Ltd. as on 31<sup>st</sup> March, 2002 were as follows:

(Rs. in thousands)					
Liabilities	Amrit Ltd. (Rs.)	Bhavan's Ltd. (Rs.)	Assets	Amrit Ltd. (Rs.)	Bhavan's Ltd. (Rs.)
50,000 pref. shares of Rs. 100 each	5,000	--	Goodwill	--	700
1,50,000 Equity shares of Rs. 10 each	15,000	--	Patents	2,000	--
4,00,000 Equity shares of Rs. 10 each	--	4,000	Land & Buildings	6,000	--
	20,000	4,000	Plant & Machinery	15,500	--
General Reserve	8,320	--	Motor Vehicles	--	400
Investment Allowance	580	320	Furniture	--	250
Creditors	500	210	Investments	1,150	--
	29,400	4,530	Stock	3,500	2,390
			Debtors	800	620
			Cash at Bank	450	170
				29,400	4,530

A new company 'C' Ltd was formed to acquire the assets and liabilities of A Ltd. and B Ltd. The terms of acquisition of business were as under:

- i) C Ltd. to have an authorized capital of Rs. 3,50,00,000 divided into 50,000, 13% preference shares of Rs. 100 each and 30,00,000 equity shares of Rs. 10 each.
- ii) Business of 'A' Ltd. valued at Rs. 3,00,00,000 settlement being Rs. 60,00,000 cash and balance by issue by fully paid equity shares of Rs. 12.
- iii) Business of 'B' Ltd. valued at Rs. 48,00,000 to be satisfied by the issue of fully paid equity shares at Rs. 12.
- iv) Preference shares of A Ltd. were redeemed.
- v) C Ltd. made a public issue of 30,000 preference shares at par and 3,00,000 equity shares at Rs. 12. The issue was underwritten at the commission allowed by law (5% of issue price) and was fully subscribed. All obligations were met.
- vi) D - who mooted the scheme was allotted 40,000 equity shares (fully paid) at Rs. 12 in consideration of his services.

Make journal entries in the books of 'C' Ltd. and prepare the Balance Sheet of 'C' Ltd. on the assumption that amalgamation is in the nature of purchase and Investment Allowance Reserve is a Statutory Reserve.

**Solution**

**Journal Entries in the books of 'C' Ltd.**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
	Business Purchase A/c. Dr. To Liquidator of A Ltd. To Liquidator of B Ltd. (Being the purchase price payable to liquidators of A Ltd. and B Ltd.)		34,800	30,000 4,800
	Patents A/c. Dr. Lands & Buildings A/c. Dr. Plant & Machinery A/c. Dr. Motor Vehicles A/c. Dr. Furniture A/c. Dr. Investments A/c. Dr. Stock A/c. Dr. Debtors A/c. Dr. Bank A/c. Dr. Goodwill A/c. Dr. To Creditors A/c. To Business Purchase A/c. (Being assets and liabilities taken over, goodwill being balancing figure.)		2,000 6,000 15,500 400 250 1,150 5,890 1,420 620 2,280	710 34,800
	Liquidator of 'A' Ltd A/c. Dr. Liquidator of 'B' Ltd A/c. Dr. To Equity Share Capital A/c. To Securities Premium A/c. To Bank A/c. (Being the payment of purchase consideration to liquidators of A Ltd. and B Ltd.)		30,000 4,800	24,000 4,800 6,000
	Bank A/c. Dr. To Equity Share Capital A/c. To Preference Share Capital A/c. To Securities premium A/c. (Being the issue of preference and equity shares to public.)		6,600	3,000 3,000 600
	Underwriting Commission A/c. Dr. To Bank A/c. (Being the underwriting commission paid @ 5% on issue price.)		330	330
	Preliminary Expenses A/c. Dr. To Equity Share Capital To Securities Premium A/c. (Being the preliminary expenses met by the issue of equity shares.)		480	400 80
	Amalgamation Adjustment A/c. Dr. To Investment Allowance Reserve A/c. (Being the statutory reserve of A Ltd and B Ltd brought into the books as per AS-14)		900	900

**Balance Sheet of 'C' Ltd as at 31<sup>st</sup> March 2002**

(Rs. 000')

Liabilities	Rs.	Assets	Rs.
<b>Liabilities</b>		<b>Fixed Assets</b>	
<b>Authorised Share Capital</b>		Goodwill	2,280
50,000, 13% Pref. shares of		Land & Buildings	6,000
Rs. 100 each	5,000	Plant & Machinery	15,500
30,00,000 Equity Shares of		Furniture	250
Rs. 10 each	30,000	Motor Vehicles	400
	35,000	Patents	2,000
		Investments	1,150
<b>Issued and Subscribed Capital</b>		Stocks	5,890
30,000, 13% Pref. Shares of		Debtors	1,420
Rs. 100 each fully paid	3,000	Bank	890
<b>Paid up Capital</b>		<b>Misc. Expenditure</b>	
27,40,000 equity shares of		Prel. Expenses	480
Rs. 10 each fully paid	27,400	Underwriting Commission	330
(of these, 24,40,000 shares are		Amalgamation Adjustment	
issued for consideration other		Reserve	900
(than cash)			
<b>Reserves &amp; Shares</b>			
Securities Premium	5,480		
Invnt. Allowance Reserve	900		
<b>Secured Loans</b>	--		
<b>Un-Secured Loans</b>	--		
<b>Current Liabilities &amp;</b>			
<b>Provisions</b>			
Creditors	710		
	37,490		
			37,490

### 9.14 SUMMING UP

Business concerns combine with each other, due to various reasons, by means of holding company or through mergers. Merger may take the form of amalgamation or absorption. When two or more companies carrying on similar business go into liquidation and a new company is formed to take over their business, it is called amalgamation. When an existing company takes over the business of one or more existing companies, it is called absorption.

If a company purchases major part (more than 50 per cent) of the equity shares of some other company the company, purchasing the shares is called a holding company.

External reconstruction takes place when a new company is floated to take over the business of a existing company which is then wound up.

In case of an amalgamation, absorption and external reconstruction, the accounting procedure is common. The purchase consideration has to be calculated, the vendor company's books are to be closed and the transactions relating to the acquisition of business are to be recorded in the books of purchasing company.

Purchase consideration is the amount paid by the purchasing company for acquiring for business of vendor company. Purchase consideration may be arrived at by Lump sum

Payment Method or Net Payment Method Net Assets or Net Worth Method and share Exchange Method.

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## 9.15 CHECK YOUR PROGRESS : MODEL ANSWERS

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1. i) The following are the objectives of mergers:
    - a) to eliminate or minimise competition,
    - b) to pool resources-technical, financial, personnel, research and development,
    - c) to secure economies of scale,
    - d) to control markets and supplies,
    - e) to improve bargaining capacity,
  - ii) Reconstruction is external reconstruction and reorganization means internal reconstruction.
2. a) Lumpsum Method ;  
b) Net Payment Method;  
c) Net Assets Method; and  
d) Share Exchange Method.

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## 9.16 MODEL EXAMINATION QUESTIONS

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I. Answer the following questions in about 30 lines each.

1. What do you mean by amalgamation, absorption, and reconstruction?
2. Bring out the similarities and differences between amalgamation, absorption and reconstruction.
3. What do you mean by purchase consideration? What are the various methods of arriving at it?
4. Discuss the contents of Accounting Standard – 14.

II. Answer the following questions in about 15 lines each.

1. What is Amalgamation?
2. Explain the meaning of absorption.
3. What do you mean by External Reconstruction?
4. What is purchase consideration?
5. Explain the terms:
  - a) Trade Liabilities;
  - b) Accumulated Losses.
6. What is Business Purchase Account?

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## 9.17 RECOMMENDED BOOKS

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1. M.A Arulanandam and  
K.S.Raman

: **Advanced Accountancy**,  
Himalaya Publishing House, Delhi.

2. R.L.Gupta : **Advanced Accountancy**, Vol. II, III & IV,  
Sultan Chand & Sons, New Delhi.
3. S.P.Jain and K.L.Narang : **Advanced Accountancy**,  
Kalyani Publishers, Ludhiana.
4. M.C. Shukla and T.S. Grewal : **Advanced Accountancy**,  
Sultan Chand & Sons, New Delhi.

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## 9.18 GLOSSARY

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- Absorption** : Take over of the business of one or more companies by an existing company.
- Amalgamation** : Take over of the business of two or more companies by a new company formed for the purpose.
- Holding Company** : It is a company which acquires majority of equity shares of another company.
- Purchase Consideration** : It is the amount agreed to be paid by the purchasing company, for acquiring the business of another company as compensation.
- Purchasing Company** : It is the company which acquires the business of another company.
- Reconstruction** : It is of two types, internal and external. Internal reconstruction means reduction or alteration of share capital. In External reconstruction an existing company starts a fresh lease of life with a new name.
- Vendor Company** : It is the company which sells its business.

**Dr. D. Obul Reddy**

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## **UNIT - 10 : AMALGAMATION**

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### **Contents**

- 10.0 Aims and Objectives
- 10.1 Introduction
- 10.2 Illustrative Problems
- 10.3 Summing up
- 10.4 Check Your Progress : Model Answers
- 10.5 Model Examination Questions
- 10.6 Recommended Books
- 10.7 Glossary

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### **10.0 AIMS AND OBJECTIVES**

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This unit aims at discussing the accounting treatment relating to amalgamation of companies.

Having studied and worked through this unit, you should be able:

- solve the problems pertaining to amalgamation of companies.

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### **10.1 INTRODUCTION**

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You have learnt the conceptual explanation, calculation of purchase consideration and proforma journal entries pertaining to amalgamation in unit 9. This unit will present you the accounting treatment pertaining to amalgamation of companies in detail taking some comprehensive illustrations.

You may recall that if two or more companies combined together to do similar business it is called amalgamation. Here a new company is created by old companies. To close down the books of Vendor company, the realisation account should be opened. It is a nominal account in nature. Profit or loss on realisation should be transferred to shareholders account. Opening entries are to be passed in the books of purchasing company. Closing entries to be passed in the books of vendor company.

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### **10.2 ILLUSTRATIVE PROBLEMS**

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#### **Illustration – 1**

Consider the following balance sheets of X Ltd and Y Ltd:

**Balance Sheets as on 31<sup>st</sup> March, 2002**

Liabilities	X Ltd. Rs.	Y Ltd. Rs.	Assets	X Ltd. Rs.	Y Ltd. Rs.
Equity Share capital (Rs. 10 each)	50,00,000	30,00,000	Land & Buildings	25,00,000	15,50,000
14% Pref. Share capital (Rs. 100 each)	22,00,000	17,00,000	Plant & Machinery	32,50,000	17,00,000
General Reserve	5,00,000	2,50,000	Furniture & Fittings	5,75,000	3,50,000
Export profit reserve	3,00,000	2,00,000	Investments	7,00,000	5,00,000
Investment allowance Reserve	-	1,00,000	Stock	12,50,000	9,50,000
P&L. A/c.	7,50,000	5,00,000	Debtors	9,00,000	10,30,000
13% Debentures (Rs. 100 each)	5,00,000	3,50,000	Cash & Bank	7,25,000	5,20,000
Trade creditors	4,50,000	3,50,000			
Other current liabilities	2,00,000	1,50,000			
	99,00,000	66,00,000		99,00,000	66,00,000

X Ltd., takes over Y Ltd., on 1<sup>st</sup> April, 2002. X Ltd discharged the purchase consideration as below:

- i) Issued 3,50,000 equity shares of Rs. 10 each at par to the equity shareholders of Y Ltd.
- ii) Issued 15% preference shares of Rs. 100 each to discharge the preference shareholders of Y Ltd. at 10% premium.

The debentures of Y Ltd will be converted into equivalent number of debentures of X Ltd. The statutory reserves of Y Ltd are to be maintained for 2 more years. Show the balance sheet of X Ltd after amalgamation on the assumption that:

- a) the amalgamation is in the nature of merger
- b) the amalgamation is in the nature of purchase

**Solution**

**a) Amalgamation in the nature of merger**

Liabilities	Rs.	Assets	Rs.
Equity share capital (Rs. 10 each)	85,00,000	Land & Buildings	40,50,000
15% Pref. Share capital (Rs. 100 each)	18,70,000	Plant & Machinery	49,50,000
14% Pref. share capital (Rs. 100 each)	22,00,000	Furniture & Fittings	9,25,000
General Reserve	80,000	Investments	12,00,000
Export profit reserve	5,00,000	Stock	22,00,000
Investment Allowance Reserve	1,00,000	Debtors	19,30,000
Profit & Loss A/c.	12,50,000	Cash & Bank	12,45,000
13% Debentures (Rs. 100 each)	8,50,000		
Trade creditors	8,00,000		
Other current liabilities	3,50,000		
	1,65,00,000		1,65,00,000

**Working Note:**

- 1) The difference between the amount recorded as share capital issued and the amount of share capital of transferor company should be adjusted in reserves. Thus,  
 General Reserve = 7,50,000 – (53,70,000 – 47,00,000) = Rs. 80,000

**b) Amalgamation in the nature of purchase****Balance Sheet of X Co. Ltd.**

Liabilities	Rs.	Assets	Rs.
Equity share capital (Rs. 10 each)	85,00,000	Land & Buildings	40,50,000
15% Pref. Share capital (Rs. 100 each)	18,70,000	Plant & Machinery	49,50,000
14% Pref. share capital (Rs. 100 each)	22,00,000	Furniture & Fittings	9,25,000
General Reserve	5,00,000	Investments	12,00,000
Capital Reserve (Working)	3,80,000	Stocks	22,00,000
Profit & Loss A/c.	7,50,000	Debtors	19,30,000
Export profit reserve	5,00,000	Cash & Bank	12,45,000
Investment Allowance Reserve	1,00,000	Amalgamation Adjustment Account	3,00,000
13% Debentures (Rs.100 each)	8,50,000		
Trade creditors	8,00,000		
Other current liabilities	3,50,000		
	<u>1,68,00,000</u>		<u>1,68,00,000</u>

**Workings****1. Capital Reserve arising on Amalgamation:**

	(Rs.'000)	(Rs.'000)
<b>A) Net Assets Taken Over:</b>		
Sundry Assets		66,00,000
Less: 13% Debentures	3,50,000	
Trade Creditors	3,50,000	
Other Current Liabilities	<u>1,50,000</u>	
		<u>8,50,000</u>
		<b>(A) 57,50,000</b>
<b>B) Purchase consideration:</b>		
To Equity shareholders of Y Ltd.		35,00,000
To Preference shareholders of Y Ltd.		<u>18,70,000</u>
		<b>(B) 53,70,000</b>
<b>C) Capital Reserve (A – B)</b>		<u><u>3,80,000</u></u>

**Illustration – 2**

Machine Ltd., and Tools Ltd., have decided to amalgamate on 31-12-2000 and form a new company called Machine Tools Ltd. On the date of amalgamation the Balance Sheets of the two companies were as follows:

Liabilities	Machine Ltd. (Rs)	Tools Ltd.(Rs)	Assets	Machine Ltd. (Rs)	Tools Ltd. (Rs)
Equity Share capital of Rs.10 per share	5,00,000	3,00,000	Sundry Assets	4,80,000	3,32,000
5% Debentures	2,00,000	1,00,000	Freehold property	2,00,000	1,00,000
Reserve Fund	--	50,000	Investments	50,000	20,000
Profit & Loss A/c	30,000	20,000	Sundry Debtors	2,50,000	1,50,000
Mortgage Loan on Freehold property	50,000	--	Preliminary Expenses	20,000	8,000
Sundry Creditors	2,20,000	1,30,000			
	<u>10,00,000</u>	<u>6,00,000</u>		<u>10,00,000</u>	<u>6,00,000</u>

The purchase consideration consists of

- The discharge of the debentures in Machine Ltd., and Tools Ltd., by the issue of equivalent amount of 6% debentures in Machine Tools Ltd;
- The assumption of the liabilities of both the companies.
- The issue of equity shares of Rs.10 each in Machine Tools Ltd., at a premium of Rs.2 per share.

For the purpose of amalgamation, the assets are to be revalued as per the following method:

	Machine Ltd. Rs.	Tools Ltd. Rs.
Goodwill	1,00,000	75,000
Sundry Assets	4,10,000	2,80,000
Freehold Property	2,60,000	1,40,000
Investments	51,000	20,000
Debtors	2,25,000	1,35,000

Show the necessary journal entries for the above transactions in the books of Machine Ltd., Tools Ltd., and Machine Tools Ltd. Prepare necessary ledger accounts also.

### Solution

#### Calculation Purchase Consideration:

Assets taken over	Machine Ltd. Rs.	Tools Ltd. Rs.
Goodwill	1,00,000	75,000
Sundry Assets	4,10,000	2,80,000
Freehold Property	2,60,000	1,40,000
Investments	51,000	20,000
Debtors	<u>2,25,000</u>	<u>1,35,000</u>
	<u>10,46,000</u>	<u>6,50,000</u>
Less: Liabilities taken over		
Mortgage Loan	50,000	
Sundry Creditors	<u>2,20,000</u>	<u>1,30,000</u>
Purchase consideration	<u>7,76,000</u>	<u>5,20,000</u>
Purchase consideration to be discharged by :		
Issue of 6% debentures	2,00,000	1,00,000
Issue of shares of Rs.10 each at a premium of Rs.2 per share	<u>5,76,000</u>	<u>4,20,000</u>
	<u>7,76,000</u>	<u>5,20,000</u>

No. of shares to be issued:

$5,76,000/12 = 48,000$  shares;  $4,20,000/12 = 35,000$  shares

**Journal Entries in the Books of Machine Ltd.**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Realisation Account Dr. To Sundry Assets A/c To Freehold Property A/c To Investments A/c. To Debtors A/c (Being assets taken over by Machine Tools Ltd. transferred to realisation account)		9,80,000	4,80,000 2,00,000 50,000 2,50,000
-	Mortgage Loan Account Dr. Sundry Creditors Account Dr. To Realisation Account (Being the liabilities taken over transferred to realisation account)		50,000 2,20,000	2,70,000
-	Machine Tools Ltd., Account Dr. To Realisation Account (Being the purchase consideration agreed to be received from Machine Tools Ltd.)		7,76,000	7,76,000
-	6% Debentures in Machine Tools Ltd. A/c Dr. Equity Shares in Machine Tools Ltd. A/c Dr. To Machine Tools Ltd. (Being the purchase consideration received)		2,00,000 5,76,000	7,76,000
-	Realisation Account Dr. To Equity Shareholders A/c (Being the profit on realization transferred Equity shareholders account)		66,000	66,000
-	5% Debentures Account Dr. To Debentureholders A/c (Being the old Debentures transferred to Debentureholders Account)		2,00,000	2,00,000
-	Debenture holders Account Dr. To 6% Debentures A/c (Being the payment made to Debentureholders through the new debentures)		2,00,000	2,00,000
-	Equity Share Capital Account Dr. Profit and Loss Account Dr. To Equity Shareholders A/c (Being the equity share capital and profit and loss A/c transferred to equity shareholders account)		5,00,000 30,000	5,30,000
-	Equity Shareholders A/c. Dr. To preliminary Expenses A/c. (Being the accumulated expenses transferred to equity shareholders a/c.)		20,000	20,000
-	Equity Shareholders Account Dr. To Equity shares in Machine tools Ltd. (Being payment made to equity shareholders)		5,76,000	5,76,000

Dr.		6% Debentures in Machine Tools Ltd. Account		Cr.	
To Machine Tools Ltd. A/c.	Rs. 2,00,000	By Equity Shareholders A/c	Rs. 2,00,000		
	<u>2,00,000</u>		<u>2,00,000</u>		

**Note:** It may be noted that while solving the problems in the examination all the above accounts need not be shown. It is sufficient if Realisation Account, Purchase Company A/c, Equity Shareholders Account, and other accounts which may need some adjustment like loss or profit on realisation are shown.

**Journal Entries in the Books of Tools Ltd.**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Realisation Account <span style="float:right">Dr.</span> To Sundry Assets A/c To Freehold Property A/c To Investments A/c. To Debtors A/c (Being the assets taken over by Machine Tools Ltd. transferred to realisation account)		5,92,000	3,22,000 1,00,000 20,000 1,50,000
-	Sundry Creditors account <span style="float:right">Dr.</span> To Realisation Account (Being the Creditors taken over by Machine Tools Ltd. transferred to realisation account)		1,30,000	1,30,000
-	Machine Tools Ltd. Account <span style="float:right">Dr.</span> To Realisation Account (Being the purchase consideration payable by Machine Tools Ltd.)		5,20,000	5,20,000
	6% Debentures in Machine Tools Ltd. A/c <span style="float:right">Dr.</span> Equity Shares in Machine Tools Ltd. A/c <span style="float:right">Dr.</span> To Machine Tools Ltd. (Being the purchase consideration received.)		1,00,000 4,20,000	5,20,000
	5% Debentures Account <span style="float:right">Dr.</span> To Debentureholders A/c. (Being the old Debentures transferred to Debentureholders account)		1,00,000	1,00,000
	Debentureholders Account <span style="float:right">Dr.</span> To 6% Debentures in Machine Tools Ltd., A/c. (Being the payment made to Debentureholders through new debentures)		1,00,000	1,00,000
	Realisation Account <span style="float:right">Dr.</span> To Equity Shareholders A/c. (Being the profit on realization transferred to Equity shareholders account)		58,000	58,000



Dr.		Investments Account		Cr.	
To Balance b/d	Rs.	By Realisation A/c.	Rs.		
	20,000		20,000		
	<u>20,000</u>		<u>20,000</u>		

Dr.		Debtors Account		Cr.	
To Balance b/d	Rs.	By Realisation A/c.	Rs.		
	1,50,000		1,50,000		
	<u>1,50,000</u>		<u>1,50,000</u>		

Dr.		Preliminary Expenses Account		Cr.	
To Balance b/d	Rs.	By Equity shareholders A/c	Rs.		
	8,000		8,000		
	<u>8,000</u>		<u>8,000</u>		

Dr.		Equity Share Capital Account		Cr.	
To Equity shareholders A/c	Rs.	By Balance b/d	Rs.		
	3,00,000		3,00,000		
	<u>3,00,000</u>		<u>3,00,000</u>		

Dr.		5% Debentures Account		Cr.	
To Debentureholders A/c.	Rs.	By Balance b/d	Rs.		
	1,00,000		1,00,000		
	<u>1,00,000</u>		<u>1,00,000</u>		

Dr.		Reserve Fund Account		Cr.	
To Equity shareholders A/c	Rs.	By Balance b/d.	Rs.		
	50,000		50,000		
	<u>50,000</u>		<u>50,000</u>		

Dr.		Profit and Loss Account		Cr.	
To Equity shareholders A/c	Rs.	By Balance b/d.	Rs.		
	20,000		20,000		
	<u>20,000</u>		<u>20,000</u>		

Dr.		Sundry Creditors Account		Cr.	
To Realisation A/c.	Rs.	By Balance b/d.	Rs.		
	1,30,000		1,30,000		
	<u>1,30,000</u>		<u>1,30,000</u>		

6% Debentures in Machine Tools Ltd. Account			Cr.
Dr.			Rs.
To Machine Tools Ltd. A/c.	Rs. 4,20,000	By Equity Shareholders A/c	4,20,000
	4,20,000		4,20,000

Equity shares in Machine Tools Ltd. Account			Cr.
Dr.			Rs.
To Machine Tools Ltd. A/c.	Rs. 4,20,000	By Equity Shareholders A/c	4,20,000
	4,20,000		4,20,000

Machine Tools Limited Account			Cr.
Dr.			Rs.
To Realisation A/c.	Rs. 5,20,000	By 6% Debentures in Machine Tools Ltd.	1,00,000
		By Equity Shares in Machine Tools Ltd. A/c	4,20,000
	5,20,000		5,20,000

### Journal Entries in the Books of Machine Tools Ltd.

#### First Method:

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Business Purchase Account To Liquidator of Machine Ltd. A/c. To Liquidator of Tools Ltd. A/c. (Being the purchase price payable to the liquidators of Machine Ltd. and Tools Ltd. on Amalgamation.)	Dr.	12,96,000	7,76,000 5,20,000
-	Sundry Assets A/c. Freehold property A/c. Investments A/c. Debtors Account Goodwill A/c. (Balancing figure) To Mortgage Loan A/c. To Sundry Creditors A/c. To Business Purchase A/c. (Being the assets and liabilities taken over)	Dr. Dr. Dr. Dr. Dr.	6,90,000 4,00,000 71,000 3,60,000 1,75,000	50,000 3,50,000 12,96,000
-	Liquidator of Machine Ltd. A/c. Liquidator of Tools Ltd. A/c. To Equity Share Capital A/c. To Share Premium A/c. To 6% Debentures A/c. (Being the issue of 83,000 equity shares of Rs.10 each at a premium of Rs.2 per share and Rs. 3,00,000 6% Debentures in settlement of the purchase price to the liquidator of Machine Ltd. & Tools Ltd.)	Dr. Dr.	7,76,000 5,20,000	8,30,000 1,66,000 3,00,000

Instead of passing three journal entries as above in the books of Machine Tools Ltd., only two entries can be passed in the following manner:

**Second Method:**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Sundry Assets A/c. Dr.		6,90,000	
	Freehold Property A/c. Dr.		4,00,000	
	Investments A/c. Dr.		71,000	
	Debtors A/c. Dr.		3,60,000	
	Goodwill A/c. (Balancing figure)		1,75,000	
	To Mortgage Loan A/c.			50,000
	To Sundry Creditors A/c.			3,50,000
	To Liquidator of Machine Ltd. A/c.			7,76,000
	To Liquidator of Tools Ltd., A/c.			5,20,000
	(Being the assets and liabilities taken over on amalgamation and the purchase price due to the liquidators of Machine Ltd. and Tools Ltd.)			
--	Liquidator of Machine Ltd. A/c. Dr.		7,76,000	
	Liquidator of Tools Ltd. A/c. Dr.		5,20,000	
	To Equity Share Capital A/c.			8,30,000
	To Share Premium A/c.			1,66,000
	To 6% Debentures A/c.			3,00,000
	(Being the issue of 48,000 shares of Rs.10 each at a premium of Rs.2 per share and 6% Rs.2,00,000, Debentures to liquidator of Machine Ltd. and 35,000 shares of Rs.10 each at a premium of Rs.2 per share and Rs.1,00,000 6% Debentures to the liquidator of Tools Ltd. in settlement of the Purchase prices)			

**Note:** It is advisable to pass separate entries for the take-over of the assets and liabilities from individual companies.

**Balance Sheet of Machine Tools Ltd. as on 31<sup>st</sup> Dec, 2000**

Liabilities	Rs.	Assets	Rs.
<b>Share Capital</b>		<b>Fixed Assets</b>	
83,000 equity shares of Rs.10 each fully paid up	8,30,000	Goodwill	1,75,000
<b>Reserve and Surplus</b>		Freehold property	4,00,000
Share premium	1,66,000	Sundry Assets	6,90,000
<b>Secured Loans</b>		Investments	71,000
Mortgage loan	50,000	<b>Current Assets</b>	
6% Debentures (assumed to be secured)	3,00,000	Debtors	3,60,000
<b>Current Liabilities</b>			
Sundry Creditors	3,50,000		
	<u>16,96,000</u>		<u>16,96,000</u>

**CHECK YOUR PROGRESS - 1**

Calculate purchase consideration from the following:

A.P. Limited and India Limited agreed to amalgamate and form a new company Hindustan Limited. Balance sheets of both the companies are as follows:

Liabilities	India Ltd.	A.P. Ltd.	Assets	India Ltd.	A.P. Ltd.
	Rs.	Rs.		Rs.	Rs.
Authorised, issued and paid up capital 50,000 shares of Rs.10 each	5,00,000	5,00,000	Goodwill	1,00,000	50,000
Share premium	50,000	1,50,000	Land & buildings	3,00,000	2,50,000
Reserves and surplus	2,00,000	1,75,000	Plant & Machinery	3,50,000	3,25,000
Profit & Loss A/c.	50,000	25,000	Furniture	50,000	25,000
Sundry Creditors	2,50,000	1,50,000	Stock	60,000	50,000
Bills payable	40,000	60,000	Sundry Debtors	1,00,000	1,50,000
			Other		
			Current Assets	1,30,000	2,00,000
			Discount on Issue of Debentures	-	10,000
	<u>10,90,000</u>	<u>10,60,000</u>		<u>10,90,000</u>	<u>10,60,000</u>

Hindustan Limited takes over all assets and liabilities at book value except goodwill.

### Illustration - 3

X Ltd., and Y Ltd., are doing similar business. To avoid unnecessary competition and to economise expenses, they have decided to amalgamate and form as one company in the name of XY Ltd. On 31<sup>st</sup> March, 2001. On this date their Balance Sheets are as follows:

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
	Rs.	Rs.		Rs.	Rs.
Share capital Rs.10 per share	1,00,000	60,000	Goodwill	-	10,000
Sundry Creditors	18,650	8,310	Patents	2,500	8,000
Profit & Loss A/c.	-	640	Plant & Machinery	40,000	21,000
Bank overdraft	6,050	-	Furniture & Fittings	4,600	3,280
			Stock	42,460	16,990
			Debtors	15,630	9,550
			Cash	-	130
			Profit & Loss A/c.	19,420	-
	<u>1,24,610</u>	<u>68,950</u>		<u>1,24,610</u>	<u>68,950</u>

XY Ltd. agreed to take over the current assets at book values and fixed assets at the following values:

	X Ltd.	Y Ltd.
	Rs.	Rs.
Goodwill	1,000	1,000
Patents	500	2,000
Plant and Machinery	27,000	11,000
Furniture and Fittings	<u>3,000</u>	<u>2,300</u>
	<u>31,500</u>	<u>16,300</u>

1. XY Ltd., has issued 1200 6% preference shares of Rs.10 each, 6,449 equity shares of Rs.10 each and has agreed to pay the balance of purchase consideration in cash to X Ltd.
2. Y Ltd., has agreed to receive its purchase consideration in 3,430 equity shares of Rs.10 each, and the balance in cash from XY Ltd.
3. Sundry creditors of X Ltd., agreed to receive 1200 6% preference shares of Rs.10 each issued by XY Ltd., and the balance in cash available after payment of all other liabilities and expenses.
4. Liquidation expenses of X Ltd., are Rs.500 and Y Ltd. are Rs.300.
5. In order to pay off the purchase consideration of X Ltd., and Y Ltd., and to strengthen its working capital position, XY Ltd., has issued 7% 100 debentures of Rs.100 each at a discount of 5% per debenture and 1800 6% preference shares of Rs.10 each, to the public and the amount is received.

Prepare necessary ledger accounts in the books X Ltd., and Y Ltd., to close them and pass entries in books of XY Ltd., and prepare opening Balance Sheet as on 31<sup>st</sup> March, 2001.

**Solution**

**Books of X Ltd.**

**Calculation of purchase consideration and mode of discharge**

Assets taken over	Rs.	Mode of payment	Rs.
Agreed value of fixed assets	31,500	1200 6% preference shares of Rs.10 each	12,000
Book value of current assets	58,090	6,449 equity shares of Rs.10 each	64,490
		Cash (Balance)	13,100
	<u>89,590</u>		<u>89,590</u>

Dr.		Realisation Account		Cr.
	Rs.			Rs.
To Patents	2,500	By XY Ltd.		89,590
To Plant & Machinery	40,000	By Sundry Creditors		10
To Furniture & Fittings	4,600	By Equity shareholders (Loss)		16,090
To Stock	42,460			
To Debtors	15,630			
To Cash (Expenses)	500			
	<u>1,05,690</u>			<u>1,05,690</u>

Dr.		Equity Shareholders Account		Cr.
	Rs.			Rs.
To Profit Loss A/c.	19,420	By Equity Share Capital		1,00,000
To Realisation A/c. (loss)	16,090			
To Equity shares in XY Ltd.	64,490			
	<u>1,00,000</u>			<u>1,00,000</u>

Dr.		Sundry Creditors Account		Cr.	
		Rs.		Rs.	
To 6% Preference shares in XY Ltd.		12,000	By Balance b/d	18,560	
To Cash		6,550			
To Realisation A/c(Gain)		10			
		<u>18,560</u>		<u>18,560</u>	

Dr.		Cash Book				Cr.	
Particulars	Cash	Bank	Particulars	Cash	Bank		
	Rs.	Rs.		Rs.	Rs.		
To XY Ltd.	13,100	-	By Balance	-	6,050		
To Cash (C)	-	6,050	By Realisation A/c (expenses)	500			
			By Bank (C)	6,050	-		
			By Sundry Creditors	6,550	-		
	<u>13,100</u>	<u>6,050</u>		<u>13,100</u>	<u>6,050</u>		

Dr.		XY Ltd. Account		Cr.	
	Rs.		Rs.		Rs.
To Realisation A/c.	89,590	By Equity shares in XY Ltd.		64,490	
		By 6% Preference Shares in XY Ltd.		12,000	
		By Cash		13,100	
	<u>89,590</u>			<u>89,590</u>	

Dr.		6% Preference Shares in XY Ltd. Account		Cr.	
	Rs.		Rs.		Rs.
To XY Ltd. A/c.	12,000	By Sundry Creditors A/c.		12,000	
	<u>12,000</u>			<u>12,000</u>	

Dr.		Equity Shares in XY Ltd. Account		Cr.	
	Rs.		Rs.		Rs.
To XY Ltd. A/c.	64,490	By Equity Shareholders A/c.		64,490	
	<u>64,490</u>			<u>64,490</u>	

**Books of Y Ltd.  
Calculation and Discharge of Purchase consideration**

Assets taken over	Rs.	Mode of payment	Rs.
Agreed value of fixed assets	16,300	3,430 equity shares of Rs.10 each	34,300
Current assets at Book Value	26,670	Cash (Balance)	8,670
	<u>42,970</u>		<u>42,970</u>

Dr.		Realisation Account		Cr.
	Rs.			Rs.
To Goodwill	10,000	By XY Ltd. A/c.		42,970
To Patents	8,000	By Equity shareholders(Loss)		26,280
To Plant & Machinery	21,000			
To Furniture & Fittings	3,280			
To Stock	16,990			
To Debtors	9,550			
To Cash	130			
To Cash (Expenses)	300			
	<u>69,250</u>			<u>69,250</u>

Dr.		Equity Shareholders Account		Cr.
	Rs.			Rs.
To Realisation A/c.	26,280	By Equity Share Capital		60,000
To Equity shares in XY Ltd.	34,300	By Profit and Loss A/c.		640
To Cash	60			
	<u>60,640</u>			<u>60,640</u>

Dr.		Cash Account		Cr.
	Rs.			Rs.
To XY Ltd. A/c.	8,670	By Sundry Creditors		8,310
		By Realisation (expenses)		300
		By Equity shareholders A/c.		60
	<u>8,670</u>			<u>8,670</u>

Dr.		Sundry Creditors Account		Cr.
	Rs.			Rs.
To Cash	8,310	By Balance b/d		8,310
	<u>8,310</u>			<u>8,310</u>

Dr.		Equity Shares in XY Ltd. Account		Cr.
	Rs.			Rs.
To XY Ltd. A/c.	34,300	By Equity Shareholders A/c.		34,300
	<u>34,300</u>			<u>34,300</u>

**Books of XY Ltd.  
Journal Entries**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
2001 March 31	Goodwill A/c. Dr.		2,000	
	Patents A/c. Dr.		2,500	
	Plant & Machinery A/c. Dr.		38,000	
	Furniture & Fittings A/c. Dr.		5,300	
	Stock A/c. Dr.		59,450	
	Debtors A/c. Dr.		25,180	
	Cash A/c. Dr.		130	
	To Liquidator of X Ltd. A/c.			89,590
	To Liquidator of Y Ltd. A/c.			42,970
	(Being the assets taken over and purchase consideration is due to the liquidators on amalgamation)			
	Liquidator of X Ltd. A/c. Dr.		89,590	
	Liquidator of Y Ltd. A/c. Dr.		42,970	
	To Equity Share Capital A/c.			98,790
	To 6% Preference Share Capital A/c.			12,000
	To Cash A/c.			21,770
(Being the issue of 9,879 equity shares of Rs.10 each, 1200 6% preference shares of Rs.10 each and the balance paid in cash in discharge of purchase consideration)				
	Cash A/c. Dr.		9,500	
	Discount on Issue of Debentures A/c. Dr.		500	
	To 7% Debentures A/c.			10,000
(Being the issue of 100, 7% Debentures of Rs.100 each at a discount of 5% to the public)				
	Cash A/c. Dr.		18,000	
	To 6% Preference Share Capital A/c.			18,000
(Being the issue of 1800 6% preference shares of Rs. 10 each to the public).				

**Balance Sheet of XY Ltd.  
as on 31st March, 2001**

Liabilities	Rs.	Assets	Rs.
Share Capital		Goodwill	2,000
3,000 6% preference shares of Rs.10 each (including 1,200 shares issued to Liquidator of X Ltd.)	30,000	Patents	2,500
9879 equity shares of Rs.10 each	98,790	Plant & Machinery	38,000
7% 100 Debentures of Rs.100 each	10,000	Furniture & Fittings	5,300
		Stock	59,450
		Debtors	25,180
		Cash (130+ 18000 + 9500 - 21770)	5,860
		Discount on Issue of Debentures	500
	<u>1,38,790</u>		<u>1,38,790</u>

## CHECK YOUR PROGRESS - 2

- i. Purchase consideration is Rs.5,50,000, is paid in the form of equity shares of Rs.3,00,000 in shares of Rs.100 each, in the form of 12% debentures Rs.1,50,000 and the balance in the form of cash. Pass journal entry in the books of vendor company for receiving purchase consideration.
- .....  
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- ii. For the above problem write journal entry in the books of purchasing company for payment of purchase consideration.
- .....  
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## 10.3 SUMMING UP

When two or more companies carrying on similar business go into liquidation and a new company is formed to take over their business, it is called amalgamation. In case of amalgamation, liquidation expenses, paid by vendor company or purchasing company, are debited to the Realisation Account. While passing journal entries in the books of purchasing company, if the total amount of assets taken by the company is more than the liabilities and purchase consideration, the difference is transferred to capital reserve account and shown on liabilities side of Balance Sheet. On the other hand, if the total amount of total liabilities and purchase consideration is more than the total assets taken over, the difference is transferred to goodwill account and shown on the assets side of Balance Sheet.

## 10.4 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i	India Limited		Rs. 7,00,000	
	A.P.Limited		Rs. 7,90,000	
2. i	Shares of Purchasing Company A/c	Dr.	3,00,000	
	12% Debentures Account	Dr.	1,50,000	
	Cash account	Dr.	1,00,000	
	To Purchasing company Account.			5,50,000
ii	Liquidation of Vendor Company A/c	Dr.	5,50,000	
	To Share Capital Account			3,00,000
	To 12% Debentures Account			1,50,000
	To Cash Account			1,00,000

## 10.5 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. State the various accounting entries to be passed in the books of vendor company in the event of amalgamation.

**II. Answer the following questions in about 15 lines each.**

1. What is amalgamation?

**Problems**

1. Rama Engineering Company Ltd., and Krishna Engineering Company Ltd., amalgamated into Ramakrishna Engineering Company Ltd. on 31<sup>st</sup> March, 2001 on which date their Balance Sheets were as follows:

Liabilities	Rama Engg. Ltd.	Krishna Engg. Ltd.	Assets	Rama Engg. Ltd.	Krishna Engg. Ltd.
	Rs.	Rs.		Rs.	Rs.
<b>Share capital</b>			<b>Fixed Assets</b>		
Fully paid shares of Rs.100 each	4,00,000	8,00,000	Goodwill	--	1,60,000
			Building	1,20,000	1,00,000
			Plant	2,40,000	3,20,000
<b>Reserves &amp; Surplus</b>			Furniture	20,000	40,000
Capital Reserve	2,00,000	40,000	<b>Current Assets</b>		
General Reserve	40,000	--	Stock	4,00,000	5,60,000
Profit & Loss A/c	1,60,000	--	Sundry Debtors	4,16,000	52,000
Sundry Creditors	80,000	3,20,000	Cash	4,000	8,000
			Profit & Loss A/c.	--	1,60,000
	<u>12,00,000</u>	<u>14,00,00</u>		<u>12,00,000</u>	<u>14,00,000</u>

The shareholders of the 'amalgamated' companies are to be paid equity shares in Ramakrishna Engg.Co.Ltd., for the amount of purchase consideration, for which purpose all assets and liabilities are to be taken at book values, except the good will of Krishna Engg. Ltd. which is considered valueless.

Calculate the purchase consideration and show the opening Balance Sheet of Ramakrishna Engineering Co.Ltd.

(Ans : Purchase consideration as per net assets method, Rama Engg. Co. Ltd. Rs.8,00,000; Krishna Engg. Co. Ltd., Rs.5,20,000; Balance Sheet total Rs.22,80,000)

- For problem 1 above pass journal entries to close the books of Rama Engg. Co. Ltd., and Krishna Engg. Co. Ltd.
- For problem 1 above, show important ledger accounts in the books of Rama Engg. Co. Ltd., and Krishna Engg. Co. Ltd.
- Telangana Equipments Ltd., and Rayalasema Equipments Ltd. carry on similar business and it is agreed that they should amalgamate into Andhra Pradesh Equipments Ltd. The new company, Andhra Pradesh Equipments Ltd., is to take over the assets and liabilities of the existing companies. On 31<sup>st</sup> December,2000 the Balance Sheets of the two companies are as follows:

Liabilities	Telangana Equip.Ltd. Rs.	Royalaseema Equip.Ltd. Rs.	Assets	Telangana Equip.Ltd Rs.	Royalaseema Equip. Ltd. Rs.
Share Capital:			Freehold Property	2,10,000	1,20,000
Fully paid shares of Rs 10 each	3,00,000	1,60,000	Plant & Mach.	50,000	30,000
General Reserve	1,60,000	--	Motor Vehicle	20,000	--
Profit & Loss A/c	40,000	40,000	Stock	1,20,000	1,56,000
5% Debentures	--	1,20,000	Debtors	1,64,000	42,000
Sundry Creditors	1,50,000	64,000	Cash & Bank	86,000	36,000
	<u>6,50,000</u>	<u>3,84,000</u>		<u>6,50,000</u>	<u>3,84,000</u>

The new company took over the assets and liabilities at book values with the following exceptions:

- Goodwill of Telangana Equipment Ltd., and Royalaseema Equipment Ltd. is to be valued at Rs.1,60,000 & Rs.60,000 respectively.
- Motor Vehicle of Telangana Ltd. is to be valued at Rs.60,000
- Debentures of Royalaseema Equipment Ltd., are to be discharged by the issue of 5% Debentures of Andhra Pradesh Equipments Ltd., at a premium of 4%. The debtors and cash of Royalaseema Ltd., are retained by the liquidator and debtors are recovered and the sundry creditors are paid out by him.

You are required to pass journal entries to close the books of Telangana and Royalaseema Equipments Ltd. Also draw up the Balance Sheet of the new company as on 1st January, 2001.

(Ans : Purchase consideration as per net assets method: Telangana Equipments Ltd., Rs.7,00,000, Payable in fully paid shares of, say Rs. 10 each. Royalaseema Equipments Ltd. Rs. 3,66,000 to be discharged in the form of 5% debentures Rs.1,24,800 including 4% premium, and in the form of shares Rs.2,41,200. Balance Sheet total of AP Equipments Ltd. on 1-1-2001 Rs.12,16,000).

- APOLLO Ltd., and Blue Max Ltd., agreed to amalgamate and form account new company Apollo-Blue Max Ltd., which will take over all the assets and the liabilities of the two existing companies.

In the case of Apollo Ltd., the assets and liabilities are taken over at book values for shares in Apollo-Blue Max Ltd., at the rate of 5 shares of Rs.10 each in Apollo-Blue Max Ltd., at a premium of 10 per cent, for every 4 shares in Apollo Ltd.

In the case of Blue Max Ltd (a) The 5% Debentures would be paid off by the issue of an equal number of 7% Debentures in Apollo Blue Max Ltd., at a discount of 10 per cent. (b) The 6% preference shareholders of Blue Max Ltd., would be allotted 4,7% preference shares (of Rs.100 each) in Apollo-Blue Max Ltd., for every 5 shares held in Blue Max Ltd. (c) The equity share-holders would be allotted sufficient shares to cover the balance amount after adjusting asset values by reducing plant and machinery by 10 % and providing 5% on sundry debtors. Equity shares to Blue Max Ltd. were also issued at a premium of 10 per cent.

The liquidation expenses of the vendor companies came to Rs.5000 each and were paid directly by the new company.

The summarised Balance Sheets of Apollo Ltd., and Blue Max Ltd., on 31<sup>st</sup> December, 2000 the date of merger, were as follows:

Liabilities	Apollo Ltd. Rs.	Blue-max Ltd. Rs.	Assets	Apollo Ltd. Rs.	Blue-max Ltd. Rs.
6% Preference shares of Rs.100 each	--	3,00,000	Plant & Machinery	8,00,000	8,00,000
Equity shares of Rs.10 each	4,00,000	5,00,000	Stock	90,000	70,000
5% Debentures	--	2,00,000	Sundry Debtors	95,000	50,000
Contingency Reserve	50,000	--	Cash & Bank	65,000	50,000
P&L A/c	5,00,000	--	P&L A/c.	--	1,40,000
Sundry Creditors	1,00,000	1,00,000			
	<u>10,50,000</u>	<u>11,00,000</u>		<u>10,50,000</u>	<u>11,00,000</u>

Show the journal entries in the Books of Apollo Ltd., Blue Max Ltd., and Apollo Blue-Max Ltd., in respect of the merger.

**Hint :** Purchase consideration and its payment:

	Apollo Rs.	Blue Max. Rs.
Debentures (2,00,000 x 90/100)	--	1,80,000
Preference shares in Apollo-Blue Max (3,00,000 x 4/5)	--	2,40,000
Equity shares in Apollo Blue Max : 40,000 shares x 5/4 = 50,000 shares of Rs.10 each at a premium of 10% i.e. at Rs.11.	5,50,000	--
Balance of Rs.3,57,500 in 32,500 shares of Rs.11 each including premium (Assets taken over at adjusted values Rs. 8,77,500 minus liabilities taken over Rs. 1,00,000 = Rs. 7,77,500 minus debentures Rs. 1,80,000, Preference Shares Rs. 2,40,000 = Rs. 3,57,500)	--	3,57,500
	<u>5,50,000</u>	<u>7,77,500</u>

(Ans: Loss on Realisation- Apollo Ltd. Rs. 4,00,000; Blue Max Rs. 2,500 to equity shareholders)

6. Show important ledger accounts in the books of Apollo Ltd., and Blue Max ltd., to the above problem and also give the opening Balance sheet of Apollo-Blue Max Ltd.,

(Ans: balance Sheet total Rs. 19,17,500)

## 10.6 RECOMMENDED BOOKS

I. R.L. Gupta and M.Radhaswamy : **Advanced Accountancy**, Volume -II, Sultan Chand & Sons 23, Daryaganj, New Delhi.

2. S.N.Maheshwari : **Advanced Accountancy, Volume-II,**  
Vani Educational Books New Delhi.
3. S.P. Jain and K.L. Narang : **Advanced Accountancy,** Kalyani Publishers,  
Ludhiana.
4. M.C. Shukla and T.S. Grewal : **Advanced Accountancy,** Sultan Chand & Sons,  
New Delhi.

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## 10.7 GLOSSARY

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- Amaalgamation** : Take over of the business of two or more companies by a new company formed for the purpose.
- Purchase consideration** : It is the amount agreed to be paid by the purchasing company for acquiring the business of the Vendor company as compensation.
- Purchasing Company** : It is the company which acquired the business of another company.
- Realisation Account** : It is an account which will be opened to close the business in the Vendor company.

**Dr. D. Obul Reddy**

# UNIT - 11 : ABSORPTION

## Contents

- 11.0 Aims and Objectives
- 11.1 Introduction
- 11.2 Illustrative Problems
- 11.3 Summing up
- 11.4 Check Your Progress : Model Answers
- 11.5 Model Examination Questions
- 11.6 Recommended Books
- 11.7 Glossary

## 11.0 AIMS AND OBJECTIVES

This unit aims at discussing the accounting treatment pertaining to absorption of companies.

Having studied and worked through this unit, you should be able to:

- explain the accounting procedure relating to absorption;
- solve the problems.

## 11.1 INTRODUCTION

We have already discussed the calculation of purchase consideration and proforma journal entries pertaining to absorption (Amalgamation in the nature of Purchase) in Unit 9. This unit is presented to illustrate the accounting treatment pertaining to Absorption of Companies. When an existing company takes over the business of one or more existing companies, it is called absorption. The companies whose business is taken over are liquidated. Hence no new company is created or formed but only the existing company (usually big one) buys the business of other existing company or companies. The main difference between amalgamation and absorption is that in case of amalgamation two or more companies go into liquidation and a new company is formed to take over the business of old companies. Whereas in case of absorption one or more companies go into liquidation and some existing company (usually strong one) buys the business of other existing company or companies and no new company is formed.

## 11.2 ILLUSTRATIVE PROBLEMS

### Illustration - 1

The following is the Balance Sheet of Akshaya Ltd., as on 31<sup>st</sup> December, 2000

	Rs.		Rs.
Share Capital 1,00,000 shares of Rs.10 each fully paid	10,00,000	Goodwill	2,00,000
General Reserve	80,000	Land & Buildings	2,00,000
		Plant & Machinery	4,40,000
		Patents and Trade Marks	30,000

Contingency Reserve	30,000	Stock	2,10,000
Profit & Loss A/c.	80,000	Sundry Debtors	1,80,000
Workmen's Compensation Fund	50,000	Less: Provision for D.D.	12,000
Sundry Creditors	1,60,000	Cash at Bank	1,32,000
		Preliminary Expenses	20,000
	<u>14,00,000</u>		<u>14,00,000</u>

Akshaya Ltd., was taken by Xerol Ltd., which has agreed to pay Rs.14,00,000. This will be paid Rs.12,00,000 in fully paid shares of Rs. 100 each and the balance in cash. There was a contingent liability in respect of a claim for compensation under the workmen's Compensation Act. The claim was not taken over by Xerol Ltd. Akshaya Ltd., ultimately paid Rs.20,000 towards this claim. The expenses of the liquidation of Akshaya Ltd., came to Rs.10,000 which were paid by Xerol Ltd., in addition to the purchase consideration agreed. Land and Buildings of Akshaya Ltd. are to be revalued at Rs.3,00,000. The Balance Sheet of Xerol Ltd. as on 31<sup>st</sup> December, 2000 was as under:

	Rs.		Rs.
Share Capital: 20,000 shares of Rs.100 each fully paid	20,00,000	Goodwill	2,60,000
General Reserve	2,00,000	Land & Buildings	6,00,000
Profit & Loss A/c.	1,00,000	Plant & Machinery	8,00,000
6% Debentures	4,00,000	Stock	5,00,000
Sundry Creditors	2,00,000	Sundry Debtors	3,00,000
	<u>29,00,000</u>	Cash at Bank	4,40,000
			<u>29,00,000</u>

Give the necessary journal entries to close the books of Akshaya Ltd., and show the important Ledger accounts. Also give the journal entries in the books of Xerol Ltd., to record the takeover and redraft its Balance Sheet after the completion of absorption.

### Solution

#### Books of Akshaya Limited Journal

Date	Particulars	L.F	Dr. Rs.	Cr. Rs.
--	Realisation Account <span style="float: right;">Dr.</span>		13,92,000	
	To Goodwill A/c			2,00,000
	To Land & Buildings A/c			2,00,000
	To Plant & Machinery A/c.			4,40,000
	To Patents and Trade Marks A/c			30,000
	To Stock A/c.			2,10,000
	To Sundry Debtors A/c.			1,80,000
	To Cash at Bank A/c.			1,32,000
	(Being the transfer of various assets to realization account on sale of business to Xerol Ltd.)			

--	Sundry Creditors A/c.	Dr.	1,60,000	
	Provision for Doubtful Debts A/c.	Dr.	12,000	
	To Realisation A/c.			1,72,000
	(Being the transfer of sundry creditors and the provision for doubtful debts to realisation account)			
--	Xerol Limited Account	Dr.	14,00,000	
	To Realisation A/c			14,00,000
	(Being the purchase consideration agreed to be paid by the Xerol Ltd.)			
--	Shares in Xerol Ltd. A/c.	Dr.	12,00,000	
	Cash Account	Dr.	2,00,000	
	To Xerol Limited A/c.			14,00,000
	(Being the respect of shares and cash in satisfaction of purchase consideration.)			
--	Xerol Limited A/c.	Dr.	10,000	
	To Cash Account			10,000
	(Being the payment of liquidation expenses, which are to be met by Xerol Ltd.)			
--	Cash Account	Dr.	10,000	
	To Xerol Limited A/c.			10,000
	(Being the liquidation expenses reimbursed by Xerol Ltd.)			
--	Workmen's Compensation Fund A/c.	Dr.	20,000	
	To Cash A/c			20,000
	(Being the payment of claim from Workmen's Compensation Fund A/c.)			
--	Share capital A/c.	Dr.	10,00,000	
	General Reserve A/c.	Dr.	80,000	
	Contingency Reserve A/c.	Dr.	30,000	
	Profit and Loss A/c.	Dr.	80,000	
	Workmen's Compensation Fund A/c.	Dr.	30,000	
	Realisation A/c. (Profit)	Dr.	1,80,000	
	To Shareholders A/c.			14,00,000
	(Being the transfer of various accounts and profit on realization account to sundry shareholders a/c.)			
--	Shareholders A/c.	Dr.		
	To Preliminary Expenses A/c.		20,000	
	(Being the transfer of preliminary expenses to shareholders a/c.)			

	Dr.	13,80,000	
Shareholders A/c.			
To Shares in Xerol Ltd. A/c.			12,00,000
To Cash A/c.			1,80,000
(Being the payment of dues to sundry share - holders in the form of shares received from Xerol Ltd. as cash balance)			

**Important Ledger Accounts**

Dr.		Realisation Account		Cr.
		Rs.		
To Sundry Assets		13,92,000	By Sundry Creditors	1,60,000
To Shareholders A/c. (Profit transferred)		1,80,000	By Provision for D.D. By Xerol Ltd.	12,000 14,00,000
		<u>15,72,000</u>		
				<u>15,72,000</u>

Dr.		Cash and Bank Account		Cr.
		Rs.		
To Balance b/d		1,32,000	By Realisation A/c. (transfer)	1,32,000
To Xerol Ltd.		2,00,000	By Xerol Ltd. (Exp)	10,000
To Xerol Ltd. (expenses received)		10,000	By Workmen's compensation fund claim paid	20,000
			By Shareholders A/c. (settlement)	1,80,000
		<u>3,42,000</u>		
				<u>3,42,000</u>

Dr.		Xerol Limited Account		Cr.
		Rs.		
To Realisation A/c. (Purchase consideration)		14,00,000	By Shares in Xerol Ltd.	12,00,000
To Cash A/c. (Expenses received)		10,000	By Cash	2,00,000
		<u>14,10,000</u>	By Cash (Exp-received)	10,000
				<u>14,10,000</u>

Dr.		Shares in Xerol Limited Account		Cr.
		Rs.		
To Xerol Ltd. A/c.		12,00,000	By Shareholders A/c.	12,00,000
		<u>12,00,000</u>		
				<u>12,00,000</u>

Dr.		Workmen's Compensation Fund Account		Cr.
		Rs.		
To Cash A/c. (Claim Paid)		20,000	By Balance b/d	50,000
To Shareholders A/c. (transfer)		30,000		
		<u>50,000</u>		
				<u>50,000</u>

Dr.		Shareholders Account		Cr.	
		Rs.			Rs.
To Preliminary Expenses		20,000	By Share Capital A/c.		10,00,000
To Shares in Xerol Ltd.		12,00,000	By General Reserve A/c.		80,000
To Cash A/c.		1,80,000	By Contingency Reserve A/c.		30,000
			By Profit and Loss A/c.		80,000
			By Workmen's compensation Fund A/c.		30,000
			By Realisation A/c.		1,80,000
		<u>14,00,000</u>			<u>14,00,000</u>

**Books of Xerol Ltd.  
Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Business Purchase A/c. Dr. To Liquidator of Akshaya Ltd. A/c. (The purchase consideration agreed to be paid for the takeover)		14,00,000	14,00,000
-	Land and Buildings A/c. Dr. Plant and Machinery A/c. Dr. Patents and Trade Marks A/c. Dr. Stock A/c. Dr. Sundry Debtors A/c. Dr. Cash A/c. Dr. Goodwill (Balancing figure) A/c. Dr. To Sundry Creditors A/c. To Provision for Doubtful Debts A/c. To Business Purchase A/c. (Being the assets and liabilities taken over. Goodwill is the difference between total credits and debits)		3,00,000* 4,40,000 30,000 2,10,000 1,80,000 1,32,000 2,80,000	1,60,000 12,000 14,00,000
-	Goodwill A/c. Dr. To Cash A/c. (Being the payment of liquidation expenses to Akshaya Limited)		10,000	10,000
-	Liquidator of Akshaya Ltd. A/c. Dr. To Share Capital A/c. To Cash A/c. (Being the discharge of purchase consideration)		14,00,000	12,00,000 2,00,000

\* Revaluation figure

**Balance sheet of Xerol Ltd.**  
as on 31<sup>st</sup> Dec. 2000

Liabilities	Rs.	Assets	Rs.
<b>Share capital</b>		<b>Fixed Assets</b>	
Issued and Subscribed:		Goodwill	
32,000 share of Rs.100each, fully paid (of which 12,000 shares were allotted for consideration other than cash)	32,00,000	(2,60,000+2,80,000+10,000)	5,50,000
		Land and Buildings	
		(6,00,000+3,00,000)	9,00,000
		Pant & Machinery	
		(8,00,000+4,40,000)	12,40,000
<b>Reserves and Surplus</b>		Patents and Trade Marks	30,000
General Reserve	2,00,000	<b>Current Assets</b>	
Profit and Loss A/c.	1,00,000	Stock (2,10,000+5,00,000)	7,10,000
<b>Secured Loans</b>		Sundry Debtors	3,00,000
6% Debentures	4,00,000		+1,80,000
<b>Current liabilities and Provisions</b>			4,80,000
Sundry Creditors	3,60,000	Less: Provision	12,000
		Cash and Bank	
		(4,40,000+1,32,000-2,20,000- 10,000 = 3,62,000)	3,62,000
	<u>42,60,000</u>		<u>42,60,000</u>

**CHECK YOUR PROGRESS - 1**

Calculate purchase consideration from the following information:

Nishan Limited was absorbed by Mahendra Limited. For this purpose Mahendra Limited paid Rs.20 cash and 2 shares of Rs.10 each calculated at Rs.16 each for every one share in Nishan Limited. For debentureholders Mahendra Limited issued debentures at a discount of 5% and paid Rs.10,000 for liquidation expenses. Nishan company has debentures of Rs.1,50,000 and 30,000 shares of Rs.50 each.

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The following is the Balance Sheet of Artos Ltd. As on 31<sup>st</sup> December, 2000

Liabilities	Rs.	Assets	Rs.
<b>Share capital</b>		Goodwill	8,00,000
10% preference shares of Rs.10 each, fully paid	10,00,000	Land & Buildings	7,00,000
Equity shares of Rs.10 each Rs.8 paid up	20,00,000	Plant & Machinery	13,00,000
General Reserve	4,00,000	Stock	7,00,000
Profit and Loss A/c.	8,00,000	Sundry Debtors	9,00,000
Insurance Fund	1,00,000	Less: Provision for D.D.	40,000
Provident Fund	60,000		8,60,000
Workmen's profit sharing fund	2,80,000	Cash and Bank	6,40,000
Sundry Creditors	2,40,000		
Bills Payable	1,20,000		
	50,00,000		50,00,000

Supreme Ltd., has decided to absorb the business of Artos Ltd. For this purpose land and buildings are to be valued at Rs.12,00,000. Plant and Machinery at Rs. 10,00,000 and other assets are taken at book values. The consideration being the assumption of trade liabilities, the payment of liquidation expenses of Rs.5,325, the payment of workmen's profit sharing fund at a premium of 10%, the issue of one equity share of Rs.20 each for every two preference shares in Artos Ltd., the issue of one equity share of Rs.20 for every three equity shares in Artos Ltd., and the payment of Rs.4 per equity share in Artos Ltd., in cash. The equity shares of Supreme Ltd., are quoted in the market at Rs.45.

Calculate purchase consideration and make journal entries in the books of both the companies.

### Solution

Calculation of purchase consideration.

In the problem all modes of payments are clearly given. Therefore, the net payment method can be adopted.

Particulars	Amount	Form of Payment
i) Shares for preference Shareholders for every 2 shares held one share of Rs.20 1,00,000 shares x Rs.20 x 1/2 i.e., 50000 x Rs.20	10,00,000	Equity shares
ii) Shares for equity shareholders for every 3 shares held one share of Rs.20  2,50,000 shares x 1/3 = 83,333 shares ∴ 83,333 shares x Rs.20	16,66,660	Equity shares

iii)	Since fraction share cannot be issued, that 1/3 share is satisfied in cash at market value i.e., $1/3 \times \text{Rs. } 45$	15	Cash
iv)	Payment in cash at Rs.4 per share ∴ 2,50,000 shares × Rs 4	10,00,000	Cash
v)	Workmen's profit sharing fund Add: 10% premium	2,80,000 <u>28,000</u>	3,08,000 Cash Cash
vi)	Liquidation expenses	5,325	
	Total purchase consideration	<u>39,80,000</u>	

**Books of Artos Ltd.,  
Journal**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
--	Realisation Account To Goodwill A/c. To Land and Buildings To Plant and Machinery A/c. To Stock A/c. To Sundry Debtors A/c. To Cash and Bank A/c. (Being the transfer of assets taken over to Realisation A/c.)	Dr.	50,40,000	8,00,000 7,00,000 13,00,000 7,00,000 9,00,000 6,40,000
--	Sundry Creditors A/c. Bills payable A/c. Provision for Doubtful Debts A/c. To Realisation A/c. (Being the transfer of liabilities taken over to Realisation A/c.)	Dr. Dr. Dr.	2,40,000 1,20,000 40,000	4,00,000
--	Supreme Ltd. A/c. To Realisation A/c. (Being the purchase consideration received)	Dr.	39,80,000	39,80,000
--	Realisation A/c. To Workmen's Profit Sharing Fund A/c. (10% premium being loss on payment of workmen's profit sharing fund transferred to Realisation A/c.)	Dr.	28,000	28,000
--	Realisation A/c. To Bank A/c. (Being the payment of liquidation expenses )	Dr.	5,325	5,325

--	Equity shareholders A/c. To Realisation A/c. (Being the loss on realization transferred to equity shareholders A/c.)	Dr.	6,93,325	6,93,325
--	Equity Share Capital A/c. General Reserves A/c. Insurance Fund A/c. Profit and Loss A/c. To Equity shareholders A/c. (Being the transfer of accumulated profit to the equity shareholders A/c.)	Dr. Dr. Dr. Dr.	20,00,000 4,00,000 1,00,000 8,00,000	33,00,000
--	Provident Fund A/c. Workmen's Profit Sharing Fund A/c. To Bank A/c. (Being the payment of liabilities not taken over by Supreme Ltd.)	Dr. Dr.	60,000 3,08,000	3,68,000
--	Preference Share Capital A/c. To Preference Shareholders A/c. (Being the transfer of Share Capital of shareholders A/c.)	Dr.	10,00,000	10,00,000
--	Bank A/c. Shares in Supreme Ltd. A/c. To Supreme Ltd., A/c. (Being the receipt of purchase consideration)	Dr. Dr.	13,13,340 26,66,660	39,80,000
--	Preference Shareholders A/c. To Shares in Supreme Ltd. A/c. (Being the discharge of amount due to preference shareholders)	Dr.	10,00,000	10,00,000
--	Equity Shareholders A/c. To Shares in Supreme Ltd. A/c. To Bank A/c. (Being the discharge of amount due to equity shareholders)	Dr.	26,06,675	16,66,660 9,40,015

Dr.		Realisation Account		Cr.	
		Rs.		Rs.	
To Sundry Assets	50,40,000	By Sundry Liabilities	4,00,000		
To Workmen's profit Sharing fund A/c.	28,000	By Supreme Ltd. (Purchase Consideration)	39,80,000		
To Bank (Liquidation exp.)	5,325	By Equity Shareholders A/c. (Realisation loss)	6,93,325		
	<u>50,73,325</u>				<u>50,73,325</u>

Dr.		Cash and Bank Account		Cr.	
		Rs.			Rs.
To Balance b/d.		6,40,000	By Realisation A/c. (transfer)		6,40,000
To Supreme Ltd., A/c. (Purchase consideration Cash part)		13,13,340	By Realisation A/c. (Exp)		5,325
			By Provident Fund		60,000
			By Workmen's P. S. Fund		3,08,000
			By Equity Shareholders A/c.		9,40,015
		<u>19,53,340</u>			<u>19,53,340</u>

Dr.		Equity Shareholders Account		Cr.	
		Rs.			Rs.
To Realisation A/c. (Loss)		6,93,325	By General Reserve		4,00,000
To Shares in Supreme Ltd.		16,66,660	By Insurance Fund		1,00,000
To Bank A/c.		9,40,015	By Profit & Loss A/c.		8,00,000
			By Equity Share Capital		20,00,000
		<u>33,00,000</u>			<u>33,00,000</u>

Notes: i) Preference shares, unless otherwise specified, are non-participating and hence, they are not entitled to any share in any accumulated reserves or undistributed profits. Therefore, accumulated reserve like general reserve, insurance fund and profit and loss account credit balance etc., belong to equity shareholders.

ii) Though ledger accounts are not asked for unless realisation account is prepared the profit or loss, which has to be transferred to shareholders account, cannot be known.

iii) To Know the cash position, which has to be paid to shareholders as final settlement, cash (and Bank) account has to be prepared. To Debit balance available in the cash (and Bank) account must be equal to the credit balance in the shareholders account. By paying the cash balance cash account and shareholders account must automatically get closed.

#### Books of Supreme Limited Journal

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
--	Business Purchase A/c. Dr. To Liquidator or Artos Ltd. (Being purchase consideration payable for the acquisition of Artos Ltd.)		39,80,000	39,80,000
--	Land and Buildings A/c. Dr.		12,00,000	
	Plant and Machinery A/c. Dr.		10,00,000	
	Stock A/c. Dr.		7,00,000	
	Sundry Debtors A/c. Dr.		9,00,000	
	Bank A/c. Dr.		6,40,000	
	To Sundry Creditors A/c.			2,40,000
	To Bills Payable A/c.			1,20,000

To Provision for Doubtful Debts A/c.			40,000
To Business Purchase A/c.			39,80,000
To Capital Reserve A/c. (Balancing figure)			60,000
(Being the assets and liabilities taken over from Artos Ltd., the difference between total debits and credits transferred to capital reserve a/c.)			
Dr. Liquidator of Artos Ltd A/c.		39,80,000	
To Equity Share Capital A/c.			26,66,660
To Bank A/c.			13,13,340
(Being the discharge of purchase consideration)			

Notes: i) L&B and P&M are shown in the Purchasing company books, at the agreed values and their assets at book values.

ii) Supreme limited has taken over only trade liabilities (S.Crs., B/P here)

iii) Sundry debtors are to be shown at its full value without deducting provision, if any, doubtful debts. Provision for doubtful debts a/c., should be shown separately.

iv) Goodwill of Artos Ltd., which is taken over by Supreme Ltd., is not shown in the books of Supreme Ltd., as the value of assets taken over is more than the purchase price. The difference between total debits and total credits is capital reserve. Capital reserve account and goodwill account are not shown simultaneously. Hence, Goodwill is not shown.

### CHECK YOUR PROGRESS - 2

i) Calculate profit or loss on realisation from the following:

	Rs.
Total of the assets as per book values	2,45,000
Total of the liabilities as per the book values	55,000
Purchase consideration	2,15,000
Liquidation expenses paid	5,000
Profit and Loss Account (Credit)	15,000

ii) Write Journal entry for profit on realisation transferred to shareholders account.

### Illustration -3

East Coast Company Ltd., sells its business to Metal Products Ltd., as on 31<sup>st</sup> December, 2000. On that date the balance sheet of the company was as follows:

Liabilities	Rs.	Assets	Rs.
<b>Paid up share capital</b>			
6,000 shares of Rs.100 each	6,00,000	Goodwill	1,50,000
Reserve Fund	1,50,000	Freehold Property	4,50,000
Profit and Loss A/c.	60,000	Stock	1,05,000
10% Debentures	3,00,000	Plant & Machinery	2,50,000
Trade Creditors	90,000	Bills Receivable	15,000
		Sundry Debtors	80,000
		Cash and Bank	1,50,000
	<u>12,00,000</u>		<u>12,00,000</u>

Metal Products Ltd., has agreed to take over the assets, except cash and Goodwill, at 10% less than the book values, to pay Rs.2,24,000 for Goodwill and take over the debentures.

The purchase consideration payable to East Coast Co. Ltd., was discharged by the allotment of 4,500 shares of Rs.100 each at a premium of Rs.10 per share and the balance in cash.

The cost of liquidation amounted to Rs. 10,000 which were met by East Coast Co. Ltd.

You are required to show the important accounts in the books of East Coast Co. Ltd., and pass necessary entries to record the acquisition of business in the books of Metal Products Ltd.

### Solution

In this problem how much the Metal Products Ltd., is paying to East Coast Co. Ltd., is not specified. Therefore, net assets method can be adopted for calculating purchase consideration.

### Calculation of Purchase consideration

Assets taken over at revised values:

	Rs.
Goodwill	2,25,000
Freehold Property (Rs.4,50,000 – Rs.45,000)	4,05,000
Plant and Machinery (Rs.2,50,000 – Rs.25,000)	2,25,000
Stock (Rs.1,05,000 – Rs.10,500)	94,500
Bill Receivable (Rs.15,000 – 1,500)	13,500
Sundry Debtors (Rs.80,000 – Rs.8,000)	<u>72,000</u>
	10,35,000
Less: Debentures taken over	<u>3,00,000</u>
Purchase Consideration	<u>7,35,000</u>

**Mode of Payment of Purchase Consideration:**

Shares: 4,500 shares of Rs.100 each at a premium of 10%	4,95,000
Cash (Rs.7,35,000 – 4,95,000)	<u>2,40,000</u>
Total Payment	<u><u>7,35,000</u></u>

**Books of East Coast Company Limited**  
(Important Accounts)

Dr.	Realisation Account		Cr.
	Rs.		Rs.
To Goodwill	1,50,000	By Debentures	3,00,000
To Freehold Property	4,50,000	By Metal Products Ltd.	
To Plant & Machinery	2,50,000	(Purchase consideration)	7,35,000
To Stock	1,05,000	By Shareholders A/c.	
To Bills Receivable	15,000	(loss on realisation)	25,000
To Sundry Debtors	80,000		
To Bank (Liquidation exp.)	<u>10,000</u>		
	<u><u>10,60,000</u></u>		<u><u>10,60,000</u></u>

Dr.	Bank Account		Cr.
	Rs.		Rs.
To Balance b/d.	1,50,000	By Realisation (Exp.) A/c.	10,000
To Metal Products Ltd.	2,40,000	By Trade Creditors	90,000
		By Shareholders A/c.	
		(final settlement)	<u>2,90,000</u>
	<u><u>3,90,000</u></u>		<u><u>3,90,000</u></u>

Dr.	Shareholders Account		Cr.
	Rs.		Rs.
To Realisation A/c. (loss)	25,000	By Share Capital A/c.	6,00,000
To Shares in Metal Products	4,95,000	By Reserve Fund A/c.	1,50,000
To Bank (final settlement)	<u>2,90,000</u>	By Profit and Loss A/c.	<u>60,000</u>
	<u><u>8,10,000</u></u>		<u><u>8,10,000</u></u>

Notes: i) Cash and Bank was not taken over by Metal Products Ltd., hence not transferred to Realisation Account.

ii) Trade creditors were not taken by the Purchasing Company, hence not transferred to Realisation Account and were paid by the East Coast Company.

**Journal Entries in the Books of Metal Products Ltd.**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
-	Business purchase Account Dr. To Liquidator of East Coast Co. Ltd. (Being the purchase consideration payable for the acquisition of East Coast Company Ltd.)		7,35,000	7,35,000
-	Goodwill A/c. Dr. Freehold Property A/c. Dr. Plant & Machinery A/c. Dr. Stock A/c. Dr. Bills Receivable A/c. Dr. Sundry Debtors A/c. Dr. To 10% Debentures A/c. To Business Purchase A/c. (Being the assets and liabilities taken over from East Coast Company)		2,25,000 4,05,000 2,25,000 94,500 13,500 72,000	3,00,000 7,35,000
-	Liquidator of East Coast Co. Ltd. A/c. Dr. To Share Capital A/c. To Share Premium A/c. To Bank A/c. (Being the discharge of purchase consideration by issuing 4,500 shares of Rs.100 each, at a 10% premium and the balance paid in cash)		7,35,000	4,50,000 45,000 2,40,000

**CHECK YOUR PROGRESS -3**

1. Find out total of the equity shareholders account from the following:

	Rs.
Equity share capital	2,00,000
Balance of General Reserve	50,000
Profit and Loss Account (Cr.)	30,000
Loss on Realisation Account	15,000
Discount on issue of Debentures	5,000
Shares paid by purchasing company	2,00,000
Cash paid to equity shares	60,000
.....	
.....	
.....	

**11.3 SUMMING UP**

When an existing company takes over the business of one or more existing companies, it is called absorption. In the case of absorption assets and liabilities taken by the purchasing

company are clubbed together with assets of purchasing company while preparing balance sheet.

### 11.4 CHECK YOUR PROGRESS : MODEL ANSWERS

1. Purchase consideration Rs. 17,12,500
2. i) Profit on Realisation Rs. 15,000  
 ii) Realisation Account Dr.  
     To Shareholders Account.
3. Total of Equity Shareholders Account is Rs. 2,80,000

### 11.5 MODEL EXAMINATION QUESTIONS

#### I. Answer the following questions in about 30 lines each.

1. Write proforma entries in the books of purchasing company
2. Explain the accounting treatment pertaining to Absorption with an example.

#### II. Answer the following questions in about 15 lines each.

1. What is absorption?
2. Explain the various items which are to be debited to Realisation Account

#### Problems

f. Balance Sheet of Apex Ltd. on 31<sup>st</sup> December, 2000 was as follows:

Liabilities	Rs.	Assets	Rs.
<b>Share capital</b>		Land and Buildings	2,30,000
8,000 Equity shares of Rs.50 each, fully paid	4,00,000	Plant and Machinery	1,80,000
General Reserve	50,000	Furniture	20,000
Workmen's Accident Compensation Fund	30,000	Stock	90,000
1000 7% Debentures of Rs.50 each	50,000	Sundry Debtors	1,00,000
Sundry Creditors	40,000	Less: Provision for D.D.	5,000
Bank Overdraft	10,000	Cash	2,000
Staff Provident Fund	40,000	Discount on Issue of Debentures	3,000
	<u>6,20,000</u>		<u>6,20,000</u>

The business of Apex Ltd. is taken over by Balaji Ltd. on 31<sup>st</sup> Dec. 2000. The purchase consideration is to be discharged as follows:

- i) A cash payment of Rs. 10 for every share in Apex Ltd.
- ii) An exchange of 5 shares in Balaji Ltd. of Rs. 10 each, at the market value of Rs. 15 per share, for every two shares in Apex Ltd.

- iii) A cash payment of Rs. 60 for every debenture in Apex Ltd., in full discharge of the debentures.

There was an outstanding liability of Rs. 8,000 on account of workmen's compensation fund. The liquidation expenses of Rs. 5,000 were borne by Apex Ltd.

Show the Realisation Account, Cash Account and the Shareholders Account in the Books of Apex Ltd.

(Answer: Purchase consideration Rs. 4,40,000; Realisation Loss Rs. 94,000)

2. The Balance Sheet of Luma Co. Ltd. on 31<sup>st</sup> March, 2001 was as follows:

Liabilities	Rs.	Assets	Rs.
<b>Share capital</b>			
20,000 shares of Rs.10 each	2,00,000	Fixed Assets	2,00,000
Sundry Liabilities	50,000	Current assets	40,000
		P & L Account	10,000
	<u>2,50,000</u>		<u>2,50,000</u>

Monarch Ltd., absorbed the Luma Co. Ltd., and took over the assets for Rs. 1,52,000, payable Rs. 1,00,000 in shares of Rs. 10 each, and Rs. 52,000 in cash in order to enable Luma Co. Ltd., to pay off its liabilities and the cost of liquidation.

Pass Journal entries to close the books of Luma Co. Ltd., and prepare Shareholders Account, Bank Account and Realisation Account.

(Hint : Luma Ltd. pays Sundry Liabilities Rs. 50,000 and liquidation expenses Rs. 2,000)

(Answer: Realisation Loss Rs. 90,000)

3. Oasis Ltd. decides to sell its business to Madhulika Ltd. On 31<sup>st</sup> Dec. 2000 on which date its balance sheet was as below:

Liabilities	Rs.	Assets	Rs.
<b>Share capital:</b>		<b>Goodwill</b>	60,000
50,000 shares of Rs.10 each	5,00,000	Land and Buildings	1,50,000
General Reserve	50,000	Plant and Machinery	2,20,000
Profit & Loss A/c.	40,000	Stock	2,00,000
10% Debentures	1,00,000	Sundry Debtors	1,50,000
Sundry Creditors	1,50,000	Cash at Bank	70,000
Bills Payable	10,000		
	<u>8,50,000</u>		<u>8,50,000</u>

Madhulika Ltd., took over all the assets except cash at bank. Goodwill is taken over at Rs. 1,00,000; land and buildings at Rs. 1,80,000 and other assets at book value. Madhulika Ltd., also undertook to discharge sundry creditors and bills payable. The purchase consideration is payable as Rs. 90,000 in cash, and the balance in the form of fully paid shares at Rs. 150 each, (the par value being Rs. 100 only). Liquidation expenses were Rs. 15,000/-

Record the above transactions in the journals of the two companies.

ii) Though share's par value is Rs. 100, it is issued at Rs. 150, to Oasis Ltd.

(Answer : Purchase consideration Rs. 6,90,000; Realisation Profit Rs. 55,000)

4. In order to effect economies in the working, the Inventaa Ltd., agreed to take over the Capol Co. Ltd., as a going concern as both are engaged in the same business. The balance sheets of the two companies on 31<sup>st</sup> Dec. 2000, the date of absorption, are given below:

Liabilities	Capol Ltd. Rs.	Inventaa Ltd. Rs.	Assets	Capol Ltd. Rs.	Inventaa Ltd. Rs.
<b>Authorised Capital</b>			Goodwill	50,000	3,00,000
Shares of Rs.10 each	<u>8,00,000</u>	<u>20,00,000</u>	Land & Buildings	3,57,820	10,38,300
			Plant & Machinery	1,64,390	3,87,680
<b>Paid up Capital</b>			Sundry Creditors	39,840	72,400
Fully Paid shares of			Stock	78,520	1,79,260
Rs.10 each	5,00,000	15,00,000	Bills Receivable	--	36,210
P&L A/c.	26,950	98,850	Bank Balance	--	1,68,420
10% Debentures	1,00,000	5,00,000			
Sundry Creditors	43,620	83,420			
Bank Overdraft	20,000	--			
	<u>6,90,570</u>	<u>21,82,270</u>		<u>6,90,570</u>	<u>21,82,270</u>

The Inventaa Ltd., was to pay the debentures (by its own debentures) and liabilities of Capol Ltd., and take over the assets. The Purchase consideration being the issue of 40,000 fully paid shares of Rs. 10 each, and the payment of Rs. 30,000 in cash by the Inventaa Ltd., to the Capol Ltd. The Inventaa Ltd. was also to pay Rs. 14,000 towards liquidation expenses.

Prepare the accounts showing the absorption in Capol Ltd., and the Balance Sheet of the Inventaa Ltd., after the absorption.

**Hints:** On acquisition of Capol Ltd. business, there is an excess debit of Rs. 32,950. As it is not desirable to show capital reserve and goodwill simultaneously, it was credited to Goodwill A/c. Hence, finally goodwill is Rs. 3,00,000 - Rs. 32,950 = Rs. 2,67,050.

[Answer: Purchase consideration Rs.4,44,000. Balance sheet total (before paying Sundry Creditors and O.D.of Capol Ltd.) Rs.27,45,890.]

5. Godavari Co. Ltd., agreed to acquire the business of Kinnerasani Ltd., as on 31<sup>st</sup> December, 2000. The summarised balance sheet of Kinnerasani Ltd. on that date was as follows:

Liabilities	Rs.	Assets	Rs.
<b>Share capital</b>		Goodwill	2,00,000
1,20,000 fully paid shares of		Buildings & Machinery	12,80,000
Rs.10 each	12,00,000	Stock	3,36,000
General Reserve	3,40,000	Debtors	72,000

Profit & Loss A/c.	2,20,000	Cash and Bank	1,12,000
6% Debentures	2,00,000		
Creditors	40,000		
	<u>20,00,000</u>		<u>20,00,000</u>

The purchase consideration payable by Godavari Ltd., was agreed as follows:

- A Cash payment equivalent to Rs. 2.50 for every Rs. 10 share in Kinnerasani Ltd.
- The issue of 1,80,000 shares of Rs. 10 each fully paid, in Godavari Ltd., at an agreed value of Rs. 15 per share.
- The issue of such an amount of fully paid 5% debentures of Godavari Ltd., at 96 per cent, as is sufficient to discharge the 6% debentures of Kinnerasani Ltd., at a premium of 20%.

The Directors of Godavari Ltd., agreed to value the buildings and machinery at Rs. 24,00,000, the stock at Rs. 2,84,000, and the debtors at their face value subject to an allowance of 5% to cover doubtful debts. The cost of liquidation of Kinnerasani Ltd., came to Rs. 10,000.

Give ledger accounts to close the books of the Kinnerasani Ltd., and draft journal entries required in the books of Godavari Ltd.

Hints: i) Purchase consideration	Rs.
a) Cash 1,20,000 x Rs. 2.50	3,00,000
b) Shares 1,80,000 x Rs. 15	27,00,000
(Rs. 18,00,000 face value of shares Rs. 9,00,000 share premium)	
c) Debentures Rs. 2,00,000 x 120 /100	<u>2,40,000</u>
	<u>32,40,000</u>
ii) Face value of debentures issued = Rs. 2,40,000 x 100 /96 = Rs. 2,50,000	
iii) The liquidation expenses are borne by Kinnerasani Ltd.	
iv) Good will a/c. in Godavari Ltd. is	Rs. 4,15,600.

(Answer: Realisation Profit : Rs. 12,30,000).

6. The following are the summarised Balance Sheets of Navabharathi Ltd., and Yuvabharathi Ltd., on 31<sup>st</sup> December, 2000.

	Navabharathi Ltd. Rs.	Yuvabharathi Ltd. Rs.
<b>Liabilities</b>		
<b>Authorised Capital</b>		
Shares of Rs.10 each	<u>20,00,000</u>	<u>8,00,000</u>
Issued Capital	10,00,000	80,000
General Reserve	2,00,000	1,00,000
Profit and Loss A/c.	1,12,580	77,300

**Current Liabilities**

Accounts Payable  
Taxation Provision

2,24,200	78,960
<u>1,50,000</u>	<u>96,000</u>
<u>16,86,780</u>	<u>11,52,260</u>

**Assets**

Freehold premises  
Leasehold premises  
Plant & Machinery  
Fixtures and Fittings  
Stock & Work in progress  
Accounts Receivable  
Unexpired Payments  
Cash and Bank

	Navabharathi Ltd. Rs.	Yuvabharathi Ltd. Rs.
	3,88,560	--
	--	3,12,480
	4,68,560	2,15,260
	43,440	20,940
	3,04,580	1,97,340
	2,52,820	1,88,660
	5,960	2,800
	<u>2,22,860</u>	<u>2,14,78</u>
	<u>16,86,780</u>	<u>11,52,260</u>

Navabharathi Ltd., took over the fixed assets and stock and work in progress of Yuvabharathi Ltd., from 1<sup>st</sup> January, 1996 for a sum of Rs.9,00,000 to be satisfied by an allotment of shares. The vendor company has to pay the necessary costs of sale amounting to Rs.20,000. The accounts receivable realised Rs.1,82,000. The absorption being complete, you are required to show:

- The Realisation Account, Cash Account and Shareholders' Account in the books of Yuvabharathi Ltd., assuming that the final taxation liability of that company to be Rs.74,000
- The necessary journal entries in the books of Navabharathi Ltd., and to prepare the balance sheet after absorption.

**Hints:** (i) Navabharathi Ltd., has taken over only fixed assets and stock for a sum of Rs. 9,00,000 consideration. Accounts receivable (i.e. Sundry Debtors) and cash are not taken over. Unexpired payments (like prepaid insurance) also are not stated as taken over by the Navabharathi Ltd. Since they cannot be separately realised, it can be assumed that Navabharathi has taken them and paid Rs. 2,800. Thus, the total purchase consideration comes to Rs. 9,02,800.

(ii) Taxation provision is Rs. 96,000. Actual liability paid is Rs. 74,000. Therefore Rs. 22,000 balance has to be transferred to shareholders account.

(iii) Accounts payable (i.e. Sundry Creditors) are paid by Yuvabharathi Ltd.

(Answer: Realisation profit Rs. 1,27,320; Balance Sheet total Rs. 25,86,780)

## 11.6 RECOMMENDED BOOKS

1. R.L. Gupta and  
M. Radhaswamy

: **Advanced Accountancy, Volume-II**  
Sultan Chand & Sons, New Delhi.

2. S.N.Maheswari : **Advanced Accountancy, Volume-II,**  
Vani Educational Books, New Delhi.
3. S.P.Jain and : **Advanced Accountancy,**  
K.L.Narang Kalyani Publishers, Ludhiana.
4. MC. Shukla and : **Advanced Accountancy,**  
T.S. Grewal S. Chand & Sons, New Delhi.

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## **11.5 GLOSSARY**

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- Absorption** : Taking over the business of one or more companies by an existing company.
- Vendor Company** : It is a company which sells its business.
- Liquidator** : A person who is appointed to conduct the liquidation proceedings of the company.
- Liquidation Expenses** : Expenses incurred towards winding up of the Vendor Company.

**Dr. D. Obul Reddy**

BRAOU

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## **UNIT - 12 : RECONSTRUCTION**

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### **Contents**

- 12.0 Aims and Objectives
- 12.1 Introduction
- 12.2 Illustrative Problems on External Reconstruction
- 12.3 Inter Company Owings
- 12.4 Internal Reconstruction
- 12.5 Summing Up
- 12.6 Check Your Progress : Model Answers
- 12.7 Model Examination Questions
- 12.8 Recommended Books
- 12.9 Glossary

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### **12.0 AIMS AND OBJECTIVES**

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The aim of this unit is to illustrate the accounting treatment pertaining to reconstruction of companies.

Having studied and worked through this unit, you should be able to:

- explain the accounting treatment in case of external reconstruction and internal reconstruction;
- explain the concept of inter company owings; and
- solve the problems on external and internal reconstruction.

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### **12.1 INTRODUCTION**

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You may recall that the accounting procedure in case of amalgamation, absorption and external reconstruction is same. Further the previous three units made you perfect in calculating the purchase consideration and preparing the accounts pertaining to Amalgamation and Absorption. This unit is presented to illustrate the accounting treatment pertaining to external reconstruction and internal reconstruction.

Reconstruction is of two types, internal reconstruction and external reconstruction. In case of internal reconstruction the company changes its capital structure by reducing share capital. In case of external reconstruction a new company is floated to take over the business of an existing company which is then wound up.

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### **12.2 ILLUSTRATIVE PROBLEMS ON EXTERNAL RECONSTRUCTION**

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#### **Illustration - 1**

Given below is the Balance Sheet of Better Ltd. as at March 31, 2001.

Liabilities	Rs.	Assets	Rs.
40,000 shares of Rs. 10 each fully paid	4,00,000	Land and Buildings	3,20,000
Creditors	3,00,000	Plant & Machinery	1,30,000
		Stock	70,000
		Debtors	1,20,000
		Cash	500
		Preliminary Exp.	5,000
		Profit & Loss A/c.	54,500
	<u>7,00,000</u>		<u>7,00,000</u>

The following scheme of reconstruction was arranged:

1. The company to go into liquidation and a new company Best Ltd. with an authorized capital of Rs. 8,00,000 to be formed to take over the assets and liabilities.
2. Preferential creditors of Rs. 10,000 included in the creditors are to be paid in full.
3. Unsecured creditors to receive either a) 50% of their claim in cash or b) 6% Debentures in the new company equivalent to their claims at par.
4. Shareholders in Better Ltd., to be allotted one share in Best Ltd., of Rs. 10 each, Rs. 5 paid for every share held in Better Ltd.
5. Reconstruction costs amounting to Rs. 6,000 to be paid by Better Ltd., from cash made available by Best Ltd.

Half of the unsecured creditors in value opted for immediate cash payment for which purpose necessary cash was made available by making a call of Rs. 5 each on the partly paid shares allotted as aforesaid. Best Ltd., valued all assets (except land and building) taken over from Better Ltd., at book value.

Prepare necessary ledger accounts in the books of Better Ltd., and the Balance Sheet of Best Ltd.

#### Solution

#### Books of Better Ltd. Calculation of Purchase Consideration

	Amount	Form
1. Payment to preferential creditors	10,000	Cash
2. Payment to unsecured creditors amounting to Rs. 2,90,000 (total creditors 3,00,000 – Preferential creditors Rs.10,000) 50% of the half of the claim $2,90,000 \times 50/100 \times \frac{1}{2} =$	72,000*	Cash
50% of the creditors	1,45,000	6% Debentures
3. Payment to shareholders 40,000 shares of Rs. 10 each Rs. 5 paid up	2,00,000	Shares
4. Payment towards reconstruction expenses	6,000	Cash
<b>Total</b>	<u>4,33,500</u>	

\* If the creditors opt for cash payment, they will get only 50% of their claim. Half of the creditors opted for cash payment. Their claim is half of Rs. 2,90,000, i.e., Rs. 1,45,000. They will get half of this claim, that is Rs. 72,500.

The value of Land and Buildings not to be taken at book value is ascertained as follows:

	Amount	From
Purchase consideration		4,33,500
Less: Book value of all assets (except land and building)		
Plant and Machinery	1,30,000	
Stock	70,000	
Debtors	1,20,000	
Cash	500	3,20,500
Value of Land & Buildings		<u>1,13,000</u>

Dr.		Realisation Account		Cr.	
	Rs.				Rs.
To Land & Buildings	3,20,000	By Best Ltd. (Purchase consideration)		4,33,500	
To Plant & Machinery	1,30,000	By Creditors (Profit)		72,500	
To Stock	70,000	By Equity Shareholders A/c. (Loss)		1,40,500	
To Debtors	1,20,000				
To Cash	500				
To Cash (Expenses)	6,000				
	<u>6,46,500</u>				<u>6,46,500</u>

Dr.		Equity Shareholders Account		Cr.	
	Rs.				Rs.
To Preliminary Expenses A/c.	5,000	By Equity Share Capital A/c.		4,00,000	
To Profit and Loss A/c.	54,500				
To Realisation A/c.	1,40,500				
To Shares in Best Ltd. A/c.	2,00,000				
	<u>4,00,000</u>				<u>4,00,000</u>

Dr.		Creditors Account		Cr.	
	Rs.				Rs.
To Cash (Pref. creditors)	10,000	To Balance b/d.		3,00,000	
To Cash (Payment)	72,500				
To 6% Debentures	1,45,000				
To Realisation A/c.	72,500				
	<u>3,00,000</u>				<u>3,00,000</u>

**Books of Best Ltd.**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
--	Land and Buildings A/c. Dr.		1,13,000	
	Plant & Machinery A/c. Dr.		1,30,000	
	Stock A/c. Dr.		70,000	
	Debtors A/c. Dr.		1,20,000	
	Cash A/c. Dr.		500	
	To Liquidator of Better Ltd. A/c. (Being the assets taken over on reconstruction and the amount due to the liquidator)			4,33,500
--	Cash A/c. Dr.		2,00,000*	
	To Equity Share Capital A/c. (Being the call money received on 40,000 shares at Rs. 5 per share)			2,00,000
--	Liquidator of Better Ltd. A/c. Dr.		4,33,500	
	To Cash			88,500
	To Equity Share Capital A/c.			2,00,000
	To 6% Debentures A/c. (Being discharge of purchase consideration)			1,45,000

\* Shareholders in Better Ltd., are allotted 40,000 shares of Rs. 10 each, treating Rs. 5 only as paid. That means the allotted shareholders have to pay the remaining Rs. 5 per share. Best Ltd., has called that amount, and the shareholders paid that amount Rs. 5 x 40,000 = 2,00,000.

Dr.		Cash Account	Cr.	
		Rs.		Rs.
To Liquidator of Better Ltd.		500	By Liquidator of Better Ltd.	88,500
To Equity Share Capital A/c.		2,00,000	By Balance c/d.	1,12,000
		<u>2,00,500</u>		<u>2,00,500</u>

**Balance Sheet of Best Ltd.**  
as on 31<sup>st</sup> March, 2001

Liabilities	Rs.	Assets	Rs.
<b>Share Capital</b>		<b>Fixed Assets</b>	
Authorised Capital 80,000 equity shares of Rs. 10 each	8,00,000	Land and Buildings	1,13,000
		Plant & Machinery	1,30,000
		<b>Current Assets</b>	
<b>Issued and subscribed and Paid up capital</b>		Stock	70,000
40,000 shares of Rs. 10 each (Allotted Rs. 5 paid up on each share for consideration other than cash) fully paid	4,00,000	Debtors	1,20,000
6% Debentures	1,45,000	Cash	1,12,000
	<u>5,45,000</u>		<u>5,45,000</u>

## CHECK YOUR PROGRESS – 1

- i) Kathu Limited was formed to acquire the business of Raghu Limited, which was to be wound up, the purchase consideration is Rs. 4,50,000. The assets and liabilities taken by Kathu Limited and their agreed values are as follows: Fixed assets Rs. 5,25,000, Stock Rs. 1,20,000, Debtors Rs. 1,80,000, Bills Receivable Rs. 20,000, Bank Balance Rs. 30,000, Creditors Rs. 1,40,000, Bills Payable Rs. 90,000 and other liabilities Rs. 1,25,000. Pass opening entry to record above assets and liabilities and find out capital reserve or goodwill.
- .....
- .....
- .....

- ii) Liquidation expenses paid by vendor company Rs. 5,000. Pass the entry in the books of vendor's company.
- .....
- .....
- .....

### Illustration – 2

Dark Co. Ltd., having proved unsuccessful, resolved by a special resolution to wind up for the purpose of reconstruction and sale to a new company, Light Co. Ltd. The Balance Sheet of the company at the date of confirmatory resolution was as follows:

Liabilities	Rs.	Assets	Rs.
<b>Share Capital</b>		Land and Buildings	4,50,000
80,000 ordinary shares of Rs. 10 each fully paid	8,00,000	Plant & Machinery	2,40,000
6% 2,000 debentures of Rs. 100 each	2,00,000	Sundry Debtors	1,05,000
Sundry Creditors	50,000	Less: Provision for Bad & D.D.	5,000
Bills Payable	20,000	Stock	50,000
		Cash at Bank	5,000
		Profit & Loss A/c.	2,25,000
	<u>10,70,000</u>		<u>10,70,000</u>

The scheme of reconstruction, assented to by all parties, was as follows:

- 1) The new company was to take over assets and liabilities.
- 2) The capital of the new company was to be Rs. 15,00,000 in 1,50,000 shares of Rs.10 each.
- 3) The new company was to discharge purchase consideration as follows:
  - a) The issue of 7% 2,000 debentures
  - b) The issue of 1,20,000 ordinary shares of Rs. 10 each with Rs. 5 per credited, as paid-up and as to Rs. 40,000 in cash.
- 4) The members of the new company were to pay the balance of Rs. 5 per share due upon the shares issued to them at Rs. 5 per share. The expenses of reconstruction amounted to Rs. 5,000. All calls were duly paid.

Pass journal entries to close the books of Dark Company Ltd., and show the opening Balance Sheet of Light Ltd.

**Solution**

**Purchase Consideration**

1. 2,000, 7% Debentures of Rs. 100 each	Amount 2,00,000
2. 1,20,000 equity shares of Rs. 10 each Rs. 5 paid up	6,00,000
3. Cash	<u>40,000</u>
	<u>8,40,000</u>

**Entries to Close the Books of Dark Limited**

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
--	Realisatoin A/c. <span style="float: right;">Dr.</span> To Land and Building To Plant & Machinery To Sundry Debtors To Stock (Being the transfer of assets to Realisation A/c.)		8,45,000	4,50,000 2,40,000 1,05,000 50,000
--	Sundry Creditors A/c. <span style="float: right;">Dr.</span> Bills Payable A/c. <span style="float: right;">Dr.</span> Provision for Bad Debts A/c. <span style="float: right;">Dr.</span> To Realisation A/c. (Being the liabilities transferred to Realisation Account)		50,000 20,000 5,000	75,000
--	Light Ltd. A/c. <span style="float: right;">Dr.</span> To Realisation A/c. (Being the purchase consideration due from Light Ltd.)		8,40,000	8,40,000
--	Realisation A/c. <span style="float: right;">Dr.</span> To Bank A/c. (Being the reconstruction expenses paid)		5,000	5,000
--	Realisation A/c. <span style="float: right;">Dr.</span> To Shareholders A/c. (Being the profit on realization transferred to shareholders A/c.)		65,000	65,000
--	Shareholders A/c. <span style="float: right;">Dr.</span> To Profit and Loss Account (Being the accumulated losses transferred to shareholders A/c.)		2,25,000	2,25,000
--	Share Capital A/c. <span style="float: right;">Dr.</span> To Shareholders A/c. (Being the share capital transferred to shareholders account)		8,00,000	8,00,000

--	6% Debentures A/c. To Debenture holders A/c. (Being the Debentures transferred to Debentureholders A/c.)	Dr.		2,00,000
--	7% Debentures in Light Ltd. A/c. Equity Shares in Light Ltd. A/c. Bank A/c. To Light Ltd. A/c. (Being the purchase consideration received from Light Ltd.)	Dr. Dr. Dr.	2,00,000 6,00,000 40,000	8,40,000
--	Debentureholders A/c. To 7% Debentures in Light Ltd. A/c. (Being the debentures received by Debentureholders)	Dr.	2,00,000	2,00,000
--	Shareholders A/c. To Equity Shares in Light Ltd. To Bank A/c. (Being the allotment of equity shares of Light Ltd., and payment of cash in satisfaction of the claim.)	Dr.	6,40,000	6,00,000 40,000

Dr.		Realisation Account		Cr.	
		Rs.		Rs.	
To Land & Buildings	4,50,000	By Sundry Creditors	50,000		
To Plant & Machinery	2,40,000	By Bills Payable	20,000		
To Sundry Debtors	1,05,000	By Provision for D.D.	5,000		
To Stock	50,000	By Light Ltd.	8,40,000		
To Bank (expenses)	5,000				
To Shareholders A/c. (profit)	65,000				
	<u>9,15,000</u>				<u>9,15,000</u>

Dr.		Debentureholders Account		Cr.	
		Rs.		Rs.	
To 7% Debentures A/c.	2,00,000	By 6% Debentures A/c.	2,00,000		
	<u>2,00,000</u>				<u>2,00,000</u>

Dr.		Shareholders Account		Cr.	
		Rs.		Rs.	
To Profit and Loss A/c.	2,25,000	By Share Capital A/c.	8,00,000		
To Equity Shares in Light Ltd.	6,00,000	By Realisation A/c.	65,000		
To Bank A/c.	40,000				
	<u>8,65,000</u>				<u>8,65,000</u>

Dr.		Bank Account		Cr.	
To Balance b/d.	Rs. 5,000	By Realisation A/c.	Rs.		
To Light Ltd.	40,000	(Expenses)	5,000		
		By Shareholders A/c.	40,000		
	<u>45,000</u>		<u>45,000</u>		

### Journal Entries in the Books of Light Limited

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
--	Land and Buildings A/c. Dr.		4,50,000	
	Plant & Machinery A/c. Dr.		2,40,000	
	Sundry Debtors A/c. Dr.		1,05,000	
	Stock A/c. Dr.		50,000	
	Goodwill A/c. Dr.		70,000	
	To Sundry Creditors A/c.			50,000
	To Bills Payable A/c.			20,000
	To Provision for Bad Debts A/c.			5,000
	To Liquidator of Dark Ltd. A/c.			8,40,000
	(Being the assets and liabilities taken over from Dark Ltd., and the purchase consideration due to the Liquidator of Dark Ltd.)			
--	Bank A/c. Dr.		6,00,000	
	To Share Capital A/c.			6,00,000
	(Being the balance of Rs. 5 per share on 1,20,000 shares received from the shareholders)			
--	Liquidator of Dark Ltd. A/c. Dr.		8,40,000	
	To Share Capital A/c.			6,00,000
	To 7% Debentures A/c.			2,00,000
	To Bank A/c.			40,000
	(Being the issue of 1,20,000 equity shares of Rs. 10 each, Rs. 5 paid up, the issue of 7% Debentures and the balance of Rs. 40,000 paid in cash, in discharge of purchase consideration)			

### Balance Sheet of Light Ltd.

As on -----

Liabilities	Rs.	Assets	Rs.
<b>Share Capital</b>		<b>Fixed Assets</b>	
Authorised Capital 1,50,000 shares of Rs. 10 each		Goodwill	70,000
	<u>15,00,000</u>	Land and Buildings	4,50,000
<b>Issued, Subscribed and Paid up</b>		Plant and Machinery	2,40,000
1,20,000 shares of Rs. 10 each fully paid up (including the amount of Rs. 5 per share on issue as part of purchase consideration)		<b>Current Assets</b>	
		Sundry Debtors	1,05,000
		Less: Provision for Bad & D.D.	<u>5,000</u>
		Stock	50,000
	12,00,000	Bank (6,00,000 - 40,000)	5,60,000

7% Debentures	2,00,000	
Sundry Creditors	50,000	
Bills Payable	20,000	
	<u>14,70,000</u>	<u>14,70,000</u>

### 12.3 INTER COMPANY OWINGS

If any amount is owed by the purchasing company to the vendor company or vice-versa at the time of amalgamation or absorption of companies, this is to be eliminated. Suppose, A Limited acquires the business of B Limited and the latter company owes a book debt of Rs. 5000 to the former company, then after the absorption both the sundry debtors and sundry creditors should be shown in the Balance Sheet of the purchasing company at the figures after deduction of Rs. 5000. This will not affect the entries to be passed in the books of vendor company (B Ltd.) but the purchasing company (A Ltd.) is required to pass one more entry i.e.,

Sundry Creditors A/c.	Dr.	5,000	
To Sundry Debtors A/c.			5,000

The same entry will be passed in the books of purchasing company even if Rs. 5,000 is owed by 'A' Ltd. to 'B' Ltd.

Similarly, before acquisition, if some goods are sold by purchasing company to the vendor company or vice-versa and goods remain unsold on the date of acquisition, when the business is acquired, the unsold stock at invoice price will also be acquired by the purchasing company for which it must have taken some profit. Thus, it becomes essential to reduce the unsold stock to its cost price and the profit element will automatically be adjusted either in the figure of goodwill or capital reserve.

On the otherhand, if goods are purchased by the purchasing company from the vendor company and some goods remain unsold with the purchasing company the way to eliminate the unrealized profit charged by the vendor company is to debit goodwill or capital reserve and credit the stock account with the amount of unrealized profit.

**Example:** X Ltd., has bought goods of the invoice value of Rs. 15,000 from Y Ltd. The company invoices goods at cost plus 20%. Later, X Ltd. acquires the business of Y Ltd. Out of these goods purchased, Rs. 6,000 in stock are remained.

**Sol:** Calculation of unrealized profit:

$$6,000 \times 20/120 = \text{Rs. } 1,000$$

X Ltd. must pass the following additional entry in addition to usual entries:

Goodwill or Capital Reserve A/c.	Dr.	1,000	
To Stock A/c.			1,000

#### Inter - Company Holdings

The term inter-company holding refers to the stake held by one company in another company. There may be three situations with reference to inter-company holdings:

- i) Shares held by the transferee company in the transferor company.
- ii) Shares held by the transferor company in the transferee company.
- iii) Shares held by both companies in one another.

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**CHECK YOUR PROGRESS – 2**

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Give the answers for the following:

- i) To which account the liabilities not taken over by the new company are transferred for cancellation.
- ii) To which account accumulated profits and losses of the vendor company are transferred.

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**12.4 INTERNAL RECONSTRUCTION**

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In case of internal reconstruction the company will not be liquidated, but accumulated losses and fictitious assets will be written off by reducing the capital of the company. Internal Reconstruction and capital reduction mean the same. The claims of shareholders and sometimes even of creditors are suitably adjusted to write off accumulated losses, fictitious assets. No new company is formed and the old company with its reconstituted capital structure continues to carry on business. If the claims of the creditors and debentureholders are also reduced then it is more appropriate to call it as 'Reorganization'.

A company can reduce its share capital according to the Companies Act. A summary of these provisions are as under:

- i) It should be authorized by the Articles of Association.
- ii) The company should pass a special resolution for capital reduction.
- iii) The company must apply to the court for an order confirming the reduction of capital on such terms and conditions as it thinks fit. The court may direct the company to add the word "And Reduced" to its name for such period as it thinks fit. The order of the court has to be registered with the Registrar of companies.

**Accounting Treatment**

I. For reducing the Capital:

Equity Share Capital A/c. (old) Pref. Share Capital A/c. (old) To Capital Reduction A/c. (or) To Reconstruction A/c. To Equity Share Capital A/c. (new) To Pref. Share capital A/c. (new)	<table style="border: none;"> <tr> <td style="font-size: 2em; vertical-align: middle;">}</td> <td style="vertical-align: middle;">Dr. (with the paid up value</td> </tr> <tr> <td style="font-size: 2em; vertical-align: middle;">}</td> <td style="vertical-align: middle;">Dr. of the old Share)</td> </tr> <tr> <td style="font-size: 2em; vertical-align: middle;">}</td> <td style="vertical-align: middle;">(with the paid-up value</td> </tr> <tr> <td style="font-size: 2em; vertical-align: middle;">}</td> <td style="vertical-align: middle;">of new shares)</td> </tr> </table>	}	Dr. (with the paid up value	}	Dr. of the old Share)	}	(with the paid-up value	}	of new shares)
}	Dr. (with the paid up value								
}	Dr. of the old Share)								
}	(with the paid-up value								
}	of new shares)								

2. If any sacrifice has been made by creditors, debenture holders etc:

Creditors A/c.	Dr.
Debentureholders A/c.	Dr.
To Capital Reduction A/c.	
{ or Reconstruction A/c. }	
{ or Reorganisation A/c. }	

3. When Capital Reduction / Reconstruction A/c. is utilized for writing off accumulated losses, fictitious assets etc.:

Capital Reduction/ (or Reorganisation) A/c.	Dr.
To P&L A/c.	
To Prel. Expenses A/c.	
To Discount on issue of shares A/c.	
To Discount on issue of Debentures A/c.	
To Goodwill A/c.	
To Patents or Trade Marks A/c.	
To Other Assets (individually) A/c.	
To Capital Reserve A/c.	
(If any balance is left)	

### Illustration - 3

The following is the Balance Sheet of Hopeless., as at 31st March 2003.

Liabilities	Rs.	Assets	Rs.
20,000 Equity Shares of Rs. 10 each, (fully paid up)	2,00,000	Buildings	2,00,000
10% Cumulative Pref. Shares of Rs. 100 each fully paid.	1,00,000	Machinery	1,50,000
9% Debentures	1,00,000	Patents	40,000
Trade Creditors	3,50,000	Stock	70,000
		Debtors	60,000
		Cash at Bank	10,000
		Preliminary Exp.	20,000
		Profit & Loss A/c.	2,00,000
	<u>7,50,000</u>		<u>7,50,000</u>

The company proved unsuccessful and it passed the following resolution and obtained the necessary confirmation from the court.

1. The Pref. Shares to be reduced to an equal number of 12% cumulative Pref. Shares of Rs. 30 each.
2. The equity shares to be reduced to an equal number of shares of Rs. 2 each.
3. To reduce the Debentures by 20% and issue new 13% Debentures for the balance.
4. To reduce the claims of creditors by Rs. 10,000.

The amount thus made available be utilized to write off the fictitious assets, patents by Rs. 25,000 and to reduce the value of stock by Rs. 10,000 to make a provision for Doubtful debts to the extent of Rs. 15,000.

Pass the journal entries to give effect the above and show the company's post reconstruction Balance Sheet.

**Solution**

**Journal**

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	10% Pref. Share capital A/c. Dr. (of Rs. 100 each) To 12% Pref. Share capital A/c. To Reconstruction A/c. (Being the reconstruction made by converting Pref. Shares into new 12% Pref. Shares of Rs. 30 each and balance transferred to Reconstruction A/c.)		1,00,000	30,000 70,000
	Equity Share capital A/c. Dr. (of Rs. 10 each) To Equity share capital A/c. (of Rs. 2 each) To Reconstruction A/c. (Being reconstruction by making equity shares of Rs. 2 each and balance transferred to reconstruction)		2,00,000	40,000 1,60,000
	9% Debentures A/c. Dr. To 13% Debentures A/c. To Reconstruction A/c. (Being reconstruction done by issue of new 13% Debentures and the balance transferred to reconstruction A/c.)		1,00,000	80,000 20,000
	Trade creditors A/c. Dr. To Reconstruction A/c. (Being the sacrifice made by creditors transferred to Reconstruction A/c.)		10,000	10,000
	Reconstruction A/c. Dr. To Profit and Loss A/c. To Preliminary expenses A/c. To Patents A/c. To Stock A/c. To Provision for Doubtful debts A/c. (Being the amount of reconstruction utilized to write off, Profit & Loss A/c. Prel. expenses and to write down the value of others assets)		2,60,000	2,00,000 20,000 25,000 10,000 5,000

**Balance Sheet of Hopeless Ltd. (and reduced) as at 31<sup>st</sup> March, 2002**

Liabilities	Rs.	Assets	Rs.
<b>Share Capital</b>		<b>Fixed Assets</b>	
20,000 Equity shares of Rs. 2 each fully paid	40,000	Buildings	2,00,000
1000-12% Pref. shares of Rs.30 each fully paid	30,000	Machinery	1,50,000
		Patents	40,000
		Less: Written off	<u>25,000</u>
			15,000
<b>Secured loans</b>		<b>Current Assets, Loans &amp; Advances</b>	
13% Debentures	80,000	Stock	60,000
		Debtors	60,000
		Less: P.D.D.	<u>5,000</u>
			55,000
<b>Current Liabilities and Provisions</b>		Cash at Bank	<u>10,000</u>
Trade creditors	3,40,000		<u>4,90,000</u>
	<u>4,90,000</u>		

### 12.5 SUMMING UP

External reconstruction takes place when a new company is floated to take over the business of an existing company which is then wound up. In case of amalgamation, absorption and external reconstruction the accounting procedure is common. The Vendor company is to be closed and the transactions relating to the acquisition of business are to be recorded in the books of purchasing company. In the case of internal reconstruction the share capital is reorganized.

### 12.6 CHECK YOUR PROGRESS : MODEL ANSWERS

		Rs.	Rs.
1. i) Fixed Assets Account	Dr.	5,25,000	
Stock Account	Dr.	1,20,000	
Debtors Account	Dr.	1,80,000	
Bills Receivable Account	Dr.	20,000	
Bank Account	Dr.	30,000	
To Creditors Account			1,40,000
To Bills Payable Account			90,000
To Other Liabilities Account			1,25,000
To Business Purchase Account			4,50,000
To Capital Reserve Account (Bal. fig.)			70,000
<hr/>			
ii) Realisation Account	Dr.	5,000	
To Bank Account			5,000

2. i) Realisation Account  
ii) Equity Shareholders Account

## 12.7 MODEL EXAMINATION QUESTIONS

### I. Answer the following questions in about 30 lines each.

1. Explain the accounting treatment pertaining to external reconstruction with an example.

### II. Answer the following questions in about 15 lines each.

1. What is external reconstruction?
2. Explain the various items that are to be debited and credited to the Equity shareholders account.
3. What do you mean by Inter Company Owings.
4. Explain the accounting treatment pertaining to internal reconstruction.

### Problems

1. On 31<sup>st</sup> December, 2000 the Balance Sheet of Pennar Co. Ltd., was as follows:

Liabilities	Rs.	Assets	Rs.
<b>Authorised Capital</b> Shares of Rs. 100 each	25,00,000	<b>Fixed Assets</b>	16,00,000
		Stock	70,000
<b>Paid up capital</b> 15,000 fully paid shares of Rs. 100 each	15,00,000	Sundry Debtors	1,50,000
Sundry Creditors	4,75,000	Cash in hand	5,000
	19,75,000	Profit and Loss A/c.	1,50,000
			19,75,000

As the company is in difficulties, it was decided to reconstruct the company. For this purpose a new company Pinakini Ltd., is formed. The new company took over the assets excluding cash for a sum of Rs. 15,00,000 to be satisfied by the issue of 10,000 fully paid shares of Rs. 100 each and by payment of the balance in cash. The liquidation expenses amounted to Rs. 5,000.

Give necessary ledger accounts to close the books of Pennar Co. Ltd.

(Answer : Realisation Loss : Rs. 3,25,000).

2. Shakti Ltd., falls into financial difficulties and passes the necessary resolution for the winding up for the purpose of reconstruction and for sale to a new company, Trishul Ltd. The Balance Sheet of Shakti Ltd., on 31<sup>st</sup> March, 2001 is as follows:

Liabilities	Rs.	Assets	Rs.
<b>Share Capital</b> 1,00,000 shares of Rs. 10 each	10,00,000	<b>Goodwill</b>	1,00,000
Sundry Creditors	1,50,000	Land and Buildings	3,70,000
		Plant & Machinery	3,00,000
		Book Debts	1,20,000
		Stock	60,000
		Profit & Loss A/c.	2,00,000
	11,50,000		11,50,000

Trishul Ltd., took over all the assets of Shakti Ltd., for a sum of Rs.7,00,000 but not its liabilities. The capital of Thrishul Ltd., consists of 1,50,000 shares of 10 each. The purchase price of Rs.7,00,000 is to be satisfied by issue of 1,00,000 shares of Rs.10 each credited as Rs.5 paid and the balance in cash. The Balance of Rs.5 per share was paid on allotment. The winding up expenses of Shakti Ltd., amounted to Rs.5000 and the formation expenses of Trishul Ltd., were Rs.3,000.

You are required to make the necessary journal entries in the books of the companies.

**Hint :** Formation expenses are preliminary expenses.

(Ans : Realisation loss Rs. 2,55,000)

3. The following is the Balance Sheet of Samatha Co.Ltd. on 31<sup>st</sup> December, 2000.

Liabilities	Rs.	Assets	Rs.
<b>Share Capital</b>		Plant and Machinery	4,00,000
1,20,000 shares of Rs. 10 each	12,00,000	Patents	12,00,000
Sundry Creditors	14,00,000	Stock	3,00,000
		Book Debts	5,00,000
		Cash	12,500
		Preliminary Expenses	72,500
		Profit & Loss A/c.	1,15,000
	<u>26,00,000</u>		<u>26,00,000</u>

The company being unable to raise further capital and patents appearing in the books in excess of their value, the following scheme of reconstruction is submitted to the shareholders and creditors.

- The company to go into voluntary liquidation and a new company called the "Samatha Company (2001) Limited" is to be formed with an authorised capital of Rs.20,00,000 in Rs.10 per share, to take over the assets and liabilities.
- The liabilities are to be discharged by the new company in the following way: Preferential creditors of Rs.20,000 are to be paid in full, and the other creditors are to be paid 25% in cash, and 50% in 6% debentures of the new company.
- 1,20,000 shares are to be issued to the shareholders of the old company as Rs.5 per share paid, the balance of Rs.5 being payable on allotment.
- The costs of liquidation amounting to Rs.17,500 are to be paid by the new company as part of the purchase consideration.

Assuming that the scheme has been sanctioned, you are required (i) to show the ledger accounts in the books of Samatha Company Ltd., and (ii) to pass journal entries in the books of Samatha Company (2001) Ltd., and give its opening balance sheet.

- Hints :**
- Preliminary expenses and P & L A/c. (Dr.) balance are directly transferred to shareholders A/c.
  - Sundry creditors are discharged by the new company. Therefore, transfer them to Realisation A/c.

3. Purchase consideration is Rs.6,17,500 i.e., what is paid to the liquidator of vendor company (Rs.6,00,000 shares plus Rs.17,500 expenses).
4. Sundry Creditors discharged by the new company are Rs.10,55,000 i.e., Rs.20,000 pref. Creditors + 25% of Rs.13,80,000 in cash =Rs.3,45,000+50% of 13,80,000 in 6% Debentures = Rs.6,90,000, thus the total is Rs.10,55,000.
5. If assets including patents are shown at book value in the new company books, there will be capital reserve of Rs.7,40,000. Since the patents are appearing at excess value, instead of showing capital reserve, that amount is used to reduce the value of patents. Thus, in the books of new company patents value would be Rs.12,00,000 – Rs.7,40,000 = Rs.4,60,000.

(Answer: Balance sheet total: Rs.18,90,000).

4. The following is the balance sheet of Simhapuri Ltd. as on 31-12-2001.

Liabilities	Rs.	Assets	Rs.
<b>Authorised Capital</b>		Land and Buildings	4,50,000
10,000 shares of Rs. 100 each	10,00,000	Plant & Machinery	2,00,000
<b>Paid up capital</b>		Furniture	50,000
10,000 share of Rs.100 each		Stock	2,50,000
fully paid	10,00,000	Book Debts	1,50,000
8% Debentures	2,00,000	Cash	10,000
Sundry Creditors	30,000	P&L A/c.	1,20,000
	<u>12,30,000</u>		<u>12,30,000</u>

It was decided to reconstruct the company and for this purpose a new company, "Simhapuri (New) Limited" was formed with an authorised capital of 10,00,000 divided into 5,000 7% preference shares of Rs.100 each and 5,000 equity shares of Rs.100 each, to take over the assets and liabilities of the Simhapuri Ltd., on the following scheme.

- i) The debentureholders in the Simhapuri Ltd., are to accept 2,000 preference shares.
- ii) The shareholders of the old company are to receive one equity share in the new company for two shares held by them in the old company;
- iii) The cost of reconstruction amounting to Rs.15,000 is paid by the new company.
- iv) The balance of preference shares is to be issued for cash.

Assuming that the scheme is implemented, you are required (a) to close the accounts of the old company and, (b) to give the initial balance sheet of the new company.

(Answer: Purchase consideration Rs.5,15,000; Realisation loss Rs.3,80,000; Balance Sheet total Rs.13,95,000).

5. M/s. ABC & Co., after a series of heavy losses resolve to go into voluntary liquidation and to reconstruct by means of a new company under reconstruct by means of a new company under the name and style of ABC & Co. (2002) Ltd. On the date of reconstruction, the Balance Sheet of ABC & Co. Ltd. stood as follows:

Liabilities	Rs.	Assets	Rs.
<b>Capital</b>		Freehold Property	3,92,500
2,00,000 shares of Rs. 5 each fully paid	10,00,000	Machinery	2,39,000
Sundry Creditors	30,000	Motor Lorries	19,400
Bank Loan	15,000	Stocks	91,410
Bills Payable	10,000	Sundry Debtors	1,09,100
		Bank	3,590
		P & L A/c.	2,00,000
	<u>10,55,000</u>		<u>10,55,000</u>

The following are the terms of reconstruction:

- The new company is to takeover the assets of the old company and not liabilities,
- The capital of the new company is to consist of 5,00,000 shares of Rs. 5 each,
- The new company is to issue 2,80,000 shares of Rs. 5 each credited with Rs. 2.50 per share as paid up to the old company and to pay Rs. 1,00,000 in cash by way of purchase consideration.
- The balance of Rs. 2.50 per share payable by the members of the new company is to be paid as to Rs. 1.25 on application and Rs. 1.25 on allotment.

All the money due on new shares was duly paid up. The expenses of reconstruction amounted to Rs. 45,000 and the registration expenses of the new company to Rs. 25,000.

Give journal entries, Realisation Account and Shareholders Account in the books of the old company, and Balance Sheet of the new company.

- (Answer: i) Loss on Realisation Rs. 1,00,000.  
ii) Balance Sheet Total Rs. 14,55,000)

6. The following is the balance sheet of Nava Bharat Co. Limited.

Liabilities	Rs.	Assets	Rs.
<b>Authorised Capital</b>		Patents	8,50,000
10,000 Pref. shares of Rs. 100 each	10,00,000	Premises	1,30,800
10,000 Ordinary shares of Rs. 100 each	10,00,000	Plant & Machinery	42,200
	<u>20,00,000</u>	Debtors	76,500
		Stock in trade	55,000
<b>Subscribed Capital</b>		Share discount	18,000
7,500 Pref. Shares fully paid	7,50,000	Prel. Expenses	12,000
5,000 Ordinary Shares – fully paid	5,00,000	Deficiency Account	1,15,000
Sundry Creditors	30,000	Cash in hand	500
Bank overdraft	20,000		
	<u>13,00,000</u>		<u>13,00,000</u>

The following scheme of reconstruction was adopted:

- i) The preference shares be reduced to an equal number of fully paid shares of Rs. 50 each and the ordinary shares be reduced to an equal number of shares of Rs. 25 each.
- ii) The amount available be used as follows:
  - a) To write off Rs. 30,800 on premises and Rs. 15,000 on stock.
  - b) To reduce plant and machinery by Rs. 8,440 and to value debtors at Rs. 61,200.
  - c) To eliminate fictitious assets and reduce patents to Rs. 5,00,000.

Redraft the Balance Sheet giving effect to the scheme.

(Ans: Balance Sheet Total Rs. 7,35,460.)

7. The summarized balance sheet of X Co. Ltd. as on 31<sup>st</sup> March 2003 was as below:

Liabilities	Rs.	Assets	Rs.
5,000 Equity Shares of Rs. 100 each	5,00,000	Goodwill	90,000
6% Debentures	2,00,000	Land & Buildings	1,00,000
Profit Prior to incorporation	10,000	Plant & Machinery	2,40,000
Creditors	1,40,000	Patents	30,000
Bank over draft	50,000	Bank balance	5,000
		Debtors	90,000
		Motor Car	10,000
		Stock in Trade	95,000
		P&L A/c.	2,00,000
		Preliminary Expenses	40,000
	9,00,000		9,00,000

The business has passed through a depression and the worse seems to have been over.

The following scheme of reconstruction is adopted with the consent of all:

- i) Each share was to be reduced to 1/5<sup>th</sup> of its value.
- ii) Each shareholder was to subscribe for half the number of shares already held by him, at its new value and pay immediately in cash for the new shares taken by them, to help the company with working capital.
- iii) All fictitious items including goodwill and patents were to be eliminated.
- iv) A provision of 5% on debtors in respect of doubtful debts was to be created.
- v) Motor Car was to be reduced to half of its value.
- vi) Plant and Machinery was to be written down by the balance of the amount available.

You are asked to give necessary Journal entries to record the above and show the resulting Balance Sheet.

(Ans: Balance Sheet Total : Rs. 5,40,000)

## 12.8 RECOMMENDED BOOKS

1. R.L. Gupta and M. Radhaswamy : **Advanced Accountancy, Volume – II**  
Sultan Chand & Sons, New Delhi.

2. S.N. Maheshwari : **Advanced Accountancy, Volume - II**  
Vani Educational Books, New Delhi.
3. S.P. Jain and K.L. Narang : **Advanced Accountancy,**  
Kalyani Publishers, Ludhiana.
4. M.C. Shukla and T.S. Grewal : **Advanced Accountancy,**  
S. Chand & Sons, New Delhi.

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## **12.9 GLOSSARY**

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- Internal Reconstruction** : Reduction of share capital with or without reduction in borrowed capital under a scheme of reorganization without liquidation sanctioned by court.
- External Reconstruction** : If an existing company starts fresh business with a new name is called external reconstruction.

**Dr. D. Obul Reddy**

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